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Article — Digitized Version

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Intereconomics

Suggested Citation: Jonas, Rainer (1975) : The importance of the development banks for the financial infrastructure, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 10, Iss. 9, pp. 277-281,
<https://doi.org/10.1007/BF02929290>

This Version is available at:

<https://hdl.handle.net/10419/139261>

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The Importance of the Development Banks for the Financial Infrastructure

by Rainer Jonas, Bonn *

In literature and practice the term "development bank" is commonly applied to investment banks for the financing of private projects which deserve to be promoted on general economic grounds. Their salient task is usually to provide medium- and long-term funds. Complementary consultative functions are occasionally performed as well while other bank transactions, especially of a short-term nature, and debit business were, as a rule, not considered. This concept of the purpose of a development bank has proved too narrow, too normative and too general.

It is the task of the development banks to help to promote the socio-economic advance of a country through their banking services. With this aim in view they must in many cases pioneer banking services which are not – or at least not adequately – provided by the other credit institutions in a banking system, and especially not by those with purely private commercial motivations.

The development banks apply a major part of their potential capacity for the performance of banking functions to the aim of narrowing down the qualitative gap between the latent demand for banking services and the supply of such services by the rest of the banking system which is a characteristic of developing economies. Whether a specific banking service ranks as the principal function of a development bank or not can be ascertained in the individual instance only by comparing the socio-economic requirements with the available banking services of the country.

It is not claimed here that development banks should confine themselves to the performance of pioneer services or stop-gap functions. For competitive reasons, to balance earnings and risks in their operations or because of availability of attractive savings media they often have to engage in established types of banking business involving smaller hazards. These should never however be the focal point of their activities.

Definition of a Development Bank

The term "development bank" is here taken to denote an institution with financing functions which

☐ is personally, organisationally and in its business policy autonomous in relation to the state apparatus;

☐ being in principle self-supporting, enjoys a wide measure of freedom in its decisions on the management and disposal of financial funds, and

☐ by virtue of legal provisions, its articles of association or practical business policy bases its decisions essentially on the overall priorities, economic and social, of the country or region, to the partial neglect, if need be, of the aim of profitability in its banking operations;

☐ provides finance predominantly for sectors and unit categories relevant to development policy which lack adequate alternative means of finance;

☐ offers finance in suitable forms to borrowers whose credit standing or credit worthiness does not come up to conventional banking criteria or who lack adequate access to the institutionalized credit market for other reasons;

☐ is in a position to complement the financial transaction proper during various phases of project implementation by subsidiary services and – if it undertakes financial transactions involving a capital interest – does not aim at securing a dominant long-term influence on the management of the enterprise which it helps to finance.

Organisational and Functional Diversity

It is difficult to make generally valid statements about the functions of development banks and their place in the financial sector because such functions are performed by a wide variety of institutions. The following distinctive features may be mentioned as essential:

☐ As regards the competitive conditions in the capital market relating to the acceptance and disposal of funds the development banks cover a range from direct competition with the com-

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mercial banks and other financial institutions, at one end, to a complete monopoly over certain credit and debit transactions, at the other. Their functional competence varies between the extremes of a purely corrective role in an autonomous money and credit market and exclusive authority over the financing of investment projects according to graduated development planning priorities which may involve discrimination of other would-be borrowers.

□ The functional orientation can manifest itself in the organisational forms of the development finance system. There are strictly centralistic organisations in the form of a single institution which may in an extreme case combine the function of a development bank with that of a state or central bank, and there are also plural systems composed of institutions operating side by side and in competition with each other, especially in the debit business. Geographical or sectoral criteria may be important for the demarcation of spheres of competence between a number of development banks. The former are of special relevance for development banks which are under the influence of regional authorities. Other possible criteria are the size of the enterprises to be assisted, their legal status and whether they are state-owned, semi-public or private.

□ The organisational structure and the quantitative and qualitative arrangements for the credit and debit business of the individual development bank will reflect the structure of the financial sector and the distribution of tasks in it as well as the system adopted for development financing. The sectoral orientation of development finance institutions shows particularly clearly that the specific financial requirements of individual sectors have a considerable influence on the range of credit instruments employed by a sector bank.

□ The affinity of the development bank to the state is also of major importance to its operational procedures and effectiveness. The institutional organisation of development finance should conform as far as possible to the organisational and governmental structure of the state and accord with the formulation of the development plan and the autonomous implementation of sectional and subsidiary plans. The more rigorously a development plan is to be formulated and implemented, the stricter must be the arrangements concerning the financial competences of the development bank. The more centralistic an interpretation is given to the concept of state organisation and planning, the more definite will be the tendency towards a single central institution for development finance. Conversely, a regional arrangement will be advisable for the development finance institutions if emphasis is put on the plan-

ning autonomy of the regional authorities. If development banks are given regional autonomy, a corrective will however have to be provided in the form of an institutionalized interregional financial offset system so as to encourage balanced regional development.

□ The stage of economic development in a country, the degree of financial penetration and internal differentials in economic, social, geographical and financial development are of significance. Seen as an element of the financial infrastructure to which large parts of the national economy have still to gain access, a development bank must obviously extend its radius of action beyond the performance of traditional banking services. From the micro-economic point of view of bank and borrower, on the other hand, the pre-eminent need may seem to be for an intensification of their business connection by flanking measures, e.g. in the field of consultancy, management, centralized buying and selling, etc. In practice both these concepts are met, in the agricultural credit and industrial finance institutes for instance; some banks provide specialized services while others cover a variety of demands.

When development banks as elements of the financial infrastructure penetrate into what from a banking point of view is virgin land, they will act as universal banks and start first on the most urgent needs, which means as a rule on short-term consumer credits and facilities for value-preserving storage of money; money transfers will come next and then the financing of business operations, residential building or farm crops. Investment finance – to be more precise, credits for the financing of fixed assets – and any other banking services will be called for only at more advanced stages of financial penetration and consolidation.

Improvement of the Financial Infrastructure

As the development banks' activities are oriented towards development, they do not only provide above-average support measures for the commercial purposes of the individual enterprise but at the same time assist in improving and extending the financial infrastructure of the developing countries. Their contribution in this respect may be described provisionally as follows: Development banks provide innovatory banking services through the introduction of new financing instruments or techniques such as are not, or only inadequately, provided by other banks. These may include long-term investment finance, the issue of shares and debentures, acceptance of new forms of securities for credits, leasing, factoring and additional non-financial services as a complement to the grant of credits.

The contribution of the development banks to the consolidation of the organised banking sector through improvement of the monetary and financial structure results directly from the encouragement of longer-term savings, the lowering of financing costs and the prolongation of credits for projects of relevance for development and indirectly from the provision of more and better banking services on an extended time-scale in all sectors, at all stages of production and in all the markets of a progressively specialized and differentiated economic structure.

Regional, sectoral and social banking services which involve innovation and consolidation go regularly hand in hand with a partial substitution and replacement of the subsistence economy and unorganised credit sector, e.g. through the provision of banking services to previously neglected economic sectors, regions, unit-size categories or population groups. A stimulus can be given to the improvement of the financial organisation and development planning by studies, planning and consultancy work, training and other services for clients, credit institutes and planning authorities. The attraction of additional foreign capital, whether obtained in the international capital markets on commercial terms or — for the promotion of development — on "soft" terms for capital aid, can act as a catalyst.

In raw material-exporting developing countries development banks have, on the one hand, shown clear proof of their ability to enlarge the absorptive capacity of an economy for export earnings and, on the other, assisted in supranational development of a whole region.

Importance of the Transformation Function

It must be asked of what importance the development banks are in the context of the creation of efficient financial infrastructures in the developing countries. This part of their role — which is fundamental to the concept of the development banks — cannot be understood if one views the tangible economic processes through the "money veil" or merely tries to lift the "veil of financial relationships".

Credit and other financing instruments are highly potent means of economic and social organisation which serve the purpose of smoothening the manifold "real" work and service relations between economic units and getting over the relative invariability of the distribution of property and productive capital within a national economy. Money, credit and related financing instruments, besides, perform the functions of means of settlement, direction and linkage between different persons and periods and have for this reason a

significant impact on the structural changes in the economy and its growth.

The existence of a widely ramified network of relations between the development banks and all the other money, credit and capital market institutions is an indispensable prerequisite to any innovatory services which the development banks are expected to perform and pass on to the other units in this sector. The advancement of the financial relations in the banking system by innovative credit institutes makes it not only easier to settle surpluses and deficits of individual units — a purely quantitative function — but makes it possible — through a "qualitative" transformation — to reduce the antagonism between the liquidity and security requirements of capital lenders, whether they are banks or not, and the investors' demand for longer-term finance to pay for investments in fixed assets. Short-term deposits can be converted into long-term financial investments through a chain of credit relations such as exists in a banking system: their security is increased and the risks are spread by the interposition of various credit institutes which check the credit worthiness of borrowers and provide guarantees. Conversely, long-term capital aid loans to development banks maturing in 20–30 years can be split into credits of shorter duration matching the financing needs of the developing country, for instance by helping to make sure of follow-up finance for shorter-term credits.

The banking system in its entirety thus creates institutional liquidity and security by changing the maturity dates, risks and amounts of loans. Under micro- and macro-economic aspects innovatory services by credit institutes bearing on the banking system may have a positive or negative influence on the liquid assets and financial portfolios of the economic units and economic sectors. The improvement and extension of the financial infrastructures by development banks is of decisive importance for development: The transformation of the banking system under their influence has the result that the banking system will neither adapt itself passively to the requirements of the "real" side of the economy nor continue on a neutral course. Propelled by its own potential and dynamics, it will have a major impact on the "real" economy, changing it in the direction indicated by development policy. As financial relationships grow more complex as the division of labour progresses, they will have to be rationalized and standardized in the normal course of economic development and made viable and thereby self-sustaining. Traditional lending and financing patterns must be developed further; others must be created and perfected to make them universally acceptable means of economic

organisation. The most important of these financing instruments are the various forms of money, the other kinds of short- to long-term credit some of which take the form of securities (e.g. debentures, bills of trading) and marketable property titles (e.g. equity shares, investment unit and property bond certificates).

Not only do these means of organisation facilitate the development of trade and labour relations in the framework set by progressive division of labour but they create the prerequisite to growth and structural change in the economy by mobilizing productive factors.

A Key Position in the Financial Sector

Development banks are of course in the "front-line" of the expansive organised credit sector for the restraining of the unorganised credit sectors and markets which are often held to be potentially harmful for development. These sectors and markets include the financial relations in which no financial intermediary is interposed at all as is the case with the important category of suppliers' credits, private mortgages and loans from relatives, or else the financial intermediary is not subject to public control, e.g. money-lenders, traders, big landowners and others on the fringe of the credit system. Development banks play a crucial part in replacing unorganised markets by institutionalized and supervised credit sectors.

Some characteristic features of the credit market must be examined more closely to illustrate the key function of development banks in the financial infrastructure in general and the banking sector in particular and to explain at the same time why the state authorities have an enduring interest in keeping these institutions under control.

Credit and other financial relations, the credit sector and the credit markets differ essentially in several respects from the products and services of other sectors of the economy: In the credit markets supply and demand are to a limited extent only kept in balance through the rate of interest, that is through the price. Above a certain limit no credits will be provided however high a rate of interest may be offered. This is in fact tantamount to rationing of credit which is usually attributed to market imperfections although this is too paradigmatic an explanation. Money and credit are abstract products: the law and trust are their only foundation. They are not naturally scarce and must therefore be kept scarce by artificial means. Besides, credits are as a rule, in spite of all the standardization by the law, highly heterogeneous products. Normative and in part arbitrary notions about the limits of credit worthiness therefore exercise directive functions which are

as potent as the rate of interest or even more potent; this is especially true of the essentially unconsolidated credit markets of the developing countries.

The development banks make in fact a decisive contribution to the elimination of forms of effective credit rationing which hamper development. They may do so for instance by suitable geographical or substantive decentralization of their organisation and procedures to make credit more easily accessible to economic subjects who were previously undersupplied with credit. Or they may actively support the pioneering efforts of borrowers by keeping the cost of credit at a tolerable level and refraining from excessive demands for security.

Almost all developing countries have by now recognized the suitability of money and credit relations and credit institutes as directive instruments for the economic sectors concerned with tangible goods and services. As the availability of financial resources must in any case be manipulated, money and credit are ideal instruments for the effective transmission of directive impulses of development policy. The credit sector amplifies these directive impulses through the multiplier effects of credit creation and termination. Such impulses can be passed on to other economic units on a wide front through the ramifications of the credit system.

The specific features mentioned explain why the credit system is liable to a variety of restrictions on competition and subjected to much more stringent official regulation, surveillance and control than other sectors of the economy.

Structural Effects

The potential structural effects of any banking system, whether rightly or wrongly conceived, manifest themselves in the removal or cumulative strengthening of the economic dualism and social polarization which are characteristic features of developing countries. These repercussions which lead to greater differentials in incomes, wealth and/or value creation may arise between highly industrialized metropolitan convergence areas, on the one side, and backward agrarian regions, on the other. Similar differentials may be caused between technologically advanced sectors of the economy and superficially mechanized small enterprises, between social or ethnical groups, between enterprises of different sizes or legal status. Polarization effects due to differentials in commercial bank earnings and risks in different regions, sectors or customer categories can be countered by the promotion of development banks, that is credit institutes with more communal or general economic objectives. Graduated

action can be taken against such polarization tendencies by differentiating the supply of banking services to the various classes of borrowers. This introduces a subsidy element corresponding to the borrowers' priority rating for development.

This indirect procedure which leaves the initiative for the opening of a credit relation essentially with the credit user has in many cases proved inadequate. To put it differently, lack of suitable credit facilities is a major, though by no means the sole, constraint against the closing of the quantitative and qualitative investment gap in partially underdeveloped economies. Besides, the availability of subsidized credit affects the commercial advantageousness of an individual investment object in any case only in relatively narrow margins. As regards other investment obstacles, the development banks have in many instances eschewed their traditional passiveness in the credit business and taken upon themselves the task of stimulating, researching and promoting projects.

Further Evolution of the Development Bank Concept

The extension of the financial infrastructure of a developing country includes the replacement of the subsistence economy, barter economy and superficial monetarization which are characteristic of large areas, through decentralization of the commercial banking system which mostly concentrated on the capital cities, certain sectors of the economy and some sections of the population. If financial sector services are made available to previously neglected sections of the population, additional resources can be mobilized, which will in general tend to increase the capacity and improve the structure of the whole range of banking services.

Savings, credit and investment facilities designed especially with an eye to the capabilities and requirements of the previously neglected sections of the population are often an indispensable prerequisite to bringing the latter within the scope of the national money and credit system. Such special services, in combination with suitable institutionalized direction and control mechanisms for the financial sector, are also needed in order to prevent that sub-sections of this sector form a cocoon with a more or less closed circulation and the dualism in the developing economies is aggravated by the transfer of loan maturities, credit risks and sizes to which reference has been made.

A static view of the division of labour among the financing institutions in a financial sector does less than justice to the importance of the development banks for the financial infrastructure of

developing countries. When credit instruments and subsidiary services are used to overcome underdevelopment, the aim is to change the existing economic and social conditions. This change will in turn transform the tasks of the financial sector and its institutions and the division of tasks between them. The extension of the financial infrastructure is a dynamic process in the sense that the increasing demand for financial and non-financial bank services in an expansive developing economy subject to rapid structural change calls for continuous re-examination and readjustment of the financial instruments and their deployment. It is only logical that borrowers who have been enabled by differentiated subsidized development bank services to stand on their own feet should be gradually weaned from assistance by the development banks and be passed on to the commercial banks which for the most part conduct their business according to private commercial considerations.

This specific form of a constantly readjusted division of labour between the development banks, on the one side, and the commercial banks, on the other, also compels the latter to adapt themselves to newly opened sub-sections of the credit market and results ultimately in a further improvement of the financial infrastructure. The existence of a progressive financial infrastructure is of great importance for a developing country, both positively and negatively — negatively insofar as non-bank development measures may be rendered inoperative or cancelled out by financial counter-currents, positively in that it may place an excellent instrument of direction and control in the hands of the authorities which make development decisions.

High Risk Factors a Continuing Problem

The main difficulties inherent in the concept of the development banks show up in their debit business. Financing institutes with the task of providing financial and other pioneering services on the mentioned scale inevitably incur above-average risks while the costs-earnings ratio is unfavourable. If they concentrate their financing activities on medium-sized and small enterprises in the manufacturing sector, difficulties often arise because they must deal with a large number of different, widely dispersed low-value units which on account of their small size, inadequate capital basis and lack of experience show low and fluctuating rates of profitability. The risk element is often such as to render their bank operations unprofitable, with the mostly unavoidable consequence that the exceptional burdens falling on the development banks must be offset by state subsidies or compulsory deposits of the commercial banks.