FONDATION POUR LES ÉTUDES ET RECHERCHES SUR LE DÉVELOPPEMENT INTERNATIONAL

Are public development banks counter-cyclical? A brief

Florian Léon

Florian Léon, Research Officer, FERDI. **florian.leon1@ferdi.fr**

The Covid crisis and its economic implications have underlined the importance of public action in times of recession. Both developed and developing countries are in urgent need of capital. In this context, public development banks are expected to take over from private banks to support economic activity. Although rarely explicit, supporting the economy in times of recession is one of the roles of public development banks. This note synthesizes current scientific knowledge on the contracyclicality of public development banks.

Paper prepared for the 14th AFD International Research Conference on development.

policy brief
212
October
2020
note brève

LA FERDI EST UNE FONDATION RECONNUE D'UTILITÉ PUBLIQUE.
ELLE MET EN ŒUVRE AVEC L'IDDRI L'INITIATIVE POUR LE DÉVELOPPEMENT ET LA GOUVERNANCE MONDIALE (IDGM).
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GÉRÉE PAR L'ANR AU TITRE DU PROGRAMME « INVESTISSEMENTS D'AVENIR » PORTANT LA RÉFÉRENCE « ANR-10-LABX-14-01 »

What the academic works say

Unlike private banks, whose activity is normally pro-cyclical, public development banks have a counter-cyclical or a-cyclical action. In periods of growth, private banks easily grant credit, but the flow is restricted during a downturn. On the contrary, public banks maintain or even increase their lending during an economic downturn. Several academic studies have empirically given support to this idea (Micco and Panizza, 2006; Brei and Schclarek, 2013; Cull and Martinez-Peria, 2013; Bertay et al., 2015[1]). The counter-cyclical effect is particularly important for business credit. Using a large set of firm data to estimate the probability of obtaining credit from a public bank, Wagner (2020) shows that this probability increases significantly when economic conditions deteriorate.

Several explanations for this behavior of public banks in the face of the economic situation have been put forward:

Firstly, public banks have a mandate (implicit or explicit) to stabilize economic activity (Micco and Panizza, 2006; Brei and Schclarek, 2015). Public banks are guided less by the search for short-term profitability than by a long-term vision. As such, they will consciously increase their credit lines in times of recession even if this implies taking greater risk.

Secondly, public banks are a tool at the service of political leaders (Shleifer and Vishny, 1994). As such, political motives (e.g. re-election, clientelism) influence the activity of public banks. The granting of credit by public banks is therefore more linked to the electoral calendar (increase in loans during the electoral period) than to economic cycles (Dinç, 2005). In addition, the allocation of funds is more driven by political objectives than economic ones (Sapienza, 2004), which may explain the lack of a link between the operations of public banks and the economic situation rather than contra-cyclicality.

Thirdly, the public bank model is more conducive to maintaining their activities in times of crisis, thanks to the stability of their resources. Public banks rely primarily on their own resources or on debt raised on the financial markets (de Luna-Martinez and Vicente, 2012). In addition, they usually benefit from a state guarantee, which reassures their creditors and depositors (Brei and Schclarek, 2015). So, public banks are less prone to bank runs and can even continue to raise funds in times of crisis.

Finally, the loan portfolio of public banks is an additional source of stability. Their loans are primarily oriented towards long-term corporate loans (de Luna-Martinez and Vicente, 2012). The long-term relationship with their clients (long maturity) encourages public banks to maintain their support during a downturn. Moreover, while household demand for credit tends to shrink in times of crisis (fall in housing loans), firms most often need access to additional funds in difficult times when other sources of financing (especially commercial loans) dry up.

There is a lack of evidence that one argument fully explains the counter-cyclical behavior of public banks. Neither the political argument, nor the stability of resources argument, is sufficient to explain the difference in behavior between public and private banks (Micco and Panizza, 2006; Brei and Schclarek, 2013; Iannotta et al., 2013; Bertay et al., 2015). Thus, the mandate (to stabilize activity) could be a central explanation. Nevertheless, little work has actually tested this hypothesis. Behr et al (2017) are interested in banks with a public mandate (but not necessarily public ownership). They show that banks with a public mandate are less pro-cyclical than banks without a public mandate in Germany. Brei and Schclarek (2018) study the differences between «commercial» public banks and public development banks. Public development banks have an explicit developmental mandate. In the case of Latin America, they show that the two types of public banks act counter-cyclically without

1. Empirical articles have largely focused on the ownership rather than on mandate, due to the lack of data.

revealing any real difference between the two types of public banks. It is likely that the countercyclicality of public banks is not due to a single reason but rather to a combination of factors (notably mandate and stability of resources).

To better understand the contra-cyclicality of public development banks

If these academic works have interesting findings, it is useful to question the conditions that facilitate, or impede, countercyclicality. Contracyclicality seems to be conditional on the environment in which public development banks operate. Indeed, while this environment is strong for South American public banks, the evidence on Europe is not clear-cut (Cull and Martinez-Peria, 2013; Iannotta et al., 2013). Moreover, there is little work on other continents (Africa and Asia). Yet the institutional environment in which public banks operate plays an important role. The contracyclicality of public banks exists only in countries with good institutions (Betray et al., 2015). In weakly democratic countries, it would appear that public development banks are more politically driven (Frigerio and Vandone, 2020). Consequently, there is no guarantee that the presence of public development banks in countries with weak public governance is beneficial in mitigating the effects of shocks.

Empirical studies have largely ignored banks with an international mandate. This concentration on banks with a national mandate is probably due to technical reasons[2]. However, international public bank actors are far from negligible. According to AFD data, there are 100 public development banks with an international mandate (out of a little over 400 public development banks). These internationally mandated banks include multilateral and regional banks as well as banks from one country but which operate in other countries (most often poor countries). The weight of these actors can be relatively important in countries with a low financial development. However, there is no guarantee that these internationally oriented banks will behave in a similar way to national banks. If national (public) banks are prepared to bear a short-term cost, it is in their long-term interest to support their economy. Foreign banks – private but also public – may, however, be tempted to redirect their actions to safer countries in the event of a shock to a country. Foreign (private) banks tend to be more pro-cyclical than local banks (Fungacova et al, 2013; De Haas and van Lelyveld, 2014; Bertay et al, 2015). This withdrawal behavior is perfectly rational as other lenders also reduce their exposure. Some case studies of regional or multilateral banks during the 2008-09 financial crisis show that international banks take into consideration the economic situation of the target country, even if political motivations are not neglected (Griffith-Jones et al, 2011; Presbitero and Zazzaro, 2012). Nevertheless, a more in-depth analysis of public banks with an international mandate would be welcome to identify whether their strong presence in (poor) countries is a factor of economic stabilization. In particular, it is likely that the behavior of "internationally mandated" banks differs depending on whether the crisis is global (as in the case of the 2008-09 financial crisis, or Covid) or local. In the local case, it is possible for a bank to turn to unaffected countries, while in the global case all countries are affected.

Finally, academic papers often compare the behavior of banks before and during a crisis; but they rarely include the post-crisis period. However, a comprehensive analysis of cyclicality should also examine whether there may be possible adverse long-term effects. Indeed,

2. Empirical tests assess the sensitivity of the bank's loans to the country's economic activity. It is easy to identify the reference economic situation for a national bank since it is the country in which the bank operates. For banks with an international mandate, however, the analysis is more complex apart from systemic shocks (financial crisis, Covid). The analysis of contracyclicality must be based on the economic situation of borrowers; but banks with international mandates usually operate in several countries.

the performance and quality of the portfolio of public banks may deteriorate during the crisis, affecting banks' ability to intervene thereafter. In addition, short-term economic support may run counter to the long-term social and environmental objectives of development banks. From a macroeconomic point of view, public bank support in times of crisis can allow unviable companies to remain in the market («zombie firms») and slow down economic recovery. A comprehensive analysis of the behavior of public banks over the cycle would provide a better understanding of how their cyclical actions affect the long-term orientation of these banks and the economy as a whole. The effects may be conditional on the institutional framework and the independence of public development banks from political power if the allocation of loans is driven by extra-economic imperatives in times of crisis (Chen et al, 2016). Finally, an analysis of the characteristics of the clientele of public banks is also necessary to better understand the effectiveness of their action (Wagner, 2020). Such an approach makes it possible to better identify the firms to which public banks' support is directed in times of crisis.

Conclusion

The academic literature has highlighted the importance of public development banks in times of crisis. Nevertheless, the contracyclicality of public banks does not seem to be automatic and is shaped by the institutional framework in which the public bank operates. Until now, research has been confined to a few geographical areas (Latin America, Europe) and does not allow us to make conclusions about the existence of counter-cyclical action by public banks in other environments (Africa, Asia). Nevertheless, some studies suggest that contracyclicality exists on a broader geographical basis (Wagner, 2020). Finally, several questions deserve attention, for instance the counter-cyclical role of public banks with an international mandate, and the long-term effects of this counter-cyclicality (post-crisis effects).

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Contact
www.ferdi.fr
contact@ferdi.fr
+33 (0)4 73 17 75 30

n° ISSN : 2275-5055

policy brief
212
October
2020
note brève