Review of Political Economy

ISSN: (Print) (Online) Journal homepage: https://www.tandfonline.com/loi/crpe20

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To cite this article: Régis Marodon (2022) Can Development Banks Step Up to the Challenge of Sustainable Development?, Review of Political Economy, 34:2, 268-285, DOI: 10.1080/09538259.2021.1977542

To link to this article: https://doi.org/10.1080/09538259.2021.1977542

Published online: 27 Sep 2021.

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REVIEW OF POLITICAL ECONOMY
2022, VOL. 34, NO. 2, 268–285
https://doi.org/10.1080/09538259.2021.1977542

Routledge
Taylor & Francis Group

Can Development Banks Step Up to the Challenge of Sustainable Development?

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ABSTRACT

Public development banks (PDBs) — at sub-national, national, regional or international level — can cooperate and become central in the implementation of sustainable economic models. PDBs are over 500 globally. They are both providers of public funding and enablers to leverage private finance. PDBs need to acquire 'sustainable development analytical tools' to select operations on the basis of criteria other than purely financial ones. This paper explores why development banks can play a leading role. It proposes five recommendations for decision-makers: (1) Streamline into financing decisions the need to transition towards low-carbon and equitable economies. (2) Mobilise and encourage the private sector such that all stakeholders reach convergence on sustainable development. (3) Use development banks to channel funds for transition purposes into concrete projects, programmes consistent with international agreements signed by their governments. (4) Support emergence of a responsible demand, given that PDBs themselves are not originators of projects. (5) Build a global coalition of PDBs, to tackling global problems.

ARTICLE HISTORY
Received 11 May 2021
Accepted 31 August 2021

KEYWORDS
Development banks; sustainable finance; Sustainable Development Goals; climate; IDFC

JEL CODES
F340; G21; H4; O1; O16

1. Introduction

There are some 520+ public development banks (DBFIs) across the globe, present on all continents and operating within an international, regional, national or sub-national perimeter. They are independently managed and ensure the financial implementation of the public mandate entrusted to them.

Their rationale has been heavily debated. Is a state-owned development bank better able than a private bank to optimally allocate its available resources? The economic literature raises questions on what role the state should play in finance. In what way are development banks different? Can their very existence be justified?

Clearly, certain market imperfections greatly harm social balances and the smooth running of the economy. Persistent poverty and inequality, the need for affordable social housing and financing for small farms or businesses all justify proactive public policies across the world. At international level, financing for low-income countries, who have only a limited access to financial markets, justifies resources should be channelled,

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at least partly, through development banks. The same holds true when it comes to financing for local authorities or support for international trade.

Yet, over the last twenty years, the nature of the problem has changed. Environmental and social awareness has brought to light the importance of externalities in investment and production processes. The United Nations' approval of the 'Sustainable Development' concept at the 1992 Rio Summit, then of the Sustainable Development Goals (SDGs) in 2015, concretely signals the need to think differently, with a universal and cross-cutting approach, instead of prioritising the sole path of economic development.

While the world remains preoccupied by the persistence of poverty and inequalities, by climate change and the loss of nature, the Covid-19 crisis is a reminder that the problems are interlinked and that, most often, they call for a combination of local and global actions.

We are entering a period of transition, during which we must chart the critical path to ensuring that consumption and production modes are compatible with sustainable growth. What are the possible modalities and who are the agents of change able not only to ensure a coherence between investment choices and the crucial need for sustainability but also to incite the international financial community to evolve?

This paper analyses the special role that development banks can play on this road to transition. It proposes that they take on greater responsibility and imagine their transformation through a mandate centred on the SDGs. It points up the societal responsibility of public development banks, currently insufficiently mobilised. It shows how the DBFIs have key advantages allowing them to broaden their operating procedures to include a cross-cutting vision of their activities and impacts, as the SDGs presume. It proposes five operational recommendations for development banks based on their purposes, their mandates, their governance, their financial tools and their sectors of operation. Lastly, it underscores the interest of having the DBFIs form a new global coalition.

2. Who Are the Development Banks?

2.1. Definition of a Development Bank

Despite their current global renaissance, we know quite little on Public Development Banks and Development Financing Institutions (DBFIs). Apart a few large and renowned ones standing at the front of the scene, such as the World Bank, The European Investment Banks or the China Development banks, DBFIs are a financial continent that remains largely unexplored. To that end, the Institute of New Structural Economics (INSE, Peking University) has initiated and then collaborated with the French Development Agency (AFD) to compute the first ever-exhaustive database on DBFIs (Xu, Ren, and Wu 2019; Xu, Marodon, and Ru 2021).

A first difficulty is to specificity the common characteristics of these institutions, in order to distinguish them from other official arrangements, including in particular government credit programmes, aid agencies, sovereign funds, grant-executing agencies, state-owned commercial banks with policy functions, cooperative banks or microfinance institutions. Five criteria need to be fulfilled at the same time to qualify as a DBFI:

(i) Government should play a steering role in setting the corporate strategy, the most common being holding the majority of the capital base.
(ii) It must have a separate legal status, dedicated personnel, financial statements and is not set up to achieve short-term goals;
(iii) Its mandate should focus on proactively implementing a public policy to fill a financing gap or market failure where private capital markets are unwilling or unable to offer financial support;
(iv) It should deploy financial instruments such as loans, equity investments, or guarantees that require some form of financial return as the main product and service;
(v) Without prejudice to its ability to receive grants, it must be in the capacity to finance itself beyond periodic budgetary transfers;

2.2. Panorama of Development Banks

According to the first database on DBFIs based on the definition stated above (Xu, Marodon, and Ru 2021), it has identified 527 institutions, totalling USD 13 trillion of assets in 2019 (excluding the two large US mortgage banks), representing 15 per cent of World GDP. Based on the first-hand data collection (Xu, Marodon, and Ru 2021), estimating the balance sheet rotation at an average of six years, DBFIs contributed to USD 2.3 trillion new financing in 2019. According to World Bank estimates, gross capital formation — a reasonable proxy of global investment — was USD 22.3 trillion USD in 2019, inducing that the annual financing of DBFIs is about 10 per cent of the world's investment.

However, these global figures hide major differences between DBFIs in terms of size, location, geographical operation and mandate.[1] Indeed, nine mega DBFIs, whose individual balance sheet exceeds USD 500 billion, concentrate 2/3 of total assets. At the other end of the spectrum, 166 micro DBFIs, whose assets is less than USD 500 million, account for merely 0.14 per cent of aggregate total assets.

Even though in absolute terms the vast majority of DBFIs appears to be modest in size, they carry a substantial weight in their respective countries or regions. They are indeed distributed across every region of the world, including in the least developed countries. As such, Africa and Southern Asia concentrate 25 and 20 per cent of national DBFIs respectively. National banks accounts for 70 per cent of the number of DBFIs worldwide, while multinationals account for only 9 per cent. An important feature of the base is also to reveal that 21 per cent of the DBFIs are sub-national DBFIs, created by local governments to compensate imbalances between various national territories.

Eventually, DBFIs differ in terms of ownership structure, geographical scope, asset size and mandate, constituting a rich and diverse financial system, heavily connected with the 2030 agenda. One could assume that virtually all large infrastructure projects or support programmes to SME investments around the world are connected to one or several DBFIs.

[1]For a detailed analysis, please refer to: Xu, Marodon, and Ru (2021).

3. Two Centuries of History

3.1. The Rationale for Development Banks

The appropriate scoping of the state's responsibilities in the financial and monetary realms is one of the subjects that sparks most debate among economists, though in-depth research on actual public development finance institutions has been fairly limited (Griffith-Jones and Ocampo 2018). Development banks have at times been stigmatised by free market advocates, while at other times, particularly during periods of crisis or war, there has been a call to reinforce them. Fortunately, we are now better able to understand that everything boils down to context and the moment in history.

Historically, the establishment of public financial institutions has targeted a twofold objective (Schmidt et al. 2011).

The first is to channel investments into infrastructure or sectors that the government considers a priority (Diamond 1957). This was notably the case during the industrial revolution and the 19th century was the cradle of national and specialised public banks. The driving idea was to support the construction of the infrastructure needed and rendered feasible by industrialisation (Mazzucato and Penna 2018). In this, the founding role played by public development banks was what forged their basic identity, as they invested in new sectors or organised financial pools that opened pioneering outlets for investment, most often partnered by the private sector. In 1850, the French Caisse des Dépôts invested massively in the capital of the newly created railway companies in France, permitting a rapid emergence of this quite new transport technology at the time.

The second objective aims to overcome market imperfections, especially those linked to the various economic, environmental and social impacts accompanying any development project, the so-called externalities. They are also questions of coordinating and implementing public policy, and information asymmetries, which leads this sectors to being underfinanced (Armendariz de Aghion 1999; Hausmann, Panizza, and Fernández-Arias 2020).

As a result, some projects judged to be economically, environmentally, or socially relevant by public authorities are not financed by private banks, as the rate of return is considered too low compared to the risk. This is the case when it comes to financing an industrial and innovation policy, or some infrastructure. These types of projects require long-term finance that the private sector is not always willing to provide, particularly when the risk involved stems from a governmental policy choice.[2] It is for example the case for the small family farms that make up the economic and social bedrock of many countries, particularly low-income countries.

The role of the public sector in the financial system intensified during the reconstruction in the wake of World War II. These years were marked by the state's growing role in regulating the economy both in the near term (Keynesian policies) and long term (planning). The International Bank for Reconstruction and Development (IBRD), later known as the World Bank, was created at this time and emerged as the financial pillar of a multilateral system that needed rebuilding, notably to assist those countries that had been ravaged by war. The German KfW was also established during this period (1948)

[2]The French Caisse des Dépôts provided its first financing in support of territorial development in 1822 to the Port of Dunkerque.

funded by the Marshall Plan. In the post-war years, development banks were bolstered or created so that they could take over, at local level, the drive for industrial investment (Diamond 1957). This was the case of the Industrial Development Bank of Turkey (TSKB), which the country set up in 1950 in partnership with the World Bank.

Another reason for creating development banks emerged in the 1950s and 1960s, as governments were eager to foster regional integration. Solidarity between countries holding stakes in the same financial institution unlocked powerful political and financial leverage. The existence of these banks enabled states to jointly raise capital, giving them the possibility to finance structural projects in a given sub-region. The objective of economic integration dovetailed with political ambitions, and proved to be a contributing factor to peace and security between neighbouring countries within the same geographical region.

This is the moment when regional banks appeared on the scene. The European Investment Bank (EIB — 1958) illustrates the success of this shared vision between European governments. The pooling of European debt is operational for quite some time yet through the EIB's bond issuance, and the bank is still one of the world's best-rated signature. It has played a major role in funding European infrastructure and innovation, as well as European SMEs through lines of credit to national banking systems. The Council of Europe Bank (CEB — 1956), the Corporación Andina de Fomento (CAF — 1970), the West African Development Bank (WADB — 1973), and more recently the Black Sea Trade and Development Bank (BSTDB — 1997) also exemplify this reality. The European Bank for Reconstruction and Development (EBRD), established to facilitate the integration of Eastern Europe, extended its mandate southwards because of the absence of a full-fledged Mediterranean development bank, that would be a great signal that peace and prosperity are a feasible and suited future for that sub-region.

Mention should also be made of the years following the African independencies, when the need for national financial institutions independent of the former colonial powers was to be met by the newly established governments (Duchaussoy 2017). The local financial sector was embryonic, having very few national institutions. In these circumstances, development banks had to support the autonomy of the newly constituted nations and fully contribute to promoting the drive for economic growth.

3.2. DBFIs' Decline and Revival as Public Policy Instruments

After many years of a more Keynesian and plan-based vision, the 1970s and 1980s were marked by a challenge to government intervention in the economy. The political issues of the Cold War divided the world and ideological clashes often prevailed over economic considerations.

In the realm of finance, the general trend was towards liberalisation (cf. John Williamson and the Washington Consensus). The recommendations of the structural adjustment programmes implemented by the International Monetary Fund and World Bank pointed in this direction, although paradoxically the World Bank is itself a large Public Development Bank. The shortcomings, real or perceived, in the management of public institutions, be it governments, state-owned enterprises or public banks, brought on widespread distrust of public sector effectiveness (Scott 2007), not only on account of suspected corruption but also because it was seen as a systemic failure. The private

sector and rules of free competition were called on to take over. Financial regulations were revised and relaxed, and the move towards the privatisation of public banks, facilitated by management irregularities in some institutions (La Porta, Lopez-De-Silanes, and Shleifer 2002; Smallridge and de Olloqui 2011), became common in many countries.[3]

Public development banks were caught up in this movement and many were liquidated, restructured or privatised, particularly in Latin America and Africa. Poor governance was a major obstacle in weak institutional environments. In less developed countries, in particular, a consensus emerged that the context in these countries was not conducive to reaping the potential benefits of development banks.

At the same time, in Europe and particularly in France, Germany and Italy, the picture was less clear-cut. Certainly, in France, the experience of the Sociétés Locales de Développement (local development agencies) had ended in failure, bar a few exceptions. Yet, although state-owned commercial banks were privatised, some public development banks escaped this trend and their potentially structuring role continued to receive support and recognition. Several countries that had recently left the Soviet bloc created their own development banks in the 1990s, more often than not successfully.

In the wake of discussions on the new institutional economy during the 1990s and evidence that the private sector was blind to certain risks, it was effectively the 2000s and especially the major 2008 financial crisis that gradually shone the spotlight on the positive state's regulatory role (Griffith-Jones and Ocampo 2018; Thorne and du Toit 2009).

The possibility of mobilising public development banks in this countercyclical role hangs on two specific features that universal banks do not have (Brei and Schclarek 2015):

- The first is institutional: as the state is the shareholder of development banks, the need to safeguard the economy stands as a priority. The bank can be used to transfer resources to economic agents who can justify their need. The risk of moral hazard is lower than when private intermediation is involved, and the signal is useful for restoring market confidence.
- The second characteristic is structural: public development banks have balance sheets based on long-term resources (De Luna-Martinez and Vicente 2012), which limits the risk of a maturity mismatch. Fanny Mae and Freddie Mac as well as Dexia,[4] privatised institutions that were DBFIs at their inception, were caught in the crossfire of the 2008 financial crisis for this reason. By contrast, the business model of DBFIs does not require a fast turnover of assets. They lend over a duration that matches their resources and thus have no great need for short-term refinancing. In the event of market volatility, they are less exposed than others to the risk of illiquidity. This more stable balance sheet structure (Macfarlane and Mazzucato 2018) is clearly an advantage in periods of crisis, as it allows them to step in until market tensions ease.

All in all, development banks' business model positions them very differently from private banks. They have, of course, to factor in banking margins and risks that affect

[3]The World Bank's 2013 report on financial development is symptomatic of this view (Global Financial Development Report: Rethinking the Role of the State in Finance).

[4]The case of Dexia bank, a former public development bank, now privatised, that specialised in local government financing, is interesting on this count. Its liquidation (by orderly resolution) in 2009 owed nothing to the quality of its portfolio, which was excellent, but rather to the maturity mismatch of its refinancing.

their financial equilibrium and sustainability. They remain governed by banking law or similar standards but, on top of this, they also have to meet the requirement of fulfilling their government mandate. They are expected to strike the right balance between operating equilibrium, risk management and allocation of their resources with a view to maximising the economic, social and environmental impacts of their financing. This robust financial stability and investment thesis fashions them into specific instruments able to play a government-defined role which differs from that of commercial banks across all financial systems. Redefining and amplifying this role in line with the Sustainable Development Goals could constitute a fresh rationale for their continuing and expanding trajectory.

3.3. The Covid-19 Crisis and Sustainable Development

In peacetime years, there is almost no history of a decision leading to the lockdown of all 'non-essential' economic activities in less than 24 hours, except for health services and distribution of food supply (Marodon 2020). Neither is there any prior example of the recipe that can ensure a successful recovery, given the magnitude and depth of the crisis. Governments and central banks, especially in developed economies, which have more fiscal space, have put in place large-scale financing measures and blown the cap on fiscal deficit ratios.

In these unprecedented circumstances, the mobilisation of governments, both in terms of speed and scale,[5] much more so than in 2008 when a wait-and-see approach had prevailed for several months. This attitude was, in fact, justifiable given that the 2008 crisis was endogenous to the financial system and spurred financial institutions, whatever their level of exposure, to relevant caution. In 2020 and 2021, the crisis is purely exogenous and affects first and foremost the real economy. It stems from the policy decision to close borders, restrict economic activity and even confine whole countries. The consequences and risks are thus of a very different nature, and rebooting economic activities that were healthy pre-crisis depends over-archingly on the recovery of world trade, with each actor seeking to return to the pre-crisis situation as soon as possible. Unlike 2008, the current revival requires above all a particularly agile and dynamic financial system capable of generating the necessary liquidity. The public component, including DBFIs, has thus been particularly in demand since March 2020, as confirmed by the numerous cases observed within the International Development Finance Club (IDFC Response to COVID-19 Crisis — IDFC). This is also because the private financial sector has been unwilling to lend, unless strong public guarantees or co-financing with DBFIs was available, due to widespread uncertainty.

The urgent need for a swift reboot of the economy has also opened the debate on the nature and quality of this reboot. Is it a matter of returning to the previous situation as quickly as possible? Before the Covid-19 crisis, many development banks had already engaged at enhancing the compatibility of their financing with the international agreements on climate and the SDGs, which their own governments had signed in 2015.

[5]According to the International Monetary Fund, the G20 countries had already mobilised USD 10 trillion in July 2020, twice the amount that they had announced in March. Source: https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19.

In a context of climate change, loss of nature and social inequalities, questions are being raised on the extent to which operations, albeit cost-effective, are really of benefit in the long run. Certainly, assessing investment opportunities goes hand in hand with identifying related externalities. Whether these are positive or negative, considering them can quite radically change the view on a project. Good examples of this are given by projects that are justified economically but whose realisation nonetheless implies the destruction of a landscape or a natural area. The INELFE project for the electrical interconnection between France and Spain is interesting from this standpoint. Heated debates took place between nature conservationists and those defending the economic priority of interconnecting electric networks between France and Spain. The need to strike a balance between these two stances led to justifiable interventions by the EIB (EUR 350 Million) and the European Commission, permitting that most of the cable link was laid underground, at a higher cost, but with limited damage to the natural landscape.

Many are hoping that the economic recovery and the monies spent on it will provide the opportunity for a fresh start on new foundations. The DBFIs should be at the forefront of a 'new finance' aimed at reconciling financial equilibrium, risk coverage and a resolute step in the direction of a sustainable and inclusive development model.

4. Development Banks for Sustainable Finance

One prerequisite is, of course, the setting-up of a governance system and effective regulation of the activities of development banks. Here, no one-size-fits-all model exists, but the economic literature reminds us that, if directors are not relatively free from political interference in the financial and operational management of their institution, the risk of nepotism and abuses is high (see particularly Smallridge and de Olloqui 2011). It is equally crucial that regulatory and supervisory banking practices be aligned on industry standards. In some cases, exceptions to Basel III standards may be envisaged, to help DBFIs fulfil their mandates better, provided they are justified and proportionate.

Once these fundamentals are clearly and firmly established, five structuring recommendations can be proposed, which could give development banks a leadership role in financing the transition without crowding out private financing.

- Mainstream the imperative to transition in financing decisions
- Mobilise and redirect private finance
- Use development banks to channel transition funds
- Promote the emergence of a responsible demand
- Build a new global financing architecture

4.1. Mainstream the Imperative to Transition in Financing Decisions

For governments that engage in the multilateralism dynamic and participate in the ongoing transition, two points tend to gather consensus:

- The United Nations agreements of 2015 on the SDGs and the Paris Climate Agreements represent a unified strategic horizon for all countries.
- The SDGs are a matter for all economic actors, at all levels, in all countries, all sectors, whatever their level of income. The private sector needs to become part of this dynamic. This is a requisite for the transition to take place.

This new imperative for sustainable development requires a thorough rethink of the mandate and functioning of development banks (Attridge, te Velde, and Soren 2019; Clark et al. 2019; Griffith-Jones, Attridge, and Gouett 2020).

Since 2015, a growing number of development banks have already integrated into their evaluations the issue of the carbon emissions linked to the projects they fund. The multilateral banks and IDFC members have committed to ensuring that their activities are compatible with the Paris Agreement objectives. Many of these institutions are setting up criteria and metrics to guide their strategies, their analysis of counterparties and transactions, and to proactively management climate risks.

Yet, much remains to be done. Although the climate question is pivotal, it is only part of the problem. Strictly speaking, no 'climate project' exists independently of its social and economic impacts. The relative failure of current policies to fight global warming — given that emissions continue to rise — is because they have not adequately integrated the diverse dimensions of sustainable development.

Moreover, when crafting pro-poor policies, the questions of climate and nature are essential and must not be viewed as secondary (OECD 2019), not only because the impact of global warming is felt worldwide but also because this warming, as well as natural resource depletion, is exacerbating the fragility of the most vulnerable populations. The challenge lies in ensuring consistency between investment choices and the imperative of sustainability — which is a major responsibility for development banks. This issue is particularly challenging in low-income countries, which have relatively low CO_2 emissions and high poverty rates. They are compelled to make trade-offs to ensure the investments crucial to their economic growth while, at the same time, giving utmost importance to climate change.

The Covid-19 crisis reveals just how devastating the great planetary issues of climate and the loss of nature can be in a world that fails to prepare for them. It also shows that the economic and social consequences (resurgence of poverty, unemployment, exploding debt, bankruptcies, etc.) of a transition involving an annual 7 per cent reduction in carbon emissions, for instance, have been vastly underestimated, where this drop in emissions is achieved through a proportional drop in growth.

There is also a lesson to learn from the last twenty years of climate finance (Buchner et al. 2019): the multiplication of commitments made in good faith, no matter who the actors may be, are unable to move the needle on the necessary scale. During the Covid-19 lockdowns, we saw increasing declarations to the effect that the 'world after' would not be as before, that lessons would be drawn from the crisis, that we would have to 'reinvent ourselves'. Yet, the stimulus measures implemented are primarily aimed at boosting consumption and pushing production back up to its former levels. Reconstitute the 'world before' — basically the only world that we know — as quickly as possible.

One of the challenges of the 21st century is to give a new direction to all financial flows to ensure their compatibility with the SDGs, include climate. A first step is doubtless for

development banks: to have a simple and credible analytical tool to qualify the compatibility of their business with sustainability.

The main difficulty is linked to the multi-faceted character of the SDGs and their mutual coherence. It is indeed very difficult to determine whether an investment project or public policy programme is comprehensively positive for all 17 SDGs, but also and more importantly, assess to what extent the negative impact on one of the goals should be disqualifying. Their interactions are too numerous and often still largely unknown. Research work plays a decisive role in shedding light on this. Further questions arise concerning priorities, and these are not identical for Mauritania and for Germany. The magnitude of the social or environmental damage potentially caused by an investment compared to the expected economic and financial benefits is highly specific to each investment, each context, each country.

Development banks are on the front line regarding these questions.

Each development bank needs to address these questions to make sure that its own constraints and the social structure and economic level of the country in which it operates are tailored in its approach. But all of them must ensure that each project includes an assessment of the externalities of the investment under consideration and clarify what it could achieve or has to avoid, in any related aspects. This is the only way to justify unlocking an emissive investment or harming a natural area, if the achievement of vital social progress is truly is the balance.

In fact, there is hardly any other means to ensure that financing initiatives prioritise activities with direct or indirect co-benefits for climate or nature. Innovative operations must be identified and hold top priority when the projects are able to trigger structural changes, be it on a small scale (pilots) or large scale.

Governments should ask all public development banks, to develop such methodologies, use them as concrete ‘echo chambers’ able to mobilise research resources, and then catalyse other financial flows. The myth of market self-regulation has reached its limits. Setting a new course for the financial system can only be achieved through the alignment of financing with their measured impacts, under the eye of regulators likely to impose the precise and demanding standard to set the pace of the transition.

4.2. Mobilise and Redirect Private Finance

Among the needs to redirect global investment, the vast bulk of which is private, is the need to finance the various transitions. Today, this requires changing scale, especially when it comes to climate. Some preliminary remarks are useful:

- Markets are not efficient when it comes to giving the signals needed to channel private resources in the direction of the SDGs. In fact, markets pay little attention to the long term, sending no price signals on externalities and encouraging ‘free-rider’ behaviour, particularly in fragile political and economic contexts.
- Private finance continues to invest heavily in the industries it knows well, even though some of these are contributing to climate change and the loss of nature. Investments in oil-related sectors are still very high, representing around USD 500 billion globally

each year,[6] that is, triple the total annual amount of official development assistance (UDS 152 billion in 2019).[7]

- On the other hand, the flows of private resources required to finance the costs of transitioning towards sustainable and inclusive economies are far higher than current flows. The International Energy Agency estimates the energy transition alone will cost USD 44 trillion. This is beyond the reach of public financing alone, be it domestic or international. What's more, it would prove ineffective should private investors continue to pull in the opposite direction by financing investments detrimental to the SDGs.
- The 47 least developed countries, in particular, run a serious risk of being unable to finance this transition even though their populations are the furthest away from the SDGs. Even if financing is doubled, the amount of official development assistance mobilised would be incommensurate with their needs, estimated minimally at one trillion dollars a year.[8]
- Public debt levels, already elevated before the Covid-19 crisis, leave no leeway for the conjecture that governments will be able to implement the necessary transition infrastructure without a major redirection of private capital and adapted financial packages. One of the priorities that the Tharman report[9] underlines in its proposed reform of the international financial architecture is the mobilisation of vastly greater private investment.

These arguments are not new (Gössinger and Raza 2011). The creation of many development banks in the mid-1970s, including Proparco, was based on this rationale. With the mobilisation of the international community around the SDGs, this line of reasoning is gaining strength and everyone agrees that what is crucial is for all stakeholders to fully take on board the pressing need for transition.

This means that potentially available private sector funds must be channelled into sustainable development. Development banks are well-placed to help this redirecting of private financial flows (Griffith-Jones, Attridge, and Gouett 2020). They are already often present in most of the financing rounds for large infrastructure projects and are in a position to bring their influence to bear. They need to strengthen their catalytic role through well-adapted financing methods and channels, in order to drive up SDG-compatible financing. In other words, what counts is not only that their own financing be in line with the requirements of the transition, but also that they try to bring all financial actors on board, so that a project that fails to adequately account for its social and environmental consequences finds no takers. More importantly, it is essential that projects contributing to a low carbon economy find sufficient funding.

To facilitate the mobilisation of private funds, the most common financial instrument is blended finance, which involves subsidising part of a private investment through grants or low-interest loans (Eslava and Freixas 2018). Other frequent arrangements rely on

[6]IEA (2019).
[7]https://www.oecd.org/fr/cad/financementpourledeveloppementdurable/normes-financement-developpement/aide-publique-au-developpement.htm.
[8]https://www.brookings.edu/blog/future-development/2019/07/29/how-much-does-the-world-spend-on-the-sustainable-development-goals/.
[9]Making the Global Financial System Work for All, Report of the G20 Eminent Persons Group on Global Financial Governance, October 2018.

trust funds, or ad-hoc mechanisms such as first-loss guarantees (e.g., for mezzanine finance). To be effective, development banks need to establish precise rules to prevent blending from introducing a competitive bias or, more importantly, from creating moral hazard by generating unjustified profit for private players.

Moreover, it is very difficult to put a figure on the level of subsidy that an investment requires to enable it to integrate a positive externality or cover a risk. This same question was raised by states with respect to the unfair use of Overseas Development Assistance for commercial purposes. The rules of the OECD's 1978 Arrangement — which has since been regularly added to and updated — had attempted to establish a common framework to allay this concern. Different international actors have endeavoured to establish rules of conduct for blended finance (particularly the IFC and more recently the OECD via the Tri Hata Karana Roadmap) to limit possible criticism of moral hazard. The international debate is focusing on this question: beyond standards and regulations, how can investments be steered towards sustainability and, during an intermediary transition stage, how can those who take this direction be encouraged by financial incentives?

Given their knowledge of the economic realities of each sector, their experience gained from different operations and their close ties to government, development banks are probably the financial actors best positioned to move this debate forward and systematise this type of intermediation. To do so, they must be able to make substantive financial commitments by having their capital increased by governments and leveraging their balance sheets,[10] in line with objectives that their shareholders need to set for them much more precisely and ambitiously.

4.3. Use Development Banks to Channel Transition Funds

To accomplish their mission, development banks need to have a level of capital commensurate with their counterparty-risk-bearing capacity, while also ensuring that liabilities are backed by long-term resources. The failure of some development banks, regardless of the quality of their management, often stems from the conjunction between an unbalanced liability structure and an inadequately collateralised activity.

A prerequisite for their missions to succeed is government support, be it through loan guarantees, subsidised interest rates, tax breaks or maintaining a sound capital adequacy ratio. A mission broadened to include sustainable development financing presupposes extending the term of loans, as is often the case in the social housing sector. Loans with maturities of 30, 40 or even 50 years are justified if they promote solutions that prevent investments from being locked into highly emissive activities.

The question then arises of development banks' having sufficient capital, as well as access to grants or subsidies to support virtuous projects, or transform non-virtuous projects to become so.

- Ethically and economically speaking, the neo-classical rationale would suggest that companies pay and factor into their product the pricing of all related costs: not

[10] The leverage effect is the amount of additional lending permitted either by increasing equity capital or by receiving budget allocations from government.

only the direct costs of inputs to production, such as labour and capital, but also the costs of all externalities, particularly if they cause environmental damage. Social responsibility and ethical treatment of employees also exist in most labour legislations and should be imposed as a standard to be met.

- Another vision, less market-oriented, would justify providing a subsidy to a private company, as long as it yields a benefit for the community as a whole. The subsidy in a way 'buys' a positive externality. This is the approach adopted, for example, by the Global Environment Facility, the Green Climate Fund or the European Commission. These grants supplement and bolster an operation financed at near-market rates, thus ensuring its feasibility via specific financing for the environmental component.

Having no market value, the fair 'purchase price' for a social or environmental benefit is hard to determine. Assessing the appropriate level of a grant or subsidised interest rate that can be optimally given to a private enterprise for a specific operation thus remains complex.

It requires having the capabilities to distinguish between limitations that can be overcome and those that are in any event unsurpassable. When this involves subsidising an environmental or social externality, it also requires being able to put a 'price' on what the subsidy makes it possible to offset. Currently, the fact is that very few quantitative methods dispose of the necessary elements for calculating the right level of subsidies to apply. One important and valuable exception is using the shadow price of carbon to evaluate projects, as the European Investment Bank does; such a practice could be generalised to other DBFIs.

In light of this, there is a certain consensus around the idea that a subsidy backed by market financing can 'buy' three types of services:

- Promoting an 'inclusive service' component, such as opening up access to a service that is unaffordable for poor consumers at a market price.
- Gaining a collective advantage for the community by preserving a common good that has no market price (climate, nature, conservation of a landscape, etc.). This may involve promoting an SDG that is difficult to operationalise in a specific context.
- Enabling the implementation of an investment offering high economic and social utility, but whose risk/return profile is unacceptable to private investors, particularly in fragile or crisis countries.

These questions are crucial for a successful transition. Development banks, operating in close contact with the economic realities of their country, provide some evidences on whether or not it is justifiable to grant subsidies or reduced interest rates through their intermediation:

- Their mandate relies on the fact that market imperfection exists, whether they affect social housing, SMEs or financing for the poorest countries. If an additional dimension relating to the environment or climate is integrated, this is but another brick in an edifice already designed with this imperfection in mind, and is thus relatively easy to integrate.

- Although providing a grant to a company may raise questions of moral hazard, it is less so for a public entity not driven by profit. Certainly, it is financially healthy and necessary for development banks to balance their accounts. It is just as healthy and necessary that government or the international community give them the means to support positive externalities resulting from their clients' operations. If this involves creating a market bias in favour of sustainability, development banks are effective tools, wielded by the state and suited to acting as executing agencies, at least to inspire an initial phase before such mechanisms can be extended to the private sector.
- All countries and sectors have their own specificities. Faced with the very different economic realities of countries, national or sub-national development banks know better than anyone does what constraints apply to local economic agents. A 'tailor-made' response is possible, if the bank itself has access to the necessary support funding.

In exchange for this government support, development banks must stand accountable. Their contribution to sustainable development must be auditable. Financial innovation must also step up to the mark, particularly through investments in impact funds, results-based aid or guarantees.

4.4. Promote the Emergence of Responsible Demand

Development banks do not originate projects, they finance them. This means that they count on the capacity and motivation of project sponsors and owners to design sustainable projects. However, DBFIs can provide technical assistance or funding to generate desirable projects, or even help in the design of key projects for a sustainable economy, which will prioritise particular areas of investment.

In reality, there is a relatively broad spectrum of initiatives ranging from private enterprises following a 'traditional' model to those working to integrate their externalities into their business model. For some, the prime objective remains financial profitability and factoring in the transition, or even simple CSR criteria, is a constraint.[11] For others — ground-breakers that need to be identified and supported — an investment project must be designed with the whole gamut of impacts, and profitability is but one factor among many.

- Innovations, whatever qualities they may have, are still 'laboratories'. They are certainly relevant, but very few go to scale.
- For many countries, catching up the infrastructure deficit remains a non-negotiable priority, as it is their prime lever for development. The 'silk road' promoted by China is based on this premise. Social externalities, such as environmental impacts, of this type of large-scale investment are systematically underestimated, especially with regard to more emotional or political concerns.
- Even though things are slowly changing, many small businesses still continue to perceive the reconciliation of financial, social and environmental agendas as purely theoretical, costly and far-removed from their everyday reality.

[11] Added to this are questions of taxation and distortions to competition linked to the diversity of social and environmental standards across the world.

Sustainable development is a complicated, cross-cutting notion that is hard to mainstream in financing decisions. It is even more so for entrepreneurs, who are focused on product design and their market trends. In the current context, is there a critical mass of businesses and projects ready to take up the challenge of sustainable production? In the vast global fabric of SMEs, how can we kindle and support the motivation required to ensure that investments take sustainability issues into account?

This key question runs up against the fact that the support tools, advisory assistance and 'non-banking' services that development banks could offer to their clients are insufficient to generate this type of demand on a massive scale. Considerable progress has been made, but purely and simply abandoning certain economic activities sparks the fear of social chaos. Such is the case of coal production in countries like South Africa and Poland since their energy mix and employment are closely tied to this sector.

This implies that investors must build up their capacity to identify possible options, clarify and spell out long-term objectives, then translate these into investments that underpin concrete steps in the right direction. Admittedly, entrepreneurs' motivation alone will not suffice. Failing public financial support and without technical and financial assistance, the transition will remain problematic.

Disseminating good practices, 'show-casing' and funding projects with positive environmental externalities and supporting clients to change their approach should come with the responsibility of 21st-century development banks much more clearly and ambitiously. The current Overseas Development Assistance rules, based on volumes more than impacts, should be reviewed to incentivise financial flows toward sustainable development. The momentum for such change could come from the national DBFIs that do not abide by these rules and through which concessional resources could be usefully channelled.

4.5. Build a New Global Financing Architecture

The current political climate is marked by the resurgence of nationalism and questions of immigration and security. Several elections, including those in the world's largest democracies, have shown that, unfortunately, inter-governmental cooperation is not granted and that an inward-looking attitude based on nationalism and denial of science is an option. This would hardly be compatible with building global cooperation on the various transitions, as this presupposes trust, cooperation and time.

Global governance of the transitions is not yet stabilised; the example of climate and the United States' withdrawing and then re-joining the Paris Agreement under two different administrations prompt caution as to the possibility of building on a long term consensus. Apart from citizen mobilisation, the political thrust must come from actionable solutions concretely financed and implemented. This is the field of the public development banks, and first and foremost the national DBFIs.

SDG financing necessarily means rethinking the international finance landscape and perhaps even its very architecture. Currently, this system locks the actors into fixed roles, each acting according to their own logic. Yet, multilateral banks, special international funds (e.g., Green Climate Fund, Global Partnership for Education), national development banks, aid agencies, foundations, ONGs, cities, regions or federal states, private

firms must share a common 'radar screen', in the form of the SDGs, to guide their financing decisions.

Development banks can collectively organise themselves to act as this powerful new vector for financing the transition. They need to build an offer that can link up the great planetary questions and their operational responses.

To do so, the development banks need to form a coalition, a global platform on which they can collaborate and coordinate their efforts internationally. Basically, this means doing things differently and in a more collaborative way.

- The first priority is to develop a service to governments in order to channel towards transition solutions the resources injected by the monetary authorities in the wake of the Covid-19 crisis. These resources must translate into sustainable projects, distributed fairly across countries. A coalition of development banks can create this actionable plan linking the decisions taken in international fora with local solutions
- Bank staff must be trained on the issues, methods and analyses required to integrate a larger range of impacts when assessing an operation. A coalition can organise these types of exchange, scale them up and finance them. The processes for discussion, experience-sharing and cross-comparing situations are perhaps some of the most powerful drivers of change.
- Development banks operating in low-income countries with shallow financial systems, particularly in Africa, must benefit of a special solidarity from the larger, older and more financially sound banks. For those whose mandate is to finance international development, they must set up specific financial tools to strengthen the paid-in capital of the smaller and more vulnerable banks. Long-term credit lines, Tier 2 funding (i.e., included in the bank's regulatory capital under Basel III see Bolton et al. 2020), bond issue guarantees, grants for technical assistance and training, and equity investments are some of the solutions.

5. Conclusion

The magnitude of the changes needed to bring a solution to sustainability sometimes has us believe that 'we will never make it', given the necessary step change in our habits, efforts, and even in what we have to give up. Tocqueville, although he lived before this period of climate change, considered democracies to be short-sighted and incapable of averting long-term dangers (https://jancovici.com/recension-de-lectures/societes/de-la-democratie-en-amerique-alexis-de-tocqueville-1840/). Could it be that this grim future is unstoppable?

A great many surveys, however, indicate that a new roadmap for the transitions is mustering broad grassroots support from the general public, and that the Covid-19 health crisis has further bolstered the learning process and raised conceptual awareness and forward-looking attitudes.

Based on the above and on the latest expert reports, various conclusions can be drawn.

- Governments must make sure that their DBFIs meet four key conditions to ensure the effectiveness of the financings they mobilise: a credible 'sustainable' development

strategy; independent high-quality governance to be carefully respected as this is a guarantee of the institution's financial sustainability; a level of capital aligned with increases in their risk-taking, and new challenges; and alignment with their national climate plan.

- The imperative to transition plunges us into a world that is no longer unequivocal, a world that has to deal with the complex impacts of any investment project. Mainstreaming criteria and analytical tools based on the SDG roadmap in the project appraisal cycle is a prerequisite for success.
- Public development banks can amplify their dual function as a provider of public funding and an enabler of private financing through blended finance or support for impact investments. Their leverage effect must be scaled up and maximised.
- At international level, the global and regional DBFIs must support and strengthen national DBFIs through a better understanding of how the latter operate. They must use their intermediation more systematically to give these national DBFIs easier access to local markets and concessional financing, provided that this delivers benefits for the climate and the other SDGs. They must also transfer their expertise so that these national development banks can act as effective relays for the implementation of the key agreements signed between governments.

By synergising international, multilateral, regional and national levels and by highlighting how the interests of countries — and their citizens — dovetail with the preservation of the planet, development banks can make a difference. They have the potential to form an alliance that, at scale, will make it possible to finance the economic actors and actions of the transition.

Disclosure Statement

No potential conflict of interest was reported by the author(s).

Funding

The author(s) reported there is no funding associated with the work featured in this article.

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