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Elizaveta Alekseevna Selyavina
PhD candidate,
Financial University under the Government of the Russian Federation, Moscow, Russia
MSc in Local Economic Development,
London School of Economics and Political Science, London, UK
Economist 1 grade, Department for Strategic Analysis and Research, Vnesheconombank, Moscow, Russia
selyavinaliza@gmail.com

SECTION 22. Policy. Innovations. Theory, practice and methods.

WHAT IS A NATIONAL DEVELOPMENT BANK? THEORETICAL FOUNDATION AND TAXONOMY DESIGN

***Abstract**: This article identifies theoretical roots of development bank's existence. Based on the substantial amount of data observed we suggest an umbrella definition of a development bank. Further, reflecting diagnosed fundamental heterogeneity of national development banks, we suggest relevant taxonomy to avoid potential misleading benchmarks. The paper posits that a development bank is able to be an effective tool of intelligent government intervention aimed at providing economic growth and mitigating market failures.*

Key words: development bank, development theory, political theory, development financial institution
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Virtually every country has at least one institution regarded as a development bank (DB). Its potential role in boosting economic growth and complementary domains of development is highlighted by the experts in development economics. At the same time, while the performance of global DBs, such as Institutions of the World Bank Group, European Investment Bank, African DB, Inter-American DB, is discussed in the literature (e.g. [2, 15]), there is a marked gap in studies of DBs on national and regional scales.

Yet, national DBs seem to perform highly successfully in last decades [21, 13] and therefore become a widely employed tool of policymakers in promotion development. Thus, after the global financial crisis there have been 'calls to create a development bank even in the United States' [18, p. 15], while the New DB of BRICS countries was established just recently [27] (1).

However, national DBs' strategies and operational plans are often not upgraded in line with growth theory evolution, as well as DBs' management is not aware of challenges, opportunities and progress, experienced by other DBs. In this vein, in the latest survey, experts of the World Bank underline that 'despite its size and importance, little is known about DBs', and acknowledge 'an increasing number of requests for data and new studies about DBs' [6, p. 2]. Following this demand, the current thesis aims to shed light on a phenomenon of national DBs.

I. Theoretical foundation

Obviously, DBs reflect 'their environment and their times' [7, p. viii], particularly the fundamental attitude towards government presence in the economy. The latter always determines the rationale behind development banking. In this vein, theoretical roots of DB's creation as well as of its critique can be found in two competing theories – 'development' and 'political' theory respectively. The concept of sustainable development and agency theory also provide valuable insights into the question.

According to the *development view*, government's participation is vital for economic growth, while one of its hybrid form is DBs' investments [18]. Indeed, economic theory provides a series of reasons that support the continuing need for DBs such as market failures, economies of scale, difference between economic and social benefits and risk aversion of the private sector. Thus, DBs aim at facilitating economic growth by investing in strategic long-term projects and balancing market failures by supporting underserved, infant industries, which often lead to social benefits [8, 25, 3, 14]. In a similar spirit, *social view* is often identified as a supportive concept to the state presence in the economy (e.g. [11]). In fact, it seems to be part of the development approach, since lack of the socially desirable investments, in essence, is a market failure.

Essential role of DBs is also underlined by proponents of *sustainable development concept* (e.g. [19]), according to which apart from conventional economic there are also social and environmental pillars of development. This triple bottom line approach highlights distinctive ability of DBs to address the sustainability challenge. Thus, Mazzucato [16] points out that 'wind, solar and biomass technologies have been the largest benefactors of development bank funding in recent years' (2) (*ibid*., p. 139). Indeed, DBs' contribution to 'environmental, social, cultural or sport domains' of development [23, p. 80] leads to the large positive externalities.

However, there is an alternative approach – *political view* [24, 12, 22], according to which government intervention in the economy seeks political gains 'in terms of electoral voting shares, political support' [11, p. 5] or opportunistic advantages of wealth accumulation, and can produce unintended distortions, limit intermediation, financial innovation and competition [9]. In addition, 'public banks are more prone to bureaucratisation, agency issues and poorer governance than their private counterparts' [23, p. 33]. Therefore, DBs, being one of the government instrument, are supposed to be biased in their investment decisions dictated by redistributive politics, and therefore be both inefficient and ineffective in allocation of resources, sometimes even harmful for economic growth.

In this vein, *agency theory* should be stressed. As Körner and Schnabel [11, p. 4] put it, 'public banks may suffer from two principal-agent problems: first, between the politician and the bank manager, and second, between society (the taxpayer) and the politician'. While the former type of conflict is accelerated by soft budget constraints and might lead to the misguided and limited managerial incentives to be efficient, the latter is of special interest for the purpose of the current research. Thus, an effective DB allocates resources in consistence with its mission and interests of society (taxpayer), which can be in conflict with political interests and connections leading to the resource misallocation. In essence, this is the point made by the proponents of the political view.

Finally, to avoid the binary thinking, in the literature there is an attempt to suggest *synergetic and symbiotic forms of market and government co-existence* [26], since 'the classical paradigms of social and economic development seem to have exhausted themselves' [17, p. 491]. It might seem that compilation of development and political views in integrated approach is hardly achievable since their different policy implications. However, in practice 'in attempting to address the central problem from the perspective of one paradigm, they [government] made the problems under the others worse' [5, p. 110]. From this *eclectic perspective*, a DB can be justified as an organizational innovation [10], an underestimated vehicle for communication between government and private sector, an effective tool of coordination between top-down and bottom-up approaches of national and regional development.

II. What is a development bank? (3)

In essence, previous literature on DBs is thin and mostly limited to descriptive reports. To our knowledge, there is no one clear-cut definition of a DB. Thus, The Latin American Association of Development Financial Institutions for the purpose of identification a DB as its member uses the self-definition selection principle, since 'it is difficult to define whether an institution is a development bank or not' [14, p. 17]. Based on the reviewed literature (table 1), we suggest the following *umbrella definition of a DB*: a financial institution, often controlled by the public sector and operated under special legal mandate, offering long-term lending to the bankable economic development projects in line with broad-based development support aimed at achieving socioeconomic goals in a country, region, sector or particular market segment.

Table 1

Review of "Development Bank" Definitions

Development Bank is…	Reference
A financial institution devoted primarily to stimulating the private sector of the economy.	[7, p. 4]
A financial intermediary supplying long-term funds to bankable economic development projects and providing related services.	[10, p. 14]
A specialized financial institution with functions and operations that can be defined with regard to its hybrid financial development character. An institutional instrument of public policy whose performance is measured mote in terms of social benefits […]	[4, p. 62]
A financial institution that is primarily concerned with offering long-term capital finance to projects that are deemed to generate positive externalities and hence would be underfinanced by private creditors.	[14, p. 16]

A financial institutions set up to foster economic development, often taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities.	[28: 10]
A non-monetary financial institution controlled by the public sector that is primarily active in equity participations and bond issue subscriptions and awards long-term loans (that are beyond other financial institutions' capability or willingness to provide) in a bid to further national and regional development.	[23, p. 38] (based on the OECD and IMF definition)
A bank or financial institution with at least 30 percent state-owned equity that has been given an explicit legal mandate to reach socioeconomic goals in a region, sector or particular market segment.	[6, p. 4]

It should be borne in mind that strategic *vision* of DBs is to be complementary to private banks meaning not to create market distortions [20]. In addition, one should be careful in description of DB's *functions*. For instance, during recent global financial crisis, most DBs successfully participated in the federal government's *anti-cyclical efforts* [6]. However, this function is supportive and can be treated just as an additional rationale for DBs' existence [14], since monetary policy is generally the object of central banks' mandate. As we noticed, in relation to DBs economists determine two main functional directions: investment in long-term costly projects, which bring economic growth under condition of underfinance by market, and bridging the gaps of market failures. While the former function is well understandable – 'investment is essential to the process of development' [7, p. 7], the latter requires additional discussion.

De la Torre and Ize [5] link market failures to several types of frictions. Thus, the asymmetric information and control gap – principal-agent issue – includes market failures of *adverse selection* of a contract, *moral hazard* and *shirking* during the contract implementation and *false reporting* afterwards, while interaction between the individual and the group may suffer from *externalities*, *free riding* and *coordination failures*. However, mentioned market failures are not idiosyncratic features of market. Instead, in practice it is highly feasible to diagnose them in DB's activity as well (4). In this vein, Rudolph [20] finds typical market failures that a DB is supposed to offset in high-risk segment of SME, while Levy-Yeyati et al. [14, p. 12] underline 'agriculture (plagued by asymmetric information and aggregated shocks), R&D-intensive sectors like the pharmaceutical industry (with a large share of intangible assets and potentially large spillovers), or capital-intensive industries with long start-up periods involving negative cash flow (such as the aerospace industry)'.

Therefore, in the discussion of market failures, which a DB is supposed to mitigate, one should think about strategic sectors rather than traditional market failures cited in economic literature. Moreover, in accordance with such approach market failures become dynamic and time- and context-dependent.

To shed light on this potential provider of development, we design a conceptual taxonomy for development institutions and highlight the role of DBs with its further stratification, which is essential for generating the research population of the thesis.

III. Taxonomy design

As Diamond [7, p. ix] put it, 'development banks cannot be fruitfully discussed in isolation from the many other institutions and factors related to economic development'. However, for the best of our knowledge, no study on development financial institutions (DFI) have brought them together in the conceptual paradigm. Consequently, in the relevant literature one can find controversial treatment of DBs: for instance, World Bank's economists [6, p. 7] refer to the study on Fannie Mae and Freddie Mac [1] as an example of DB's failure. Fragile boundaries between pivotal and complementary DFI lead to the complaints about public ownership structure: '…the privatization of profits (for the shareholders and executives) in good times but the socialization of downside risk (for the taxpayer)' [*ibid.*, p. 5]. However, while this argument is applicable to the complementary DFI such as housing finance providers, it is not consistent with DBs' fundamental nature, according to which profits go to the special development funds rather than privatized by executives. In this vein, it is essential to distinguish pivotal DFI from complementary ones (figure 1).

At the same time, complementary DFI are present in our taxonomy, since they can provide innovative solutions to development issues. For instance, in case of insurance companies 'use of catastrophe insurance might be able to diversify the weather related risk towards other investors and facilitate the interest of commercial banks in lending to farmers' [20, p. 5].

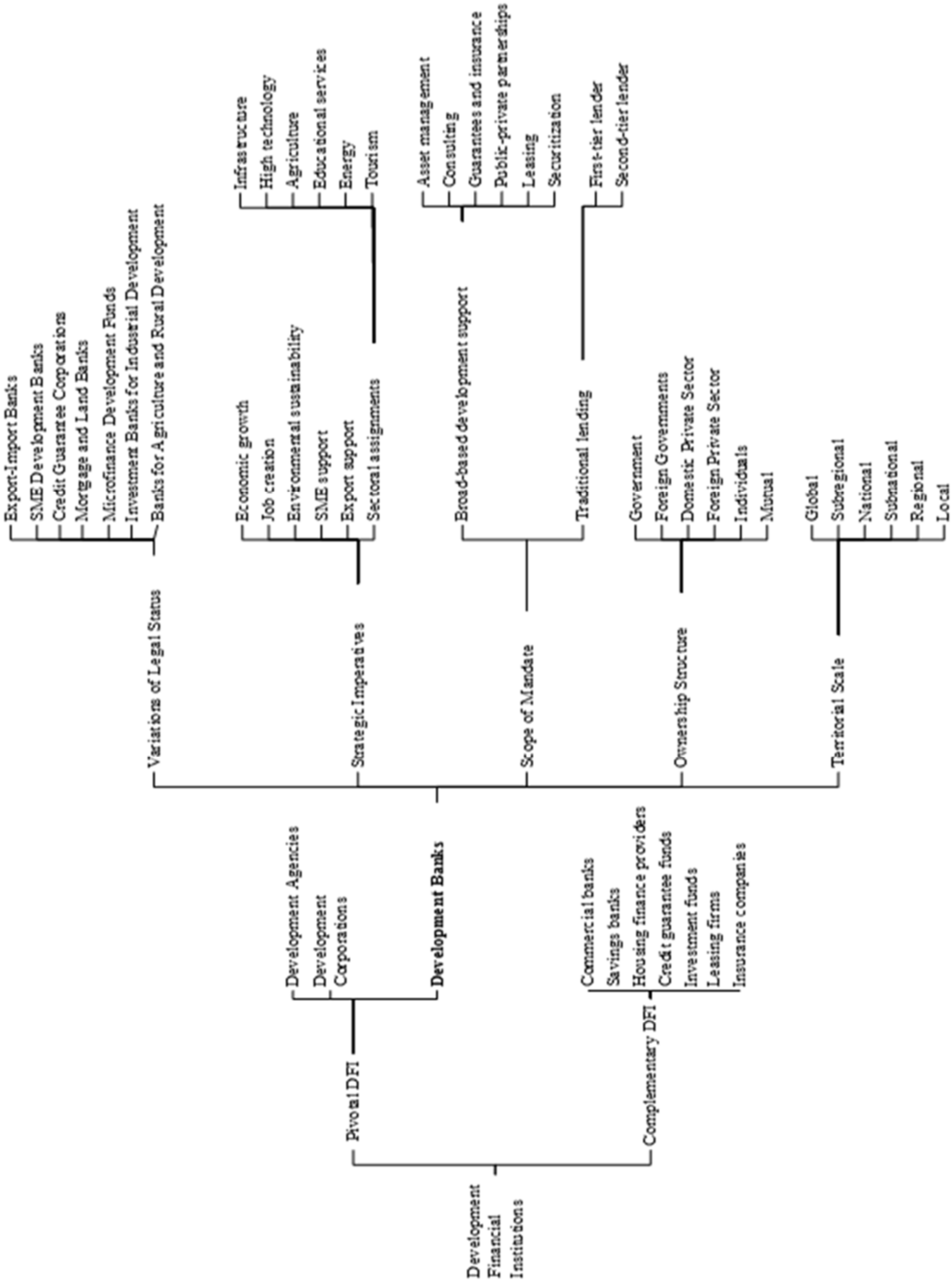

Figure 1 - The taxonomy of DFI with the focus on DBs.
Source: Author's compilation based on data described in the text

Based on empirical observations, we suggest to classify DBs according to their legal status, strategic priorities, scope of mandate, ownership structure and territorial scale. Besides, DBs use dissimilar financial instruments in their operational activities: long-term and short-term loans, syndicated loans, bonds or other securities, stakes (shares, stock), guarantees, public-private partnerships, etc. Technically, a DB may invest in projects directly or, being a second-tier institution, provide target-oriented resources to the first-tier banks. Worth noting, that the rationale behind their establishment also varies: from the post-war economic restructuring via infrastructure investment to financing the most innovative high-risk firms and activities [4].

We think that careful taxonomy of DFI, particularly DBs, is essential for accurate assessment of their effectiveness. Otherwise, benchmarking of different DBs and further generalization of research findings are prone to misleading conclusions.

IV. Conclusion

To sum up, we demonstrate the existence of reasonable arguments both pros and cons DB's foundation. However, it seems that such binary judgement overlooks non-linear character of development process. Hence, we find eclectic approach based on synergetic state-market collaboration to be the most fruitful. In this vein, we do not expect markets to promote sustainable development themselves and treat a DB as a by-product of cross-fertilisation between development and political views, which is able to be an effective tool of intelligent government intervention aimed at providing economic growth and mitigating market failures.

(1) Although the New DB is not national per se, its mandate is grounded on cooperation of national DBs of the BRICS states.
(2) For instance, 'approximately $40 billion has been provided be development banks between 2007 and 2010 in support of a variety of renewable energy projects' (Mazzucato 2013: 139).
(3) Thereafter, we mean national DB.
(4) The extensive discussion of market failures one can find in Stiglitz (1994).

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