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The role of Public Development Banks in supporting the post-COVID-19 crisis recovery in emerging and developing countries

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There is not a ‘one-size-fits-all’ solution to respond and recover from the current global health emergency and economic fallout resulting from COVID-19. A combination of pragmatic solutions is needed to face the debt issue and give countries room to make the policy choices and investments that will also lay foundations to recover, putting people and nature at the heart of economic growth and development. Public Development Banks (PDBs)—multilateral, regional, national, sub-national—have at their disposal

instruments to provide fresh financing through specific lines of credits or programmes during the crisis, and can therefore supply an important boost to stimulus packages, recovery efforts and long-term structural transformation.

Servicing debts

The more than 400 PDBs around the world can play a vital role not only in minimising economic decline and supporting recovery, but also in financing structural transformation, helping to lay the foundations for a financial model that is conducive to an equitable and sustainable growth, in line with the 2030 Agenda's Sustainable Development Goals.

Multilateral and regional PDBs are important sources of financing, especially for emerging and developing countries. By making use of their credit and lending instruments—concessional and non-concessional—and by providing non-reimbursable technical cooperation resources, they allow governments to access new funding at preferential rates and terms¹. For example, in order to support the fight against COVID-19, The West African Development Bank (BOAD) has granted its Member States US\$ 200 million in concessional loans (US\$ 25 million per State) to be disbursed immediately; in addition, it has frozen debt repayment of about US\$ 128 million owed by Member States for what is left of 2020.²

Yet, how were levels of public debt of developing and emerging countries before the COVID-19 crash? According to the IMF's World Economic Outlook (WEO) published in April, 2019³ estimates' show the balance of public external debt of these economies to be close to 30% as a proportion of GDP, while the total gross government debt (which includes both domestic and external debt) would be around 53%. By region, the total gross government debt is 68% in the case of Latin America and the Caribbean, 55% for emerging and developing Asia and 49% for Sub-Saharan Africa. In practice, these debt-to-GDP ratios must be within certain levels in order to be perceived by lenders as sustainable. The IMF estimates the maximum sustainable debt level before a default occurs:⁴ this threshold is 58% for emerging markets and 40% for low-income countries, which indicates that regions such as Latin America and the Caribbean and Africa were at unsustainable levels before the shock. Furthermore, according to another report of the IMF published in February 2020, half of low-income countries are at high risk of, or are already in debt distress.⁵

Unsustainable debt levels result in an increase in the Country Risk Premiums and in reductions in credit ratings by the large rating agencies, making access to external financing more limited and costly. This would also harm the countercyclical capacity of PDBs, if they were to resort to funding in the international capital market.⁶

Softening the effects of the current crisis will inevitably lead to an increase in countries' debt levels⁷—parting from already unsustainable levels. The challenge ahead will be to gradually seek debt level reductions, involving fiscal adjustments that will improve countries' Primary Fiscal Balance, and ensure sustainable economic growth rates. Insofar as the country's economy grows at a rate higher than the interest rate incurred when borrowing, the necessary fiscal effort—measured as a percentage of GDP—will be lesser; alternatively, if both rates are similar, the debt/GDP ratio will tend to remain constant; and if the growth rate is lower than the interest rate, the ratio will deteriorate. The higher the interest rate and the debt stock, the greater the primary fiscal effort.

Acting counter-cyclically in times of crisis

Many countries will not be able to service their debt, fight the pandemic, and invest in recovery. Sudden economic halts, like the one we are currently experiencing, entail the destruction of the productive capacity, of the employment,

income reduction of many companies, and even the bankruptcy of several of them. Governments' responses to the economic shock have included stepping up their support for Public Development Banks, in order to play a countercyclical role and ease financing and liquidity constraints. PDBs have the ability to adapt their roles to changing development needs at different stages of development. Thus, PDBs are not only better suited for carrying out countercyclical lending during a crisis, but are also particularly suited to reignite growth after a crisis.⁸

Looking back at empirical evidence from the 2008 financial crisis, we can observe that, for example, the European Investment Bank (EIB) increased loan disbursement by 57% and increased credits to SMEs by 128%.⁹ Furthermore, PDBs raised their loans portfolio on average 36% between 2007 and 2009, with some (10%) increasing their loans by more than 100%.¹⁰ Back then and today with the current crisis, PDBs have extended both short and long-term credits to existing and new customers who were facing difficulties in debt refinancing and in receiving new lines of credit. Furthermore, by massively reallocating funding and by putting in place easing measures, PDBs have given their support to most affected sectors and contribute to maintaining jobs¹¹, as seen from the examples of Peru (COFIDE), Colombia (Bancoldex, Finagro) or Brazil (BNDES). National PDBs can act as a "financial arm" of many countries, using a full range of instruments including the moratorium and rescheduling of existing loan obligations, working capital loans, and portfolio insurance policies.

Lending models: Reaching the furthest behind?

It should be mentioned, however, that many PDBs carry out their lending operations through private financial institutions. "A total of 52% of DBs lend through a combination of first-tier (lending directly to end customers) and second-tier operations (lending to other private financial institutions which subsequently on-lend to end-customers)"¹², 36% lend through first-tier, and 12% only through second-tier operations. Targeting through private intermediaries therefore implies that the credits' recipients are selected through private banks' traditional criteria. In this context, will local producers or entrepreneurs' financial indicators be good and solvent enough for approval under the scrutiny of commercial banks? This could result in the granting of available rescue funds to stronger medium enterprises, leaving behind the most vulnerable and the most in need. On the other hand, due to the crisis, producers who were already beneficiaries of credits are leaning towards asking for restructuring- either through the granting of grace periods or improvement of conditions for a new amortization plan, whilst others even may stop complying with their credit obligations. This situation will undoubtedly have negative effects on the quality of PDBs portfolio and on their projected income. The lower cash flow can not only harm their availability of resources for granting new loans disbursed in these times of crisis, but also affect their solvency indicators, which are constantly monitored by credit rating agencies. In other words, the countercyclical capacity of development banks might be threatened, making it harder to assume a leading role to help countries and regions overcome the crisis.

Although second-tier lending models might help PDBs reach more end-customers and cover more locations without incurring in higher operating costs, it is not always clear that credit will reach beneficiaries or sectors yearning for support. It would be worth looking for creative mechanisms that enrich the second-tier scheme with targeting considerations towards sectors that, being promising, do not have access to private financing.

¹ Provision of public aid through PDBs comes in the form of guarantees on loans, subsidised loans or equity, either directly or channelled through credit institutions or other financial institutions. Given that PDBs can borrow from other financial institutions or issue debt, these guarantees allow them to borrow at a relatively lower cost and eventually transfer that lower cost to final borrowers.

² <https://www.boad.org/en/>

³ <https://www.imf.org/en/Publications/WEO/Issues/2019/03/28/world-economic-outlook-april-2019>

⁴ IMF (2017). Working Paper. Debt Limits and the Structure of Public Debt, by Alex Pienkowski.

5 IMF (2020). Policy Paper. The evolution of public debt vulnerabilities in lower income economies

6 There are different options for DBs to fund their business operations, including (i) taking savings and deposits from the public, (ii) borrowing from other financial institutions, (iii) raising money in the domestic or international capital markets, (iv) using their own equity, and (v) receiving budget allocations from the government. Most DBs combine all these funding options.

7 Debt service costs are lower and will stay lower for a longer time, hence it is reasonable for countries to borrow more, even if this implies to raise the size of their debts relative to GDP to levels previously regarded as dangerous, in order to fund their recoveries.

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10 Mazzucato, M. & Penna C. (2016). Beyond Market Failures: The Market Creating and Shaping Roles of State Investment Banks. Journal of Economic Policy Reform 19, no.4: 305-26.

11 IDFC Response to COVID-19 Crisis. <https://www.idfc.org/idfc-response-to-covid-19-crisis/>

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