

National Development Banks in the BRICS: Lessons for the Post-2015 Development Finance Framework

In 2015, the framework to succeed the Millennium Development Goals (MDGs) will be agreed. As described in the outcome document of the United Nations (UN) Rio+20 conference, *The Future We Want*, the mobilisation and effective use of stable, sufficient and suitable development finance must be a crucial part of this framework. While there is now broad agreement that National Development Banks (NDBs) have the potential to contribute positively to development objectives, it is less clear how this can best be done in practice. As a contribution to this debate, this Policy Briefing summarises research on the experience of NDBs in the BRICS countries.

There are good reasons to think that National Development Banks (NDBs) should be central to the post-2015 development financing framework. The 2014 Asia-Pacific Outreach Meeting on Sustainable Development Financing, for example, stressed the importance of NDBs in providing long-term financing for infrastructure. The potential of NDBs in financing innovation and small and medium enterprises (SMEs), and the vital countercyclical role they can play were emphasised by the Intergovernmental Committee of Experts on Sustainable Development Financing (ICESDF). Countercyclical lending takes place in a credit crunch, when private sector sources of finance dry up. It is a vital support for economic activity, which can reduce the depth of economic downturns and hasten recovery from recession. These reports will be important inputs to the Third International Conference on Financing for Development to be held in Addis Ababa in July 2015, where the potential of NDBs is likely to figure prominently.

What is the origin and role of development banks in the BRICS?

As well as their long record of success in developed countries like Germany,

renewed interest in NDBs reflects the prominent role they have played in the BRICS (Brazil, Russia, India, China and South Africa). Historically, NDBs in the BRICS focused on domestic infrastructure financing. Since the 2000s, however, some have emerged as international actors, financing exporters from their own countries, and infrastructure in other developing countries. In the aftermath of the 2008 financial crisis, the NDBs of Brazil, China and Russia also played an important role, stepping in when private finance dried up.

Brazil

The Brazilian Development Bank (BNDES) started operations in the 1950s. Initially concentrated on infrastructure development, the focus expanded to include industrial development in the 1960s. BNDES has also become a major player in funding, and even helping shape industrial policy, including through support of innovative enterprises. In the 1990s, BNDES oversaw a broad privatisation programme of major publicly owned companies, often taking an ownership stake. From 2003, BNDES also began promoting the internationalisation of

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key productive sectors of the Brazilian economy. Most recently, BNDES acted as countercyclical lender between 2009 and 2011, expanding its total lending by 70 per cent.

Russia

Originally responsible for restructuring USSR liabilities, the Russian Bank for Development (VEB) evolved to oversee strategic investments in infrastructure and large export-oriented enterprises in Russia. Largely because of the countercyclical role described above, VEB increased its disbursement from US\$4bn in 2004 to US\$16bn in 2011.

China

The China Development Bank (CDB) was created following the 1994 government budget reform. The CDB played a key role in China's rapid urban growth by providing asset-backed loans to Local Government Financing Vehicles (LGFVs) for large-scale urban infrastructure projects. Since the 2000s, the CDB has also supported state-owned firms to 'go-global', often linked to China's strategic goal of securing natural resources. As well as providing credit lines to foreign buyers for the purchase of Chinese products, the CDB also grants loans on favourable terms to countries in exchange for long-term oil or gas supply agreements. As in Brazil, the CDB was the main countercyclical lender in China after the global financial crisis.

South Africa

Strategically redesigned and re-launched after the apartheid era, the Development Bank of Southern Africa (DBSA) has also supported domestic infrastructure development. More recently, the DBSA has performed this role across the countries of the Southern African Development Community (SADC). Within South Africa, the bank has provided credit to municipalities for basic infrastructure, and financed electrification programmes in remote rural areas. Contrary to NDBs in Brazil, China and Russia, however, the DBSA has not been able to act as a countercyclical lender due to the progressive deterioration of the bank's assets, which was heavily impacted by the financial crisis.

India

Development banking in India is much more fragmented, with a number of specialised financial institutions. The main categories are:

- *Industrial development banks* – the Industrial Finance Corporation of India (IFCI), the Industrial Development Bank of India (IDBI) and the Small Industries Development Bank of India (SIDBI);
- an *agricultural development bank* – the National Bank for Agriculture and Rural Development

(NABARD); the Export-Import Bank of India; and *housing development banks*, such as the National Housing Bank (NHB).

While not a development bank *per se*, the Exim Bank of India channels government credit for foreign buyers of Indian exporters.

What are the similarities and differences of the BRICS' development banks?

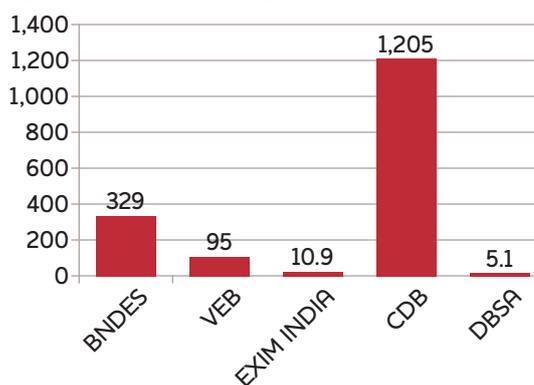
Similarities

The first common feature is that NDBs have traditionally supported each country's influence within their region. BNDES has directed its operations towards Latin America and the Caribbean. China's and India's development banks have largely targeted neighbouring Asian countries, while Russia has operated in the Commonwealth of Independent States (CIS) economies and South Africa in the SADC region. In recent years, this has begun to change. Particularly since 2007, Africa has seen increasing investments and development assistance from the BRICS, with their NDBs playing an important role. China and India have been the most pervasive across the continent, while Brazil has mostly focused on the former Portuguese colonies of Mozambique and Angola. Russia has been less prominent. In their external operations the NDBs exhibit some common practices, particularly the principle of non-interference in recipient countries' affairs, and a 'mutual benefit' view of development assistance. In this regard, off-take agreements for the purchase of goods from domestic companies by the foreign recipients of credit are a common feature of deals.

Differences

The NDBs also differ in a number of important respects. First, the size of these institutions is very different. With US\$1,205bn, the CDB has more than double the assets of all the other NDBs combined.

Figure 1 NDBs assets in US\$bn (as of December 2012)

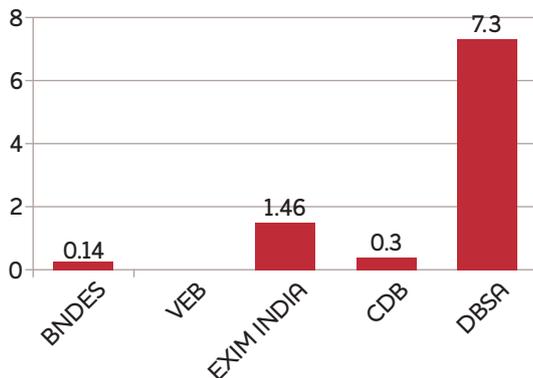


Source: Authors' own, based on data from Barone and Spratt (2015).

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Second, the banks have different approaches to risk, as highlighted by their non-performing loans (NPLs). The CDB and BNDES operate rigorous risk assessments of the projects they finance, but this only explains part of the difference. NPL ratios measure the proportion of total loans that are judged to be at risk of default. Their very low NPLs are also related to the fact that they tend to finance large corporations rather than (riskier) SMEs. In contrast, VEB does not pursue financial sustainability and has a special programme for the financing of SMEs. While not publicly available, it is reasonable to assume that NPLs will be higher as a result. The poor performance of DBSA is largely the result of the 2008 financial crisis, where it was exposed to a number of sectors that were badly affected. More recently, the DBSA has narrowed its operations to focus on infrastructure. This highlights the fact that different sectors carry different degrees of risk, irrespective of the stringency of the loan assessment process. The strategic choice of sectors where NDBs should concentrate their activities, thus brings implications for the amount of risk they will be required to hold.

Figure 2 Non-performing loan ratio (as of December 2012)



Note: BNDES's and CDB's figures are reported as of June 2013. Source: Authors' own, based on data from Barone and Spratt (2015).

A third important difference is source of finance. BNDES and VEB have similar funding sources, both obtaining long-term, low-cost finance from pension funds and government bonds. The CDB issues low-interest bonds with long-term maturities, backed by the government. The DBSA issues bonds, receives lines of credit from multilateral and bilateral development finance institutions. Most of the resources of the Exim Bank of India, in contrast, come from market borrowing, making it more vulnerable to economic shocks and shifts in market sentiment.

Development banks' potential to address funding gap for much needed development infrastructure

Currently, 1.4 billion people in the world have no electricity, 0.9 billion do not have clean

drinking water, while 2.6 billion lack sanitation. The projected infrastructure investment shortfall is expected to exceed US\$1tn per year by 2020, which may increase by 50 per cent once the costs of climate change mitigation and adaptation are taken into account.

Some of this additional finance could be provided by new multilateral development banks. The recently launched BRICS' New Development Bank, and Asian Infrastructure Investment Bank, for example, may channel a share of their members' huge foreign exchange reserves towards sustainable infrastructure. As well as reducing the infrastructure funding gap in developing countries, the shift this would cause in the global development finance landscape could also have other beneficial effects. Competition between traditional and new institutions, for example, should improve the options and terms available to borrowing countries.

Much will depend on how these new banks operate in practice, and how institutions such as the World Bank adapt in response. Even in the best case scenario, however, the scale of the funding gap means that there will remain a big shortfall in infrastructure investment in developing countries.

Well designed, managed and resourced national development banks will therefore be needed if post-2015 development goals are to be met. The experience of the BRICS shows that such institutions can supply affordable long-term finance to key strategic sectors such as infrastructure, and perform vital countercyclical roles in national economies.

Some of the design features needed to perform these roles can therefore be found in the experience of the BRICS and other developed and developing countries. What is less clear is how all of the pieces of the jigsaw should be fitted together in different country contexts. The post-2015 framework will not be just about growth, but about inclusive and sustainable growth. As they are driven by strategic mandates rather than (short-term) commercial considerations, NDBs are perfectly suited to supporting these goals. To do this, however, they need mandates which balance different development objectives, and the interests of different groups in society. This is not easy, and further research is needed so that NDBs can fulfil their potential as key development actors in the post-2015 development financing framework.

“By enabling more developmentally focused private investment, NDBs can also influence the evolution of financial sector development, strengthening its ability to serve the real economy and meet vital development goals.”

Policy recommendations

NDBs should support activities that create large developmental benefits but do not attract sufficient private investment, either because returns are not attractive enough, or risks are too high. Whilst the difficulties may be worse in lower income countries, attracting investment to these sorts of activities is a problem in countries of all kinds. One of the world's most successful national development banks is KfW of Germany, for example, while Canada is home to a widely admired public SME bank. Given this, what policy lessons can countries of all kinds who are considering establishing an NDB learn from the experience of the BRICS?

Provide stable financing source for NDBs

Funding is central to ensuring that NDBs can do things that private financial institutions cannot or will not do. If NDBs are reliant entirely on commercial financing, they will face the same incentives as private institutions. If NDBs are to finance long-term infrastructure projects on affordable terms, a significant proportion of their revenues should be long-term, low-cost and insulated from market insecurity.

Undertake countercyclical lending

Insulating funding sources from the market also allows banks to behave countercyclically, increasing lending when private finance falls. This is not just about the type of funding, however, but also its scale. To be able to offset a sharp reduction in the supply of private finance across the economy, NDBs need to be relatively large, with assets greater than 5 per cent of GDP. They also need to take a long-term view of risk assessment.

Clear mandate and effective monitoring framework

As well as being *able* to act countercyclically, NDBs need also to be *willing* to do so. This requires a clear mandate, which should specify strategic sectors and other objectives in areas like affordable access to services for the poor and environmental sustainability. Different sectors carry different risks. And NDBs' risk tolerance should reflect this. To be effective, a clear monitoring framework is required to measure results and incentivise staff to improve outcomes in these areas.

Support inclusive growth and exports

Successful NDBs focus on supporting economic growth in productive sectors through the provision of stable, affordable long-term finance and by supporting national exporters. The experience of the BRICS suggests that NDBs can successfully support exporters under various credit arrangements.

Rigorous loan approval process

Although sectors should be selected strategically, individual loans should be based on a rigorous assessment process. To be successful, NDBs need to minimise the level of NPLs, and a strong approval process also helps ensure that finance is allocated efficiently to productive enterprises and projects.

Work with the private sector to leverage private finance and encourage a 'development-friendly' financial sector

Funding long-term development projects is subject to significant risks and public development banks can mitigate these risks, increasing the flow of private finance. By enabling more developmentally focused private investment, NDBs can also influence the evolution of financial sector development, strengthening its ability to serve the real economy and meet vital development goals.

Promote sustainable urban development

NDBs have supported structural change in the BRICS, with the role of the CDB in China being particularly significant. With two billion people projected to be moving to urban centres in the next three decades, the need for investments in urban infrastructure can only become more important. Public development banks appear uniquely well-suited to perform this role.



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Further reading

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Credits

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AG Level 2 Output ID: 423

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ISSN 1479-974X