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WHY DOES THE STATE PROVIDE FINANCIAL SERVICES? THE LOGIC OF DEVELOPMENT BANKS IN HISTORY

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Why does the State provide financial services? The logic of development banks in history

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Abstract

Development banks are key to understand the financial and economic history of nations, however they have been understudied. This paper reviews literature to outline a framework to analyze the history of development banks. It discusses two approaches, the economic development view, that favors the role of development banks in the economy, and the political view, which describes these organizations as tools that serve the interests of political regimes, but create inefficient outcomes. The paper argues that, while the two have valid elements, the functioning of development banks in history largely responds to a political logic. However, this article proposes that politics is not an exogenous element to the economic functions of these institutions, nor that politics is a single explanation or that it excludes the economic functions of banks. The central aim of the article is to explain that both domains, *economic domain* and *politican domain*, are linked. A historical result depends on the context-specific institutional arrangement between both domains.

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Introduction

State owned financial institutions still serve the majority of individuals in developing countries. However, development banks have been understudied and its behavior and performance have been neglected, despite that today there are at least 286 development banks operating in 117 countries (Caprio, Fiechter, Litan, Pomerleano 2005). These organizations have played a crucial role in the economic history of the world during the last century, and we require a better understanding of their evolution with a long term perspective. Only a historical, long term, perspective would allow to capture complexity of the functioning of these organizations and their insertion in the State.

The literature that analyzes, directly or indirectly, development banks has been classified two streams. One stream, analyzes their economic functions and their possible impact on the development of a country's economy and financial system. Another stream describes them as instruments of the political system with the purpose of political control and redistribution of resources to interest groups. The former has a predominantly optimistic view of its functions. The second tends to study them as a negative element in the institutional environment of the economy of a country. But as Musacchio and Lazzarini (2014) point out, this is not black and white, the history of development banks is more nuanced than is commonly perceived.

This paper discusses these two approaches and argues that, while the two have valid elements, the functioning of development banks in history largely responds to a political logic. However, this article proposes that politics is not an exogenous element to the economic functions of these institutions, nor that politics is a single explanation or that it excludes the economic functions of banks. The point of the article is to explain that both domains, *economic domain* and *politican domain*, are linked. A historical result depends on the context-specific institutional arrangement between both domains.

The perspective of economic efficiency

Literature in economic and financial development attributes several functions to development banks. Economists argue that the explicit objective underlying the creation of these institutions has been to resolve problems derived from "market failures" in financial markets that cause credit rationing. The rationale behind development banks is supported by an empirical argument: many companies cannot access financing (either credit or securities markets) from the private financial system despite the fact that their financing is desirable because of their viability. Several authors argue that development banks help alleviate capital scarcity by supporting new or existing industries, mainly capital intensive projects. Development banks also engage when potential investment opportunities are not recognized by the private sector or that have long maturities or high social returns. Target borrowers might also constitute an area the government wishes to develop (Gerschenkron 1962, Armendáriz 1999, Rodrik 2007, Musacchio and Lazzarini 2014).

In a widely accepted view, Gerschenkron (1977, p. 52) claimed that: "Thus, it is possible that in a country, for reasons such as unfavorable attitudes toward banks and bankers, or inadequacy or insufficiency of talent in the banks, the activities of the banks in the great spurt may be sup-plemented by promotional activities of the state, despite the absence of an 'extreme degree of backwardness.' "

Musacchio & Lazzarini (2014, pp. 236-37) explain how the design of an industrial policy shapes the conceptual role of development banks: there are at least three interrelated spheres of action. They can alleviate capital scarcity and promote entrepreneurial action to boost new or existing industries, especially industries that need to finance capital intensive projects (Cameron 1961, Gerschenkron 1962, Armendáriz 1999). Second, development banks may finance projects that have long maturities or that have low financial returns but high social returns. And third, they engage in activities in the event that potential investment opportunities are not recognized or not acted upon by private sector. They coordinate entrepreneurs to act or provide information about discovery costs (Rodrik 2007).

Eslava and Freixas (2016) stress that public banks "is a practice in search of a theory". There are few models in economic theory that provide a purely conceptual frame to this question. Armendariz (1999) pioneered the theory with a model for the provision of long-term capital to industry when private markets fail to provide it. Her work also explains the relevance of development banks in fostering the acquisition and dissemination of expertise in long-term industrial finance, expertise that in the absence of these institutions would not be disseminated. More recently, Eslava and Freixas (2016) develop theoretical model to answer to the question of how a development bank is intended to remedy frictions that cause credit rationing and which instrument, among those used by these institutions, is best suited for solving those frictions.

Government ownership of banks has been justified not only to ensure that underserved groups or sectors receive credit, or to ensure that economic growth is consistent with national objectives, also to respond to financial crisis as well as to counter the power of strong private banks or to promote the development of local financial industry (Caprio, Fiechter, Litan and Pomerleano 2005).

A central aspect of the economic logic of public development banks is that they have been intended to change the allocation of credit within a market system. And most of the time, its pursuit is far from substituting the market, development banks have been intended to change the allocation of credit within a market system (Hason 2005, Caprio, Fiechter, Litan and Pomerleano 2005). Thus, the idea that a development bank should contribute to economic efficiency is intrinsic to a market oriented view of these institutions. However, the economic logic might also contain notions of distributive efficiency and distributive justice.

The principle that a government development bank serves to overcome market failures, acting as an enabler of an efficient outcome (that otherwise would not exist due to those failures and frictions), has motivated economists to evaluate banks according to their performance. Most economic development literature to focus in loan recovery and financial performance as measures of success of those organizations. Such approach was prevalent since the late 1980s. And it might be a reasonable approach, but scholars agree that it is insufficient and sometimes misleading, because it reflects what banks should do, but not their actual interest and goals. Other authors claim that there are social returns that might not be reflected in the P&L statements, these might imply a broader impact of the activities of a development bank. Armendariz (1999) claims that there are positive impacts that are difficult to measure, for instance the creation and dissemination of expertise. Thus, there might be apparent contradictions in how to approach the economics of these organizations.

Many authors do not share that optimism. LaPorta López-de-Silanes and Shleifer (2002) argue that higher government ownership of banks is associated with slower subsequent development of the financial system, lower economic growth, and lower growth of productivity. These authors argue that their results are supportive of the political view on the effects of government interference in markets.

Moreover, since the 1950s, the work of Boskey (1959 p. 115) pointed out that development banks engage in various non-financial activities. For instance, they serve as technical agencies in some industries (agroindustry and mining are common cases) and establish enterprises and become owners or shareholders. These activities make difficult to assess their economic performance and create adequate incentives (Hason 2005 p. 22). The reason of that involvement might be to complement their financial tasks in order to solve market failures. In practice, solving a friction in a market is a complex task, consequently development banks need to involve in diverse tasks to address the problem with relative efficacy. At the same time, being involved in diverse functions might be a result of political goals of the government that uses these organizations as tools to solve broader issues, usually transversal to an industry.

Notions such as the indispensable role of development banks in the industrial policy of a country and the government ownership of banks as part of the "commanding heights", an approach advocated by Arthur Lewis (among other economists, such as Myrdal), associates their economic purpose to the decision/action of the political actors that constitute the State. Consequently, the economics of development banks cannot be disentangled from political institutions.

The political rationale

The relationship between the development banks and the political objectives of a government is undeniable. For example, in his monograph Boskey (1959 p. 8) claims that: "It would […] be wrong to suggest that public banks are necessarily subject to political influence or that private banks are necessarily immune to any kind […] The closer the link to government through ownership and management, the greater the likelihood of government influence on investment decisions".

Since the studies of Diamond (1957) and Boskey (1959) up to the present, it has been well understood that development banks have powerful constituencies of borrowers, managers, and government officials who see the institutions as a way to allocate funds toward political interests, or toward cronies (see also Caprio, Fiechter, Litan, Pomerleano 2005 pp. 2-3). LaPorta F. López-de-Silanes and A. Shleifer (2002) explain that in literature, there is a "political" view of government ownership of banks. That view differs from the "development" view held by many economists. The "political" view argues that government control of finance, through its banks or otherwise, politicizes resource allocation. Musacchio and Lazzarini (2014 pp. 236-37) explain that in this view rent-seeking capitalists may request subsidized credit or cheap equity even for projects that could be founded and launched using private sources of capital. With this, politicians maximize personal objectives or crony deals and development banks may end up bailing out companies that would otherwise fail.

If development banks are embedded in the political institutions, then their action must be understood as part of the political system or of the political processes. However, economists tend to view politics as an exogenous effect to development banks. Public development banks show that economic decisions are not independent of political decisions.

First, we cannot understand the action of development banks in the same way than private credit markets. In the interventions of development banks, the objectives of the government might modify the way credit markets operate. The expectations of borrowers might be different than in a private market. For instance, in the case of rural financial markets, credit contract enforcement might be extremely difficult in a rural environment. But dismantling a practice of poor loan discipline has a political cost. This is particularly true when politicians aim to gain the favor of rural producers, then it is difficult to enforce loans discipline in an atmosphere in which political ends. With this, private intermediaries may be deterred from serving the poor because of political sensitivity surrounding the enforcement of rural loan contracts. Widespread default demonstrates to rural people that government is not able or not willing to enforce contracts, consequently it affects the expectations and behavior of borrowers in these credit markets (Von Pischke 1981 p. 18-19).

As Von Pischke (1981 p. 10-12) stresses, rural people view development banks as "benevolent intrusions to be exploited". In these context a development institution has limited access to the depth of information about financial flows, behavior and priorities of the borrower. The lack of essential information pushes the intermediary or agency to ration credit. But credit rationing in this case is different from that applied by private intermediaries. That rationing needs to be based in the priorities of the government, which are political. Hence "political criteria, broadly defined, are inherent in farm credit programs designed by governments and development assistance agencies seeking to promote the welfare of target groups selected on extra-market criteria". As Musacchio and Lazzarini (2014) argue, governments do not choose to intervene at random, there is no natural experiment, there is a selection bias in the interest of the government.

If development banks are a failure, then it is hard to understand why they still prevail. But the logic of government intervention may lead to situations in which the state cannot leave projects or sectors easily. A common cycle is that government banks start with a social policy mandate and concentrate on high risk and low private return activities. This would lead to recurrent losses that would soon be followed with a reorientation towards profitable activities. In turn, this would lead to a deviation from the social policy mandate, triggering political pressure to restart this cycle (Levy Yeyati, Micco and Panizza 2004, De La Torre

2002). It is common that some programs stay in the operation of development banks because they gain inertia.

Relaxing the finance constraint of borrowers and projects that don't have access to the private financial system might be an evident function, but in many cases borrowers qualify for loans from private intermediaries, so it is not what they necessarily do. The fact that projects/borrowers that can have access to other type of finance use the development banks contributes to create an inertia in their operation, because they form a new constituency, and one that can justify their operation because of its viability.

The State also absorbs risks of the rural economy (market, financial, natural disaster, among other), or good part of it. Hence it does not necessarily promote development, but plays a relevant role in absorbing shocks. This creates an incentive to for borrowers to take loans from government intermediaries. It is also an incentive for the private financial system to work with development banks.

The first relevant aspect to understand in the politics of development banks is comparing their structure of governance with that of private financial intermediaries. The latter are organizations with several stakeholders, but that in first place respond to their shareholders maximizing profits. Government banks also have several stakeholders, and respond in first place to the interest of the State, which is it owner. Hence different administrations and political systems relate different to these institutions. Moreover, they have to negotiate with the constituencies of the bank: borrowers, managers, government officials and politicians all across the State.

The second aspect to consider is to understand their actual function in a particular context: What is the goal of development banks? What is their objective function? What is the capital which value they have to maximize? Literature has focused in what they produce, which it is not necessarily their final mission. The goal is fuzzy, and they tend to have multiple goals, they are a type of multi-product firm, but not in the same way that a traditional financial intermediary.

The set of goals depends on the original mandate for development each bank has in each context. As obvious it might sound, industrial banks are supposed to support industry, and agricultural banks are supposed to support agriculture. But this might differ depending on the views and perspectives about development of each time in history, and the priorities that governments define for economic policy. "Theories of change", interaction between the government and interest groups and economic problems that demand attention from policy makers vary over time. For instance, development banks target production, employment, investment, entrepreneurship, poverty and infrastructure, depending on what is considered the adequate formula for development in a specific sector. This is a result of two different forces, the policy makers' prevailing views of development and their vested interest in addressing demands or favoring particular groups and organizations. Such combination comes together, and it is difficult to disentangle what are the effects of different forces when defining a strategy for development bank.

Sometimes development banks target several variables, reflecting competing views and contending political interests. They also showing that policy makers could be inclined to tackle a problem from different angles.

The logic of interventions: the Mexican case 1930-1990

What are the objectives of a government when forming development banks? During the thirties, the formation of these institutions in Mexico was associated, at least, with a combination of economic development and political control objectives. The first was a perspective in which a “developmentalist” policy might be an effective way to promote economic “modernization” and “development” of regions.[1] To accomplish this, it was important to overcome the limitations of private markets. This was expressed in the objectives behind the creation of these banks, either in the law or their statutes. With it, an implicit objective was job creation.

The problem to resolve was not an invention of the political regime. It was a fact that the private financial system had been devastated in the revolution, and in the thirties it was still in its recovery. Many sectors of the economy had the potential to grow but lacked the liquidity and capital to start their projects.[2]

Political control was a goal that was implicit in the action of these banks. The assertion that the government achieved political control using development banks is a hypothesis not easy to document and demonstrate. What was evident is that the government used the development banks to support groups of political interest. We also might argue that the government responded to the demands of politically organized groups through the development banks. The case of agricultural development banks is one example of this.

Mottier (2013) shows that a crucial part of the agrarian reform entailed reorganizing the existing system of public agricultural credit loaned by the federal government through the

[1] The notions of modernization and development were concepts relevant to the framing of policies. These notions were mainly associated with industrialization first, and second with the development of the rural economy.

[2] See Vernon (1963), Haber, Maurer and Razo (2003), Del Angel (2004), and Méndez Reyes (2016 and 2009).

Banco Nacional de Crédito Ejidal. Needless to say, another sensitive sector was mining. The State was previously aware of this. The participation of organized mining workers in the armed factions of the Revolution was well-known. The miners had also shown strong labor organization, and their unions were hostile. Picket lines, strikes and confrontations were a constant in this industry.

I don't argue that the government used the banks for rent-seeking operations. Nor that there was cronyism or favor to politically connected entrepreneurs or elites. We might believe that this happened, but it is not an essential part of my argument.

Mexico is an ideal case study for this analysis because there was a sharp break between a period in which most rural credit was private and in which most rural credit came from government development banks.

Over time, Mexico's agricultural development banks expanded their roles. The first of these, the *Banco Nacional de Crédito Agrícola,* was founded in the 1920s. By the 1950's there were three large agricultural banks. In addition to the *Banco Nacional de Crédito Agrícola*, there was the *Banco Nacional de Crédito Ejidal*, founded in 1936, for the farmers who managed *ejidos* (land in collective ownership), and, as of 1954, the FIRA, a state development fund whose function was to promote private lending to commercial agriculture. Additional programs were subsequently created in the 1970s and 1980s, each of which responded to particular constituencies of agriculturalists and pastoralists (Del Angel, 2011 and 2010; Sanderson, 1986).

Mexico's development banks eventually expanded their purview beyond lending to farmers, they invested in equity and provided insurance to the rural economy. One thing they did was become second tier lenders, by encouraging private commercial banks to enter the market for rural credit, and then repurchasing those loans (much in the way that Fannie Mae and Freddie

Mac are second tier lenders for U.S. home mortgages). They also expanded into crop insurance. The first such attempts were designed as technical solutions to protect farmers' income from weather risks. In 1961 a formal agricultural insurance organization was created. This insurer originally only had the goal of covering climate risks, but it eventually became a mechanism to cover credit risks, hedging loans granted to farmers. This permitted the concealment of the actual losses of development banks, and it motivated moral hazard among farmers, and within a few years it became a political tool, a flagship of corruption in rural finance.

The process by which the government entered the market for rural credit drove out the private moneylenders and hindered the formation of a rural credit market by private institutions. It created a loyal constituency of small farmers for the Partido Revolucionario Institucional (PRI), the party that was the dominant political force, which could count on their support in both local and national elections. The PRI then went on to control Mexican politics from 1929 to 2000, when it finally lost both its control of the Presidency and Mexico's lower house of congress.

It is one thing to know the rough outlines of the story of Mexican rural credit, but it is quite another to know whether the system of government-run development banks was created for political or economic ends. Indeed, one can point to occasions when the government appeared to have political goals (as when it supported sugar cane growers in the state of Morelos during the 1960s) and when it appeared to have largely economic goals (as when it provided support to the livestock industry in Southern Mexico during that same period). At this point, we basically have a series of unconnected anecdotes; we do not yet know the central tendency of government policy.

My goal, in short, is to nail down the causal story. We know, for example that during the 1930's, President Lázaro Cardenas made the first major step in transforming the rural economy by making good on promises made during the Mexican Revolution to redistribute land to peasants. That land distribution also required the provision of financial instruments and the creation of institutions that would allow those lands to be exploited (Warman, 2001; Bennet, 1965; Anderson, 1963). Thus, the Mexican state became the banker to the peasants. One could therefore tell a causal story in which development banks emerged for economic reasons. Nevertheless, just prior to the land distributions of the 1930s, the government faced the threat of organized violence in rural areas—most particularly because small farmers tended to be deeply religious and there had been an open civil war between church and state in the late 1920s. One could therefore tell a causal story in which development banks emerged for political reasons.

Did the PRI open branches of development banks in order to lower the cost of rural credit in underserved areas, or because it was behaving strategically; opening branches in key electoral districts that might potentially swing to another party—or that might even blow up into armed insurrection (during the early years of the development banks, some regions of Mexico remained armed camps that were highly hostile to the government for both religious and secular reasons). In short, we have not yet sorted out the disparate information about the growth of development banking into a coherent narrative.

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