

# PUBLIC BANKS AND COVID-19

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COMBATTING THE PANDEMIC  
WITH PUBLIC FINANCE



Edited by  
David A. McDonald  
Thomas Marois  
Diana Barrowclough

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An accompanying interactive website with additional public bank profiles can be found at **PublicBanksCovid19.org**.



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The **Municipal Services Project (MSP)** is a global research network that explores alternatives to the privatization and commercialization of service provision with a focus on analyzing successful public service delivery models in an effort to understand the conditions required for their sustainability and reproducibility. Learn more at [www.municipalservicesproject.org](http://www.municipalservicesproject.org).

The **United Nations Conference on Trade and Development (UNCTAD)** was established in 1964 as a permanent intergovernmental body of the United Nations. It is the focal point in the United Nations Secretariat for the integrated treatment of trade, investment, finance and development issues. Learn more at [www.unctad.org](http://www.unctad.org).

**Eurodad** – the European Network on Debt and Development – is a network of 49 civil society organizations from 20 European countries. It works for transformative yet specific changes to global and European policies, institutions, rules and structures to ensure a democratically controlled, environmentally sustainable financial and economic system that works to eradicate poverty and ensure human rights for all. Learn more at [www.eurodad.org](http://www.eurodad.org).

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# Public Bank Associations

The **Association of African Development Finance Institutions (AADFI)** represents more than 60 public financial institutions with the objective of promoting economic and social development in Africa throughout cooperation among banks and financial institutions.

The **Association of Development Financing Institutions in Asia and the Pacific (ADFIAP)** is the focal point of all development banks and other financial institutions engaged in the financing of development in the Asia-Pacific region. Its mission is to advance sustainable development through its members. Founded in 1976, ADFIAP currently has 87 member institutions in 36 countries.

The **Latin American Association of Development Financing Institutions (ALIDE)** is the international organization that represents Latin American and Caribbean development banking. It was created in 1968 and represents 42 public banks in 22 countries in the region, with permanent headquarters in Lima, Peru.

The **European Association of Public Banks (EAPB)** is the voice of the European public banking sector, representing over 90 financial institutions. EAPB members are national and regional promotional banks, municipality funding agencies and public commercial banks across Europe.



## Chapter 1

Diana Barrowclough  
Thomas Marois  
David A. McDonald

# INTRODUCTION: PUBLIC BANKS MATTER AT A TIME OF COVID-19

**C**ovid-19 has had a devastating impact on lives and livelihoods around the world. Lockdowns and public health measures have decimated the economies of most countries, leading to dramatic state interventions to stem the fallout. Governments have been on the frontline of this economic defence, as have public banks. Nobody expected the private sector to take the lead. Corporate shareholders took no proactive stance towards bailing out struggling businesses, households or governments. Rather, governments and public banks have charted the path to recovery. There are good reasons for this, and the future of stable, sustainable and equitable societies will depend on building on the lessons now being learned.

This book focuses on the role that public banks have played in managing the economic crises of Covid-19 to date. Researched and written between May and October of 2020, it is a ‘rapid response’ effort to document and critically reflect upon public bank actions and policies in the initial stages of Covid-19 in different parts of the world. Working with researchers on every continent,

the book is the most ambitious effort to date to explore and document the ways in which public banks have responded to Covid-19. It sheds light on public bank policies and actions and assesses the challenges they face. We make a preliminary assessment of their effectiveness in achieving their goals and stemming the economic impacts of the pandemic.

This has been no easy task, as the ground was constantly shifting: programmes announced were not always put in place directly; some seemingly “new” programmes were really just being fast-forwarded; bold new policies were surpassed just weeks later by even bolder ones, and so on. Nevertheless, the chapters provide a useful snapshot of a tumultuous time. Based on desktop analysis of bank media statements and reports, financial databases and government news releases, as well as interviews with leading bank personnel (carried out virtually), the book provides a unique perspective of what some are calling the most damaging global crisis in more than a century. The lessons learned from these contributions should contribute to a better understanding – both theoretical and empirical – of how public banks can be better supported for the future and how they can help to ensure that this pandemic does not lead to another “lost decade” (UNCTAD 2020).

Two other contextual factors are important to help gain an understanding of the contributions of these chapters. The first is that Covid-19 did not strike upon a world economy that was otherwise stable and in good shape. On the contrary, many have long been worried that the last few decades of excessive de-regulation, hyper-financialization, privatization and globalization had left the world economy in an unbalanced, inequitable and precarious state. Covid-19 served to pull back the curtains and shine a light on this fragility, but it did not create it. Second, the coronavirus is widely believed to be related to global warming and climate change, as it was caused by a zoonotic transmission that emerged in the intensifying clash between humans and our environment. Further human-made disasters can therefore be expected, all of which must

be addressed through just processes and with more equitable outcomes. This future makes it all the more important to learn the lessons from the experiences of Covid-19.

Our introductory chapter begins by tracing the path of coronavirus and its concomitant economic impacts, highlighting the liquidity blockages and fractures created in the flow of money that necessitated such a rapid and special response from public banks. Next, it draws on our contributors' findings to highlight five promising lessons of how public banks responded to the Covid-19 emergency. It then turns to the underlying question of '*why public banks*', exploring what is important and distinct about them. We conclude by considering the potential of public banks to 'build forward better for people and the planet' and how to deal with the coming backlash against rising public debt and a premature return to an obsession with austerity.

## FROM HEALTH CRISIS TO A FINANCIAL AND ECONOMIC CRISIS

When Covid-19 struck, for most governments the only response was either 'gradual stop' or 'sudden stop' through policies of social distancing and eventual lockdown. If economies can be thought of as supertankers – charting a course across oceans involving millions of moving parts and requiring time, distance and technical expertise to change course – it was as if these massive boats had hit an iceberg. Within days of turning off the engines, consumer demand and supply dried up simultaneously, even in countries that did not lock down their economies. This sparked record flows of capital in and out of equities and foreign exchange markets and interrupted productive processes and employment everywhere (Aum et al. 2020; Anderson et al. 2020; Correia et al. 2020). No country was spared the economic effect of the contagion, even if they had no confirmed cases of the virus (such as in the Pacific islands).

Ideally, in such times, governments lead the way with respons-

es that are rapid, bold, generous and crisis-facing. Political will is essential, as is the fiscal space or economic capacity to finance the blockages in the flow of finance, to fund increased health sector bills and unemployment benefits, and to underwrite the firms, households, public services, local authorities and even banks that are reeling as the flow of money is interrupted. What individual countries did varied according to their fiscal resources and the contexts of their unique political economies. Even as late into the crisis as October 2020, when this chapter was finalized, it is notable that the poorest countries of the world were struggling as they had less capacity to face Covid-19 than their wealthy counterparts. While rich countries could devote tens of billions of dollars (equalling as much as 50% of Gross Domestic Product – GDP) on their fiscal and monetary packages, many poor countries could spend amounts worth only a few per cent of GDP. By August 2020, Japan had spent as much as 52.6% of its GDP on a variety of fiscal and monetary packages; Germany had spent 38.5%, Canada 30% and the United States 27.5%, while even the large and higher income developing countries had spent only a fraction of this (UNCTAD 2020).

Some country differences in the financial scale and type of response also reflect the extent to which societies would comply with the measures of social distancing and lockdown; but even in those countries where compliance was highest, additional finances still needed to be directed to the Covid-19 effort (for example, China spent almost 18% of GDP on a variety of fiscal and monetary policies alongside high levels of social compliance). While the international financial institutions such as the International Monetary Fund (IMF) and the World Bank augmented their resources and scaled up their capacities to help, many have criticized their responses for being too little, too conditional and unevenly distributed (Kentikelenis 2020).

These international financial institutions (IFIs) are not the focus of this volume, however. Instead, the book highlights the role of national and regional public banks, which are too often overlooked and under-studied despite their extremely significant roles in de-

velopment, in supporting government policies, and in providing public financial capacity. Here we focus on how they functioned to ‘keep the ship afloat’ amidst a global pandemic wave, and what lessons we need to draw from this as we think forward.

## FIVE PROMISING LESSONS OF PUBLIC BANKS FACING COVID-19

The contributions to this book make one thing clear: Public banks have not stood idle in response to the economic and social damage wrought by the onset of the Covid-19 pandemic. Rather, public banks have emerged as dynamic financial institutions capable of responding to the needs of their societies. Five overarching and promising lessons stand out: public banks have the potential to **respond rapidly**; to fulfill their **public purpose mandates**; to **act boldly**; to **mobilize their existing institutional capacity**; and to build on **‘public-public’ solidarity**. In short, public banks are helping us navigate the tidal wave of Covid-19 at the same time as private lenders are turning away.

These promising lessons are drawn from the case studies in this volume, but this is not to say that every public bank responded in the same way or to the same extent. For some, it is more about the *potential* of positive actions than actual *practice*. Nonetheless, the lessons remain real, and are visible across a diverse public bank landscape.

**Rapid responses:** In bank after bank, country after country, one thing stands out: public banks responded rapidly to the onset of the Covid-19 pandemic and to the sudden stop in economic activity. The significance of this must not be under-emphasized. Because public banks are within the public sphere, they can work with public authorities at times of crisis and react quickly as a matter of policy.

**Public purpose mandates:** Where the mandates of public banks reflect a clear public purpose, these banks were able to fulfill their mandates in responding to the Covid-19 crisis. The most promising cases are where their mandate is unambiguously supported by the



political authorities. Where political authority support was ambiguous, fractured or even hostile to public banks, the responses have been much less effective.

**Bold, generous and crisis-facing action:** In many cases, public banks have responded to the challenge of Covid-19 with bold and generous actions that faced the crisis head-on. Central banks have pumped hundreds of billions of dollars into the economy to provide financial liquidity, relax financial regulations and support national financial responses. Public banks have crafted unprecedented responses to allow micro-, small- and medium-sized enterprises (MSMEs), large businesses, public entities, governing authorities and households time to breathe, time to adjust and time to overcome the worst of the crisis. Typically, this meant offering liquidity with generously reduced rates of interest, preferential repayment terms and eased conditions of repayment. For the most vulnerable in society, public banks offered non-repayable grants.

**Existing institutional capacity and historical legacies:** Public banks took advantage of having built-up expertise, capacity to coordinate with others and existing lines of communication and decision-making systems. In many cases, these capacities fit within a long historical legacy of the public bank working with and in society in vital and credible ways. These historical legacies cannot be created suddenly at times of crisis. Where they already exist, it has tended to be advantageous to Covid-19 responses, placing governments in a stronger position. This is most evident in public banks with clear and accountable public mandates.

**Public-public solidarity:** Be they in the global north or south, public bank responses to the Covid-19 pandemic demonstrated the advantages of non-competitive public-public solidarity among public financial institutions (PFIs) – between public banks and other public entities and governing authorities. Public-public solidarity can be guided by political direction and it can occur as a result of already existing institutional linkages and collaborative public sphere legacies. While we see notable central bank and public bank coop-

eration in most cases, there is evidence of public solidarity extending to the responses of sovereign wealth funds and public pension funds, as well as among national public banks and between public banks in different countries.

Finally, we have witnessed a broad range of tools and instruments that public banks have used to carry out their roles, depending on their mandated function, their position within the overall financial system, the level of political support and the depth of their pockets. Table 1.1 provides a rough summary of what is possible in the face of Covid-19.

**Table 1.1: *Public bank functions and actions in response to Covid-19***

| <b>General functions</b>  | <b>Specific actions taken</b>   |
|---------------------------|---|
| <i>Liquidity</i>          | <ul style="list-style-type: none"> <li>• Public banks, notably central and multilateral banks, have created new flows of finance to channel them into cash-strapped households, economic sectors and governments</li> </ul>   |
| <i>Lending</i>            | <ul style="list-style-type: none"> <li>• Increased lending to public and private clients, as well as to national and sub-national governments</li> <li>• Emergency lending programmes</li> <li>• Reduced and concessional interest rates</li> <li>• Increased or unlimited credit ceilings</li> <li>• Fast processing</li> <li>• Broader client base</li> <li>• Repayment holidays and deferrals</li> </ul> |
| <i>Grants</i>             | <ul style="list-style-type: none"> <li>• Non-repayable financial resources provided to poorer countries, communities and public service providers</li> </ul>  |
| <i>Loan guarantees</i>    | <ul style="list-style-type: none"> <li>• Governments backing public bank lending</li> <li>• Public banks backing further on-lending by other public and private banks</li> </ul>  |
| <i>Regulatory support</i> | <ul style="list-style-type: none"> <li>• Central banks and governments re-regulating financial rules to support increased lending and to support public and private banks' balance sheets</li> </ul>  |

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| <i>Debt relief and aid provisioning</i>  | <ul style="list-style-type: none"> <li>• Deferred payments on loans</li> <li>• Debt forgiveness</li> <li>• Grants</li> <li>• International development programme support</li> </ul>  |
| <i>Advisory services</i>   | <ul style="list-style-type: none"> <li>• Information and advice to clients about the crisis</li> <li>• Assistance with the development of government policy</li> <li>• Provision of technical expertise for debt restructuring</li> <li>• Provision of sector-specific technical expertise (e.g. health, water, MSMEs)</li> </ul>  |
| <i>Social and equity-oriented services</i>                                     | <ul style="list-style-type: none"> <li>• Provision of income support and transfer payments</li> <li>• Emergency personal loans</li> <li>• Easing of eligibility criteria</li> <li>• Concessionary loans and grants</li> <li>• Support and subsidies for essential services</li> </ul>  |
| <i>Retail banking services</i>   | <ul style="list-style-type: none"> <li>• Enhanced online services and digitalization services</li> <li>• Reduced service fees</li> <li>• Mortgage and personal loan holidays and deferred payment options</li> <li>• Dissemination and application of public health and safety protocols</li> <li>• Enhanced financial and technical support for customers</li> </ul>  |
| <i>Collaboration with other public banks and public financial institutions</i> | <ul style="list-style-type: none"> <li>• Syndicated and solidarity public-public financing</li> <li>• Loan guarantees and on-lending support programmes</li> <li>• Bond purchases by public financial institutions</li> <li>• Mandated sharing of capital resources and deposits among public banks</li> <li>• Cross-subsidies to cover concessional services</li> <li>• Coordinated sharing of information, best practices and programme lending</li> </ul> |
| <i>Collaboration with private banks</i>  | <ul style="list-style-type: none"> <li>• Syndicated financing</li> <li>• Loan guarantees and on-lending support programmes</li> </ul>  |
| <i>Supporting government ministries</i>  | <ul style="list-style-type: none"> <li>• Enacting support and financial aid programmes announced by governments</li> <li>• Provision of technical expertise</li> <li>• Offering emergency response coordination assistance nationally and internationally</li> </ul>   |

Source: Compiled by authors.

## WHY BANKS?

The promising lessons and specific actions undertaken by public banks in response to the Covid-19 pandemic underscore the importance of banks in general. This is because banks are themselves unique financial institutions that specialize in creating money, as well as managing it. Banks have acquired the political right to create and circulate new money as credit within the economy and in society. This is an incredibly powerful function – by managing money to make credit, banks can create money itself, and they can create money through credits well in excess of the actual money held in their reserves (McLeay et al. 2014; Pettifor 2016).

In other words, banks are financial intermediaries that can magnify existing money resources (Spratt 2009). This is a function that governments cannot perform. Governments must acquire money resources before spending them. This can be done via taxation, receipts from public enterprises or from money raised in borrowing from others. But this is at a ratio of 1:1. The money governments raise (from taxes, enterprises and borrowing) equates to the money they spend. Banks, on the other hand, can magnify money resources three- to thirty-fold via ‘fractional reserve’ banking where institutions need only hold onto a portion of the money lent out.

## WHY PUBLIC BANKS?

Because banks can magnify existing money resources, they have become one of the most important institutions in society. It is also one of the historical reasons why governments founded *public* banks and why public banks persist as credible financial institutions. A public bank is a bank that can be understood as located in the ‘public sphere’. This can happen in different ways. A bank can be *owned* publicly – that is, by a government, public authority or

public enterprise; or it can be *controlled* publicly – that is, governed according to a legally binding public interest mandate, or according to public law, or by meaningful public representation on the governing board, or by some combination of these governance factors. Either or both situate a bank within the public sphere and as a *public* financial institution (Schmit et al. 2011; OMFIF 2017).

### **Can public banks function differently from private banks?**

Being located within the public sphere opens up the *potential* for public banks to function differently from private banks. Private corporate banks are directly exposed to competitive market imperatives and to the short-term profit-maximizing horizons of shareholders. Public banks need not follow these imperatives. The public sphere can shield public banks from ‘the market’. They are not *necessarily* shielded – some public banks compete with private banks and governments mandate them to be profit-maximizing – but they can be as a matter of political will, and they can have a mandate that is complementary to, rather than competitive with, private banks. Consequently, public banks can offer loans, credits and grants in ways that are otherwise impossible for private, profit-seeking banks. In turn, public banks can and do operate according to a much wider variety of logics than private ones. Contributions to this book from the regional public bank associations are evidence of this, as are the ‘social’ mandates of the Council of Europe Development Bank (CEB) and the small- and medium-sized enterprise (SME)-focus of public banks in Argentina, China, Italy and others described in this volume. Yet other banks focus on supporting local governmental institutions as well as business.

### **How are public banks made accountable?**

Public banks can also function differently because they can be democratically governed. That is, control over the bank need not be limited to shareholders alone but can extend to include societal representatives, as is done in the German development

bank, KfW. In turn, decision-making can be rendered transparent and accountable via publicly accessible debate and available documentation. There is no causal link, however. Just as public banks can be made democratic, so too can they be made less-than representative, undemocratic or even authoritarian. In this respect, Covid-19 has also exposed less than ideal public banking and governing authority practices, notably in the cases of Turkey and India, where a long history of public banking has been turned in a different direction by government, as well as in Mexico. This strength or weakness of public bank governance ultimately depends on social forces in time- and place-bound historical contexts. What public banks do and how they evolve are the results of recurrent power struggles among and between contending public and private interests within capitalism (Marois and Gungen 2016). In fact, far from being *meant* to finance market development or being *destined* to fall victim to political corruption, public banks are much more ‘dynamic’ and indeterminate institutions whose functions are shaped and reshaped by class-divided social forces in the shadow of contemporary financialized capitalism (Marois forthcoming).

### **Aren't public banks minor players?**

Public banks continue to comprise a large and diverse part of the global financial sector to a degree that often surprises people. As of mid-2020, there were 910 public development, commercial/retail and universal banks worldwide with nearly US\$49 trillion in combined assets (McDonald et al. 2020). As we see in China, there are many massive ‘commercial’ public banks tasked with responding to Covid-19. Likewise, with Argentina’s Banco de la Nación. In Brazil, too, there is a widespread public banking sector that includes all types of public banks: commercial, universal and development.

Recent research indicates that, if we include public central banks and multilateral banks, then institutional numbers reach 1,160 and combined assets exceed US\$66 trillion. Going one step further

to include public pension and investment funds, there are some 1,651 public financial institutions commanding just under US\$82 trillion in public financial assets (Marois forthcoming). Other estimates similarly show that public banks are much more significant in number and scale than previously recognized (Xu et al. 2019).

This underscores the enormous *existing* capacity of financial institutions within the public sphere. But it also exposes the paucity of existing research and debate. Some World Bank and United Nations documents have systematically underestimated global public banking capacity at somewhere between US\$2 and \$5 trillion in assets (see de Luna-Martínez and Vicente 2012; UN IATF 2019, 143). Other researchers prefer only to focus on public *development* banks, with estimated institutional numbers in the range of 400 to 500 globally, with combined assets of just over US\$11 trillion (Xu et al. 2019; FiC 2020).

It is worth emphasizing, too, that the Covid-19 crisis has led to a general increase in public banking activity and assets held. For some contributors to this book, this crisis moment is an opportunity to create new public banking institutions and local alternatives focused on supporting community development and more equitable economic opportunities (both in the global north, particularly in the USA, and in the global south).

### **What's the difference between types of public banks?**

Public banks come in many different institutional types. In this book we mostly focus on development, commercial/retail and universal types of public banks, but we also include central banks and multilateral/regional banks. While they are all public financial institutions, there are some distinguishing features and functions. *Central banks* are positioned at the zenith of national financial systems and are unique for issuing currency, holding national reserves, setting base interest rates, having regulatory and supervisory control over other domestic banks, and for acting as a lender of last resort to other banks. The chapter on central banks in this volume details the

extent to which Covid-19 has contributed to a sea-change in their actions, with operations, if not mandates, becoming much more directly supportive of government policy needs.

*Multilateral* banks are owned by a group of countries to raise capital, lend capital, plan investments, provide expertise for members, and, sometimes, play a lender-of-last resort role at times of crisis. In addition to the Council of Europe Development Bank, this volume also describes the different experiences and orientations of Covid-19 interventions of the European Investment Bank (EIB), Inter-American Development Bank (IADB) and the Commonwealth Development Corporation.

Central and multilateral public banks often work closely with national and sub-national level development, commercial/retail and universal public banks. *Development* banks, also known as investment, promotional, policy, or as second tier banks, tend to focus on providing long-term, 'patient' finance for economic and social development purposes and will have considerable specialized knowledge on sectors like infrastructure, rural development, MS-MEs, corporate finance, exports, public services and so on. These banks will often 'on-lend' to other commercial/retail and local development banks as well as directly to governments, large industry and non-profit organizations.

Commercial banks, also known as retail or first tier banks, accept short-term deposits from individuals, households, small businesses, corporations and public sector agencies for use as loanable capital. These banks provide retail financial services, from savings to insurance, chequing to investments, mortgages to car loans, and do so via sometimes quite local and sometimes quite extensive national and international branch networks. Other types of public banks that provide similar retail services include savings banks and postal banks. Finally, universal banks take what both development and commercial banks do and combine them into a single institution to offer retail and development/investment services.



### **Where do public banks get capital to make loans?**

Different sources of capital, as well as size, shape what public banks can do. Most public banks are usually ‘capitalized’ by governing authorities, which provide the bank’s initial paid-in equity and ‘callable’ capital (the latter being a government’s promise to pay if and when the bank calls for additional capital). To grow and expand operations, public banks must access new and recurrent sources of capital. Some public commercial and universal banks do this by accepting savings and deposits from society at large (as in Turkey, Argentina, Brazil and China). Public development and multilateral banks will often raise new capital by issuing bonds in domestic and international bond markets (as in Germany and with the EIB, IADB and CEB). For all types of public banks, governments can directly inject new capital to boost lending capacity. Often, government contributions are made to support mandated lending to MSMEs, farmers, green transitions and so on. Financial regulations may require state, municipal and local authorities to make financial contributions or to deposit their receipts with public banks, both of which boost lending capacity (keeping in mind for every dollar deposited banks can lend multiples more).

Like all banks, public banks borrow from other banks – public and private, domestically and internationally, including from the central bank – to meet their financial commitments. Other public financial institutions like sovereign wealth funds, insurance providers and pension funds will also channel money capital into public banks, potentially constituting a form of public-public financial solidarity (Barrowclough and Gottschalk 2018). There is strong evidence of public sphere collaboration in response to the Covid-19 pandemic, with pension funds and central banks supporting development banks, and development banks in turn supporting public commercial banks, health authorities, municipalities and so on (Marois forthcoming).

### **Are public banks naturally better at responding to crises like Covid-19?**

Public banks are *not* naturally better or worse at responding to crises than private banks. However, because they exist within the public sphere, public banks do not *need* to function according to market-based and profit-maximizing imperatives. This opens up a world of possibilities. As a consequence, many public banks operate very differently from private ones. As noted above, this has contributed to rapid and directed interventions at times of crisis, such as with Covid-19. The ability of banks to create credit means that money can be invested before it has been saved (McLeay et al. 2014). Another way of looking at it is that banks, be they public or private, can make money available *now* to be repaid in the *future*, thus commanding “a power to make available time” (Konings 2018, 79). But only through the public sphere can banks command time and money in the public interest in ways that can be transparent and accountable. The Eurodad contribution to this book reinforces this message and challenges us to rethink and reclaim public banks for a sustainable and socially equitable future beyond Covid-19.

## **BUILD FORWARD BETTER FOR PEOPLE AND PLANET**

Public banks of all types are actively engaged in the question of how to build back better, even if the crisis of Covid-19 has meant many are concentrating on immediate recovery. Central banks have been behaving in ways that would have been unthinkable in recent decades, harking back to their former role when they were an essential partner in support of national development goals. Even those that are evolving the least are nonetheless revising their financial models and regulatory approaches to include health and environmental stress-testing and risk disclosure. Sustainability criteria for public banking has passed from niche debate to increasingly mainstream action across the globe, in low-income countries just as much as in

wealthy ones (UNCTAD 2019; Barrowclough 2020).

This is happening across the spectrum of financial institutions: just as central banks are showing renewed interest in their financial capacity to create and guide flows of money towards greener activities and away from fossil fuels, so too are other public banks and funds. National and sub-national public development, retail/commercial and universal banks are, in many cases, already advanced towards greener and more just transitions. Over the last 10 to 15 years, public banks have integrated green mandates and are acting to fund explicit decarbonization activities and environmental sustainability (Marois forthcoming). The United Nations' Sustainable Development Goals (SDGs) have provided a global narrative and orientation for these lending activities and many public banks are actively reappraising their mandates and work programmes to better align with them (for example, the Islamic Development Bank insists the SDGs should guide both their lending programmes and technical assistance to member countries).

There is a risk, however, that the more market-oriented and neo-liberal orientations of the IFIs and some multilateral development banks (notably the World Bank) could undermine the policy space and credibility of national and sub-national public banks to effect pro-public and socially-equitable alternative transformation. Also, as public institutions have necessarily taken on increased debt to combat Covid-19, there is the threat of an austerity backlash, with critics dusting off their timeless criticisms of what they argue to be the inherent inefficiencies of public banks (La Porta et al. 2002; Barth et al. 2006; Cull et al 2017). They will likely raise the spectre of the politicization of public banks, arguing that public banks follow political mandates (ignoring that this constitutes a foundation of effectiveness in cases like Germany's KfW). All this will be resurrected not to suggest ways to make public banking better, or for them to more effectively catalyze a green and just transition, but rather as a bludgeon to force through bank privatizations that will further concentrate financial capacity in the private sector.

To argue that public banks should lead efforts to build forward better for people and the planet is not, however, to naively suggest that a bank is necessarily better by virtue of being publicly owned. There is no innate purpose or essential policy orientation that is common to all public banks. This is because public banks are contested and pulled between contending public and private interests. They are also just one element within the landscape of all financial institutions, which is nested within a global environment that is created by national and international economic and political forces.

To ensure a pro-public orientation of public banks, many things and social forces need to be aligned – or at the least not actively *misaligned* (Eurodad 2017). If public banks are to make a significant contribution to the post-Covid world, they can be most effective when they are part of a pro-public and socially just development articulation, with democratic central banks at the apex, supported by a diverse mixture of financial institutions with differentiated and distinctive roles. This in turn needs to be positively integrated with broader government policies and national development goals that are subject to substantive democratic structures.

To support public banks in the wake of Covid-19, three broad organizing strategies are needed within banks themselves and in the wider political economic landscape in which they exist. They include definancialization, decarbonization and democratization (Marois forthcoming; UNCTAD 2019,143-177). We outline each of these in turn.

First, public banks offer a potential path towards **definancialization**; that is, a path away from the short-term, speculative and often predatory practices of the hyper-financialized hyper-globalized world that emerged from the 1980s, as financial markets were liberalized and cross-border capital flows were completely unregulated. The global financial crisis revealed the waste and damage that excessively financialized markets can generate, and many countries established new public banks and funds or strengthened existing

ones in recognition that private banking had failed to do enough for development.

Ideally, the entire financial system would be re-regulated so as to be less highly concentrated, more competitive and less vulnerable to banks that are ‘too big to fail’, but even without this public banks can be a bastion for change. They can be shielded by the public sphere so they need not operate only in narrowly financial terms and can do more to provide catalytic and ‘patient finance’ that provides long-term public benefits in the public interest (UNCTAD 2019; Macfarlane and Mazzucato 2018). Instead of short-term profit-maximization, solidarity-driven public banks can help each other to coordinate lending to reduce the cost of borrowing and generate cost savings for governing authorities (ALIDE 2018). Through the use of a fractional reserve system, public banks can also offer a powerful fiscal advantage to state authorities (von Mettenheim 2010). This can help to reduce dependencies on foreign, private, market-based finance and the monopoly control of private bankers over public policy (Scherrer 2017; Marshall and Rochon 2019).

Second, public banks offer a potential path towards **decarbonization**, the urgency of which has not diminished with the Covid-19 crisis. Widespread agreement around the failure of private banks to respond to the financing needs for mitigating global warming has made room for the potentially catalytic role of public banks to respond in new and innovative ways (Campiglio et al. 2017; Carney 2015; Scott et al. 2017; UNCTAD 2019). There is now a very long list of central banks, public banks and public financial institutions that have taken on board the need to restructure and reorient themselves in line with the decarbonization challenge (Dikau and Volz 2020; Mazzucato and Semieniuk 2017; FiC 2020; Marois forthcoming; UNCTAD 2019). Empirical evidence suggests that public investors are the main reason that renewable energy finance grew at all in the years following the global financial crisis (Mazzucato and Semieniuk, 2018).

Finally, public banks offer a potential path towards **democratization**; that is, for society to have a meaningful say over how financial resources are deployed (Epstein 2010; Block 2014). Democratization of bank governance and decision-making is a process that can, among other things, drive innovation alongside social inclusion and equity through internalizing the public interest and mobilizing towards identified societal priorities. The democratization of finance is a central and recurrent demand made by academics and community groups critical of financialized capitalism. At the same time, public banks cannot exist as an island of democratic governance within a broader sea that follows other, non-democratic principles and this is a challenge that needs to be addressed going forward if public banks are to be able to contribute effectively in the Covid-19 building forward better phase.

## FUTURE RESEARCH

This book is the first study of public bank responses to Covid-19 and raises as many questions as it answers, highlighting the need for further case study and empirical work. How effective have their policies been? Who benefitted and why? What can make their policies and actions more equitable and democratic?

Research will need to systematically identify where the money came from that enabled public banks to respond rapidly and at scale. Capital markets played a role, but it is not evident that they played a dominant role. Where else did monetary resources come from? What role did different private and public sources play? Importantly, did these different sources of finance differentially affect how public banks *could* respond to the Covid-19 crisis?

It is also not clear that Covid-19 financial responses have been able to underwrite a ‘green’ recovery. If not, why not? Moreover, what can be done to ensure future responses to crises deliver sustainable and just recoveries? Related to this, public services have

been on the Covid-19 pandemic frontlines, notably in the health, water, sanitation, transportation and education sectors. Have public bank emergency responses provided effective and appropriate support for these essential public services?

The Covid-19 crisis has also shone a light on otherwise hidden public bank coordination networks and collaborative practices. These public-public networks need to be better understood and expanded, with knowledge sharing and capacity support building being critical to a more sustainable global public banking network.

One of the biggest black holes in our understanding of public banks is around representative governance structures. There is an urgent need to examine and rethink public banks' accountability and transparency practices. As global ambitions mount over the future role of public banks funding green transitions, so too must our demands to democratize the processes of financing such structural change. At the same time, we need to come to grips with the coming economic and political implications of ramped up public bank Covid-19 lending. There is no avoiding future losses and a heavy strain of the balance sheets of public banks. This will have political ramifications. How can we prepare public banks for this as well as their government shareholders and affected communities, both in terms of dealing with the economic losses and the political fallout?

Finally, there is an opportunity to rethink public banks as dynamic and contested institutions. This means finding alternative means of pro-public assessment. It is unacceptable that private sector performance indicators (such as profitability as a proxy for efficiency) are grafted onto public banks that function according to very different operational mandates (for a parallel argument in the water sector see McDonald (2016)). Determining and implementing appropriate alternative criteria may well prove the difference between public banks functioning in the public or private interest.

## LAYOUT OF THE BOOK

When we initially reached out to potential contributors in April 2020, shortly after the declaration of a global pandemic, it was not clear who would be able to participate and what kind of information they would be able to collect. We provided authors with a standardized list of questions to investigate in their locale – including background information on the bank, a summary of the pandemic outbreak in the study location, key actions taken by the bank to respond to Covid-19 and their intended beneficiaries, the effectiveness of these bank actions, collaboration with other public service providers and public banks, and the impact of Covid-19 on longer-term operations. However, the constantly shifting nature of the crisis, combined with very different personal and geographical contexts of the researchers, made consistency across the chapters difficult.

But it is perhaps the eclectic nature of this book that is its greatest strength, illustrating both a universality of public bank experiences as well as their diverse realities. Collectively, they offer a set of insights that must be fully sampled to appreciate the overall flavour. In this respect we encourage readers to review a broad selection of chapters, from different locations and different perspectives. We have therefore intentionally placed the case studies in this book in random order to promote geographical and institutional exploration (with the exception of the chapters written by the public bank and development finance institution associations, which are clustered together).

Lastly, we want to remind readers that this is a ‘rapid response’ project, which means that the authors and the editors were working under very tight timelines to release the findings, as were the copyeditors and designers. We therefore ask our more diligent readers to forgive us any minor formatting, citation or typographical errors.



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## Chapter 2

María José Romero

# RECLAIMING PUBLIC DEVELOPMENT BANKS TO FINANCE A SUSTAINABLE AND EQUITABLE RECOVERY POST COVID-19

**P**ublic development banks (PDBs) are in a unique and powerful position to play a key role in the post Covid-19 recovery. Following efforts to frame policy responses to the Covid-19 pandemic under a ‘building back better’ approach, this paper aims to contribute to a debate that focuses on reclaiming public banking for the public good. It presents the challenges that most PDBs face, including the fact that their operations have been skewed toward private interests over and above the public interest.

This chapter also details the key features that PDBs, at different levels, need to possess to maximize development results for the most vulnerable members of society. This includes delivering on the climate crisis and contributing to the fight against inequalities, especially gender inequalities. As a whole, this chapter makes a strong case in support of pro-public and accountable institutions working at different levels in a complementary way.

## INTRODUCTION

The Covid-19 pandemic has the potential to seriously undermine developing countries' progress toward achieving the Sustainable Development Goals (SDGs) (United Nations 2020). The health, economic and social crises triggered by the Covid-19 pandemic have magnified pre-existing structural problems and vulnerabilities, exposing – and even intensifying – inequality at all levels and across all spheres (Furceri et al. 2020). All this comes on top of the ecological crisis that the world was already facing before the pandemic struck.

Developing countries are in urgent need of more and 'better' development finance. According to the World Bank, the additional financing needs for developing countries arising from the crisis will be exceptionally high and are likely to persist over the medium term (World Bank Group 2020). In March 2020, the United Nations Conference on Trade and Development (UNCTAD) called for a US\$2.5 trillion package for developing countries (UNCTAD 2020a), which followed a 2019 call for financing a Global Green New Deal (UNCTAD 2019).

With efforts to frame policy responses to the Covid-19 pandemic under a 'building back better' approach in mind, it is key to learn lessons from the problematic aspects of the prevailing development model, and to call for a rethink of the institutions that have played a dominant role in channelling development finance up to this point. It is imperative to reclaim public banking for the public good. The pandemic has shown the important role that the state plays when directing and guiding public policies and finance in the public interest. The 'right' type of finance needs to flow through the 'right' type of institutions. The private commercial financial sector alone is unlikely to provide the finance needed to help developing countries emerge from the current crisis, in a way that matches the challenge of inequalities and of financing

environmentally sustainable development.

In 2017, Eurodad and partners published the discussion paper *Public development banks: towards a better model* (Eurodad 2017). This proposes a framework to assess existing institutions, and the governments backing them, to get better at supporting development, becoming more accountable and learning from past mistakes. This current chapter builds on arguments put forward in the 2017 discussion paper and aims to further contribute to the debate on the types of institutions needed to finance a sustainable and equitable recovery in the context of Covid-19.

This chapter focuses on the mandate, policies, business model and governance that public development banks need to have in order to serve the public good in an accountable and transparent way. To start with, we describe what public development banks are and explain the challenges that they face, including the challenges posed by the Covid-19 pandemic. Then we argue why we need public development banks and make a strong case in favour of pro-public and accountable institutions working at different levels in a complementary way.

We also detail the key features that public development banks need to have to maximize development results for the most vulnerable people in society, including delivering on the climate crisis and contributing to the fight against inequalities, especially gender inequalities. If governments are serious about financing an equitable recovery after Covid-19, public development banks should be reclaimed to serve the public good.

## WHAT ARE PUBLIC DEVELOPMENT BANKS?

Public development banks (PDBs) are state-owned financial institutions that aim to deliver on public policy objectives to support economic development in a country or region. Although PDBs are concerned with financial returns, profit is not the



overall goal of their activities. This makes them different from private commercial banks and some other kinds of state-owned financial institutions, such as state-owned commercial banks or insurance companies.

PDBs are run at different levels, which can be grouped into three categories:

- **National:** including sub-national institutions such as local or municipal PDBs, and provincial or state-level PDBs.
- **Regional:** including both continent-wide PDBs, and those focusing on a sub-region.
- **Global:** including institutions with a world-wide scope of operations.

Regional and global PDBs, owned by a group of countries, are known as multilateral development banks (MDBs). Examples include the African Development Bank or the World Bank Group (WBG), among others. Meanwhile, governments' PDBs operating in developing countries are commonly known as development finance institutions (DFIs).<sup>1</sup> These institutions are typically organized in different associations – for instance, the Association of Bilateral European Development Finance Institutions (EDFI), or the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP). Examples include the German's DEG – a subsidiary of the German development bank KfW – or France's PROPARCO – a subsidiary of the AFD. DFIs are dedicated to supporting private sector companies, public enterprises and services as well as municipal, state and national governments.

Over the last decade, PDBs have seen a resurgence, particularly given the important role they have played in providing countercyclical financing when private capital is in short supply. Although much of the emphasis has been placed on the role of the existing MDBs, national development banks (NDBs) are relevant players in

<sup>1</sup> Other authors, such as Macfarlane (2018), prefer the term 'state investment bank' (SIBs) to differentiate from 'development finance institutions'. SIBs are active both in the developing and developed countries.

providing finance to sectors and regions that private financial institutions do not serve sufficiently. They were major players in the financial sector of many economies as they developed (for example, in Germany, India, Turkey and Brazil), and they continue to play an important role today, particularly in emerging countries.

A 2012 survey by the World Bank estimated that state-financed institutions accounted for “25% of total assets in banking systems around the world” (Luna-Martínez and Vicente 2012). More recent research by Marois (2019) indicates that, by 2017-18, national public banks plus multilateral banks numbered more than 700 institutions and controlled over US\$40 trillion in assets. The figures have continued to grow, with new NDBs recently created in both developed and developing countries (World Bank Group 2018). The Development Bank of Nigeria started its operations in 2017 and the FinDev in Canada in 2018. In Ghana, conversations are currently ongoing to set up the Development Bank Ghana with the support of global and European institutions (Business Ghana 2020). In India, similar discussions are focused on setting up an NDB to finance both social and economic infrastructure projects (Indian Express 2020).

At the regional level, new multilateral institutions have also been recently established. In 2016, two new Southern-led institutions started their operations: the BRICS’ [Brazil, Russia, India, China and South Africa] New Development Bank and China-led Asian Infrastructure Investment Bank (AIIB). Although these institutions might replicate other multilateral banks, particularly in terms of portfolio, and environmental and social standards, their creation can be understood as a coordinated political response to the discontent of emerging countries with the lack of representation and the slow pace of governance reform, as well as frustration with the policy conditions and advice received from the World Bank (Horta 2019; Bond 2016; Barone and Spratt 2015; Schablitzki 2014).

In 2019, the European Union started discussions to rethink its

financial architecture for development. A High-Level Group of Wise Persons on the European financial architecture for development was created and developed options to create a new EU Development Bank (Wieser et al. 2019). This discussion is likely to continue in the coming years, now energized with the need for additional financing to support the recovery from the Covid-19 pandemic.

In recent years some global and the regional multilateral development banks have substantially increased their capital to expand their business operations, for instance, the Inter-American Development Bank (in 2012), the World Bank Group (in 2018) and the African Development Bank (in 2019), while others are currently in the process of discussing doing so (for example, a capital increase for the Islamic Development Bank is being considered) (Islamic Development Bank 2019). At the European level, the European Investment Bank (EIB) as the ‘EU Bank’ has also increased its role. The Juncker Plan – which aimed to promote growth and create jobs – was centred around the EIB, which in practice meant putting together a guarantee fund for the EIB.

## CHALLENGES FACING MOST PDBS

PDBs are very diverse and not all PDBs succeed. They are institutions with different sizes, development objectives, business models, funding arrangements, financial performance and governance practices. While some have contributed positively to development outcomes, we have also seen that PDBs – the most scrutinised being the multilateral development banks – can have considerable negative development impacts. Moreover, the potential role of most PDBs is being skewed towards providing for private interests over and above the public interest.

The development model promoted by major MDBs has been at odds with delivering on their development mandate (Brunswijck 2019; ITUC 2020). In some cases, we have seen that PDBs’ policies

and operations result in major negative development impacts, including human rights and environmental impacts (see Eurodad 2010 and 2012, among others). There is limited evidence to support the financial and development additionality of DFIs' interventions. For instance, research by Dreher et al (2019) points out that World Bank Group (WBG)'s International Finance Corporation lending tends to favour companies from major WBG shareholders. Compelling figures released by the Center for Global Development also indicate how marginal DFI operations are in terms of volumes and development impact (Kenny 2019). Concerns have also been raised in relation to the lack of transparency and poor accountability of DFIs' operations (SOMO et al. 2015).

Before Covid-19, most discussions on development finance were focused on using public money and institutions to leverage private finance. The dominant policy paradigm has argued that public interventions are better used if directed to de-risk private finance and to create markets (World Bank Group et al. 2015). The WBG's 'Maximising Finance for Development' approach is perhaps the best-known illustration of this drive (World Bank, N.D.). The objective has been to mobilize the trillions of dollars managed by private institutional investors to help finance the UN 2030 SDGs. 'De-risking' private finance is central to this approach and implies changing the investment climate and using financing instruments like guarantees, equities or public-private partnerships (PPPs) to underwrite private returns. As part of this, we have also seen an increased financialization of development lending, which implies the creation of financial products out of bundled loans, ostensibly to diversify risk, which can then be traded.

This private finance-led approach to close a so-called 'financing gap' has shown its limitations. Despite the rhetoric in support of an increased role of DFIs as development actors, recent figures have been a reality check to the highly anticipated leveraging potential of DFIs. In April 2019, research by Attridge and Engen (2019), from the Overseas Development Institute (ODI) revealed

that “each US\$1 of MDB and DFI invested mobilises on average US\$0.75 of private finance for developing countries, but this falls to US\$0.37 for low income countries.” Existing evidence also refers to the geographical concentration – in favour of middle-income countries – of publicly-backed private finance, while DFIs face serious challenges to broaden their activities in the least-developed countries (Kenny et al. 2020a).

## WHAT HAPPENS IN THE CONTEXT OF THE COVID-19 PANDEMIC?

The Covid-19 pandemic has resulted in highly volatile private capital (UNCTAD 2020b) and the disruption of global supply chains, with food and essential medical supplies suffering the most. The solution has focused on finding large-scale counter-cyclical funding to help maintain economic activity, and especially jobs. Equal if not more efforts in some cases have been focused on channeling money into the health sector, local authorities and national governments to help purchase the supplies needed and to support the health crisis. All this has increased the demand for support from DFIs and MDBs for public authorities and private sector companies in an unprecedented way. In some cases, this has led to the capitalization of DFIs (i.e. capital injection from governments, which in the case of donor governments can be reported as official development assistance).

DFIs and MDBs have been at the centre of the financial response to the crisis. From early March 2020 onwards, most DFIs and MDBs announced emergency packages to support the health, economic and social crises. Bilateral DFIs are strengthening their collaboration so they can share risk across their balance sheets and are sharing due-diligence processes and pipelines. A DFI Alliance, made up of 16 Organisation for Economic Co-operation and Development (OECD) DFIs, has agreed to work together to ensure a central role for DFIs post-Covid-19 (EDFI 2020a). They have also

joined the Response, Recovery and Resilience Investment Coalition ('R3 Coalition'), which aims to link DFIs with impact investors and philanthropic networks (GIIN 2020). In the case of the WBG, the pandemic has pushed the World Bank to respond in a speedy way as developing countries' demand for support saw a dramatic increase. Most resources were channelled through the WBG's private sector arm – the International Finance Corporation (World Bank 2020).

However, some of the challenges presented above have not gone away with the crisis, and might even have been intensified (Coalition for Human Rights in Development 2020). On the one hand, DFIs' business models seem unsuited to responding to crises, as they are not ready to take much risk in their operations. If they rely on private sources of capital – for instance, selling bonds in the private capital market – they are likely to be strongly influenced by those financing sources, as they need to make sure they maintain good scores from credit ratings agencies. This has an impact, for example, on their risk appetite and potentially on the sectors they might invest in. On the other hand, the speed of the response has led, in most cases, to a focus on existing clients – leaving little space to shift portfolios to where they are most needed or to sectors that are most strategic in a context of a sustainable and equitable recovery. It has also tended to bypass practices that ensure high standards in terms of accountability, and social and environmental impact (Oxfam International 2020; Bank Information Center 2020). Moreover, in the case of the WBG there has been a persistent prioritization of private over public interests, and there seems to be no prospect of any immediate re-orientation away from the 'Maximizing Finance for Development' approach. On the contrary, the current WBG stance, compounded by the limited fiscal space that developing countries will face in the post-Covid-19 context, might indicate that the WBG's approach to development finance, with private finance at its core, will even be strengthened.

## THE NEED TO RECLAIM PUBLIC DEVELOPMENT BANKS

The Covid-19 pandemic has led to calls to re-focus the state as an agent with the capacity to enact public policies and to direct finance toward the public interest. In June 2020, the World Bank estimated that the additional financing needs for developing countries arising from the crisis will be exceptionally high and is likely to persist over the medium term (WBG 2020). Pandemic-related external financing gaps for low-income countries could be in the range of US\$25 billion to US\$100 billion per year – assuming that incremental financing needs arising from the crisis are in the range of 2.5 to 10 per cent of Gross Domestic Product per year and that only half of these can be met internally. For middle-income countries, the equivalent range is US\$150 billion to US\$600 billion annually.

However, in the post Covid-19 context, it is imperative that the ‘right’ type of finance flows through the ‘right’ type of institutions (Chadwick 2020). The private commercial financial sector alone is unlikely to provide the finance needed to support the sustainable and equitable recovery that is so urgently needed. Before the pandemic, it was clear that private investors failed to provide stable and sufficient levels of long-term financing for sustainable infrastructure, making evident the need to provide and ensure climate finance (Griffith-Jones et al. 2020).

Tackling the crisis and paving the way for a sustainable and equitable recovery requires a strong public sector commitment at all levels. We are calling on all PDBs to step up their game and play a greater role in the development process to maximize development results for local people, including strengthening public health systems, delivering on the climate crisis and contributing to the fight against poverty and inequality.

While some have called for a greater role for Northern-led DFIs, with specific demands to rethink their business models as a result of getting increased capital, others have argued that national PDBs are

better placed to support essential public services and the local private sector (Griffith-Jones and te Velde 2020; EDFI 2020b; Chadwick 2020; Kenny et al. 2020b). We argue that, given the specific level of activity of different institutions, it is important to achieve greater coordination and better integration, in order to build complementarities and avoid unnecessary competition. A strong case can be made – under the principle of subsidiarity<sup>2</sup> – for seeing national PDBs as the primary tools for implementing development plans. This includes support for health systems, sustainable infrastructure and the local private sector, among other key tasks. Regional and global PDBs can contribute by supporting these national institutions, where they exist, or helping to build them, if not. Importantly, this requires strengthening of the policies, procedures and governance system of NDBs and a substantive change in the way that most regional and global multilateral PDBs currently channel their finance (Kenny et al. 2020b).

By working through national public institutions – rather than private sector companies directly – national stakeholders, including national and local governments, as well as local public and private sector actors and workers’ cooperatives, are more likely to be empowered to drive their development path, and to hold PDBs to account (for more analysis on this discussion see Kring et al. 2019, Gallagher and Studart 2016, and Marois 2019).

In order to understand the potential of PDBs, it is worth detailing their five main functions:

- **To direct finance** – or provide it on better-than-market terms – to sectors or regions that are important for a national development plan, in line with human rights and an equitable transition.
- **To build the financial sector**, either by filling gaps in the supply of credit (lending to households or businesses that

<sup>2</sup> For instance, at the European Union, the principle of subsidiarity is defined in Article 5 of the Treaty on European Union. It is the principle whereby the EU does not act (except in the areas that fall within its exclusive competence), unless it is more effective than action taken at national, regional or local level.



cannot access credit from commercial banks) or by helping to create demand (helping businesses or other customers to develop bankable projects). Particular attention has to be paid to equity considerations and to prevent further financialization of our economies.

- **To promote economic stability**, by playing a countercyclical role, to ensure a supply of credit when a financial or economic crisis causes the commercial financial sector to freeze.
- **To improve standards**, by insisting on, for example, human rights safeguards in the projects or institutions they finance.
- **To encourage innovation**, structural transformation and promote environmental sustainability.

If the institutions are to perform all of these functions to the highest standard, a holistic approach is essential to upgrade current policies and practices at all levels.

## A REFORM AGENDA FOR PUBLIC DEVELOPMENT BANKS

The need for a greater role of PDBs calls for a discussion on the key characteristics of these institutions to deliver for the public good. How can PDBs be improved so they can realize their full potential to support sustainable and equitable development? What are the governance arrangements and mechanisms that would prevent the risks of over-reliance on private finance?

We suggest key features of PDBs should be developed around four main pillars. We present the rationale behind the pillars below, while the key features are summarized in Table 2.1.

### A. Mandate and role

Mandate and role are derived from the explicit policy objective of the institution, linked to development outcomes, and in line with international commitments, which include the Sustainable Development Goals (SDGs), the Paris Agreement, international human rights law

and gender equality commitments. The mandate and role drive PDBs' activities and clearly focus their investment decisions, such as clients and sectors to target. They also allow stakeholders, including civil society groups, to hold banks and management to account, particularly for the human rights and environmental outcomes of all their activities.

### **B. Operational strategy**

The business model of a PDB drives the processes that enable the institution to fulfil its core mandate of financing development projects. It refers to how PDBs raise money, including identifying the right mix of public and private funding, and their investment methods, as both have an impact on the ability of the institution to deliver positive development outcomes. It also refers to the internal systems developed to focus, assess and monitor the outcomes of the operations.

### **C. Financial sustainability**

The long-term financial sustainability of PDBs is key to delivering their development mandate in the longer term. This does not mean, however, maximizing commercial profitability. It means ensuring sufficient cost recovery and surplus to remain institutionally viable, while focusing on delivering development outcomes. The long-term financial sustainability of a PDB should not undermine its ability to invest in higher risk areas, or projects where development returns are high but profitability may be low.

### **D. Good governance**

The governance of PDBs refers to who makes decisions, and how decision-makers are held accountable. It includes provisions to ensure insulation from undue political influence and corporate pressure, and to ensure democratic accountability. Accountability has to be understood in its broadest sense, which means downwards accountability (towards citizens and affected communities) and upwards accountability (towards national parliaments, governments and courts of auditors).

**Table 2.1: Core features of a model public development banks**

| Core features & key components                      | Explanation/Detail   |
|---|--|
| <b>A: MANDATE AND ROLE</b>                          |  |
| i. Strong development mandate                       | The mandate of PDBs is to deliver sustainable development outcomes, in line with the agreed SDGs, avoiding vague or dual mandates. For instance, this means a focus on reducing poverty and inequalities, and encouraging domestic resource mobilization.  |
| ii. Targeting finance where it is needed most       | PDBs target regions, sectors or clients that are most in need, or that have the highest development pay out, and not only a high level of return for the PDB. Special attention is given to initiatives and actions that do not reinforce gender inequalities.   |
| iii. Responsible social and environmental standards | PDBs take responsibility for the social and environmental outcomes of all their activities, including human rights, labour rights, climate and gender impacts. The PDB aligns its policies and operations with the Paris Agreement and actively contributes to the fight against climate change, for instance, by pursuing a truly carbon-free strategy. The PDB ensures that companies they work with, as clients or partners, do not avoid or evade taxes. |
| iv. Responsible gender equality standards           | The PDBs' responsibility to gender equality and women's rights is embedded in a policy addressing gender and development. As a result, PDBs: promote gender equality and women's rights, where possible make its programmes and projects more gender-inclusive avoid gender bias and minimize gender-related vulnerabilities and risks   |
| v. Stable, long-term perspective                    | The focus of PDBs is on long-term, sustainable, predictable and counter-cyclical funding to help bolster financial stability and support the sustainable transformation process of national economies.   |
| vi. Support for national strategies                 | PDBs align their activities to democratically determined national plans, to ensure that they help improve the financial sector, steering these toward a more sustainable, just and long-term path.   |

**B: OPERATIONAL STRATEGY**

|   |   |
|---|---|
| i. Right mix of public and private funding                    | PDBs receive some public funding, so they are not purely commercial institutions.   |
| ii. Careful choice of methods of investing                    | PDBs invest in ways that ensure their development mandate takes precedence over generating financial returns.   |
| iii. Internal systems to focus, assess and monitor operations | PDBs have the internal capacity to assess and systematically show the impacts of their policies and investment decisions (ex-ante and ex-post comprehensive impact assessments analysis are conducted regularly), and have effective human rights, environmental, gender-sensitive and fiscal due diligence procedures, accompanied by supervision and monitoring mechanisms. |

**C: FINANCIAL SUSTAINABILITY**

|  |   |
|--|---|
| i. Prioritize development outcomes                   | PDBs ensure development outcomes take precedence over profitability.  |
| ii. Reinvest any profits                             | PDBs reinvest any profits to support the development focus of their institution.  |
| iii. Take care with public grants                    | Strong public accountability must be in place if PDB operations are subsidized by official development assistance beyond initial capital injections.                      |
| iv. Incentivize staff to deliver for the public good | PDBs draw on their development focus to recruit and motivate staff, explicitly avoiding the bloated salary and bonus culture of parts of the commercial financial sector. |

#### D: GOOD GOVERNANCE

|   |  |
|---|--|
| i. Equal borrower representation at multilateral PDBs               | Multilateral PDBs have a governance structure that gives, as a minimum first step, equal voting power to borrowing countries.  |
| ii. Strong transparency policies, based on the right to information | PDBs have a strong and carefully implemented transparency policy based on: the right of access to information across stakeholders, including civil society organizations; automatic disclosure of information with limited exceptions; the right to request information across stakeholders, including civil society organizations; and public access to decision-making, across stakeholders including civil society organizations. |
| iii. Active participation of civil society and bank employees       | PDBs have open channels for the meaningful participation of civil society groups, including trade unions, feminist and women's rights organizations, and bank employee unions, in their decision-making processes and in project design, implementation and monitoring.  |
| iv. Insulation from political and corporate pressure                | PDBs have specific governance arrangements in place that protect them from undue political influence and corporate pressure that might be contrary to the bank's mandated purpose. This will ensure that the public mission of the banks is not be diverted by both political and corporate considerations.  |
| v. Strong accountability systems                                    | PDBs have well-implemented accountability systems, including independent evaluations; parliamentary scrutiny; meaningful participation of external stakeholders, including a broad range of civil society organizations; and effective and user-friendly independent complaints mechanisms.<br>PDBs can be challenged in front of courts, as immunity of banks undermines their accountability.                                      |

## CONCLUSION

The Covid-19 pandemic has confronted us with critical challenges. Public development banks are in a unique and powerful position to play a key role in the post Covid-19 recovery. They can – and should – play a very significant role in the development process as a whole to maximize development results for local people, including strengthening public health systems, delivering on the climate crisis and contributing to the fight against poverty and inequalities.

As this chapter shows, PDBs can direct finance to important sectors or regions, build and steer the financial sector into a more sustainable and equitable path, promote economic stability, improve standards – for example, through environmental, social or human rights safeguards – encourage structural transformation and promote environmental sustainability.

However, PDBs face considerable challenges when it comes to performing their roles, and some of them have been rightly questioned about the negative impacts of the development model promoted and their operations. Most of their challenges have not gone away with the Covid-19 pandemic, and some might even be intensified. Importantly, the potential role of most PDBs has been skewed toward private interests over and above the public interest. This has to change.

This chapter makes a strong case in support of pro-public and accountable institutions working at different levels in a complementary way. National development banks can be the primary tools to implement development plans, while regional and global PDBs can support these national institutions where they exist, or help to build them if they do not exist. This is not free of challenges either, but it would ensure a development path that is more rooted in national needs.

This chapter also presents key features that public development banks need to possess to maximize development results for the

most vulnerable members of society, including delivering on the climate crisis and contributing to the fight against inequalities, especially gender inequalities.

In the months and years to come, civil society organizations have the opportunity to actively contribute to the debate on the types of institutions needed to finance a sustainable and equitable recovery post Covid-19. The Finance in Common Summit taking place on 12 November 2020 will be just one opportunity to further advance this debate. The Summit is being organized by the World Federation of Development Finance Institutions and aims to bring together the whole development bank community along with other key stakeholders, such as governments and representatives from the private sector, civil society, think tanks and academia. We call on civil society and academics to reclaim public development banks and engage in a public debate on this matter.

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## Chapter 3

Milford Bateman

# THE COVID-19 CRISIS AS AN OPPORTUNITY TO BREAK WITH THE FAILING GLOBAL MICROCREDIT INDUSTRY

**T**he Covid-19 crisis is putting the future of the global microcredit industry at serious risk. Among other factors, this is because the poor are increasingly unable to repay the large volumes of microcredit that they have accessed in recent years. Since the international development community believes that the microcredit model has made a hugely positive impact in addressing poverty and can do so going forward, the global microcredit industry has begun to receive significant financial support in order to continue to operate. However, with even mainstream economists now accepting that the microcredit model has in fact failed to address global poverty, this article argues that these emerging bailout efforts will amount to nothing more than “throwing good money after bad.” There is now an opportunity to plot a new trajectory towards community-owned and controlled local financial institutions. Economic history shows that these alternatives have a vastly better track record of addressing poverty, economic development and inequality, as well as usefully promoting greater democracy and participation in society. I illustrate my argument by pointing

to just one of the several appropriate models for all to learn from and adapt to the current Covid-19 crisis conditions: the New Deal reconstruction of the rural financial system in the US that arose as a response to the Great Depression. If the Covid-19 crisis is to be successfully addressed in the Global South, a similarly radical all-encompassing approach to the restructuring of local financial systems urgently needs to take centre stage.

## INTRODUCTION

The microcredit model is a financial innovation that, since the 1980s, has been widely promoted in the Global South to combat rising poverty, joblessness, inequality and gender disempowerment. Defined as tiny loans – microloans – that are used to establish or expand an informal microenterprise or self-employment venture, the mainstream belief since the 1980s is that microcredit has been very successful in its assigned mission. However, the Covid-19 crisis has now created an unprecedented worldwide crisis, and the global microcredit industry is likely to be one of its many institutional victims. The incomes of the global poor are in free fall right across the Global South. The poor will likely be unable, and perhaps also unwilling, to repay the very large quantity of microcredit they have racked up with the world's microcredit institutions (hereafter MCIs).<sup>1</sup> As a result, many MCIs have been quickly plunged into serious difficulty. Accordingly, rescuing the global microcredit industry has become one of the paramount objectives of the international development community as it responds to the rapidly deteriorating situation in the Global South. Financial and other forms of support are already arriving not only to assist many of world's MCIs directly, but also to support the commercial banks and global investors that

<sup>1</sup> As of 2018, it was estimated that the volume of microcredit debt held by formal MCIs was around \$US124 billion spread over 140 million borrowers (Microfinance Barometer 2019).

finance their operations. If, as is now expected, the Covid-19 crisis extends well beyond 2020, considerably more financial support is also to be expected. If all goes according to plan, the vitally important global microcredit industry will be saved from collapse. It will then be able to play a central role in helping the poor cope for the duration of the Covid-19 crisis, and then in rebuilding their lives and communities in its long aftermath.

The entire effort to rescue the global microcredit industry is based on the unshakeable belief that microcredit has been a very successful anti-poverty intervention to date. It therefore seems entirely logical in these difficult times to want to continue to provide microcredit to the global poor. Summing up this very widely held feeling was the UK's *Economist* magazine, which proclaimed “nursing the (microcredit) industry back to health will give a big bang for the buck” (Economist 2020a). It also follows that there is no sense in making any major changes to the structure and operations of the global microcredit industry. Why tinker with what is widely believed to be a winning formula?

But what if the long-standing belief in the power and impact of microcredit is misplaced, and microcredit, in fact, doesn't actually work? This would undermine the rationale for wanting to rescue the global microcredit industry. Sadly, this is indeed the sour reality that has emerged in recent years. Today, even one-time leading microcredit advocates now accept that microcredit has essentially had zero impact on global poverty. Even worse, a growing number of economists working in the heterodox tradition have demonstrated that the microcredit model has quite seriously frustrated the fight against poverty in the Global South. Rescuing the global microcredit industry today is, therefore, not a straightforward issue at all. Bailing out a major financial institution that has actually failed in its assigned mission to date would surely be the textbook definition of “throwing good money after bad.”

In the context of the most serious economic and social calamity since the Great Depression, I argue that propping up the existing



global microcredit industry is the very worst way to assist the global poor. What is urgently needed instead is a radical new approach to local finance. This approach involves an effort to begin to rebuild local finance in the Global South through the programmed conversion of historically ineffective and now-failing MCIs into a variety of community-owned and controlled financial institutions. Specifically, I argue for the conversion of MCIs into one of three formats: credit unions, financial cooperatives or community development banks (CBDs). Unlike in the case of microcredit, these three local financial institutions have amassed a very impressive track record of successfully addressing poverty and promoting sustainable and equitable development everywhere in the world. Importantly, this success has very often been achieved against a background of economic and social crisis not dissimilar to the current situation. A key reason for this historic success is because of the aim of such community-owned and controlled financial institutions. Rather than operating to *extract* wealth from the community to be enjoyed by a narrow financial elite (one that is increasingly located abroad in “tax-efficient” or low-regulation jurisdictions),<sup>2</sup> most community-owned and controlled financial institutions exist to *recycle* wealth back into the community to be used and invested by successive generations. In addition, being built on principles of democracy and participation, it is important to note that community-owned and controlled financial institutions have historically played an important role in consolidating and extending democracy into the wider fabric of the local community.

In very practical terms, I would argue that we should look for practical inspiration to the great US President, Franklin D. Roosevelt. In the context of the devastation of the Great Depression, Roosevelt saw the enormous damage being inflicted upon America's rural poor and he understood that the only way to really assist them into the

<sup>2</sup> In Cambodia's large and hugely profitable microcredit sector, for instance, all of the top ten MCIs are now either fully or mainly owned by wealthy foreign banks, investment bodies and the international development agencies (Bateman 2020).

longer term was to restructure the rural financial system almost entirely. Accordingly, beginning in 1933, the Roosevelt administration put into place a new farmer-owned and managed rural financial system. This not only proved successful in quickly addressing poverty in the large number of rural communities left devastated by the Great Depression; it also went on to play a major role in creating an efficient agricultural system in the USA. If the Covid-19 crisis is to be effectively addressed in the Global South today, then an equally bold move should be a priority of the very highest order.

## ADDRESSING THE “COLD TURKEY” PROBLEM

Quite clearly it is not feasible to do nothing and allow the global microcredit industry to crash. Forcing the global poor to have their current access to microcredit immediately cut off – for poor communities to go “cold turkey” – would in the short term inflict serious damage. For example, many millions of informal microenterprises and self-employment ventures engaged in simple trading activities would encounter real problems without a daily source of working capital with which to restock their tiny businesses. This is what Michael Schlein, the CEO of one of the world's most influential microcredit advocacy and investment bodies, the Boston-based ACCION, is referring to when warning that, “The financial engine for half the world's jobs will... seize up” if the microcredit sector is allowed to collapse (quoted in the Economist 2020b). Moreover, an immediate absence of microcredit would inflict pain on those using microcredit simply to try to cope with the effects of poverty, many of whom were struggling even before the Covid-19 crisis. Further restricting the ability of the poor to purchase healthcare services, medicine and personal protective equipment (PPE), could also quickly become a life-or-death issue.

In the early stages of the Covid-19 crisis (April-May 2020), people realized that a whole host of financial support measures were ur-

gently needed to allow the global microcredit industry to continue to function (Carstens 2020, Ogden and Bull 2020, Rozas 2020, Zetterli 2020). Leading microcredit advocates Liebermann and DiLeo (2020) were fairly typical in what they advocated: repayment holidays of up to 90 days, emergency funds to inject liquidity into MCIs and to take bad loans off the books, government and international donor bailouts to protect the largest MCIs, and measures to protect global investors. Importantly, Liebermann and DiLeo saw nothing fundamentally wrong with the global microcredit industry that might be usefully addressed through the application of the rescue package they were advocating.

By June-July 2020, however, it became clear that the Covid-19 crisis was not going to be over in a short time period but was likely to deepen and extend much further into the future. This deteriorating situation was reflected in the growing number of reports of delayed repayments, savings accounts being depleted fast, outright defaults beginning to grow, and investors starting to run for cover. To preserve their own liquidity, many MCIs also began to avoid further lending, while pushing and even threatening clients to continue to repay their microloans regardless of the huge problems they were now facing. In India, for example, many MCIs were found to be ignoring pleas for a moratorium on repayment and were instead demanding that clients, especially women clients, continue to repay (Guérin *et al.* 2020). A similar situation was reported in Pakistan (Rhyne 2020). Many other MCIs accepted a three-month or more repayment holiday, but simply rolled up the missed interest and capital payments into a larger microloan that has to be fully repaid when the Covid-19 crisis eases (Joseph *et al.* 2020).

At time of writing (August 2020), it is now clear that the global microcredit industry is facing a potential catastrophe. The debate within the international development community has therefore shifted away from introducing temporary support measures towards a discussion of the design of financial bailout programs that would be large enough to ensure a significant part of the current

global microcredit infrastructure remains intact. Still, however, there has been no real debate as to whether a fundamental *restructuring* of the global microcredit industry itself is also required as a way of better dealing with the unprecedented threat that the Covid-19 crisis represents to the global poor.<sup>3</sup>

## ADDRESSING THE “ELEPHANT IN THE ROOM” PROBLEM

As with any financial transaction, before using scarce funds to revive the microcredit model, it would seem sensible to do all the necessary due diligence. In other words, we must be absolutely convinced that microcredit has really worked in the past so that we can be confident that it will work going forward to help those negatively affected by the Covid-19 crisis. It is especially important to be certain that microcredit will do no harm. It would also help if we had an idea of what the alternatives to “more microcredit” are and if supporting them might not be a better strategy.

We are therefore presented with a very serious dilemma: in practice, the microcredit model has *not* worked to date in the manner it is supposed to have done, *so it cannot therefore be concluded that it will work going forward*. Given the almost universal celebration of the microcredit model's supposed effectiveness ever since it arrived on the development scene in the 1980s, for many this will be a simply stunning statement. After nearly 40 years of rapid growth, how can it possibly be true that the global microcredit industry does not work?

In the 1980s, the microcredit model represented a major financial innovation that, it was widely predicted, would robustly address the problem of global poverty and deprivation. As is well known,

<sup>3</sup> Even those analysts supportive of microcredit that appear to have highlighted the need for a 'reform' of the current global microcredit industry, such as Malik et al. (2020), actually recommend only a few minor operational changes that the global microcredit industry might wish to consider.

these claims began with the US-trained Bangladeshi economist and future (in 2006) Nobel Peace Prize recipient, Dr. Muhammad Yunus, who famously claimed at the time that the microcredit model would “eradicate poverty in a generation.” As the supply of microcredit rapidly grew in the 1990s and into the 2000s, the international development community began to believe its own publicity that the microcredit model was indeed succeeding. The global poor were accessing more microcredit than ever, so the common-sense feeling was that it simply must be helping them; otherwise why would they want so much of it?

More scientific evidence to confirm the belief that “microcredit worked” then appeared in the form of a number of influential impact evaluations and studies (Pitt and Khandker 1998; see also the summaries of previous impact evaluations compiled by Goldberg 2005 and then Odell 2010). Much sophisticated econometric analysis produced by leading mainstream economists attached to the main international development institutions also appeared to confirm the validity of the microcredit model as a poverty reduction intervention (for example, see Beck, Demirgüç-Kunt and Levine 2007). With so much high-profile support and validation coming its way, Bernd Balkenhol, former Director of the Social Finance Program at the International Labor Organization (ILO), felt able to report in the mid-2000s that the international development community now saw the microcredit model as “the strategy for poverty reduction *par excellence*” (Balkenhol 2006, 2 - underlining in the original).

### **If it's too good to be true, it usually is**

Just as the celebrations began to peak in the mid-2000s, the first real signs began to emerge that the entire uplifting narrative was fundamentally flawed (see Bateman 2010). While many factors were involved in the radical reappraisal of the microcredit model's impact on poverty and development, I will briefly summarize three of the most important inter-related problems.

First, microcredit has certainly helped a lot of new informal microenterprises get established. But what has always been deliberately ignored in the analysis of microcredit impact, as even World Bank economists now belatedly admit was a serious error (see McKenzie and Paffhausen 2017), is that a very large percentage of these new microenterprises fail very quickly. Failure not just ends any ongoing income flow but can also wipe out any of the assets or savings that had been possible to accumulate prior to failure. It can also lead to the loss of any valuable collateral lodged with an MCI, such as vehicles, housing or, most devastating of all, land (Bateman 2020). Moreover, even when some new microenterprises succeed, they typically only do so by taking clients away from many other existing microenterprises struggling to compete in the same local market. This “displacement” effect hurts competitors who are typically forced to contract and lose any employees. The combined result of failure and displacement, or what is formally termed “job churn” (Nightingale and Coad 2014), is all too often a zero-sum employment outcome. Even worse, the intense competition created in so many communities in the Global South – thanks to the unstoppable microcredit-assisted entry of new microenterprises (and, more recently, so-called “gig” workers) – inevitably helps to push average incomes down to the subsistence level. Put simply, a combination of quite standard labour market pressures tend to ensure that any positive employment and income impacts created by microcredit-assisted new microenterprises are all too often swamped by the negative economic and social impacts of the resulting increased local competition (Bateman 2019a).

A second serious flaw in the operation of the microcredit model became evident from the early 2010s onwards. As it became clear that the microcredit model was associated with limited-to-no net employment and income gains for the poor, the microcredit advocacy community felt that a new goal was needed in order to justify its existence and, more importantly, its continued expansion. Without any fanfare or formal announcement, microcredit advo-

cates began to promote a completely new narrative: that they were involved in a “fight to extend useful financial services to low-income households.” The term “financial inclusion” came into being to describe how the global poor should now see microcredit as one of a number of financial tools that would simply help them to better *manage* their poverty (see Collins et al. 2009). This might mean ensuring regular access to basic utilities (water, electricity, etc.) as well as funding housing, healthcare and the education needs of the family. However, this new justification for the microcredit model to continue expanding, which it did, gave rise to the serious problem of over-indebtedness. Beginning in Bolivia in 1999, in all of the countries and regions in the Global South that were to go on to become the most “financially included,” we find that household debt began to rise to quite destructive levels (Guérin, Morvant-Roux and Villarreal 2013). The global poor could not fight off what became quite a harmful dynamic. Rising microdebt ultimately diverts income from consumption into debt service, and the immediate economic boost provided by more microcredit has everywhere been swamped by the longer-term outflow of wealth from the communities of the poor (Mader 2015).

A third core problem with the microcredit model is directly related to its commercialization that began in earnest in the 1990s. This move was demanded by key microcredit advocates keen to close what they argued at the time was an “absurd gap” between the limited supply of microcredit and the supposedly massive latent demand for it. The international development community then joined in to support the conversion of MCIs into for-profit bodies. The hope was that the global microcredit industry could be weaned off subsidies and become financially self-sustaining – though, crucially, still retain its social mission. By the mid-2000s, however, the destructive impulses inherent to deregulated capitalism began to take root in many of the largest MCIs. Reckless lending to advance rapid but unsustainable growth goals soon emerged as the defining feature of the global microcredit indus-

try. The CEOs and senior management of the largest commercialized MCIs wanted to grow as large as possible, as fast as possible, in order to be in a position to inflate their salaries and bonuses. Shareholders and investors willfully egged them on so that they could reap growing dividend flows, and then profit even more when their equity investments were later sold off for much more than the purchase price. Inequality also rose as a new “microcredit millionaire” class began to emerge alongside the rapidly growing number of individuals floundering under the weight of their growing debts to MCIs or having lost everything they own on an unwise microenterprise project. In addition, the reckless lending practices of the largest MCIs, combined with the inability of the poorest communities to absorb unlimited amounts of microcredit, led to a growing number of hugely destructive microcredit sector boom-to-bust events. Notable “busts” occurred in Bolivia, Bosnia and Herzegovina, Nicaragua, Pakistan, and then, the largest to date, in Andhra Pradesh state in India (Guérin).

### **Why did no one see this coming?**

There exists a long succession of impact evaluations and serious studies carried out by recognized specialists that, as noted above, were said to have provided an abundance of empirical evidence that microcredit works. Sadly, it is now recognized that almost all of these impact evaluations were seriously flawed and willfully biased in favour of claims that microcredit produces a positive impact. Put simply, careers are not generally advanced by challenging the official pro-microcredit ideology of key governments (especially the US government), prestigious foundations (e.g., the Gates Foundation) or the international development agencies, notably the World Bank (see Duvendack and Maclean 2015). Instead, one learns how to skillfully provide the positive narratives and required impact evidence that one is largely expected in advance to find, if not explicitly paid to produce. Sadly, even recent high-profile winners of the Nobel Prize in Economics winners appear not



to be immune to this temptation.<sup>4</sup>

The fundamental error committed by uncritically supporting the ineffective global microcredit industry is very profound indeed. An unprecedented investment of financial resources, technical support, political capital, academic research and institutional commitment has been largely wasted on supporting an intervention that, it is now increasingly accepted by one-time leading advocates (Roodman 2012; Altman 2014, Waterfield 2020), has actually had zero impact on poverty. The growing disillusion was best captured by Morduch (2017), advisor on microcredit to many international development agencies and co-author of *The Economics of Microfinance* (a standard university textbook), who bravely admitted that:

Yunus's vision – and the assumptions it rests on – is coming apart. Microfinance has proved fairly robust as a banking idea, but not as an anti-poverty intervention....Aid agencies and foundations have been left feeling confused, disappointed and perhaps betrayed – and have started moving on.

Even worse than under-performing against high expectations is that the growth of the microcredit industry has also generated a raft of destructive downsides that have actually helped to *undermine* the ability of the poorest communities to escape their poverty (Bateman 2010; Bateman and Chang 2012; Mader 2015; Bateman et al. 2019). Meanwhile, as many social anthropologists and sociologists point

<sup>4</sup> The 'last word' on the subject of the impact of microcredit was supposedly provided by the six country impact evaluation project headed up by the 2019 Nobel Economics Prize co-recipients Abhijit Banerjee and Esther Duflo, who could only conclude that microcredit had essentially no impact on poverty (see Banerjee, Karlan and Zinman, 2015). However, in order to come to even this tepid conclusion all six of the case studies used weak methodologies, ignored important downside factors ('distortion by omission'), and also apparently indulged in some quite unethical research practices (see Bédécarrats, Guérin and Roubaud 2017, 2019, 2020; see also Bateman 2013). One possible reason for Banerjee and Duflo adopting such problematic tactics was that otherwise their impact results might have rather awkwardly confirmed what the 'harshest critics' of microcredit have long argued – that microcredit has actually had a harmful effect on the global poor – as well as the fact that their own pioneering impact evaluation methodology based on the the Randomised Control Trial (RCT) had actually failed over many years to pick up on this rather important development.

out, the default form of employment that microcredit was established to validate and expand – the informal sector – simply cannot be divorced from the rising poverty, inequality, precarity, deprivation, crime, ill health and vulnerability that have become the defining features of life today at the “bottom of the pyramid” (see Davis 2006).

Further exacerbating the problem here is the fact that, largely as intended, the trumped-up effectiveness of the microcredit model was widely used by the international development community to further marginalize and discredit all collectively organized, locally owned and controlled financial interventions. In the era of neoliberalism, the idea that the global poor should seek to deploy their “collective capabilities” through their own financial institutions simply had to be destroyed. All such financial institutions were ignored and marginalized. Where possible, they were converted into conventional investor-owned financial institutions. Given the effectiveness of community-owned and controlled financial institutions across so many locations in achieving more than what the global microcredit industry can legitimately claim to have achieved anywhere, this was a fundamental error. But it is an error that can now be corrected.

## **ADOPTING A ROOSEVELTIAN APPROACH TO RECONSTRUCTING LOCAL FINANCE**

An entirely new approach to the impending rescue of the global microcredit industry is urgently required. This approach must use the expected financial support and bailout funding to insist on the construction of a new and improved local financial system. The guiding principle is that of the need to build back better, a simple moral imperative that is rightly informing very many international organizations and governments at this unprecedented historical juncture (for example, see OECD 2020). Rescuing the local financial system by building back better' has two quite reasonable goals:

- It must assist in resolving the immediate objective of helping the community to survive the Covid-19 crisis;
- It must also create the core institutional foundations necessary to build a much more pro-poor, democratically owned and managed, and explicitly *developmental* local financial system capable of promoting bottom-up growth in the post-Covid-19 era

In terms of the sheer extent of economic decline and social disruption, the most relevant parallel to the Covid-19 crisis today is the Great Depression. The Roosevelt administration's response is widely seen as a great success. It is therefore an obvious example to study. The most relevant aspect to consider is the rural financial system, which was driven to the point of collapse. However, rather than simply reconstruct or bail out the existing ineffective rural credit structure – which was what the banks, established elites and Republican politicians were demanding – Roosevelt opted for a very dramatic change.<sup>5</sup> This came with the passing of the *Farm Credit Act* of 1933, which represented the first step in constructing an entirely new farm credit system. Through an executive order, all existing agricultural credit bodies were put under the supervision of a new agency, the Farm Credit Administration (FCA), prior to the recapitalization and restructuring of very many of them. More importantly, the FCA established twelve Banks for Cooperatives (BCs) and a number of production credit associations (PCAs) that combined to provide crucial low-cost long-term and short-term loans to the ailing agricultural sector. Roosevelt also pushed through the *Federal Credit Union Act* of 1934. This greatly enhanced the existing credit union network by creating a network of chartered member-owned credit unions to support individuals in the hardest-hit communities.

This radically new cooperatively owned farmer credit system involved the investment of significant financial resources from the state. But this investment was well spent. The new financial system

<sup>5</sup> The following account is drawn from the comprehensive Living New Deal website. See <https://livingnewdeal.org> (accessed July 2020).

quickly rescued the US agricultural sector from collapse, and so reduced poverty in the rural communities. It also created a solid institutional foundation that decisively underpinned its future success. Moreover, in spite of numerous revisions, the still broadly cooperatively owned farmer credit system put in place by Roosevelt remains today the single biggest provider of farmer credit in the USA. Importantly, it is widely recognized that these initiatives would probably not have been possible in “normal” times. The sheer magnitude of the Great Depression, plus the thorough discrediting of the previous financial regime that effectively caused it (see Galbraith 1955), allowed Roosevelt to outflank those who combined to try to block what they erroneously saw as an attempt to bring socialism to America. A root-and-branch restructuring of the local financial system was the result. Such a Rooseveltian approach to local finance is, I would argue, urgently required today and also manifestly feasible. Defining and implementing such an approach, moreover, is an urgent requirement before scarce financial resources are wasted.<sup>6</sup>

## TWO PRACTICAL OPTIONS FOR PROGRESSIVE CHANGE TODAY

A feature of the neoliberalized financial sector that emerged after 1970 is the extent to which ownership changes were encouraged in only one direction: away from public and collective ownership forms and towards private corporate investor-driven forms. The classic example is the UK's ultimately disastrous de-mutualization of its hugely successful saver-owned building societies (see Elliot and Atkinson 2008). Another related feature of recent history is the use of financial support and bailouts to provide “no-strings” financial support to the many private financial institutions that began to fail from the 1970s onwards. It was always expected that the main beneficiaries of such

<sup>6</sup> The global banking and financial elites appear to have already been able to profit handsomely from the government's financial support designed to mitigate the economic impact of the Covid-19 crisis (see The Washington Post 2020).

deals would be the key stakeholders in a struggling financial institution: the CEOs, senior managers and shareholders. As noted by many economists (for example, Stiglitz 2019), this effectively ushered in a period in which the financial sector was able to enjoy significant financial rewards during the good times, but then look to government and the general public to absorb the costs when things begin to turn sour. The most spectacular recent example of this new trend was evidenced during the global financial crisis that erupted in 2008. A large number of financial bailouts were undertaken to save key US, European and Asian financial institutions but without any attempt to change the unstable (neoliberal) model of finance that had actually created the problems in the first place (Mirowski 2013, Tooze 2018). As a result, with even fewer and bigger banks than before 2008, another financial crisis, perhaps even larger than in 2008, is almost inevitable (Hudson 2015, Keen 2017).

What I am proposing in the context of the current Covid-19 crisis is thus the very opposite to what transpired after 2008. Rather than bailing out the CEOs, senior managers, investors and corporate financiers that now own and control the global microcredit industry (very many of whom have enjoyed spectacular financial returns in recent years), public financial support and bailout funding directed towards the rescue of the global microcredit industry should instead be used to effect a major Rooseveltian-type change to the local financial sector. This will involve the conversion of for-profit MCIs into a range of community-owned and controlled financial institutions that have a far better track record of promoting local economic development, including under very difficult conditions. Above all, this will involve the recycling of wealth back into the local community as a whole, rather than its concentration into the hands of a narrow local elite or, even worse, taken outside of the community into the hands of global financial elites located in “tax-efficient” or low regulation locations.

Even before the Covid-19 crisis, many similar proposals had been put forward to reform the local financial system in order to facilitate sustainable and equitable local economic development. Some of the

most cohesive arguments along these lines have been put forward by those attached to what might be called the “community wealth building” movement (for example, see Jackson and McInroy 2017, Guinan and O'Neill 2019). Moreover, these ideas and concepts are also seen as one of the best ways to address the immediate dangers of the Covid-19 crisis (Guinan et al. 2020).

However, the changes proposed here represent quite a radical change to the current ideology and ownership structures relating to local financial institutions in the Global South. Inevitably, as after 2008, they will not be supported by the neoliberal-oriented international development community, nor, for obvious financial self-interest reasons, by the global microcredit industry itself.<sup>7</sup> But as Roosevelt understood, and do so many others today (for example, Bernards 2020), extraordinary times demand extraordinary measures. This is the essence of what is meant by building back better.

There are two general options for the ideal types of institutions that an MCI may be converted to as a condition for bailout funding and other forms of support. There are overlaps between these various types – most commonly the case where a financial cooperative also adopts a community development banking function. However, the ownership structure and social mission are taken as the key defining features that distinguish these institutions from MCIs.

### **Option 1: Financial cooperative or credit union**

This first option involves a move to convert a struggling MCI into a credit union or financial cooperative. A credit union is a member-based savings and loan organization servicing a particular

<sup>7</sup> After the UK government bailed out what was at one time the world's largest bank, the Royal Bank of Scotland (RBS), there were serious proposals, including by one member of the UK Parliament (see Thomas 2016), to convert it into a mutually owned bank with a social mission to promote economic development as well as provide quality and affordable financial services for customers in lower-income segments. Powerful ideological and financial sector resistance to such a measure, plus the Conservative government's desire to get hold of the funds generated by returning RBS to the private sector, ensured that the proposal was blocked.

group, such as the population of a specific geographic area or a set of company employees. A financial cooperative provides similar services to a larger group of members, but it can also have non-members as clients. Both financial institutions exist to provide quality low-cost services, while also recycling any profit back into improving and diversifying member services and providing a regular financial bonuses or dividends. Crucially, quite unlike today's MCIs, the goal of such local financial institutions is *not* to grow at a breakneck pace but to serve the needs of existing member/savers. Because they are unwilling to operate aggressively and exploit clients and employees in order to maximize profits, at times this has meant that financial cooperatives and credit unions are less competitive compared to investor-owned financial institutions. Deregulation can also sometimes open up the door for unscrupulous individuals within a financial cooperative or credit union to abuse and defraud their own institution.<sup>8</sup> Nonetheless, history shows that they “work” to improve the lives of the poor.

In Italy, for example, financial cooperatives have been a major part of the financial sector for more than a hundred years, especially in the north of the country. Suffering greatly in the 1930s on account of their collective foundations, after 1945 they flourished once more and played a major role in the reconstruction effort. While after 1945 the private investor-driven banks preferred to support through imports the renewed conspicuous consumption habits of Italy's still-wealthy elites, the financial cooperative sector played a vanguard role in promoting sustainable economic development and poverty reduction (Bateman 2007). After restructuring and re-capitalizing to repair the war damage, the financial cooperatives went on to play quite a decisive role in rebuilding the region's formal small and medium enterprise (SME)-based industrial sector into one of the world's leading examples. Japan's mutual (*sogo*) banks

<sup>8</sup> Probably the most spectacular instance of this led to the collapse of the credit union sector in the US in the 1990s (see Black 2005).

and the credit banks (*shinkin*) formed out of the larger pre-war credit unions played a key role in the post-war period by financing those small enterprises capable of integrating into the supply chains of the leading companies. Crucially, as Girardin and Ping (1997) emphasized, robust oversight by local governments and the central Zenshiren Bank helped to (re)build local trust and ensure minimal fraud and speculative activity using depositors' money. And in the Global South, it is often overlooked that financial cooperatives have played a quite crucial role in supporting equitable economic development, notably in southern Brazil (Jacques and Gonçalves 2016) and many parts of Colombia (Fajardo Rojas 1998).

Financial cooperatives and credit unions naturally have their own problems, including the extra complication of being run more democratically. However, history shows that they tend not just to be far more effective at addressing poverty and promoting equitable and sustainable development, but are also much more resilient when it comes to coping with wider macroeconomic fluctuations and supporting the poor in the aftermath of a crisis of one sort or another (Goglio and Alexopoulos 2012, ILO 2013, McKillop et al. 2020).

### **Option 2: Community Development Bank**

The second option available to those providing a bailout to a struggling MCI is to facilitate its conversion into a community development bank structure. While many community development banks (CDBs) offer conventional financial services to members of the community, their main role is to proactively encourage economic and social development. A CDB can do this in many ways: by promoting new enterprises in general, supporting specific new sectors of high-growth enterprises, facilitating technology transfer, promoting innovation, and encouraging horizontal networks and clusters of local enterprises in order to reap collective economies of scale and scope. In more recent times, CDBs have been specifically highlighted in connection with the provision of “patient” (long-term) capital that might help the local enterprise sector to sustainably expand



(in numbers and average size), upgrade technology, diversify and export. CDBs are owned and controlled by the community, typically involving some element of public management by the local government overseen by an independent supervisory board of individuals drawn from the wider community.

Like financial cooperatives and credit unions, the concept of the CDB has a long pedigree of success. Many banks in Europe not specifically referred to as CDBs nevertheless function as CDBs. In Germany, for instance, the savings banks (*Sparkassen*) are owned by the local town or other administrative body. They have very successfully promoted local economic development through two mechanisms: first, through their lending activities (they provide as much as two thirds of the lending required by Germany's famous *Mittelstand* [medium-sized] companies); second, through the relationships and networking activities they see as a management responsibility to be performed within the community (Audretsch and Lehmann 2016, 106-7). In addition, the *Sparkassen* are more efficient than their counterpart private sector banks, earning a significantly higher return on capital than the wider private banking system in Germany as well as paying much more in taxation to local and federal levels of government (Brown 2019, 152). In Spain, as noted above, two of the most successful financial cooperatives – the *Caja Laboral Popular* (now known as *Laboral Kutxa* after a merger with a local credit union) and *Cajamar* – are essentially quasi-CDBs, charged by their membership to promote local solidarity and cooperation by acting as a CDB in order to promote the wider economic development of the region (see Bateman 2019b). In the US, the state-owned Bank of North Dakota serves as a CDB in many respects and has played a critical role in developing the state's economy in an equitable and sustainable manner (Brown 2014). Much of Asia's rapid economic development in the post-1945 era can be attributed to the bottom-up development impetus that was orchestrated and funded by a variety of proactive local financial institutions that essentially follow the CDB model. This began with Japan after 1945,

followed by South Korea, Vietnam, Thailand and others, and especially a decentralized China in the 1980s and 1990s (Bateman 2019c).

## THE KEY RATIONALES FOR SUPPORTING CONVERSION

There are at least four key overlapping justifications for using potential bailout funding to promote (where possible) the conversion of struggling MCIs into community-owned and controlled financial institutions. The latter are:

1. Better at promoting sustainable economic development and growth: History shows that community-owned and controlled financial institutions are far more capable of promoting sustainable economic development and poverty reduction compared to the average MCI. It helps that the average community-owned and controlled financial institution tends to be a functioning part of the local community and local society, often born as a result of past struggles and difficulties. With its democratic structure, it is also more likely to be held to its mission to promote development into the future.
2. Better at providing for the reinvestment of any surplus: One of the earliest reasons for community-owned and controlled financial institutions to emerge in the 1800s was to facilitate the recycling of locally generated wealth (profit) back into the local membership or the wider local community. This higher reinvestment attribute can also be facilitated by law, such as in Italy.<sup>9</sup> In other words, community-owned and controlled financial institutions are not *extractive* institutions, a term that would correctly describe the operations of most

<sup>9</sup> As with most cooperatives in Italy, financial cooperatives receive certain taxation benefits in return for agreeing to reinvest back into the cooperative a high percentage of their surplus. This legal measure is intended to ensure that the cooperative is better placed to create more sustainable local jobs, raise productivity in order to increase wages, and improve services to members. The cooperative is monitored by the taxation authorities to ensure compliance.

- medium-to-large MCIs operating today in the Global South.
3. Better at using fintech for the benefit of the entire community: The Covid-19 crisis has seen the very rapid deployment of financial technologies, or “fintech” by MCIs as a way to avoid contact with potentially infective cash (Haidar 2020). Fintech has enormous potential to deliver benefit to society, but it has become clear already that it has created more problems for the global poor than have been resolved. Two stand out: First, fintech is beginning to exacerbate the problem of over-indebtedness that was raised above. With access to microloans “at the touch of five buttons on your mobile,” large numbers of the global poor have already been plunged into quite astonishing levels of unrepayable debt (for the example of Kenya, see Donovan and Park 2019). Second, fintech is helping MCIs (and banks) to tap into the billions of daily tiny financial transactions of the poor and, by taking a small cut of the value of each transaction, poor communities are effectively being drained of much of their wealth (Bateman, Duvendack and Loubere 2019).<sup>10</sup> However, fintech nonetheless offers a unique opportunity for community-owned and controlled financial institutions to streamline and lower the cost of their operations, as well as retain and recycle locally generated wealth within the community (particularly if subject to democratic oversight).
  4. Better at promoting equality: A community-owned and controlled financial institution helps to build equality in the community in two important ways: (1) internal constitutional prohibitions strictly limit the value that elected officials and senior managers can extract as salaries and bonuses from their own financial institution, and (2) internal constitutional requirements dictate that any profit generated is either rein-

<sup>10</sup> For example, thanks partly to its ownership of the iconic M-Pesa mobile money platform, Safaricom is now Africa's most profitable company, earning a Wall Street-sized \$US747 million in 2019-20 (see Ngugi 2020).

vested back into the financial institution and/or passed down to individual members in the form of dividends, bonuses and other member reward systems. The problem of the “microcredit millionaires” that has emerged in many locations around the Global South, caused by CEOs, senior managers and so-called “social investors” in an MCI often quite legally diverting its earnings into their own pockets (Sinclair 2012), is much less likely to arise.

## KEY PRACTICAL ISSUES TO CONSIDER IN FACILITATING CONVERSION

In terms of the legal, institutional, organizational and other practicalities of converting MCIs into either of the desired new formats, dealing with these issues would naturally require a much longer treatment than space permits here. However, I will introduce several of the practical issues that will likely be important to resolve through negotiation when considering the conversion of a struggling MCI.

First, what type of community-based financial institution is best for the community in question? Small communities may be best suited to a credit union format that provides a limited range of financial services to saver-members and loans mainly for working capital purposes. A larger and more diverse community in terms of employment might be better served with a financial cooperative open to all local people. It would work on savings mobilization and establish a lending capacity geared to identifying and promoting more sophisticated and sustainable employment creation and other projects of value to the local community overall (e.g. cooperative development, renewable energy, local supply chains servicing local consumption needs). The financial cooperative format would be particularly appropriate for communities that receive large remittance inflows, which can become the financial base for much careful lending activity. The CDB format might also be appropriate,

especially in cases where none exist already, and where there are major economic problems, or opportunities to be exploited responsibly, that require coordinated institutional action backed up by “patient” financial support. A consultation exercise with an MCI’s clients and other local stakeholders will be required to assess what might work best.

Second, how best to ease out the current owners of an MCI? Especially if large investments were made in recent years and/or the MCI was exceptionally profitable, strictly commercial investors will likely not exit their investment in an MCI without a fight. Inevitably, equity holders will overwhelmingly prefer the sort of “no strings-no change” bailout that Wall Street’s banks and bankers received in 2008 – a restructuring process that would rescue an MCI’s equity holders by keeping the MCI alive and still under their control. However, if the MCI is on the verge of collapsing, conversion into the desired alternative ownership arrangement might not be too difficult. For example, in return for any financial bailout, a good part of the existing equity held by the current owners and investors could be swapped for an agreed amount of debt to be repaid once the new institution is up and running in the post-Covid-19 period (see also Guinan et al. 2020). The advantage of this debt-for-equity arrangement is that the original equity holders have an incentive to ensure the smooth conversion of the MCI in order that their debt is repaid in full and on time. The fact that foreign investors now own and control a large and increasing share of the equity of MCIs across the Global South further complicates the conversion process. However, it also makes it even more imperative. Foreign investors, including social impact investors, generally have little interest in or sympathy for the countries in which they invest. Even though in the absence of a bailout there may actually be considerably less value attached to the equity they hold, creative techniques will have to be adopted in order to overcome the resistance of equity holders to a change in ownership. Inevitably, the political will to effect such changes, aided by informed community mobilization, will be key.

Third, what form of regulation is required from governments? Democratic ownership and management have many economic, political and social advantages. But it is not a foolproof method of managing an(y) institution and it can often be subverted by narrow elites (both internally and externally) with a determination to do so. To ensure that any new institution operates according to the social mission it is assigned, and that it is not hijacked or destroyed by those ideologically opposed to collective action and/or hoping to benefit financially, ensuring robust regulation and (at least initially) local government oversight will be absolutely imperative. In particular, the hugely ineffective forms of self-regulation promoted by the microcredit industry itself (Sinclair 2012), will clearly have to be abandoned in favour of genuine measures to regulate the local financial system in a way that prioritizes the interests of the poor.

Fourth, who or where can we learn from? Financial institutions that work well in one context do not necessarily work well in another. There can be no guarantee in advance that the community-owned and controlled format will lead to local economic and social success. Nonetheless, it is still perfectly possible to learn from and adapt best institutional practices from elsewhere. One obvious and relevant example here is the way that the East Asian “miracle” economies learned from each other in order to create their own pro-poor collectively owned and controlled financial institutions. Beginning with Japan, each of the East Asian states that later achieved economic success did so with the help of a highly efficient developmental local financial model that was built on roughly the same core principles as pioneered in Japan but adjusted to local economic, social and political conditions (see Bateman 2019c). As Akyuz, Chang and Kožul-Wright (1999) have argued, learning from other experiences and adapting good practices to local conditions was the key to East Asia's miracle. To some extent a similar process of learning and adaptation got underway in Europe as a result of the economic destruction caused by the global financial crisis in 2008. In the UK, for instance, European and Canadian experience

has been tapped into in order to form a network of 18 regional cooperatively owned banks, which have as their goal the building of sustainable and equitable local economies (Peck 2020). Furthermore, it is important that many local governments have been successful in re-municipalizing companies that have abjectly failed to supply quality and low-cost services to the public, including many public bodies previously privatized (see Kishimoto, Steinfert and Petitjean 2020). Much important experience of facilitating similar conversions across the local economy now exist.

Fifth, how can clients of an MCI be helped to manage their financial cooperative or credit union efficiently and democratically? This will likely require extensive training, mentoring and on-the-job coaching by skilled cooperative trainers. It helps that much useful experience exists of this type of activity in Europe and elsewhere that can be tapped into by conversion projects in the Global South. For example, the UK's Cooperative College and the Workers Educational Association (WEA) both have experience running training programs and adult learning packages for those involved in setting up a variety of cooperatives, including financial cooperatives and credit unions. In terms of the CDB option, many of the world's most successful national development banks, such as Brazil's BNDES or Germany's KfW, have local units and interact extensively with local governments. As a result, they have the capability to provide training and consultancy to those communities in the Global South wishing to establish CDBs out of a struggling MCI. Germany's *Sparkassen* savings banks have an international development arm (*Sparkassenstiftung für Internationale Kooperation*) that provides advice and assistance to those wishing to replicate elsewhere their very successful cooperative financial model. Finally, there is also Spain's world-famous Mondragon Cooperative Complex (MCC), which has an international development consulting arm that provides advice and training to those who might wish to follow their example. This includes providing advice on how to establish a version of the *Caja Laboral Popular cooperative*

*bank*, which played a hugely important role in developing the region around Mondragon.

## CONCLUSION

The importance of adopting a build-back-better approach local financial systems in the context of the Covid-19 crisis simply cannot be overstated. The brief exploration of the issue in this article argues that governments in the Global South, the international development community and local activists must demand that financial support is not used to simply bailout once highly profitable MCIs, but is instead invested in the conversion of MCIs into the most appropriate of three types of community-owned and controlled financial institutions. While the Covid-19 crisis provides the immediate rescue pretext for such a bailout-cum-conversion policy, the fundamental ineffectiveness of the microcredit model as a development intervention provides the crucial rationale for the process to continue thereafter.

While certainly no panacea, history shows that community-owned and controlled financial institutions have a very good track record of providing a genuinely sustainable and equitable pathway for the global poor in order to exit poverty and deprivation. Not least of the advantages these institutions have is the ability to retain wealth generated within the local community and allow it to be used to develop sustainably the economic base and social systems for the good of the *entire* local population, not just for a narrow local elite (still less for a narrow foreign elite). And as the important examples from Europe and Asia demonstrate, community-owned and controlled financial institutions can be a very transformative development model indeed in a post-crisis rebuilding context. A new Rooseveltian approach to local finance in the time of the Covid-19 crisis thus deserves to gain traction today. We might then reasonably hope to see local citizens becoming the masters of the local financial system, and no longer simply its hapless victims.



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## Chapter 4

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# CORONAVIRUS AND THE EVOLVING ROLES OF CENTRAL BANKS: AVOIDING A “CLIMATE MINSKY MOMENT”

Central banks took the dominant financial role in many countries' efforts to deal with the economic fallout from coronavirus, using conventional and so-called 'alternative' monetary policy measures to cope with the effects of social distancing and lockdown. This chapter shows how banks in different countries used instruments such as zero or negative interest rates, differential changes in the regulation of commercial banks, capital guidance to desired end-users, exchange rate management and large-scale purchases of corporate and government bonds, or Quantitative Easing on a massive scale. The gap between what countries could do however is massive – many countries had only a fraction of the capacity needed to respond. Moreover, monetary policy was not often backed up by strong fiscal expenditures to boost demand and support the economy beyond what monetary policy alone can possibly achieve. This should be a concern for future contagions, whether viral or economic, because when one country remains vulnerable then all are vulnerable. Covid-19 has reminded us that national efforts alone can never be enough and multilateral cooperation is essen-



tial. This chapter also shows that coronavirus should not have been such a surprise, because its unfolding has followed astonishingly closely the path of a “climate Minsky moment.” This chain of events was identified by central bankers and development experts several years ago as a threat from global warming and climate change and Covid-19 is unlikely to be the last shock of this nature.

## INTRODUCTION

Central banks took the dominant financial role in many countries’ efforts to deal with the coronavirus crisis, especially those that were constrained in their use of fiscal policy. This chapter describes some of the conventional and so-called ‘alternative’ monetary policies they used to cope with the sudden stop to economic life. It situates their actions within the broader debate about what central banks can do, or should do, which has evolved over recent decades and is being reappraised. This will have important resonances, not only for central banking’s role in the immediate Covid-19 relief and recovery efforts, but also for the post-Covid rebuilding that lies ahead – in particular with respect to how central banks respond to the wider issue of global warming and climate change.

The chapter begins with a brief overview of the evolving role of central banks, highlighting aspects that have been illuminated by the Covid-19 emergency. It then describes the main tools used during 2020 by central banks around the world, including zero or negative interest rates, differential changes in bank regulations, guiding capital to desired end-users, managing exchange rates and the use of large-scale asset purchases or Quantitative Easing to finance government and corporate debt. It shows that central banks in some countries had only a fraction of the capacity to respond compared to those in rich countries – with average rescue packages of only 8% of Gross Domestic Product (GDP) compared to 27% on average for the advanced economies. This chapter also argues that

the economic fallout from coronavirus should not have been such a surprise because its unfolding follows astonishingly closely the path of a “climate Minsky moment” identified by central bankers and development experts several years ago, even to the extent that havoc is caused as much by the policies put in place as with the shock itself. The chapter concludes that Covid-19 is not likely to be the last Minsky moment and further debate is needed not so much about *whether* central banks should be supportive of government policy goals but rather *how*.

## COVID-19 AND THE EVOLVING ROLE OF CENTRAL BANKS

Historically, especially following the Great Depression and the Second World War, central banks had broad and powerful roles holding the reins of the economy (Tooze 2020a; UNCTAD 2019; Epstein 2015). They acted as guarantors of their national banking systems; the “banker of bankers”, taking whatever steps were needed to ensure financial stability, to finance government expenditures and debts and to backstop governments’ commitments to creating an economy that would support full employment. They were closely linked with government development goals and macroeconomic policies and used a wide range of techniques to support them, creating credit and guiding it to sectors and activities that the market would not have generated on its own. These included financing government debt at low interest rates, reducing the flow of credit to less desired activities and increasing it for those that were deemed important, and generally promoting the allocation of finance to where government priorities lay. They could be particularly powerful because, unlike governments, which must set taxes and determine expenditure according to budgets that are decided by voters or on their behalf by parliamentary or government committees, central banks are participants in the market, as well as being its regulators and leaders (Tooze 2020a). Being ‘in’ rather than ‘above’ the mar-

ket gave the ability to create credit without having to raise taxes or without having to find buyers for their debt, which is a tremendous potential power. Similar roles and mandates were taken up by developing country central banks too as they became independent in the post-colonial world. As had been the case in Europe, the United States and Japan, central banks were agents of economic development, vested with “wide and flexible powers” and using tools that had been tried and tested in the north (Bloomfield 1957).

However, the neoliberal revolution of the 1980s changed this (for most, if not all, countries), and the more active link between central banks and government was broken. Central banks were to be “independent” of central government and not to finance government deficits or specific activities; their mandates (either explicitly or implicitly) were narrowed to focus on price stability alone, with inflation targets to guide their course and measure their performance, and they were supposed to use indirect methods of monetary policy such as short-term interest rates rather than the direct methods of the past (Garriga 2016). All across the world, banks narrowed their mandates and tightened the scope of their responsibilities and tools. Central banks became more similar, whereas before they had differences reflecting historical context or economic size. The majority made the conduct of monetary policy their dominant role, with the specific goal of maintaining price stability as measured by a target for inflation (UNCTAD 2019; BIS 2009; Garriga 2016). In a few cases, central banks kept some additional macroeconomic objectives – such as the United States where the Federal Reserve was mandated by law to maximize employment as well as ensuring price stability. In most with diverse mandates, whether by law or statutory practice, the goal of price stability was primary. There were some exceptions to this, in particular, the rapid industrialisers of East Asia during the middle of last century and more recent examples can be found in both the developed and the developing world – for example, the central bank of China always aimed to consider government industrial policy objectives alongside monetary

ones (see MPAG 2019:2 for a recent reiteration of this principle). Generally, though, central banks trod a narrow path, focusing on setting interest rates and keeping prices stable.

This changed during the Global Financial Crisis (GFC) of 2008-09, when massive blow-outs in the financial markets (starting from the overloaded United States mortgage and junk bond market) spread rapidly throughout the world, impacting on trade, employment, incomes and aggregate demand virtually everywhere. Central banks showed they could adapt and change dramatically when times were tough and political will was forthcoming. Even those with narrow mandates for inflation targeting were able once again to make the link between monetary and financial stability, and the real economy. They created new money on a vast scale (or what seemed like a vast scale in those days), justifying the use of “unconventional measures” such as large-scale asset purchases (otherwise known as Quantitative Easing or QE) to buy government and corporate debt in an effort to boost aggregate demand and promote recovery.

These actions reminded people that the tasks of central banks have never been purely technical nor independent, even for those with narrow mandates restricted to just one goal and one instrument. For one thing, much depends on the underlying models of the economy and how different elements are forecast to respond when parameters change. Altering assumptions or altering parameters can yield entirely different results, and this kind of modelling is always as much an art as it is a technical science. Second, even the smallest monetary policy decision has never been neutral because different groups of people are always affected differently. Importers prefer high value currencies while exporters prefer low ones; borrowers want low interest rates, but savers want high ones. Trading off or balancing these decisions requires political decision-making and consideration of national goals; again something that is not technical.

In the years following the GFC, central banks were asked to re-appraise their role still further as people became more concerned about the challenge of global warming and climate change. The for-

mer Governor General of the Bank of England in 2015, in a speech to the Bank of International Settlements (sometimes called the central bank of central banks) said that climate change was a “tragedy of the horizon” for which central banks needed to prepare themselves (Carney 2015). He reminded his audience that the horizon for monetary policy was typically two years and the horizon for financial stability policy at most 10 years, while the horizon for climate change was very much longer. Once climate change became a defining issue for financial stability, it would already be too late to change it – so the sooner central banks started taking into account its physical, financial and transitional risks, the less costly and destructive it would be.

Carney warned in particular that climate change could cause another Minsky Moment – referring to the inexorable vortex identified by the late Hyman Minsky whereby financial instability and uncertainty created a general economic meltdown. This described what happened in the Great Depression of the 1930s and the GFC of the 2000s, and Carney extended the analysis to warn that climate change would similarly cause melt-downs of first financial markets and then the whole economy. This fell squarely into central banks’ undisputed basic responsibility of maintaining financial stability. As global warming leads to physical impacts such as rising sea levels, rising temperatures, extreme weather events or the loss of existing agricultural and habitable lands, this could be transmitted as a financial shock – for example, through the failures of insurance companies and markets, a fall in the value of pension funds whose investments were affected, and a rise in loan defaults and bank failures. Making matters worse, a powerful second, indirect route to financial instability could be caused by government policies designed to combat the threat of climate change – unless these were organized in a coherent and coordinated way. Even just the informal and spontaneous changes in behaviour on the part of firms and households could create destabilizing impacts if consumers abruptly started to eschew polluting products or equities and pension funds that invest in them (UNCTAD 2020, chapter 6).

A central bankers' Network for Greening the Financial System was established in December 2017 and quickly gained more than 70 member banks and financial authorities. Debate switched from being about *whether* central banks should use their role to support government policies for the shift to a more sustainable path, to *how*. It was argued that, as a minimum, even the narrowest mandate of ensuring financial stability means central banks need to do a lot to reduce the financial and economic risks associated with climate change and global warming. They needed at the least new approaches to macroeconomic modelling to accurately include corporate and financial exposure to climate change risks. Some also insisted that banks and financial institutions should disclose these risks.

But many observers went further, arguing central banks should take a considerably broader responsibility, harking back to their pre-1980s role. They could create and guide capital in ways that would no longer favour the largest corporations and enterprises (which were often polluting) and rather promote green and more sustainable ones, issuing green bonds and green finance (Camigliolo et al. 2018; Tooze 2019; UNCTAD 2019). Some central banks were already doing this, issuing green bonds, doing 'green' quantitative easing and differentiating the reserve requirement ratios for commercial banks in the system according to how much of their lending was directed to green activities. Bolder moves were also possible, such as central banks adjusting the list of corporate assets they define as 'eligible' for purchase as part of their standard portfolio management to include more corporations that are green, and further requiring that the list of assets that financial institutions are allowed to pledge as collateral when they borrow from the central bank should also include more 'green' enterprises. Some central banks already require commercial banks to incorporate environmental risk into their governance framework and adopt green lending targets. Across geographical and political jurisdictions, central banks from countries of all levels of income were trying these policy experiments, including the Central Bank of Lebanon, the Banque

de France, and the People's Bank of China (Dikau and Volz 2020).

Such a potential willingness to consider green finance arguments suggests there was already more policy space for central banks to use so-called alternative and other tools than many imagined – even before the coronavirus crisis in 2020 reinforced this message. Nobody thought the private sector would provide the support that was needed – this was the role of public banks and in particular should be led by the central banks. With the sudden stop in economic activity in March/April 2020, urgent meetings were held between ministries and bankers everywhere, turning over long-held assumptions and restrictions. Central banks took on new and experimental roles, with the implicit and explicit backing of their governments. In some cases, this required changes in the law.

One case has particular symbolic value, because it had been the first central bank in the world to narrow its role to just targeting inflation. Since 2019, it had already changed its mandate to include the goal of supporting maximum sustainable employment as well as price stability. Following Covid-19, it seemed the ground was shifting in other ways as well. On March 21, 2020, the Reserve Bank of New Zealand signed a Memorandum of Understanding with the Minister of Finance granting an indemnity to insulate the bank from financial risks associated with the use of “alternative monetary policies” including large-scale asset purchases. Moreover, an accompanying letter from the Minister reiterated that government was neither specifying nor limiting which tools the bank could use – operational independence meant the bank could use whatever tools it chooses.

This is a long way from the monetary straitjacket envisaged in the 1980s. It shows an evolving role for central banks that was starting to be thought about in the climate change context and has now been made possible by the Covid-19 crisis. In fact, Covid-19 can be seen as a classic example of the kind of Minsky Moment described above. Both the direct and indirect Minsky transmission routes have come to play – through the coronavirus and its attendant health impacts, and through the consequence of govern-

ments' policies of social distancing and lockdown to contain it. The link with a Minsky Moment was explicit, and Covid-19 was seen to bring the "tragedy of the horizon" into sharper focus (Horton 2020; Reguly 2020). As the pages below show, and as is summarized in Table 4.2, central banks everywhere pulled out whatever monetary policy stops they had to deal with it.

## CENTRAL BANKS LAUNCH THE CORONAVIRUS LIFE-RAFT

One of the first warnings that this health crisis was different from previous ones – such as SARS, Ebola and H1N1 – was that crude oil prices fell precipitously as lockdown killed the demand for travel, transport and production of goods and services generally. The bellwether indicator, Brent crude oil, fell from US\$70 per barrel on January 5 to US\$30 by early March, even before lockdown had started for many countries in the West but some months after it had begun in Asia. It dropped as low as US\$24 in mid-April, even going negative in some markets, before recovering somewhat by mid-year but nonetheless still at its lowest for 20 years (Trading Economics 2020). The shock-waves swept financial markets, contributing to nervousness already growing about lockdown and the spread of the pandemic. Exchange rates whipped up and down, equity markets followed suit, and as much as US\$84 billion fled out of developing countries in just a few months, seeking a haven in seemingly safer countries and currencies, and in so doing, further exacerbating the downward spiral. Automatic trading and synchronized, index-driven portfolio investment strategies piled in on the sell side and the swift downgrading of developing country debt by the major credit rating agencies exacerbated the size and spread of the shock. According to the Bank of International Settlements as much as US\$20 billion fled out of developing economies on just a single day in mid-March (BIS 2020). Outflows were three times larger than those recorded for a similar time period during the GFC.



This shock to the financial markets played havoc with domestic prices as well as international ones – which is the narrowest definition of the area of responsibility for central banks in the neoliberal model. They leapt quickly into action with the usual tools, trying to keep the financial markets liquid to avoid a credit crunch and debt deflation. However, the bleeding was worse than this, as the policies of social distancing and lockdown hit the whole of the economy and not only the financial sector. Consumer demand and supply dried up simultaneously even in countries that did not go into lockdown. This meant that even those central banks with mandates restricted to inflation targeting once again linked monetary and financial stability with stability in the real economy. They tried to restore confidence, boost demand and spending power as well as helping governments pay for the medical supplies and keeping hospitals, firms and households afloat. Central banks tried many different monetary tools, which can be broadly categorized in the following four groups:

**Reducing interest rates:** For modern, inflation-targeting central banks the main (often the only) tool is the short-term interest rate and in the early days of the coronavirus crisis this was the first lever many tried. Cutting interest rates is quick to do, and has the effect of lowering the cost of money across the board, which helps soften the blow to firms and households reeling from the burden of debt repayments and also to keep up aggregate demand. Most did this very quickly, cutting rates as soon as coronavirus-related policies began (with the exception of countries where interest rates were already at zero or close to it). As shown in Table 4.1, in some countries these rate cuts were not only rapid, they were very large indeed. For South Africa, the prime rate was reduced to a 55-year low; Indian bank rates fell from 5.15% in February to 4.4% in March and down to 4% by May; similarly for other countries such as Indonesia and others. China stands out because it cut rates by only a small amount, but its large public banking sector took other actions to confront the crisis. Taken together, this has significantly reduced interest rates globally and framed a new baseline for monetary policy everywhere (Lilley and Rogoff 2020).

Table 4.1: *Interest rate declines in the early stages of Covid-19*

| Country-region       | Official rate<br>April 2020 (%) | Last quarter<br>point change |
|----------------------|---------------------------------|------------------------------|
| Global average       | 1.22                            | -134                         |
| Developed countries  | -0.02                           | -132                         |
| Developing countries | 3.16                            | -146                         |
| Latin America        | 3.60                            | -277                         |
| Developing Asia      | 2.87                            | -70                          |

Note: Central bank official rates variously provided as Fed Funds rate, repo rate, discount rate, Selic ON rate, depending on country. See also BIS compilation of Covid responses at <https://www.bis.org/ifc/covid19.htm>.

How low can interest rates go? Negative interest rates might have been unimaginable once but now they are already a stick being used by some central banks to try to get commercial banks to lend rather than hoard capital. The European Central Bank (ECB), Switzerland and Japan had negative interest rate policies (usually linked to some minimum threshold of deposit), even before the coronavirus crisis, which suggests there is not so much a shortage of capital available in the world, but rather a lack of incentive to deploy it. Supporting this argument, the International Monetary Fund (IMF) estimates that at least US\$16 trillion is held in negative-interest accounts in Europe. In Denmark, when the central bank imposed negative interest rates, the commercial banks passed it on through offering negative interest rates mortgages – meaning the sum households owed fell each month by more than the sum they had repaid. This is more than free money – home buyers are paid to take on debt. Some criticized this as a risky strategy that harms profits for the banks, others complain it is bad for savers and pension funds – meaning a double hit for the elderly. (It is also a threat for today’s workers if their future retirement incomes are not well invested but put at risk).

These concerns aside, negative interest rates are on the radar screen for central bankers elsewhere too, as low interest rates are failing to boost borrowing and lending. As early as March 2020, the central bank in New Zealand put negative interest rates as a possibility on the table for the first time. By October, as a second wave of Covid was coursing through Europe, the Bank of England told its commercial banks to check their “operational readiness” for what in the UK would also be a ground-breaking move. It had cut rates to 0.1% at the start of the crisis and the message was couched as a technical IT issue; also, such a move would require a majority vote on the monetary policy committee. Nonetheless, markets view it as sign that “desperate measures” to nudge banks to lend more are being contemplated (Elliott 2020). For emerging markets and developing countries, where interest rates are still over zero, this has never been on the cards. The Central Bank of Brazil already noted in mid-2020, when its interest rate was closer to 4%, that for them to be at 2% was like being at zero for other countries. Commentators perceived this to be a warning the bank would not cut rates further nor could it try other monetary measures being used elsewhere when interest rates were no longer working to stimulate the economy.

**Increasing lending:** When interest rates are at close to zero (or what stands for zero in countries where higher rates are the norm) and when even the stick of negative interest rates are not inducing more lending on the part of banks (or demand to borrow from households and business), central banks tried more direct monetary measures. Most central banks did this through a myriad of schemes using their role as regulators to ‘re-regulate’. They reduced the reserve and capital requirements of other banks and financial institutions to reduce the risk of a credit crunch coming at a time of increased risk of loan defaults, or capital losses in the financial markets. The central bank of China freed up US\$265 billion this way by cutting the reserve ratio three times in just a few months and it further encouraged new lending by increased guarantees for loans (as high as 80% of the loans, compared to more like 60% in other countries) (MPAG 2020).

Other policies central banks used included increasing repurchase agreements and lengthening the maturities of their loans to other banks in the financial sector; sometimes relaxing the provisions for non-performing loans. They tried to make it easier for long-term lending to households and the non-financial sectors, by changing the regulations governing commercial banks loan-to-value (LVR) restrictions that determined the level and number of household mortgages banks could offer. The central banks in some countries imposed a rule that commercial banks should offer debt standstills for firms and households most affected by the Covid shock; some imposed a freeze on loan repayments (Bank of Bangladesh did this as early as January 2020). Others refused to allow banks to pay out dividends and encouraged mortgage holidays to beleaguered households.

Some banks also used credit guiding policies to increase lending to regions in need or where economic activities were deemed particularly necessary, using monetary policy to do what in other times governments could do through expenditure and fiscal policies. Often this was focused on health but also towards micro-, small- and medium-sized enterprises (MSMEs), or sectors in trouble such as tourism and the hospitality trade. As early as January 2020, the People's Bank of China (PBOC) instructed its state-owned commercial banks to lend up to 30% of loans to small- and medium-sized enterprises (SMEs) and a month later it reduced the interest rates for banks that on-lent to agriculture, farming and SMEs (MPAG *ibid*). In March, the central bank of Argentina offered particularly favourable conditions to the commercial banks in its system that lent to SMEs, as well as the 'stick' of reducing its holdings in those that did not; the central Bank of Egypt offered special loans to the tourism sector, manufacturing and agriculture, supported by government guarantees. In Nigeria, the central bank injected additional liquidity into the banking system worth as much as 2.4% of GDP, to support loans to the health, manufacturing and other impacted sectors.

**Quantitative easing:** Most interesting are central banks' use of large-scale asset purchases – an instrument that is more difficult than the lending schemes or interest rate changes described above because they cannot be reabsorbed quickly once the economy starts to recover. When central banks buy assets on a large scale – usually government bonds but in some cases corporate bonds from the private sector as well – it is harder to unwind and the massive purchasing sits as an asset on the central banks' balance sheets for a long time. It also reaffirms the view that the independence of central banks is a chimera.

For the five largest advanced economies, asset purchases were worth some 35-45% of GDP by the middle of the year (the United States, Eurozone, United Kingdom, Canada and Japan), dismaying critics who had been hoping central banks would get back to their pre-GFC slim lines. To get a sense of how big this is, consider that during the GFC the Fed's balance sheet in 2009 had risen by less than 10%. Some predict that ECB asset purchases will be up by 60% by the end of 2021 (Cavallino and De Fiore 2020). The Bank of England bought £226 billion of gilts issued by the government by September, meaning it had indirectly created and lent most of the finance needed for the government's new Covid-related expenditures (Office of Budget Responsibility 2020). It now owns just under half the total government bonds issued, double the level of the Fed Reserve in the United States and leading to debate about what it can pull out of the hat next, given that QE is not having the expansionary results its proponents expected (Stubington 2020). These figures would have been unimaginable just a year ago when austerity was still being recommended as the only solution to a stagnating post GFC economy.

Central banks in emerging economies also purchased bonds, including Colombia, India, Indonesia and South Africa. While the central banks in the north mostly aimed to avert a credit crunch, in the south their task was more about boosting confidence, acting as 'buyer of last resort' to plug the holes left as foreign owners of local cur-

rency sovereign bonds fled for seemingly safer shores. After years of extreme conservatism, they gave narrow and clearly defined explanations that focused on restoring market confidence as opposed to monetary stimulus or monetary financing of fiscal deficits (although one could argue this would be perfectly justifiable given the low cost of capital, urgent context and development benefits). South Africa purchased 30% of its government's gross issuances of bonds in April, citing the need to "ease dislocation" in the market, rather than calling it QE (SARB 2020 a,b). For many, this was the first time they had ever carried out such alternative measures and in some it required an explicit change in the law (e.g. Brazil, Czech Republic). Most used their foreign exchange reserves to pay for the bonds (as opposed to the central banks in reserve currency countries, which can buy bonds simply by injecting electronic money into the system). Few said exactly how big their buying programmes were, although those that did were small compared to the advanced economies (0.1% of GDP in the case of Korea, 2.8% in the case of Chile).

**Exchange rate management:** As predicted in the "Climate Minsky Meltdown" scenario of financial market instability described above and in Table 4.2, currency markets lurched in the rush to safety. Just as during the GFC, the hardest hit currencies were the hot and carry trade Brazilian Real, South African rand, Russian ruble and Turkish lira, with the exodus of sellers compounded by the interest rate falls, which were more pronounced in developing economies compared to the main reserve currency countries. However, advanced economy currencies were highly volatile too – the US dollar at first appreciated against the other major currencies Euro, Yen and Pound Sterling but as happened in the last crisis, this also rebounded and then depreciated again.

Central banks responded by trying to smooth the waters through buying and selling currencies in the spot and derivatives markets, especially in developing economies where their currencies were pummeled in the rush to buy reserve currencies. Their purchases were paid for by international reserve holdings or by

multilateral emergency credit lines offered through some of the regional liquidity funds (e.g. the Latin American Reserve Fund – FLAR and the European Stability Mechanism – ESM), and in a few cases through special swap agreements with central banks from the advanced economies. These actions can happen quickly. In the month of March 2020 alone, the US Federal Reserve (or ‘Fed’) offered swap lines worth US\$30 billion to US\$60 billion to 14 countries to ensure they had access to US dollar liquidity. This enabled central banks to use their holdings of US dollars, which were currently on their balance sheets as foreign reserves, as collateral for borrowing – anything rather than sell them. Others worked bilaterally. For example, the Bank of Japan offered a swap to Thailand of JPY 800 billion. These swap arrangements between central banks were incredibly important, not least to help countries avoid falling into a balance of payments crisis simply because of a shortage of foreign exchange (which happens quickly for countries dependent on commodities exports, tourism or remittances, all of which were hit by lockdown). Having access to the US dollar in particular is essential because 80% of total debt in the world is denominated in US dollars (UNCTAD 2020). On the other hand, of the 14 countries with whom the Fed negotiated credit swaps, only a few were developing countries (Brazil, China, Korea and Mexico) – some of these with very high needs even at the best of times. Once again, the exchange rate crisis revived debate about ending the hegemony of the US dollar and replacing it with other alternatives such as a bundle of currencies (Tooze 2020a).

Summing up, and as shown in Table 4.2, central banks pulled out an unusually wide range of monetary instruments and tools and used them to a very large scale in their efforts to bolster firms, households and even governments from the effects of lockdown. Some of these measures were squarely within their conventional role of ensuring price stability; others reflect the new understanding that is emerging about the central banks can play with respect to climate change, of which Covid-19 may be just one, very painful, example.

Table 4-2: Covid-19 economic impact as potential “climate Minsky Moment” and Central Bank responses

| Physical shock and policy risk drivers   | Economic shock  | Financial system shock   |
|--|---|--|
| <ul style="list-style-type: none"> <li>• Coronavirus victims ill or dying</li> <li>• Essential workers exposed to health risks</li> <li>• Social distance and lockdown for everyone else...</li> <li>• Closed airports, factories and shops</li> <li>• Work from home or no work</li> <li>• “Nowhere to spend it”</li> </ul> | <ul style="list-style-type: none"> <li>• Rapid shock to demand and supply</li> <li>• Collapse in trade</li> <li>• Unsold goods and services, drying up of new orders</li> <li>• Workers are laid off, self-employed are unpaid</li> <li>• Loan defaults, businesses go bust</li> <li>• Increased poverty</li> <li>• Reliance on government income support</li> <li>• Government revenues fall; budget deficits rise</li> <li>• Some pockets of new business and new jobs emerge to serve new demands – internet and digital economy providers rises, health technology etc., production of health products etc</li> <li>• Asset bubbles for those with capital</li> <li>• Inequality rises</li> </ul> | <ul style="list-style-type: none"> <li>• Immediate and unexpected shortage of cash-flow</li> <li>• Fall in remittances</li> <li>• Liquidity shortage</li> <li>• Credit providers tighten conditions further</li> <li>• Equity markets collapse in the rush to cash</li> <li>• Failures of insurance markets and companies</li> <li>• Loan defaults – businesses and banks go bust</li> <li>• Fall in value of pension funds</li> <li>• Debt deflation (debt is greater than asset value)</li> <li>• Capital outflows to “safe” havens</li> <li>• Rapid collapse in exchange rates for many countries</li> <li>• Fall in investment including FDI</li> <li>• Search for yield – rising risks</li> <li>• Asset bubbles as interest rates fall</li> </ul> |
| Central bank responses   | <ul style="list-style-type: none"> <li>• Lower interest rates, negative interest rates to boost lending</li> <li>• Regulatory changes to encourage increased lending by commercial banks</li> <li>• Large-scale purchases of government bonds to finance government expenditure</li> <li>• Large-scale purchases of corporate assets to finance corporate debt</li> <li>• Some guidance of credit to selected activities to encourage special sectors/regions</li> <li>• Intervention in exchange rates to support the currency</li> <li>• Credit swaps, support to foreign exchange liquidity reserve funds to support the currency and resolve balance of payments shocks</li> </ul>                |  |

Source: Expands on UNCTAD TDR2019 (chapter 6).



## COVID-19 PACKAGES AND THE ROLE OF MONETARY POLICY – GLOBAL DISTINCTIONS

At the outset of the Covid-19 crisis, many governments pledged to “do whatever it takes” and there was talk of Covid as a “levelling” crisis in the sense that all people and all countries, rich or poor, could be equally impacted. In reality, income made a huge difference, and this was evident not only at the level of household accommodation (who had a comfortable home and who did not) and jobs (who could work from home and who was either unpaid or in paid essential and dangerous work) but at the level of countries and central banks as well. Whether central banks had broad mandates or narrow ones, the disparity is clear when countries of different income levels are compared (see Figure 4.1). Some wealthier countries could put in place massive fiscal and financial packages worth 40-50% of GDP while poor economies had to cut their cloth in single figures. Brazil, a large economy reeling under the economic as well as health impact of coronavirus, was spending only 3% of GDP on its response packages by the middle of 2020 (UNCTAD 2020). Many other developing countries had much less space.

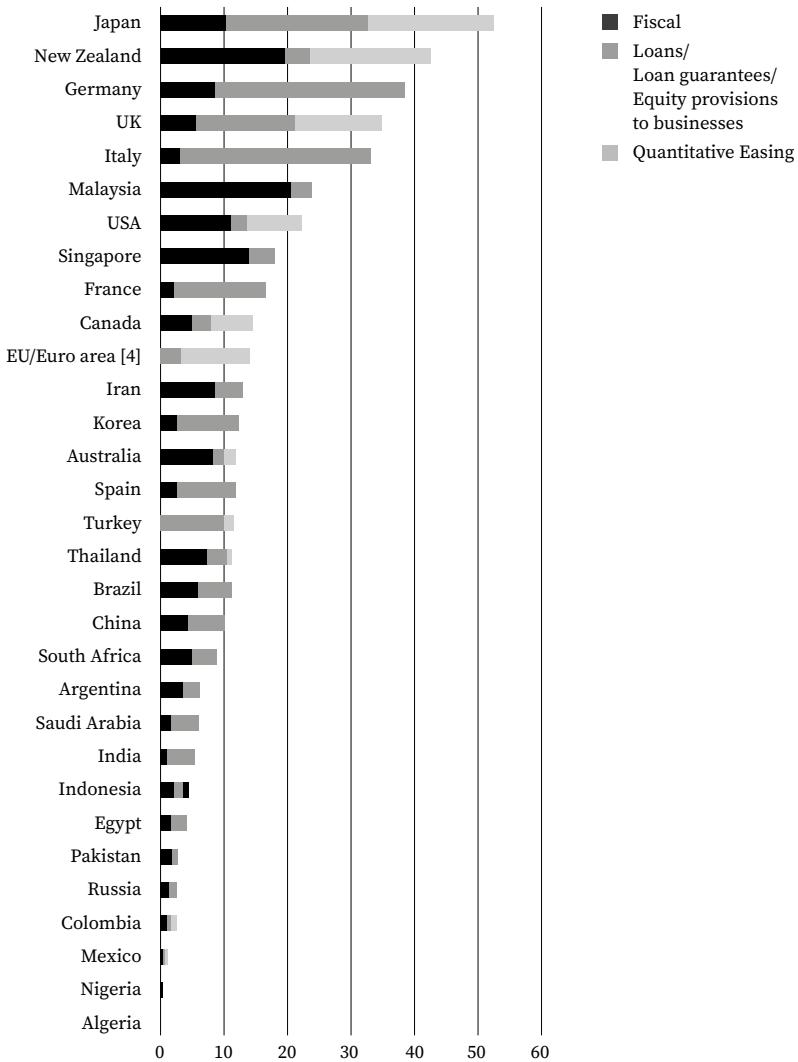
The composition of packages also varies according to national economic size, wealth and fiscal space. QE is a rich country’s tool, and central banks in developing countries are hampered by the fact theirs is not a reserve currency. Japan, which launched a stimulus and relief package worth over 50% of GDP, devoted roughly half of this to the instrument of QE, whereas Malaysia, which also had a significant package worth around 24% of GDP, could not use QE at all. Thailand – also with a sizeable rescue package, especially when compared to other developing countries – experimented with a very small amount of QE but mostly relied on loans to business and loan guarantees, supported by fiscal policy. In South Africa, the Reserve Bank argued it did not have the policy space to purchase government or corporate bonds like those in the United States or Europe could

do; moreover they were charged higher rates for borrowing on international financial markets. Their recourse was rather to the Bretton Woods institutions such as the IMF or World Bank – a choice some other developing countries tried to steer away from because of the conditionalities involved. The differences with regard to what central banks could do for Covid finance in their countries resonated with other long-standing inequities in the world; as noted by the Finance Minister of Ghana on June 3, 2020, at a virtual conference organized by the Harvard University Center for African Studies, “Suddenly the western world can print US\$8 trillion to support their economies in these extraordinary times, while Africans are judged by the old rules... You really feel like shouting ‘I can’t breathe’” (Ofori-atta 2020).

The lack of policy space for central banks in developing countries to provide emergency loans and loan guarantees and other monetary policies is also particularly important because, compared to advanced countries, their governments also had significantly less fiscal space as well. This matters greatly because while central banks and monetary policy can do a lot to create credit and even to guide it, there also needs to be demand for that credit and it is here that fiscal policy plays the essential other side of the coin to what central banks can do, because it gives governments the capacity to boost public expenditure in ways that can support demand. As central bank mandates became more narrow this further broke the link between monetary and fiscal policy and lead to silos of dis-connected policymaking.

Helping to fill this gap in some developing countries where national resources are lacking has been the emergence of strong new Southern-led regional public banks and funds (Barrowclough et al. 2020) and northern development bank aid programmes such as that by the German development bank KfW (see Marois chapter also in this volume), which offer technical assistance as well as finance. However, what is also needed is a concerted effort to restock the fiscal coffers of developing countries – for example, through combatting illicit capital flows. Financial regulation, including managing capital flows, as well as stronger taxation laws, could help in this respect.

Figure 4.1: *Country policy packages in response to Covid-19 (% of GDP)*



Source: UNCTAD 2020.

Note: Fiscal, loan and Quantitative Easing estimates are based on government and central bank announcements in reaction to Covid-19.

## CONCLUSION

Coronavirus has ended the illusion that central banks could or should simply enact monetary policy technically, somehow separate from and independent of politics. Central banks everywhere acted to support national political goals, either explicitly or implicitly, and thus 2020 is marked by a willingness and indeed necessity to leave the narrow model of the last few decades behind. The wide range of responses in different countries means central banks are becoming more diverse and complex again, with differing mandates and expectations and using a broader range of instruments. Many central banks have supported their government's fiscal policy, in particular financing government expenditure for healthcare or economic recovery packages through their purchase of government bonds (often on an extremely large scale). They are also not afraid to send strong messages to the commercial banks in their financial systems.

On the other hand, while the urgency of coronavirus has undoubtedly helped to spearhead this move – whether seen as less independence from government, or more independence to take the initiative and act as they choose – a less encouraging reason could be that it is also perhaps a recognition that deflation is now the real problem and not inflation (Tooze 2020b). In part this is because organized labour has been crushed so much it no longer has much bargaining power or ability to impact wages – which leads to the question of the distributive impact of central banks' Covid efforts (see for example Brenner 2020). Their efforts to ensure liquidity are also a way of supporting the financial sector, which does not translate directly into supporting labour or the rest of the economy. Whether households benefit or not is one of the most important yardsticks as to the distributive impacts and it is a worry that already some of the private banks that have been supported by central banks are failing to extend new loans or mortgages, apparently because they are 'overwhelmed' by the demand from

customers (or concerned about weakening shareholder returns). Asset bubbles benefit those who already own assets and the evidence is strong that rich people are getting even richer during the pandemic, while workers, savers and those without capital are getting poorer (Economist 2020).

There is also already starting to be a revival of the austerity mantra, with concerns about rising public debt and how it is to be repaid. Public debt is the inevitable consequence of taking on the debt from the private sector and needs to be seen as an investment in the future not a burdensome cost. This could be very dangerous if it leads to a premature tightening of fiscal policy again, especially as private banks and private finance have not leapt into the Covid recovery. Rather than debating whether central banks should have become so engaged, it would be more useful to critically examine the effects of their different instruments, so as to better evaluate what is most effective. For example, when central banks create and then lend money to governments for spending, can this be seen as a form of the “People’s quantitative easing” that was called for from across the political spectrum after the GFC (see Positive Money 2020). Is this a more democratic measure and is it better for reviving a stagnating economy than QE directed through the purchase of corporate bonds, which can lead to asset bubbles or, as happened last time, a flood of hot money into developing countries without producing investment or lasting benefit? Here decision-making needs to be transparent and the impact of decisions empirically evaluated, for example through the Bank of International Settlements or the UN system. Research is also needed to better understand what would have happened without these initiatives. If governments fail to use fiscal policy and expenditures to support the coronavirus relief efforts, central banks will likely keep on reaching for desperate measures to stimulate the economy – however, will these create the broad-based and expansionary effects needed, and what will be their impact on inequality? These are empirical questions as much as theoretical or ideological and need research.

It is also important that these questions should be answered, not only to ensure the success of today's Covid efforts, but also for the future post-Covid phase. Then, the attention of policy-makers and banks will turn to re-building. Building back better requires nothing less than structural transformation to a financial and economic system that is more sustainable and democratic and central banks have an extremely important role to play. Can Quantitative Easing for the People be a feasible tool as compared to QE directed via banks is an empirical question that could be further researched, to take just one example. More generally, for the financial system as a whole, as well as for central banks' place directing it, Covid-19 can be seen as a warning of what lies ahead if we do not find a more harmonious way of engaging with the environment. It has also made it impossible for us to ignore the inequalities at the heart of the current system, and the fact no country can act alone, especially when it comes to contagion whether economic or viral. The gap in 'response space' between the world's richest and poorest countries is massive, and this is not only inequitable it could hold the seeds of future crises as well. Both these inter-related issues are already on the radar screen of central banks and ideally they would also be in their mandate.

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## Chapter 5

Oscar Reyes

# THE COUNCIL OF EUROPE DEVELOPMENT BANK AND COVID-19

**T**he Council of Europe Development Bank (CEB) responded rapidly to Covid-19, approving just over €3 billion in emergency financing to 15 countries in the three months from the start of the spread of the pandemic in Europe in March 2020. As a small bank with a social mandate and a well-established programme of lending to the public sector, it amended its rules to ‘fast track’ public funding to health systems and small businesses that were under strain. CEB funding covered a broader range of operational costs (including emergency equipment and staffing) than multilateral banks typically offer. CEB’s high credit rating meant it could borrow cheaply from international capital markets, and as a non-profit lender it was able to pass on favourable rates to the national and regional governments that it serves.

## INTRODUCTION

This chapter examines CEB’s Covid-19 response through a brief survey of its emergency lending to 15 countries, which mostly involved loans to governments through the Bank’s Public sector Financing

Facility (PFF). CEB's concessional lending to health systems, which included covering emergency operating costs, offered a cost-effective alternative to government bond issues and helped regional and national governments to diversify their funding portfolio.

The first section of this chapter looks at how CEB was able to fill gaps in funding for public sector responses to the pandemic through a look at the three key features of the institution that are relatively little known. First, as a small institution with a relatively flexible governance structure, the Bank was able to quickly implement emergency lending rules to speed up lending decisions and disbursements, and waive the usual co-financing requirement that borrowers need to source 50% of the funding for a specified activity from other sources.

Second, CEB was able to raise additional funds for its Covid-19 response using its 'social bonds' programme to borrow from international capital markets. The Bank's high credit rating and track record of socially responsible lending meant that its bond issues in April and June raised €1.5 billion at very favourable rates. As a non-profit public institution, it could directly pass on the benefit of this cheap financing to its member governments. Third, CEB has established lending schemes for public health services, and micro- and small-scale businesses, so it could use its experience and contacts in these areas to act rapidly. This is shown in the section on the Covid-19 emergency response, which first outlines the extent of CEB lending, then focusses more closely on the PFF that was used to channel emergency support to health services.

The chapter then offers two brief case studies detailing CEB's Covid-19 lending to Spain, which involved a €200 million loan to the Comunidad de Madrid, and a €300m loan to the Instituto de Crédito Oficial (ICO) to support micro- and small-sized companies. The impact of CEB lending cannot easily be disaggregated from that of state financing, and it is too soon to directly establish what was achieved. The Madrid region is also facing systemic problems in its health and social care systems that finance alone cannot solve. Nevertheless,

CEB demonstrated the ability to provide rapid financial support for one of the countries that was hardest hit by the pandemic in Europe.

## WHAT IS THE COUNCIL OF EUROPE DEVELOPMENT BANK?

The Council of Europe Development Bank (CEB) is a multilateral development bank with an exclusively social mandate. It was established in 1999 as the successor institution to the Council of Europe Social Development Fund, which was originally formed in 1956 as the Council of Europe’s Resettlement Fund for National Refugees and Over-Population in Europe (Hummer 2015; PACE 2019). CEB is financially and legally independent of the Council of Europe, although it continues to be guided by the mandate and priorities of that institution (CEB 2020i, 26).

There are 42 CEB Member States, which are joint owners of the bank.<sup>1</sup> CEB financing is restricted to projects in its Member States, and it holds just over €26 billion in total assets as of 31 December 2019, including €15.6 billion in outstanding loans (CEB 2020d, 2). The bank approved €4 billion in new lending in 2019, distributed across 46 projects and programmes (CEB 2020d, 3).

### Funding priorities

CEB currently has three core priorities: fostering “inclusive growth”; offering “support to vulnerable groups”; and enhancing “environmental stability” (CEB 2020i, 15). Its core focus is providing “flexible, long-term loans to finance projects of major social benefit” (Hummer 2015, 3), including for social housing, education

<sup>1</sup> The 42 Member States consist of 40 that are Council of Europe (COE) members: Albania, Andorra, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Republic of Moldova, Montenegro, Netherlands, North Macedonia, Norway, Poland, Portugal, Romania, San Marino, Serbia, Slovak Republic, Slovenia, Spain, Sweden, Switzerland and Turkey) plus The Holy See (an observer State of the Council of Europe) and Kosovo.

and healthcare. It also offers programmatic support for public sector investment and job creation through micro-, small- and medium-sized enterprises (MSMEs) (CEB 2020m, 6).

In keeping with its social mandate, CEB aims to target lending towards “vulnerable people”, including migrants and refugees (CEB 2020i, 15). This was not specifically reflected in most of CEB’s emergency Covid-19 funding, although the health services that received support included the social care sector, such as nursing homes that were facing severe crises and equipment shortages.

Any CEB member can apply for funding, but the bank also specifies 22 Target Countries, a list comprising poorer members of the bank in Southern and Eastern Europe. CEB intends to increase lending to these countries, with a Target of €1 billion in dispersals per year out of a total of €3.5 billion in approved funding per year (CEB 2020i, 8). In fact, CEB regularly exceeds this target, with disbursements of €1.25 billion in 2018, €1.15 billion in 2017 and an estimate of up to €1.35 billion in 2019 – which may suggest the goal is not sufficiently ambitious. The majority of CEB lending is still concentrated in the richer 20 member countries (CEB 2020k, 23).

## **Governance**

CEB is overseen by a Governing Board which “sets the general orientations of CEB work and conditions for membership, elects the CEB’s highest officials and approves the annual report, the accounts and the balance sheet” (PACE 2019, 9). The Governing Board directly correlates voting rights to countries’ shares in the bank’s capital (PACE 2019, 10). There is ongoing discussion on how to give greater weight to smaller and medium-sized countries, “although ‘perfect equality’ in the sense of ‘one country, one vote’ – as in the case of the Committee of Ministers – would probably be unrealistic” (PACE 2019, 10). An Administrative Council, which is mostly comprised of representatives of national ministries of finance, “manages all the financial aspects, approves projects and the budget” (PACE 2019, 9). Two extra, online meetings of this Council

were held to process Covid-19 emergency loan requests.

Although CEB is legally independent of the Council of Europe, it must ensure that its social objectives are in line with those of the Council, and it cannot change its statutory purposes except with the approval of the Council of Europe's Committee of Ministers (CEB 2020k). CEB must also regularly inform the Council of Europe of its activities and respond to any guidance and recommendations made by the Council of Ministers and the Parliamentary Assembly of the Council of Europe (CEB 2020k). CEB lending rules include a fairly standard suite of policies governing transparency, anti-corruption, fiduciary duties, and environmental and social safeguards (CEB 2020h).

### **Funding sources**

- **Share capital:** The CEB is owned by its 42 Member States, whose shares in the Bank are directly related to their relative share of the Council of Europe budget. The three largest Member States (France, Germany and Italy, 16.7% each) together hold more than 50% of these shares (CEB 2020a, 15). The CEB has share capital of €5.4 billion (CEB 2020d, 20).
- **Profits and recapitalization:** As a non-profit institution, any profits made by CEB are reincorporated as part of the Bank's reserves, increasing its overall capital so that it can engage in more lending (PACE 2019, 10). The bank's net profit in 2019 was €105 million (compared to €98 million in 2018 (CEB 2020d, 3). CEB pays no dividends but transfers profits to the bank's reserves. It is likely that "in the coming years the CEB will likely hit the ceiling on the volume of financing it can offer to member States" (PACE 2019, 10). To increase lending beyond this point, CEB would need a capital increase from its Member States. CEB has requested capital increases six times in its history, the last of which came in 2011 (PACE 2019; CEB 2020k).
- **Bonds:** Unlike many multilateral banks and agencies, CEB receives no financial assistance or other financial subsidies from



its Member States. It raises funds by issuing bonds on international capital markets, which amounted to €4.5 billion in 2019 (compared to €4.9 billion in 2018 and €3 billion in 2017) (CEB 2020l; PACE 2019, 6). CEB is able to raise funds on very competitive terms because it has high credit ratings from the three main agencies: AAA by Standard & Poor's; Aa1 (stable outlook) by Moody's; and AA+ (stable outlook) by Fitch (CEB 2020e). These ratings are strong on account of the quality of CEB's lending track record and risk management policies.

- CEB's public lending is not subject to an explicit sovereign guarantee from its Member States, but if the Bank were to become indebted it would be able to call upon "subscribed and unpaid capital" to meet its obligations or call for a capital increase from its members – a significant backstop that reduces its perceived riskiness (CEB 2020k). The scope of the bank's lending is also tightly controlled. It only lends to Member States, sub-national public bodies or via intermediary financial institutions, such as private banks (CEB 2020g, 3). When the borrower is a non-state institution, the Member State must provide a letter indicating its "ability and willingness... to guarantee the loan" (CEB 2020g, 4). As such, CEB's members have a strong interest in maintaining CEB's creditworthiness (Hummer 2015).
- CEB's longstanding social mandate has also helped it to capitalize on recent trends in international capital markets, where investors are increasingly looking for socially responsible investments. (CEB 2020a; CEB 2020c, 6-7). Since 2017, CEB has issued almost €3 billion in "social inclusion bonds", which are aligned with the International Capital Markets' Association's social bonds principles (ICMA 2020; CEB 2020c, 6-7). These are used to raise funds for four of CEB's target sectors: social housing for low-income persons; education and vocational training; supporting MSMEs; and health (CEB 2020a, 12). The health sector was added to this scope in 2020 in response to the Covid-19 pandemic (CEB 2020d, 24).

### **Loan portfolio**

CEB approved €4 billion in new loans in 2019, and currently has a €15.4 billion loan portfolio (CEB 2020d, 2). Recently, support for MSMEs has formed the largest share of the CEB loan portfolio, with the stated aim of creating and preserving jobs. MSME support, which is provided via governments and financial intermediaries, accounted for 37% of CEB's 2019 lending. Other major areas of funding include measures "improving living conditions in urban and rural areas" (much of which is dedicated for social housing projects), which accounts for 17% of the loan portfolio in 2019, and 16% for "education and vocational training" (CEB 2020a, 4-5). These loans are often made to municipal and regional governments. In 2019, 8% of the financing approved was targeted towards "health and social care" (CEB 2020a, 5). This is consistent with the pattern of lending in previous years (PACE 2019, 6), although the proportion of health financing in CEB's lending is likely to have increased significantly as a result of the Covid-19 pandemic.

### **Distribution by recipient country**

Thirty-four of CEB's members are currently borrowing from the bank (PACE 2019, 6).<sup>2</sup> Many of the major users of CEB loans are also big contributors to its capital. The largest share of outstanding loans is currently held by France (€1.9 billion) and Spain (€1.8 billion), followed by Poland, Turkey and Belgium (CEB 2020k, 22). The concentration of lending in a handful of countries suggests that CEB should work to further diversify its portfolio, although this is partly offset by the fact that lending to major countries is often to regional governments and municipalities.

Just over half of loan recipients (51%) are Member States, with a further 27% of loans distributed to local, municipal and regional public authorities, and 22% to commercial banks and public fi-

<sup>2</sup> This figure has been adjusted to reflect the fact that San Marino and Andorra were added to the list of loanees in 2020.

nancial institutions (CEB 2020a, 4). The vast majority of Covid-19 emergency financing has been allocated directly to CEB member governments.

### **Types of lending**

CEB can provide loans and loan guarantees to co-finance projects in any of its 42 Member States. Its main financial instruments include project loans, which usually provide finance for a predefined individual infrastructure investment, and programme loans, which fund multi-project programmes – usually municipal investment plans (EASPD 2018, 2). Programme loans are also often implemented through private commercial bank partners.

CEB usually sets a 50% ceiling on the proportion of total project or programme costs that it can finance, although on a case by case basis, this can be increased to up to 90% for lending to poorer Member States (CEB Target Group Countries) (CEB 2020g, 6). A broader waiver of the rule on funding a maximum of 50% project costs was introduced for Covid-19 emergency financing (CEB 2020c, 12).

Programmatic financing facilities are used to support social infrastructure expenditure. Public sector Financing Facilities (PFF), which represent the bulk of Covid-19 emergency lending, are intended to “address temporary financing gaps”, as well as facilitating underlying investments in public services (CEB 2020g, 6). The fact that CEB can offer public sector financing under this broad scope, rather than having to restrict its lending to infrastructure costs, enabled it to offer rapid support for overburdened health sectors in response to Covid-19.

As a non-profit institution, CEB applies only a limited margin to its loans and charges no fees, passing on most of the favourable borrowing terms that it receives as a result of its high credit ratings to the social projects that it finances (EASPD 2018; CEB 2020m). CEB loan terms vary considerably in terms of disbursement amounts, maturity, currency and interest-rate structures or capital and interest payment dates (EASPD 2018, 2).

## COVID-19 EMERGENCY RESPONSE

CEB responded rapidly to the spread of the Covid-19 pandemic, issuing close to €1.5 billion<sup>3</sup> in “social inclusion bonds” in April and June 2020 to raise additional funds for its crisis response, and approving 17 emergency loans worth just over €3 billion in 15 countries by 3 July 2020 (CEB 2020b). CEB’s emergency response included adaptations to lending rules alongside operational changes to enable remote working (CEB 2020c 1, 5). A ‘fast track’ approvals process was put in place to respond to Covid-19, which saw the first emergency loan agreements signed in just one month (rather than the typical six to nine months). The new process involved additional meetings of the Bank’s administrative council, a written procedure for approvals, and a reduction (from two to one) in the number of internal appraisal committees prior to approving the funding (M. Siguenza, CEB country manager Albania, Andorra and Spain, personal communication, September 4, 2020).

### **Covid-19 emergency loans**

From April 17 to July 3, 2020, CEB approved 17 new loans (plus two loan increases) in 15 countries in response to the Covid-19 pandemic, as shown in Table 5.1.

CEB adapted its loan terms to ensure that it could respond rapidly to the coronavirus emergency. It introduced waivers on the proportion of the total cost of projects that can be financed from Covid-19 emergency loans (it usually caps its lending at 50% of the total), and the possibility for a first disbursement tranche to exceed the usual ceiling of 50% of the total loan amount (2020c, 12; CEB 2020h, 4.1). The eligibility criteria for lending were also changed to include covering salary costs for additional medical staff during the

<sup>3</sup> CEB issued €1 billion in Covid-19 Response Social Inclusion Bonds in April 2020, and a further US\$500 billion in June 2020.

Table 5.1: *CEB Covid-19 emergency response loans*

| Country             | Loan size<br>(€ million) | Borrower        | Purpose of loan   |
|---------------------|--------------------------|-----------------|---|
| Croatia             | 200                      | Government      | Healthcare, including medical supplies and equipment                              |
| Czech Republic      | 300                      | Government      | Healthcare, including medical supplies and equipment                              |
| Estonia             | 200                      | Government      | Support for MSMEs   |
| Greece              | 200                      | Government      | Healthcare, including medical supplies, staffing and equipment                    |
| Hungary             | 175                      | Government      | Healthcare, including medical supplies, staffing and equipment                    |
| Italy               | 300                      | Government      | Healthcare, including medical supplies and equipment                              |
| Kosovo              | 35                       | Government      | Healthcare, including medical supplies, staffing and equipment                    |
| Latvia              | 150                      | Government      | Healthcare, including medical supplies and equipment                              |
| Lithuania           | 200                      | Government      | Healthcare, including medical supplies and equipment                              |
| Republic of Moldova | 70                       | Government      | Healthcare, including medical supplies, staffing and equipment; support for MSMEs |
| San Marino          | 10                       | Government      | Healthcare, including medical supplies and equipment                              |
| Serbia              | 200                      | Government      | Healthcare, including medical supplies and equipment                              |
| Serbia              | 20                       | Pro-Credit Bank | Support for MSMEs. Extension of existing loan                                     |

|                 |              |                              |   |
|-----------------|--------------|------------------------------|---|
| Slovak Republic | 300          | Government                   | Healthcare, including medical supplies, staffing and equipment; support for MSMEs |
| Spain           | 200          | Comunidad Autónoma de Madrid | Healthcare, including medical supplies, staffing and equipment                    |
| Spain           | 300          | Instituto de Crédito Oficial | Support for MSMEs   |
| Turkey          | 200          | Government                   | Healthcare, including medical supplies, staffing and equipment                    |
| <b>Total</b>    | <b>3,060</b> |                              |   |

Source: CEB 2020b.

pandemic (M. Siguenza, CEB country manager Albania, Andorra and Spain, personal communication, September 4, 2020).

### **Public sector Finance Facility**

The majority of CEB's emergency Covid-19 lending (15 new loans) is drawn from its Public sector Finance Facility (PFF), which is aimed at national and sub-national public sector partners. The scope of this lending was expanded to include the emergency acquisition of medical material and equipment, including tests, ventilators and respirators as well as protective equipment for frontline staff, employment of temporary medical staff, the construction and conversion of temporary emergency facilities, medical units and hospitals to meet current emergency healthcare needs (Council of Europe 2020b; CEB 2020c, 18-19).

The extension of the PFF has allowed it to offer rapid finance at concessional rates. For example, a €200 million public sector financing facility loan to Serbia, approved in May 2020, has covered significant gaps in “the extraordinary budget lines created for Covid-19 mitigation measures,” with a key focus on improving the

supply of personal protective equipment and pharmaceutical supplies in hospitals, as well as additional medical equipment, patient monitors and coronavirus tests (Council of Europe 2020a). By way of comparison, the European Union made available €97 million to Serbia in response to the coronavirus crisis but only €20 million of this was designated for medical equipment purchases, with the rest of its emergency funding reserved for broader economic recovery measures (OECD 2020, 7). The responses of the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) have also focused on announcing plans for future funding increases to support economic recovery over a longer time scale.

A similar story can be told of the €300m PFF loan to the Czech Republic, which was projected to cover 90% of the immediate, short-term costs of addressing the pandemic at the time of its approval in mid-April 2020 (Council of Europe 2020b). CEB was able to offer the loan “under very generous conditions”, according to the Czech Government, which states that the first tranche of the emergency loan was offered at 0% interest rates for a loan period of up to nine years. These terms were more generous than could be achieved by the Czech Government directly issuing additional government bonds (Ministry of Finance, Czech Republic 2020). This, in turn, was made possible by the fact that CEB can borrow at favourable terms on international bond markets and, as a non-profit public institution, it can directly pass on the benefit to its member governments.

The PFF emergency response also included CEB’s first ever loan to San Marino, which reported that CEB offered concessional lending at a rate of less than 0.5% for up to 15 years to cover emergency medical supplies, diagnostic tests and to finance the reorganization and expansion of critical care capacity in the country’s only public hospital (Ministry of Foreign Affairs, San Marino, 2020; CEB 2020n).

## CASE STUDY 1: COMUNIDAD DE MADRID

On April 17, 2020 CEB approved a €200 million loan via its PFF to the Comunidad de Madrid regional government, to partly fund an estimated €2 billion in extraordinary expenditure on health and social services related to Covid-19 (CEB 2020c, 18). Management of health and social services is devolved to regional governments in Spain.

Madrid is Spain's third most populous region, with almost 7 million inhabitants, and was one of the hardest hit regions by Covid-19. Madrid reported 8,500 Covid-19 deaths in the three-month period from March 8, 2020, when the spread of the virus was at its most severe, although other estimates and figures including care homes put the total at closer to 15,000 (Gaceta Madrid 2020; Romero 2020). The Madrid region accounted for almost one-third of all cases in Spain at the time when the loan was approved (CEB 2020c, 18).

As with other PFF loans, CEB lending offers an alternative to borrowing on international capital markets. This has the advantage of diversifying funding sources as well as providing cheaper financing than would be available through bond issues, since CEB has a far better credit rating than the Madrid region.

The emergency loan to Madrid is being used to partly fund the hire of additional medical staff, phone line operations and payment of additional overtime expenses; to provide additional medical and pharmaceutical supplies, including diagnostic tests and ventilators; to purchase personal protective equipment; and to strengthen services in care homes for the disabled and elderly (CEB 2020c, 18-19). CEB funds were also used to part-finance the conversion of Madrid's conference centre, IFEMA, into the biggest hospital in Spain.

CEB's rapid response may well have helped to avert a far greater disaster in the Madrid region, but such financial provisions obviously cannot correct for structural failings in the region's partially privatized medical system. The IFEMA hospital helped to ease the pressure on other parts of Madrid's overwhelmed hospital sys-



tem, but its operation was far from smooth. Medical staff and trade unions criticized a severe lack of personal protective equipment and poor sanitary standards, forcing the temporary closure of parts of the site (Asuar 2020; Cadenas and Valdes 2020).

Neither could CEB's support for social care in Madrid overcome the "structural and systemic problems in relation to the Spanish model of nursing homes", three-quarters of which are privately run (Médecins Sans Frontières 2020, 3). Almost 6,000 people died at care homes in the Madrid region in the three months from March 8, 2020, when the Covid-19 crisis was at its most severe, with 88% of those deaths occurring in the period before April 17, 2020, when the region's overflowing hospitals were denying admissions to some patients (Santa Eulalia et al. 2020). The situation was compounded by the severe pressure facing ICU units in Madrid, and controversial triage protocols that excluded many care home residents (Herrerros et al. 2020; Sendles-White 2020).

A further €200 million loan for social care in the Madrid region was approved on September 25, 2020, building on an existing €200 million programme for the maintenance and upgrade of residential care homes, day care and support services that was approved in 2018 (CEB 2020b). While this loan is not explicitly part of CEB's Covid-19 emergency response measures, it will nevertheless increase support for the sector that has been hit hardest by the pandemic. At the same meeting of the CEB Administrative Council, a further €50 million loan for social care was approved to the Government of Navarra, another of the Spanish regions hit hardest by Covid-19.

## **CASE STUDY 2: INSTITUTO DE CREDITO OFICIAL**

A €300 million loan to the Instituto de Crédito Oficial (ICO), a national state-owned public bank that finances MSMEs and self-employed people in Spain, was approved on April 17, 2020. Emergency funding for MSMEs was offered as a core priority for job preservation

since, according to European Commission data, Spain's small businesses account for 72% of employment in the country (EIB 2020).

The CEB loan is for the provision of “second-floor facilities”, a phrase referring to the fact that ICO acts as an intermediary for funds that are actually distributed to MSMEs via private commercial banks. ICO determines the loan terms and provides loans or risk guarantees to the private banks, which are responsible for actually making funding approvals.

The exact distribution of the CEB lending is left to ICO, which had not requested a disbursement of funds as of the first week of September (M. Siguenza, personal communication, September 4, 2020). However, an example of this type of “second-floor facility” is the €400 million credit line that ICO arranged with BBVA, Bankinter, Cajamar and Santander banks on March 23, 2020 to help MSMEs and self-employed people in the tourist sector cope with liquidity problems arising from the Covid-19 shutdown (Bolsamania 2020). The recipients include hotels, restaurants, taxi and vehicle hire companies, as well as workers and business in related entertainment and leisure industries.

Lending decisions are administered by the private banks, but it is ICO that fixes the financial terms available through this credit line, which offers loans of up to four years' duration at a fixed interest rate of 1.5%, with an initial grace period on repayments and no opening commission (Bolsamania 2020). ICO provides a guarantee for 50% of the financing.

CEB is not the only multilateral lender to ICO, which will also receive up to €1.5 billion for its Covid-19 emergency response from the European Investment Bank (EIB 2020). Unlike EIB, however, CEB support is specifically targeted at micro- and small-scale companies (M. Siguenza, personal communication, September 4, 2020).

The emergency MSME funding builds on a long record of cooperation between CEB and ICO, and it is the fifth agreement signed between the two institutions. ICO has previously received over €2.3 billion from CEB to support MSMEs and the self-employed

(CEB 2020f).

It is too soon to measure the impact of CEB lending via ICO, but this will be calculated in terms of the number of loan awards and metrics on the size and needs of the businesses supported, to ensure a focus on micro- and smaller-scale companies has been maintained. With emergency lending distributed to provide these companies with working capital during the pandemic, it can be assumed that CEB has contributed to job savings, although it would be difficult to disaggregate its contribution from Spanish Government and EIB support to calculate the scale of this impact.

## CONCLUSION

The Council of Europe Development Bank (CEB) responded rapidly to Covid-19, offering 19 emergency loans worth €3 billion in the three months following the widespread shutdown of European economies. This represents two-thirds of the lending that the bank regularly offers on an annual basis. CEB was able to scale up its lending in response to Covid-19 because it had a well-established programme of funding for public health systems and small businesses, and the flexibility to amend loan rules to offer ‘fast track’ approvals for government support to these sectors. CEB was also able to borrow €1.5 billion in additional funds on international capital markets in April and June 2020 and, as a non-profit institution, can directly pass on the benefit of this cheap financing to its member governments.

CEB was able to rapidly step up its operations in response to a health emergency that rapidly ushered in a severe economic downturn. This is consistent with the behaviour of other public banks, which tend to act ‘countercyclically’, lending more in order to stimulate the economy at times of crisis, while in the same moments private banks tend to become more conservative and risk-averse (Griffith-Jones et al. 2018).

As a public development bank, CEB is able to offer lending on concessional terms that cannot be matched by private banks, which are required to make a profit. CEB has a strong track record of financing the public sector, in particular, as well as social sectors that are not well catered for by private, for-profit institutions. CEB financing is mainly attractive as an alternative to raising funds on international bond markets, where its high credit ratings enable it to borrow more cheaply than many of its Member States, and the regional and municipal governments that it serves.

To date, the only external examination of CEB's emergency lending has been offered by credit ratings agencies. Moody's found that "CEB's involvement in the coronavirus crisis response, and the associated increase in lending, further supports the importance of its mandate for its shareholders [Member States]" (CEB 2020e). Fitch reached a similar conclusion, taking the view that a strong Covid-19 response had increased CEB's "importance for its member states" (CEB 2020e).

It is not possible to independently verify how effective CEB's emergency lending was, in the absence of any means to disaggregate its impact from that of emergency financing raised by governments through bond issues, or subsequently offered as a result of EU funds. Likewise, while CEB has a 'social mandate' that emphasizes support to disadvantaged populations, there is no clear metric against which to assess this, although it should be noted that CEB adopted a broad definition of vulnerability for its emergency financing on the grounds that healthcare workers and older populations should be considered vulnerable in the face of the pandemic. Working to develop performance indicators for public banks, including measures of their social impact, should be a priority for future research.

What can be clearly established, however, is that CEB was able to offer cheap lending to public health authorities and (via intermediaries) to micro- and small businesses; CEB lending supported emergency staffing for public health and short-term working capital costs for small business; CEB offered concessional loan terms that

could not be achieved by private lenders; and CEB lending helped Member States and regions to receive cheap and rapid finance at a time when the Covid-19 pandemic had put significant strain on their finances. In this way, CEB has likely helped to protect numerous lives and livelihoods in the face of Covid-19.

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## Chapter 6

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# THE ROLE OF THE EUROPEAN INVESTMENT BANK IN TIMES OF COVID-19

**T**he COVID-19 pandemic represents Europe's worst humanitarian and economic crisis since the Second World War. However, initial responses by European Union (EU) institutions to the pandemic in general – and the European Investment Bank (EIB) in particular – were limited: national governments and National Promotional Banks reacted much more quickly and to a greater extent than the EU institutions. It took the European Council (EU Heads of governments and states) over a month from the beginning of the pandemic in March 2020 to reach an agreement on additional potential lending (at the end of April), due to the divided positions of Member States on the guarantee and risk-sharing financial arrangements to respond to the economic impact of Covid-19. Though the EIB introduced in March an early – but limited – Emergency Package, it was not until end April that it assumed – although not yet operational – a substantial role in responding to the crisis via the Pan-European Guarantee Fund (EGF). Funded by

the EU Member States, the bulk of EGF finance is oriented to funding enterprises, particularly Small and Medium-sized Enterprise (SMEs) and, to a lesser extent, on measures to halt the spread of Covid-19. Most of the EGF funding implemented by the EIB is to be made available through financial intermediaries, namely, National Promotional Banks and private commercial banks. For the EIB's role in responding to the crisis to be truly effective, it needs to focus more on the final beneficiaries of projects during this crisis, rather than on private financial intermediaries themselves – for which the EIB has been criticised in its main funding programme of the past half-decade, the European Financial Strategic Investment (EFSI) (the Juncker Plan, 2015-20).

## **THE EUROPEAN INVESTMENT BANK: A BRIEF BACKGROUND**

The EIB was established in 1957, and it is the financial arm of the EU. From the beginning, it was deemed essential that finance instruments would be required to facilitate the policy objectives of the European project. The EIB was designed to promote three main lending objectives: development, to prevent economic imbalances amongst its Members and encourage economic growth of the least developed regions; integration, to develop the Common Market; and investment, to rebalance capital markets through investments and the setting of interest rates (Clifton et al 2018a). From the 1960s, the EIB also began lending to non-member states and non-European countries. By the 1990s, the EIB emerged as the world's largest international development bank, overtaking the World Bank in terms of assets and liabilities volumes (EIB 1994). During the context of the financial and economic crises from 2008 (Clifton et al 2018b), the EIB came under criticism for being overly conservative, and for not prioritising the European regions most in need and those in the rest of the world (Griffith-Jones and Tyson 2012). Today, the EIB has around 3,450 employees, mostly based at its Luxembourg

headquarters. Its current capital base is €243 billion and it lent €63.3 billion in 2019 (EIB 2020a). The EIB enjoys a “triple A” credit rating (EIB 2020b). Around 90% of its loans are destined for EU Member States, while the rest is lent to neighbouring countries, as well as countries in Africa, Asia and Latin America and the Caribbean.

## THE COVID OUTBREAK IN EUROPE

Europe found itself early on at the very epicentre of the Covid-19 humanitarian crisis: the first case in Europe was officially recorded by the World Health Organization (WHO) Covid-19 Dashboard on February 21, in Italy and, by end March, Europe accounted for the vast majority of the world’s Covid-19 cases, reaching 40,000 at the time. The virus spread unevenly in Europe, first in Italy, but then to Spain, which reached a national peak, at 9,222 cases on April 1, accounting for almost one quarter of all European cases that day (WHO 2020). The high number of cases in Europe was accompanied by high death rates. Deaths due to Covid-19 rose quickly from March and deaths in Europe by far dominated world deaths that month. Official daily deaths in Europe reached 5,140 on April 8. During April, Europe started to see gradual declines in cases and deaths, in the context of different national approaches to strict lockdowns for millions of citizens and varieties of furloughs for millions of workers. However, as lockdown restrictions were relaxed, cases again rose, reaching by late August infection levels approaching the worst days, although Covid-19 deaths were significantly reduced. EUROSTAT calculations of “excess deaths” – the number of deaths in a set period when compared to the same period in previous years – reveals wide disparities across Europe. Deaths in Italy peaked first, followed by Spain (where “excess deaths” were double the deaths in previous years), France, Belgium and the Netherlands (EUROSTAT 2020a). Overall, EUROSTAT estimates there were 160,000 excess deaths in Europe between March and May 2020 (EUROSTAT 2020b). Overall, WHO re-

ports that, to August 22, Europe accounted for nearly 4 million of the global 23 million Covid-19 cases, and 216,478 deaths of the total 800,000 deaths.

The economic consequences of Covid-19 will remain with us for the long term. The World Bank recognises that Covid-19 has plunged the world economy into the worst recession since the Second World War and will see global GDP contract by 5.2% in 2020. The European Central Bank (2020) and the International Monetary Fund (2020) predict GDP in the EU will contract between 8.7% and 9.3% in 2020, before growing 5.7% and 5.2% in 2021, returning to its 2019 real GDP level only in 2022.

## **KEY FINANCIAL ACTIONS TAKEN (AND PLANNED) BY THE EIB AND EU INSTITUTIONS TO RESPOND TO COVID-19**

In an attempt to mitigate the economic and business shock of the pandemic, national governments in the EU set in place diverse emergency measures from March 2020, which aimed to support individuals, workers, and firms in difficulties. These national fiscal and financial measures amounted to around 2% of EU GDP by the end of that month (EIB 2020c). Meanwhile, financial support measures at the EU level were limited to the suspension of EU fiscal policy rules (the Stability and Growth Pact), increased lending, and redeployment of existing EU funds. These measures included a proposal to make available lending from the European Stability Mechanism (ESM) to up to 2% of GDP for each member state and €240 billion in total, to be lent without the ESM's standard conditionality of structural reforms imposed upon recipient governments (Mertens et al. 2020). In response to the macro-economic impact of the pandemic, the EIB proposed the extension of its total lending for 2020, which had been originally set at €63 billion. However, further measures at the EU level to tackle the socio-economic consequences caused by Covid-19 were still pending by end March (EIBc 2020),

which, as they are classified as “Special Activities”, are “off balance sheet” and in addition to EIB lending “on balance sheet” from the EIB’s own resources. In a 25 March joint letter, the heads of government and state of France, Italy, Spain and six other EU Member States, called for the creation of EU Commission issued “corona-bonds” to fund additional health care costs related to the pandemic (Dombey et al. 2020). However, Germany, the Netherlands and a number of other Member State governments opposed this move (Dombey et al. 2020).

The European Council took until April 23 to come to an agreement finalising a common package amounting to up to €540 billion in additional lending to mitigate the macroeconomic crisis caused by the pandemic (European Council 2020a). This package included instruments to support governments, workers and firms. It would operate through three main instruments. The first was to be managed by the ESM, as noted above; the second was to involve lending from the EU Commission to boost Member State efforts through the new “Support Unemployment Risks in an Emergency” (SURE) programme; the third was to be a €25 billion Pan-European Guarantee Fund (EGF) managed by the EIB to support firms, particularly Small and Medium sized Enterprises (SMEs) with the aim of achieving a multiplier of ten, and hence mobilising up to €200 billion of additional capital. The European Council called for the EGF to be operational by 1 June 2020 (EIB 2020d).

Subsequently, in July, the European Council agreed upon a substantially larger package of support funds (Next Generation EU) (European Council 2020b). This package included up to €750 billion in lending and pre-allocated grants, with funds to be largely raised by the EU Commission, through the issue of long-maturity debt. The details on the repayment of this debt have yet to be agreed. However, the EIB’s EGF agreed in April remains its main contribution to addressing the pandemic to date.

On May 26, the EIB Directors agreed on the EGF’s structure and business approach. All 27 EU Member States were awarded the right

to contribute to the EGF with a share pro rata to their shareholding in the EIB's capital. The EGF would become operational as soon as Member States that accounted for at least 60% of EIB capital signed their contribution agreements and a Contributors Committee will be set up to decide on proposals to the EIB for the use of guarantee. Since the EGF will operate within the EIB, any project supported by the EGF will also require final approval according to the EIB's regular procedures and its decision-making structure. The EGF will approve operations until the end of 2021. EGF is not yet operational as two Member States have not completed the ratification procedure for their participation, and a further seven, mainly from Central and Eastern Europe, have not yet made known their decision to participate (EIF 2020). As a consequence, while the selection of financial intermediaries for established EIB products has started, for EDF a preliminary Call for Expression of interest has been published on August 31, 2020 (EIF 2020).

Prior to establishing the EGF, the EIB had already implemented some emergency measures in March to repurpose existing guarantees and support for companies during the crisis. The first measure taken, launched by the European Investment Fund (EIF), a subsidiary of the EIB, on April 6, offered dedicated EU-supported guarantees to SMEs and midcap companies (those with up to 2,999 employees) to soften the impact of the pandemic, worth €8 billion. Another key initiative taken by the EIB Group was to use existing financial instruments shared with the European Commission – primarily the InnovFin Infectious Disease Finance Facility (IDFF) (EIB-European Commission 2020) – to finance projects that focused on halting the spread of Covid-19, including vaccine development. Of the fourteen operations signed in Europe under IDFF up to September 7 for a total €372 million, only one can be directly related to Covid-19, which was for €10 million and destined for Poland (EIB 2020h). The EIB Group also announced the support of emergency measures to finance urgent infrastructure improvements and equipment required by the health sector, us-

ing existing framework loans or undisbursed amounts from existing health projects. The EIB Group's Covid-related project list in the health sector included seventy-two projects and amounted to around €17.86 billion by end of August 2020, of which thirty projects totalling €10.54 billion had been signed, representing 17% of the total EIB lending for 2020 estimated at €63 billion (EIB 2020e). The project list includes fourteen projects worth €12.27 billion in total for outside the EU, four projects worth €475 million in total for Research and Development – all of which in Germany, and six projects worth €2.69 billion in total for healthcare facilities – two in Spain, one in Italy and the rest outside the EU, representing 13%, 2.7% and 15% of the list, respectively, in the context of Covid-19 response. The vast majority though is in the form of credit lines to financial intermediaries for SMEs, and concerns sixty-two projects worth €14.69 billion, i.e. 82.2% of the EIB Group's Covid-related project list. Although EIB's contribution to the health sector appears at first glance larger than its usual practice – which represented 2.24% of its total lending since its establishment (EIB 2020f), a closer examination of the figures shows this is not the case. It is expected that the EIB's response directly related to Covid-19, will be in the same order of EIB's historic average contribution in the health sector, given that projects approved but not yet signed in Covid-related projects' list concerning Research and Development as well as Healthcare facilities amount to a mere €3.17 billion, i.e. 5% of the total EIB lending for 2020. Moreover, not all loans approved are effectively signed. Scrutinising the list further, it can be observed that the total amount of the projects included in the list has to be interpreted with caution, as some projects have been signed for amounts inferior to the loan amount approved and mentioned in the list, whilst others might end up never being approved and/or signed – as for example five health projects in the UK appearing in the EIB project pipeline under appraisal since 2007. Some other projects in the EIB Group's Covid-related project list do not seem related to the Covid-19 re-



sponse, such as some projects in the Czech Republic, Italy, Spain and Belgium, which are multisector investment programmes, or the Amadeus IT Group SA project, which concerns the development of technologies used by “airlines, travel agencies and rail operators” (EIB 2020g). These examples strengthen longstanding concerns about the EIB transparency and accountability raised in the last twenty years by academia, NGOs, press as well as the European Parliament (European Parliament, 2001), and recently by the European Ombudsman (European Ombudsman 2020). This would suggest there is a process of “Covid-wash” occurring. Furthermore, the Amadeus project in particular, raises also concerns as to EIB’s consistency with its claim of being a climate bank, announced in November 2019 (Counter Balance 2020b).

Beyond Europe, the EIB group has provided funding to support infrastructure and research in the health sector to fight Covid-19. This funding is to provide up to €6.7 billion as part of the “Team Response”, and is supported by guarantees from the EU budget (EUEA 2020). This will both strengthen urgent health investment and accelerate long-standing support for private sector investment that corresponds to financial needs in up to more than 100 countries around the world.

## **INTENDED BENEFICIARIES OF EIB ACTION**

The EGF was designed to provide guarantees to the EIB and the EIF for funding enterprises – in particular SMEs – that were deemed viable over the long-term, which met financial intermediaries’ requirements for commercial lending, but were struggling as result of the pandemic. At least 65% of EGF financing is earmarked for SMEs (enterprises with up to 249 employees). A maximum of 28% is destined for non-SMEs with at least 250 employees. Of this amount, a maximum of 5% can be destined for public sector companies and entities active in the areas of health, health-research, or activities

providing essential services important in the context of the health crisis. Up to 7% of EGF funds can be allocated to venture and growth capital (through the EIF) and venture debt in support of SMEs and mid-cap companies (EIF 2020).

Counterparts and beneficiaries established in Member States that are contributors to the EGF will be eligible. No country quotas for lending guarantees were established, and every contributing Member State will proportionally guarantee all operations. Through the EGF, EU Member States will provide irrevocable, unconditional and first-demand guarantees to the EIB Group in relation to operations satisfying the eligibility criteria of the fund.

## HOW EFFECTIVE WAS EIB ACTION IN RESPONSE TO COVID-19?

The EGF is spearheading EIB action in response to Covid-19. It will provide guarantees to the EIB and the EIF to reimburse any possible losses incurred in their operations. By pooling credit risk across all of the EIB's members, the overall average cost of the EGF will be significantly reduced, compared to national schemes. Financially speaking, this appears an efficient solution given the objectives of a Regional Development Bank (Clifton, Diaz and Howarth et al 2021: Clifton et al 2021) – which the EIB can be categorised.

Most of the EGF funding will be made available through financial intermediaries – National Promotional Banks and commercial banks. Once the funds are made available and the list of financial intermediaries established, companies can file requests directly with financial intermediaries. One analysis of the EIB's role in providing long-term finance in the period following the financial crisis, from 2015 to 2020, within the context of the Juncker Plan (the European Financial Strategic Investment, or EFSI) maintained that the bank was partially successful in providing long-term finance to investments that would have not otherwise taken place (Griffith-Jones and Naqvi 2020). However, the EIB's use of complex financial products

and opaque pricing methods (Griffith-Jones and Naqvi 2020) has sometimes offered terms too generous for private investors. While increasing intermediation in EIB products, it diminishes transparency and accountability provision. We argue that especially in view of the public health crisis, it is high time for the EIB to establish a health sector strategy – as already recognised (EIB-European Commission 2018) and step up its contribution from its own funds, beyond risk-sharing facilities with the Member States and the Commission as EGF and IDFF respectively. In its response to Covid-19 economic crisis, it is imperative for the EIB to focus squarely on the final beneficiaries (SMEs, innovation, social and environmental projects) rather than the private financial intermediaries. This is not the first time the EIB has been criticised by observers for its, arguably, generous treatment of private investors. While recognizing that “market failures and investment gaps suggest that the public sector has a key role to play” (EIB 2020e, 41), the EIB has played an important role since the 1990s in promoting Public Private Partnerships (PPPs) (Liebe and Howarth 2019) for transferring design and construction to the private sector (Health Management 2007). Counter Balance (2020a 2020c) also warns that the financial instruments promoted by the EIB should not lead to privatisation – particularly of the core public services sectors such as health – which are already impacted due to decades of dismantling. For the EU’s public bank, the need for assuring transparency and accountability, in view of the increasing use of budgetary and Member States’ funds especially in the public good health sector, is higher than ever.

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## Chapter 7

Thomas Marois

# THE KfW AND COVID-19: COORDINATING PUBLIC FINANCE RESPONSES AT HOME AND ABROAD

**T**he KfW is a German public development bank with decades of institutional history and substantial financial capacity. When the Covid-19 pandemic hit Germany, the KfW formed part of the Government's coordinated financial response, collaborating with public authorities to deliver rapid and substantial support at home and abroad. In this moment of crisis, the KfW has made use of its accumulated resources and expertise to facilitate a pro-public response. The KfW offers important lessons about the importance of building up public banking capacity and about having the democratic structures in place to mobilize public banks in the public interest.

## INTRODUCTION

Germany is often singled out in the media as having, by and large, coordinated a successful response to the Covid-19 pandemic. Its first confirmed coronavirus case was in Munich on February 27, 2020 (Wieler et al. 2020). The outbreak was not unexpected, given what was happening in China and Italy, and plans were already



underway to begin dealing with the novel virus threat. By the end of February, Germany reported 26 confirmed cases, and travellers from high-risk countries like China and Italy were required to provide contact details. Over the next month or so, gatherings of more than 1,000 people were banned, EU borders were closed to non-EU citizens, and anyone coming into Germany was required to quarantine for 14 days. Between mid-March and mid-April 2020, confirmed Covid-19 cases spiked, peaking at just over 6,000 a day (a number well below other EU peaks) before falling to less than 1,000 per day by late April and early May.

According to German health experts, ample and effective public health authority capacity and facilities underpinned the country's coordinated strategy of *prevent* (through data, analysis and crisis management), *detect* (through scaled up testing), *contain* (particularly by limiting transmission to long-term care facilities) and *treat* (made possible because of existing hospital and intensive care unit (ICU) capacity and because healthcare workers had adequate protective equipment) (Wieler et al. 2020). Germany also reached out and collaborated with France, Italy and the Netherlands to pre-order 300 million doses of an in-development Covid-19 vaccine (Varagur 2020). In consequence, most Germans look favourably on the Government's coordinated response. According to one survey, over 70% of respondents stated that "Berlin's coronavirus policies were 'more democratic than undemocratic, more fair than unfair, more competent than incompetent'" (Rahn 2020). Indeed, one gets the sense that in German state authorities put the public interest first in how it sought to manage the Covid-19 crisis.

Having managed the immediate health crisis, however, is by no means the same as averting the economic crisis. As is the case everywhere, the German economy and people's livelihoods were dramatically and suddenly impacted by the lockdown measures designed to contain the spread of Covid-19. In response, two supplementary budgets were penned authorizing additional fiscal spending of €156 billion (4.9% of Germany's Gross Domestic Product – GDP) in March

2020 and another €130 billion (4% of GDP) in June 2020 (IMF 2020). The Government funds were (and are) destined for healthcare provisioning, vaccine research, financial supports for students, workers and families, grants for small businesses and the self-employed, and expanded unemployment benefits. The Government funds also provided for various bank credit guarantees, as well as green investment and digitalization subsidies to support economic stabilization and recovery. Within this flurry of economic crisis and public finance responses, the German public bank, the KfW, has assumed a central role in Covid-19 crisis recovery, both at home and abroad.

## THE KfW AS A DYNAMIC PUBLIC BANK

The KfW (Kreditanstalt für Wiederaufbau, or ‘Credit Institute for Reconstruction’) is a public development bank (or ‘promotional’ bank in EU terminology). It was founded in a time of crisis, in 1948, as an institutional vessel meant to manage post-World War II reconstruction funds coming to Germany via the US Marshall Plan (hence, ‘reconstruction’ in its name). Over the decades, the KfW has expanded significantly and evolved dynamically (Marois forthcoming). As a development bank, it does not maintain a branch network (as it does not accept personal deposits) but it has acquired a network of 80 offices within Germany and around the world. It had 6,705 employees in 2019.

Housed in a high-income advanced capitalist European country, the KfW has grown to be one of the world’s largest public banks (Hubert and Cochrane 2013; Moslener et al. 2018). According to Orbis BankFocus, an online database for all banking institutions, the KfW had assets totaling US\$569 billion in 2019. This makes the KfW the 89<sup>th</sup> largest bank in the world, out of some 32,000 public and private institutions, and the 15<sup>th</sup> largest public bank, out of 910 public institutions, with more than twice the total assets of the World Bank.

Unlike the overwhelming majority of private banks around the

world, the KfW is by mandate not a profit-maximizing bank. That is, it has not built up its current mass of public financial capital by ruthlessly pursuing financial returns, as so many of the so-called too-big-to-fail corporate banks have done. This does not mean it is a loss-making bank. The KfW has an average return on assets (ROAA) of 0.35% (between 2012 and 2019) (whereas many private banks average 1-2% ROAA). In turn, this netted the KfW an annual average profit of US\$2.10 billion over this same period, which are then recycled back into the bank's reserves to be used for further lending (Marois forthcoming). The point is that public policy and political direction, not profit maximization, are at the core of the bank's institutional persistence and functional orientation (Deeg 1999; Naqvi et al. 2018). In the words of one KfW Regional Manager, the rationale of public banks are to do 'public tasks' (confidential interview, online, October 12, 2020). Despite *not* being oriented towards profit-making, neoclassical economists and neoliberal advocates nonetheless (absurdly) insist on assessing public banks on how their profitability levels stand up against other profit-maximizing private banks (see La Porta et al. 2002). For those knowledgeable about the public banking sector, this ideological grafting of private accumulation logics onto all public banks, regardless of context, is nonsensical (Schmit et al. 2011, 104):

This wide range of underlying economic rationales [of public financial institutions in Europe] renders meaningless most performance-based analyses of public sector banks, since all that such analyses measure is financial performance (which presupposes the overriding aim of profit maximisation), neglecting all other kinds of objectives pursued by public financial institutions.

There are other ways of operating than according to private performance measures. In this the KfW is a decidedly 'public' and 'dynamic' bank, both quantitatively and qualitatively. It is firmly sit-

uated within the German public sphere, being legally owned by the Federal Republic of Germany (80%) and by the federal states (20%). At the same time, the KfW is run according to public law, not private (specifically, the *Law Concerning KfW*). The public purpose of the KfW is represented in its mandate, which is to provide for the “sustainable improvement of the economic, social, and ecological conditions of people’s lives”. This mandate and the bank’s operations are mediated by German Government ministries and their political priorities and by the bank’s own governing Board, which together constitute a representative democratic form of institutional governance (see Hubert and Cochrane 2013; Marois 2017). Importantly, KfW’s Board is broad-based and legally-defined. By law, the Board has 37 members: it is co-chaired by the Federal Ministers of Finance and Economic Affairs and Energy in rotation plus 35 further members drawn from German society. These include 14 appointments divided between the German Bundestag (Lower House) and Bundesrat (Upper House) and five more federal government ministers. The mortgage banks, savings banks, cooperative banks, commercial banks and business credit institutions each have a representative on the KfW Board, as do German municipalities, agriculture, crafts, trade and housing associations. The KfW Board membership is rounded off by representatives from four trade unions and two from industry.

As the KfW is located within the German public sphere, it can be shielded from direct exposure to market-based and financialized operational imperatives. A key element to this market shielding is the German state’s formal guarantee of the KfW’s stability, which translates into a very strong credit rating as the likelihood of default on monies borrowed is seen as remote by market actors (S&P AAA). This helps the KfW enjoy preferential access to global financial markets and receive the lowest possible interest rates. In the current low rate environment, this can mean borrowing near, at and even below 0% interest rates (that is, the KfW has borrowed long-term debt with negative yields) (Ramnarayan 2019). Indeed, KfW govern-

ment-backed debt is often regarded as a proxy for German ‘bunds’ (government bonds). This is important as most incoming sources of KfW capital now come via bond issuances in global markets (in addition to the year-on-year build up of retained earnings) (Naqvi et al. 2018, 681-82; KfW 2019, 12-13). As part of its public mandate, the KfW then passes on such financial advantages through the public sphere to its mandated ‘promotional’ lending. The spread between what the rate KfW borrows at and lends at is determined both by mandated lending programmes and by the need to be financially ‘sustainable’ (that is, to cover operating costs and lending losses).

In its more than seven decades of operation, the KfW has been anything but a static financial institution. In its first decades of operation, it moved beyond its initial post-World War II reconstruction role to involve itself in foreign aid operations and to situate itself as a cornerstone of German domestic and export-oriented industrialization, particularly by supporting small- and medium-sized enterprises (SMEs) (Deeg 1999; Moslener et al. 2018). The KfW would go on to play a central role in German reunification and acquire a catalytic hand in German energy transition.

None of these institutional changes come without challenges, conflict and contradictions (Marois forthcoming). On the one hand, for example, KfW industrial lending has grown significantly and has been geared towards accelerating domestic growth, thus underpinning German economic expansionism (Naqvi et al. 2018). On the other hand, German society is increasingly conscious of the environmental impacts of endless industrial growth, demanding that the KfW be more ‘green’ and ensure reductions in carbon emissions (*cf.* Angel 2017; Paul 2018). The KfW attempts to balance these often-competing demands. Currently, about 40% of all lending helps to reduce carbon (although 60% continues to carbonize the environment) (KfW 2017, 2; KfW 2019, 3). In recognition of such ‘green’ changes, however incomplete, the KfW is seen as an industry leader in environmental financing (Ervin 2018, 149-51). Still, at times KfW operations have caused controversy, including over costly subsidies

(as with its early promotions of solar panels for households) or in the operational mismanagement of its subsidiaries (such as the IKB financial scandal in 2008). No one should ever suggest that public banking is easy or that it should not be constantly held to account by the public.

The KfW nonetheless demonstrates that pro-public change is possible, even within the structural constraints of neoliberal financialization. In greening itself, the KfW has found innovative ways of connecting to the German public at a local level. For example, the KfW Energy-Efficient Urban Rehabilitation programme targets energy transitions within towns and cities and through municipal entities and not-for profit institutions with energy-efficiency refurbishment loans for buildings (Bach 2017). This programme has a distinctly public-public character, with over €700 million in financing directly supporting municipal energy efficiency retrofitting. Indeed, such public programme lending reflects the vision of public banks in Germany. The Association of German Public Banks (AGPB) writes that acting “on behalf of public authorities they [public banks] perform tasks that support political goals” (AGPB 2014, 3). This is reflected in KfW’s own mandate, which states that it provides “financing with a public mission” (KfW 2019b, 4). This public mission includes both public and private sector support, to the exclusion of neither. The KfW is not without its problems but it has, nonetheless, found ways and acquired institutional patterns that suggest an enduring level of societal credibility that enable it to persist and reproduce itself in the German context.

The KfW thus reflects four dimensions that can help us think about the bank as a ‘public’ and ‘dynamic’ bank.<sup>1</sup> First, it is firmly located within the public sphere through ownership, control and

<sup>1</sup> These four dimensions are more fully explained in a forthcoming book-length monograph (Marois forthcoming). A key feature of this rethinking is to avoid ascribing to public banks any essentially ‘good’ or ‘bad’ characteristics because of their being publicly-owned. Instead, it is far more important to empirically and historically focus on what public banks do and why. This means examining how contentious social forces in society struggle to make and remake public banks over time.

legal mandate. Second, it performs banking functions that, as and because they evolve over time, suggest that the KfW has no innate purpose or essential policy orientation. The KfW, in other words, is made and remade by social forces over time and in the context of Germany. Third, the KfW functions in public and private interests, responding to needs within the public sector and to those in the private sector. The balance or imbalance of this functioning is the result of competing interests over what the bank does. This too suggests that there is nothing innate or essential to being ‘public’ as each bank will acquire different orientations and functions depending on the power relationships in which it is embedded.

Finally, the KfW persists as a credible, contested and evolving institution, meaning it will always be subject to the pull of competing and class-divided interests so long as it exists and persists as an institution within capitalism. This framing provides a sober understanding of the KfW as a public bank. It grafts nothing essentially negative or positive onto the institution by virtue of merely being ‘public’ but focuses attention on how it is made to function institutionally. The bank is understood as perennially open to dynamic change, potentially progressive and potentially oppressive, as a result of social forces making it so in time- and place-bound historical circumstances in capitalism. The KfW, and public banks generally, are already unavoidably contested, and therefore dynamic, institutions (and those concerned with a green and just transition ought to recognize this). This more open way of thinking about the KfW can help us to give some context to its Covid-19 support at home and abroad.

## DOMESTIC COVID-19 SUPPORTS

As a domestic response to the impact of Covid-19 in Germany, the German Government tasked the KfW with expanding its credit offerings and guarantees for all sizes of firms, credit insurers and non-profit institutions, thus increasing the total volume of KfW

lending by “at least €757 billion (24 percent of GDP)” (IMF 2020). According to the International Monetary Fund (IMF), such lending may include “facilities for public equity injection into firms with strategic importance.” In the first half of 2020, “KfW’s financing volume more than doubled as a result of coronavirus aid programmes” (KfW 2020b). The German Government at the same time relaxed national financial regulatory requirements so that KfW-backed Covid-19 support loans given out by other financial institutions would not negatively impact their leverage ratios or exposure limits. Local and regional governments in Germany likewise provided additional financial supports to their own state and municipal public banks to support recovery.

KfW action was first initiated on March 11, 2020, when Chancellor Angela Merkel announced that the Government would do whatever it took to address the Covid-19 crisis. The KfW was key to the Government’s strategy, particularly in terms of the German Economic Stabilisation Fund (FRGFA 2020). On March 23, 2020, Federal Minister for Economic Affairs and Energy Peter Altmaier made the following statement (FMF 2020):

It is now important to help companies quickly and without red tape. An important element here is to provide access to liquidity. The improved financing conditions set out in the KfW Special Programme 2020 will help to significantly support the economy in this respect. Applications will be processed quickly and without undue bureaucracy. Payments will be made as quickly as possible because we know that, for many enterprises, every week counts.

No doubt behind the scenes discussions had been underway between the KfW and the Government in the preceding weeks. Just prior to this announcement, Finance Minister Scholtz had said that the KfW would receive a €100 billion loan to support the programme lending being asked of it by the Government (Chazan



2020). Moreover, the Government announced that, with official backing, the KfW could lend without limit to businesses in trouble (Chazan 2020). The benefit of the Government lending to and through the KfW is that the bank can then leverage its accumulated financial capacity and expertise. At the same time, the funds channelled through the KfW can be further magnified and dispersed via the country's existing public and private banks, as well as through the expansive and powerful public savings banks, the Sparkasse system. It is important to acknowledge the historic built up Germany's public financial legacy, a legacy that does not exist in other advanced capitalist systems like the US and the UK. The Chair of the Board of Managing Directors at KfW, Günther Bräunig, underscores this point (FMF 2020):

The banks and KfW have prepared intensively for today. Never before have we been able to put a full programme together this quickly. The federal government will assume close to full liability and the loan margins are extremely low.

As of late September 2020, the KfW had on offer four aid/loan programmes providing financial support to companies, self-employed people and freelance workers (KfW 2020a). These loans are to provide liquidity and to help cover operating costs, thus giving businesses and individuals time to overcome the crisis.

### **KfW Instant Loans for medium-sized enterprises**

The KfW Instant Loans for medium-sized enterprises is a programme that is notable for its speed of delivery – that is, basically 'instant'. The necessary conditions are fairly basic: it is meant for medium-sized firms of with more than 10 employees, which are active since at least January 1, 2019, and which are profitable on average for the three previous years. The credit amounts available then vary according to firm size. Ten-year loans are granted at 3% interest. The issuing or on-lending bank is backed 100% by the KfW

(which is in turn backed by the Federal Government). The structure allows for the rapid granting and release of credits for eligible companies as, once the conditions are met, no further risk assessment needs be done by the issuing bank or by the KfW.<sup>2</sup>

### **KfW loan for companies on the market for longer than five years (Entrepreneur Loan)**

The KfW Entrepreneur Loan is meant to assist with investments and to provide for working capital for companies that are older than five years. For larger companies, the KfW assumes 80% of the risk while for small- and medium-sized companies, it assumes and up to 90%. Qualifying companies can apply for up to €100 million, subject to a series of conditions.

### **KfW loan for young companies on the market for less than five years**

For companies that are less than five years old, the KfW has the ERP Start-up Loan. The conditions are similar to the Entrepreneur Loan (80% for large companies and up to 90% for SMEs, with access to up to €100 million), just with a shorter time period of being in operation as the basis of qualifying.

### **KfW Special Programme**

Finally, there is the large-scale Special Programme meant for investment and working capital in medium-sized and large companies. The programme involves syndicated financing wherein the KfW takes on direct participation of at least €25 million but no more

<sup>2</sup> The KfW showed dynamism in its initial response to the pandemic. As in many other countries around the world, the commercial banks balked at only receiving an 80% guarantee for funds to be on-lent to struggling companies. They saw their capital at risk everywhere. Within days of first announcing its 80% and even 90% guarantees, the KfW reviewed and then improved its programme. The 100% guarantee loan programme was then rolled out on April 3, 2020, which allowed commercial banks, public and private, to lend out Covid-19 support funds without risk (Mertens et al. 2020, 6). This became the KfW Instant Loan.

than 50% of the total debt. The KfW assumes 80% of the risk, subject to certain conditions being met.

The KfW reports that, as of June 30, 2020, it had received 70,000 loan applications and had in turn lent out just under €34 billion (KfW 2020b). The lion's share of applications (some 97%) came from SMEs with almost all of the loans (indeed 99.8%) being for up to €3 million in support. By mid-August 2020, loan applications had topped 81,000 and KfW loan commitments neared €43 billion. While part of the four programmes above, the KfW also directed support towards students, via the KfW Student Loan, which is a zero-interest rate loan provided until March 31, 2021. As of mid-August 2020, about 24,000 students applied with KfW loan commitments reaching €700 million.

## **INTERNATIONAL COVID-19 SUPPORTS: THE KfW DEVELOPMENT BANK**

The KfW is a corporate banking group composed of five divisions, split into domestic and international operations. Domestically, the SME Bank (Mittelstandsbank) and the Municipal and Private Client Bank (Kommunal- und Privatkundenbank/Kreditinstitute) make up the bulk of KfW lending (about two-thirds). Most of the Covid-19 support is accounted for here. In 2012, KfW founded a fifth charitable division, the KfW Stiftung, which is geared towards not-for-profit projects in Germany. Abroad, the KfW IPEX Bank (project and export financing) and the Development Bank account for about a third of KfW lending. Here I look at some of the KfW Development Bank Covid-19 lending around the world and its role in facilitating development aid.

In this international aspect of KfW operations, the Development Bank responds to funding requests from its partner countries (about 70 globally). KfW partner countries include 'least developed countries' with average gross national income (GNI)

per capita under US\$992. Normally, the KfW assesses the development project, usually via the Federal Ministry for Economic Cooperation and Development (BMZ) or the European Commission, which takes the final funding decision. So too with Covid-19 aid. Consequently, KfW aid and lending decisions are mediated by the public sphere. Where existing national development banks are already in place in the partner countries, the KfW can work with and through these institutions, refinancing their domestic loan programmes. Otherwise, the KfW works with local clients and beneficiaries, whether they are public or private institutions, depending on the domestic programme.

According to Marc Engelhardt, Head of the Task Force of KfW Development Bank, the KfW will offer about €5 billion in Covid-19 financial support via the Federal Ministry for Economic Cooperation and Development's Emergency Covid-19 Support Programme 2020 (KfW 2020c). These emergency funds will be followed up with additional Federal Government support funds that will also be channelled through the KfW in the coming months and years. The immediate concern, however, was for the KfW to react swiftly to support health initiatives and social security and to help public and private sectors weather the initial storm of the pandemic. According to Engelhardt, "[t]ime is an especially critical factor in this pandemic. This is why we want to pay out all of the additional Federal Government budget funds this year, to make tangible improvements in our partner countries very fast." As of mid-July 2020, the KfW had supported 140 projects globally, focused on Africa and the Middle East, but including commitments in Asia, Southeastern and Eastern Europe and Latin America. Having acquired not only significant financial capacity, but also decades of institutional expertise and development memory, the KfW also provides technical support around the design, preparation and implementation of funded projects. Such internal technical support and expertise is often a feature of public development banks, for example, with the North American Development Bank, the Nordic Investment Bank and the National Bank for Agriculture and Rural

Development. Internal to the KfW, Engelhardt notes that it can leverage its domestic experiences as well, for example, by learning from how the KfW at home rapidly supported German SMEs in order to provide similar support in Central America via its regional development bank, the BCIE. Below I review four country- and region-specific Covid-19 interventions by the KfW Development Bank.

### **KfW and Covid-19 in Peru**

The KfW, on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ), has loaned Peru €250 million (KfW 2020d). The loan's framework connects plans to combat the impacts of Covid-19 to realizing climate and environmental goals in Peru. It does so by first providing financial support to small businesses and their employees to overcome the immediate economic crisis and then, as recovery takes shape, by channeling resources into green investments.

In the first instance, the priority is rapid dispersal to help the heavily informal workforce in Peru, which is disproportionately impacted by the pandemic and related lockdowns. This meant targeting micro and small enterprises, many of which have little accumulated capital to weather the storm of economic restrictions imposed but nonetheless employ upwards of 50% of Peruvians. The KfW does not lend directly to such enterprises but needs to work through a local institution, which in this case involved the Peruvian public development bank, COFIDE (Corporación Financiera de Desarrollo or Development Finance Corporation). COFIDE was founded in 1971 under the Velasco military regime to promote business investments.<sup>3</sup> It has since evolved. In the 1980s, the Government made COFIDE subject to private, not public law. Since then COFIDE has tended to on-lend to other financial entities in Peru. As of 2019, it has US\$3.2 billion in assets and a return of average assets of 0.25% (Orbis BankFocus October 2, 2020). According to the KfW, COFIDE has

<sup>3</sup> For more on COFIDE and public banks in Peru, see Dancourt and Jiménez Sotelo 2018.

supported over 300,000 micro and small enterprises during the pandemic. The bulk of the KfW loan will go towards supporting COFIDE in this area. What is less clear is the extent to which this massive loan will in fact be green. The KfW reports that the Peruvian Government committed to reduce carbon emissions by 30% and to promote sustainable development, so long as this was backed by international aid, presumably including contributions from the KfW. No further details were forthcoming. A KfW Regional Manager confirms, however, that firm survival and jobs are the first priority and that they are not yet able to turn efforts towards energy efficiency, greening, and so on (confidential interview, online, October 12, 2020).

### **KfW and Covid-19 in Senegal**

In Senegal, the KfW has facilitated the transfer of a German Government grant worth €100 million (KfW 2020e). The purpose of the grant is to help address the economic and social impacts of the pandemic. A further €124 million in grant money will be provided by the European Union (EU) [which combines contributions from EU Member States and the European Commission, as well as from two other EU public banks, the European Investment Bank (see Clifton et al, this volume) and the European Bank for Reconstruction and Development]. A key feature of this programme is that the funds provided are pure grants, and are therefore non-repayable. The funds are intended to support micro-, small- and medium-sized enterprises and related jobs and to help the Government meet its needs, particularly in the health sector. The funds are expected to be dispersed by the end of October 2020.

### **KfW and Covid-19 in Zambia**

In Zambia, the KfW partnered with UNICEF and the Zambian Ministry of Health to provide €20 million in emergency Covid-19 pandemic containment financial support (KfW 2020f). The German BMZ will provide the funds, which are to be directed by the KfW towards hospitals, for use at Covid-19 treatment and isolation cen-

tres and for broad-based support. Specifically, the KfW-facilitated aid package included the delivery of personal protective equipment for medical staff in early September 2020. This included surgical masks, gloves, oxygen devices and Covid-19 test kits to be distributed to 1,400 health centres. Support will also go towards training staff in the application of the Covid-19 tests. At the same time, the funds will support general health efforts, such as tuberculosis immunizations for infants and pregnant women. The KfW funds will further target improved water and sanitation services in schools, health centres and villages to help prevent the spread and impact of Covid-19. In both urban and rural areas, water purification chemicals are to be provided. Finally, emergency income support for the poor and informal workers most impacted by the crisis will be provided. Via UNICEF, the BMZ and KfW will allocate €8.75 million in cash transfers meant to top up existing government payments to the poor to help cover basic needs in the coming months.

### **KfW support for Covid-19 research in Africa**

In Africa more broadly, the KfW Development Bank has supported Covid-19 research geared towards finding reliable and rapid tests that can be made available to the poorest people and communities (KfW 2020g). In this case, it is the German Federal Ministry of Education and Research (BMBF) that has made €25 million available to the KfW Development Bank. In turn, the KfW will direct BMBF support towards the Drugs for Neglected Diseases Initiative (€15 million) and the Foundation for Innovative New Diagnostics (€10 million). This is an important intervention in the context of Covid-19, but the work of the KfW in this sector is not new as it has been active in drug research and affordability initiatives since 2011. The aim has been “to develop new adapted diagnostic procedures that also work in places where there is often only basic health care.” The public ethos and pro-poor direction of KfW support here is clear. An unnamed KfW project manager states it in unambiguous terms (KfW 2020g):

Inexpensive, fast and safe diagnostics and medication should actually be available to everyone. However, it has always been the poorer population groups in developing countries who have lost out. Traditionally, globally active pharmaceutical companies invest around 90% of their research funds in the development of new drugs for diseases from which only the wealthy ten percent of humanity suffers.

The KfW not only supports such public health measures financially and morally. As a large, internationally active public development bank, the KfW has acquired internal expertise of the kind not normally associated with banks. There are dedicated health professionals and medical doctors on the KfW staff who are well-positioned to advise and support the bank's financial operations with appropriate technical expertise. The KfW Development Bank thus illustrates a concrete pro-public alternative to what economist Mariana Mazzucato (2020) highlights as a highly problematic and contradictory strategy of using public health money (as in the US) to support private sector Covid-19 treatment and vaccine research that will be subsequently priced well beyond what most people can afford (at about US\$3,000/treatment).

Public finance and banks are not always the solution, but they do offer important alternatives and their capacity could certainly be scaled up to meet pressing societal needs. Indeed, public banks can function in stark contrast to the profit-maximizing neoliberal model and can be made to confront societal challenges and crises in the public interest. Notably, the KfW in the first half of 2020 has announced Covid-19 related losses of €576 million (compared to a return of €904 in the first half of 2019), with similar losses expected for the second half of 2020 (KfW 2020b). This is, in effect, a wealth redistributive mechanism. Moreover, it is only through the public sphere and in the public interest that a bank could and would willingly adopt such crisis-mitigating and life-saving but loss-making operations.



## CONCLUSION

Across its seven-decade journey, the KfW as a public financial institution has been both *constituted by* and *constitutive of* the world in which it reproduces itself. In the current context, one can see events and social forces having an effect on the KfW and in turn, the KfW affecting society around it. The exact measure of its Covid-19 interventions cannot yet be known, but undoubtedly they have helped to mitigate the Covid-19 crisis for many, at home and abroad. Let it not be forgotten that, in poorer countries, such support simply would not have been forthcoming. In Germany, without its existing public banking capacity, it too would have struggled to provide rapid and effective support, much as the US and the UK have struggled to do through banks that were either unwilling or unable to do so. By contrast, the KfW has often made *time* available to businesses, health providers, public services, governing authorities and even to students to help them adjust to the pandemic.

Apparently, however, KfW workers would like to see its interventions go further and for the KfW to have a more sustained impact on society. According to KfW staff, “the emerging recovery process needs to be perceived as an opportunity to rethink our economic and social systems and promote a greener model for prosperity over the long term” (Lau and Müller-Späth 2020). We need to recognize, they continue, “the crisis as transformation” such that “green recovery” means confronting the economic and social impacts while aiming to reduce greenhouse gases and mitigating climate change. The KfW could and should play a catalytic role in a green transition.

No doubt the functions of the KfW in any green recovery and transition will be subject to contentious power struggles and the pull of public and private interests. This cannot be avoided within class-divided capitalism given contending interests between the public good and private accumulation. Yet the KfW is a decidedly ‘public’ bank. Its institutional structure and historical legacy enable it to function in

pro-public ways – particularly at times of acute crisis and as we face huge societal challenges like climate change. Its representative form of governance enables the public interest to be heard. It can leverage not only its accumulated capital but its decades of built-up expertise in local economies, public services and even in health expertise.

At times of crisis, the KfW can mobilize its capital and knowledge to confront the problem. It can do so, moreover, not based on the need to maximize its financial returns but on the need to respond to public mandates. This is possible because the bank has acquired a range of banking functions and built up its institutional capacity over time – including in its form of representative governance. Without such an institutional legacy no such emergency Covid-19 financial support would have been forthcoming through the public sphere. Governing forces would instead have to barter with private banks to provide support services by first bending Covid-19 recovery financial programmes to private interests and profit mandates in ways that meet the risk-return preferences of corporate shareholders. The existing capacity and historical legacy of the KfW provide an effective and viable alternative, one that needs to be built upon internationally as we move from Covid-19 recovery to a global green and socially-just transition.

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## Chapter 8

Nadine Reis

# THE “BANK OF WELFARE” AND MEXICO’S MORAL ECONOMY

The Mexican state-owned bank *Banco del Bienestar* (Bank of Welfare) has received a lot of attention for its role in the current Government’s ambitious political project to create an “alternative to neoliberalism” and turn Mexico into a “moral economy”. This chapter analyzes the activities of *Banco del Bienestar* (BB), with special attention to the recent economic crisis induced by the Covid-19 pandemic. Its main argument is that, while the BB contributes to the survival of the poor through its social benefit and microcredit programmes, it has primarily served to push forward an agenda of financial inclusion. This agenda is based on a confluence of interests, which includes the Washington institutions/Wall Street alliance, powerful Mexican financial and corporate elites, the Mexican military and the Mexican reactionary left. It is highly problematic because it cements a “moral economy” that increases the dependency of the poor on a patriarchal state and their inclusion in exploitative social relations with the financial and corporate elite.

## INTRODUCTION

Banco del Bienestar (Bank of Welfare) is the smallest among nine banks owned by the Mexican state that, together, form the Mexican

development bank system. Since Andrés Manuel López Obrador (AMLO) took over Government at the end of 2018 as President, and in particular with the advent of the Covid-19 pandemic, the Banco del Bienestar (BB) has received a lot of attention in the country and abroad for its role in the President's ambitious political project to develop an "alternative to neoliberalism" and turn Mexico into a "moral economy". This chapter analyzes the activities of the BB with a special focus on the recent economic crisis induced by the Covid-19 pandemic. The chapter's main argument is that, while the BB contributes to the survival of the poor through its social benefit and microcredit programmes, it has primarily served to push forward an agenda of financial inclusion. This agenda is based on a confluence of interests, which includes the Washington institutions/Wall Street alliance, powerful Mexican financial and corporate elites, the Mexican military and the Mexican reactionary left. The financial inclusion agenda is highly problematic as it cements a "moral economy" that increases the dependency of the poor on a patriarchal state and their inclusion in exploitative social relations with the financial and corporate elite.

To make this argument, I first present the history and functioning of the BB and how it emerged in the context of the financial inclusion agenda. Second, I describe the impacts of the Covid-19 pandemic on the economy and rising poverty in Mexico, before giving an overview over the main actions of the BB to respond to the crisis. After that, I expand on the details of the privatization and financialization of social policy implemented by the BB, which particularly relate to the involvement of private financial institutions in the administration of its policies. Finally, I conclude with an overview of the effectiveness of the BB programmes, drawing some general conclusions.

## **THE BANK OF WELFARE AND FINANCIAL INCLUSION**

Banco del Bienestar (BB) was created in 2001 under the name of BANSEFI (National Savings and Financial Services Bank). As part

of the World Bank-supported Savings and Credit Sector Strengthening Program in Mexico, its aim has been to generate access to safe and efficient financial services for the poor. BANSEFI was used by previous governments to implement the conditional cash transfer programmes that have become an increasingly important source of income for a large share of the Mexican population since the end of the 1990s, and that were also supported through World Bank loans.

When Andrés Manuel López Obrador (AMLO) took over the Government in 2018, he re-named BANSEFI in order to give expression to his major initiative to distribute resources to the poor and support the “economy of the people” (*la economía popular*). Like previous left-populist governments in Latin America, AMLO follows a proclaimed anti-neoliberal, but decidedly neo-extractivist economic policy. His Government has focused on increasing the income of the poor, primarily through increasing the productivity of the state oil company PEMEX, fighting corruption and imposing harsh austerity measures in the public sector, as well as investments in (highly conflictive) infrastructure megaprojects, including a new oil refinery. The freed resources are supposed to be channelled to the poor, mainly in the form of social benefits paid out to individuals.

AMLO therefore seeks to massively expand the role of what the President has called the “Bank of Welfare for the People” (*Banco del Bienestar del pueblo*). The most important programmes delivered through the BB are cash benefits for disabled people and the elderly (*Pensión para Personas con Discapacidad/Adultos Mayores*), scholarships for high school students (*Beca Benito Juárez*) and subsidized employment of youth at participating private companies (*Jovenes Construyendo el Futuro*). The official data indicate that these cash transfer programmes, with a budget of MXN 267,344 billion (US\$ 12 billion), reached almost 18 million beneficiaries in 2020 (Cámara de Diputados/CEDRSSA 2020). Moreover, the BB runs a microcredit programme for microenterprises (*Tandas del Bienestar*).

The other key political narrative, of which BANSEFI – now BB, have been an important element, is *financial inclusion*. According



to the World Bank, Mexico lags behind in terms of financial inclusion, as only 37% of adults have a bank account (World Bank 2020, 16). The World Bank has therefore supported the institutional development of the financial sector in Mexico since the end of the 1990s and continues to do so through loans to the Government (US\$500 million in 2019 and US\$1 billion in 2020). Therefore, and in order to comply with World Bank credit conditionality, the Government launched the 2020-2024 National Financial Inclusion Policy in March 2020 (Gob 2020a). The policy aims to facilitate access to financial products and services for people, in particular through the provision of microcredits for micro-, small- and medium-sized companies (MSMEs), backed by the idea that this will result in the well-being of the poor: “Increased access to financial services can lead to a significant increase in income, particularly among low-income individuals and those located in areas with lower pre-existing bank penetration. Financial inclusion promotes economic well-being by assisting vulnerable households to build up productive assets, manage risks, and respond to financial shocks” (World Bank 2019: 5).

However, critical observers argue that the financial inclusion agenda has served to re-legitimize the instrument of microcredit in light of its huge failure as a poverty reduction strategy (Bateman 2012; see also Bateman, this volume). With this policy, the Government follows the World Bank’s idea that financial inclusion contributes to economic growth and wellbeing. The BB is the key to implementing financial inclusion as it “promotes and facilitates savings among Mexicans, inside and outside the country, as well as access to first and second floor financing, in an equitable way, for individuals and corporations” (Gob 2020b). To drive home the national financial inclusion message, the Government policy also includes financial education at schools.

Another element of the financial inclusion policy is to reduce the use of cash and increase the use of financial technologies and digital payments in the economy. Most payments in Mexico are cash,

reflecting the large share of informal economic activity. Therefore, the central bank, Banco de México, launched the digital payment app CoDi (Digital Charge). In turn, the BB will use CoDi to deliver social benefits. The stated aim of implementing CoDi, and financial inclusion in general, is to draw more people into the formal economy and to combat money laundering and corruption (Galizia Cruz 2019; World Bank 2020).

In January 2020, the Government announced the ambitious goal of constructing 2,700 new branches of BB in the country, adding to the 538 existing BANSEFI branches. If this is realized, the BB will be by far the most geographically widespread bank in Mexico. Its branches will be constructed in locations without existing banking services or where services are insufficient or involve high fees. MXN 10 billion has been earmarked for branch construction, with MXN \$5 billion having already been transferred to an account at Banjército (National Bank of the Army, Airforce and Navy),<sup>1</sup> as the military is responsible for construction, equipment and transporting the cash to the branches.

As of June 2020, 230 new branches had been finished (Gob 2020c). One of the major challenges of constructing the bank branches across the country and having them use digital technologies is that many rural areas lack Internet access. In response, the Government created a new state-owned telecommunications and Internet company in the National Electricity Commission (CFE), whose aim is to provide Internet access on a non-profit basis to the population currently without access and free Internet access in public spaces (IFT 2019). The company was assigned a budget of another MXN 10 billion.

In addition to expanding access to banking and financial services, the financial inclusion agenda involves tapping into international financial markets to fund the issuing of microcredits. This usually

<sup>1</sup> Banjército is another one of the nine banks owned by the Mexican state that form the Mexican development bank system.

happens through securitization, i.e. the bundling of microcredits and selling of the loans or their derivatives as combined packages on financial markets (in turn, providing an income stream for investors). The link to debt issuance on financial markets is also evident in the case of the BB, despite the President's assertion that the bank is "financially independent". According to BB financial statements, its liabilities include one loan of more than MXN 300 million issued by Nacional Financiera (NAFIN, which issues debt for the Mexican government on international financial markets), one loan guarantee of more than MXN 300 million issued by Banjército, and one loan of more than US\$45 million issued by the Inter-American Development Bank (BB 2019, 46; BB 2020, 4, 10). The first two are specifically designated for the issuance of microcredits.

The available data remain inconclusive on the IDB loan but suggest that it is also designated for the issuance of microcredits. Moreover, the BB also conducts repo operations of substantial volume on financial markets, i.e. it borrows short term on financial markets. It remains unclear to what extent the resources of the two World Bank loans on Financial Inclusion (World Bank 2019, 2020) have been channeled to the BB. Typically, the World Bank focuses its activities regarding financial inclusion on implementing a regulatory environment that favours the integration of the economies of countries in the global south with global financial markets, and the profitability of these markets.

## THE DEVASTATING EFFECTS OF COVID-19 ON POVERTY

Mexico is among the countries with the highest level of infections and deaths due to the coronavirus. As of the beginning of November 2020, there have been more than 933,000 confirmed cases of Covid-19 and more than 92,000 deaths. However, as the Government uses the Sentinel method to track the pandemic, where only a certain number of monitoring clinics deliver data, it is estimated

(including by the Government itself) that the real number of infections was already around 2.8 million in June 2020, while independent sources assume 5.7 million (Infobae 2020).

At the end of March, the Government began to implement a series of public health response measures. In general, these were less restrictive than in many other Latin American countries, as the Government acknowledged the reality that more than half of Mexico's population make their living in the informal economy. Hence, there was never a complete confinement. However, all schools and universities were closed, public events were cancelled and economic activities that were classified as non-essential were suspended. Around 60% of all enterprises partly or fully closed their activities (INEGI 2020a). The Government launched the “Jornada Nacional de Sana Distancia” (National Workday of Healthy Distance), which urged people to stay at home and only leave the house for absolutely essential activities.

In June, a traffic light system was launched, which consists of four colours (red, orange, yellow and green). These mark the severity of the pandemic in each state and indicate, accordingly, which kind of activities are safe to resume. As of November 2020, the majority of the country is still on orange, while the infection rate is still high.

The Covid-19 pandemic has had a devastating economic impact on Mexico. According to Banco de México, more than 12 million people lost their jobs between April and May: 3.72 million in the formal sector and 8.46 million in the informal sector. Another 8 million became underemployed, i.e. employers cut their working hours (El Financiero 2020). Some 91% of enterprises reported decreased income, 30% of households reported that one or more of its members lost their job because of the pandemic, and 65% of households reported income losses (INEGI 2020a).

Not only have millions of people lost their jobs, but the share of the working poor has massively increased as incomes have declined. In May, the share of the working population who could

not afford the official basket of essential consumer goods rose to 54.9%, from 35.7% in March (Coneval 2020b). Among the most affected are women, especially because of the large number of un- or underemployed domestic workers (El Economista 2020a). The deterioration of working conditions became even more evident with the gradual opening of the economy in June. Two-thirds of those who returned to a job took up work in the informal sector, and almost three quarters of them earned less than before the pandemic began. Of the total working population, 46% state they earned less than before the pandemic. No less than 52% of the working population in Mexico work in the informal sector,<sup>2</sup> while almost half of them make their living through microbusinesses that are based on the resources of the household (INEGI 2020b). Some 60.7% of the working population earn less than two minimum wages (El Economista 2020b), which equals less than around US\$ 5.60 per day or around US\$ 170 per month.

## KEY ACTIONS BY THE BB TO RESPOND TO COVID-19

The measures taken by the BB to tackle the economic crisis caused by the Covid-19 pandemic essentially consist of an expansion of programmes that already existed, in particular the microcredit programme (however, as explained below, the programmes are hardly administered by BB itself). The pensions for the elderly programme, which pays MXN 2,670 every two months to all people over the age of 65 who have a pension of less than MXN 1,092 per month, was paid in advance for four months, i.e. beneficiaries received MXN 5,340 at once. This also applies to the pensions for the disabled programme if the beneficiaries are under 18 or indigenous people (Economía Hoy 2020). The “Sembrando Vida” (Sowing Life)

<sup>2</sup> The latest report of the National Council for the Evaluation of Social Development Policy (CONEVAL) speaks of 56.3%, also citing data from INEGI (CONEVAL 2020a, 27).

programme, which pays subsidies to the rural poor for agroforestry projects, increased by 200,000 recipients.

The microcredit programme existed before under the name “Tandas para el Bienestar” and provided an interest-free credit of MXN 6,000 to family microenterprises that have existed for more than six months. The loan must be paid back in 12 monthly payments, with an initial grace period of three months. If borrowers repay the full amount, they will have access to a second credit of MXN 10,000, and in a third and fourth round, of MXN 15,000 and MXN 20,000 respectively. Because of the crisis, the beneficiaries of this programme may defer their payments for three months, and they may access the second credit if they have paid back only 60% of the first one.

With the beginning of the *Jornada Nacional de Sana Distancia*, the Government announced the expansion of the microcredit programme. The programme, called *Crédito a la palabra* (Credit to the Word, i.e. without providing much paper work or the need for a credit history), foresees the issuing of 2 million individual credits of MXN 25,000 to MSMEs in urban areas. This includes 1 million individual credits each for the formal and informal sector. Both the formal and informal sector borrowers must pay back the credit in 33 monthly payments of MXN 824 each after a grace period of three months.

For formal sector enterprises, the interest rate is varied according to their size: 6.5% for enterprises with between 1 and 10 employees; 7.5% for those with between 10 and 20; 8.5% for those with between 20 and 50; and 10% for those with above 50 employees (IMSS 2020). Beneficiaries must be registered at the social security institute IMSS (Instituto Mexicano del Seguro Social) and must not have laid off personnel for the past six months. Interested enterprises must apply for the credit online through the IMSS. Domestic workers can also apply for this type of credit; however, they must be registered for social security. According to the President, funding for this part of the programme comes from the recovered taxes of

large corporations, which he personally urged them to pay as they owed MXN 50 billion to the state. According to Government information, tax collection from ‘large contributors’ increased by 144% although we were unable to verify this information based on statistical data from the tax administration office.

One million individual credits at interest rates of 6.5% are planned to be issued to informal microenterprises registered in the “Census of Wellbeing” (Censo de Bienestar). To register the potential beneficiaries of social benefit programmes, 26 of 31.9 million households in Mexico were surveyed within six months in 2019 (Gob 2020d). According to official information, one million microenterprises such as small kiosks, restaurants, street food stands and taxi enterprises were identified through the census, which are offered the “Credits to the Word” programme through phone calls. Should informal businesses not be registered in the census, they can register themselves through the webpage of the Secretariat of Wellbeing. According to the President, funding for this programme comes from a public development bank, Nacional Financiera (NAFIN).

In July 2020, the Government announced a further credit programme, the Direct Productive Credit (Crédito Directo Productivo), which will provide MXN 20,000 to 50,000 to formal sector microenterprises at an interest rate of 12%. The aim of this programme is to allocate MXN 300 million for a term of 18 months after a three-month grace period. These target the cities and towns most affected by Covid-19. Funding for this programme, according to the President, also comes from NAFIN (Urbeconomica 2020).

## THE PRIVATIZATION AND FINANCIALIZATION OF SOCIAL POLICY

Because of the poor infrastructure of the BB, in terms of its technological and human capacity as well as its geographical presence, all of its programmes have completely relied on collaboration with private domestic banks, in particular Banco Azteca. Banco Azteca

is part of Grupo Salinas, a powerful transnational conglomerate owned by Ricardo Salinas Pliego, Mexico's second wealthiest man (after Carlos Slim) and a close ally of President AMLO. With around 1,900 branches and more than 10,000 ATMs, Banco Azteca is the private bank with the widest geographical reach in Mexico. Its branches are usually located inside the stores of its parent company, Elektra, a retail chain that sells consumer goods such as appliances, electronics, motorcycles and computers. A key element of Salinas' business model has been 'financial inclusion', i.e. the massive expansion of lending money to the low-income sector and households, as the director of Banco Azteca explains: "[Banco Azteca] is a bank that was born as an institution of the people, so we have used financial inclusion not as a matter of rhetoric, but as a business model that we know how to do well" (La Razon 2020).

This business model became possible with the 2008 reform of the Credit Law, which created the figure of "niche banks", allowing retail chains such as Elektra and WalMart to carry out banking operations and offer financial services to their clients (Dávalos Torres 2020). Banco Azteca is known for providing credit at very high interest rates of around 88% (El Financiero 2014) and very low default rates, as it operates a fleet of debt collectors. Its return on equity was 10% in 2019 (Edwards 2020).

AMLO's system of social benefits is operated via bank cards, so-called "Wellbeing Cards" (Tarjetas de Bienestar). Without public tender, the emission and operation of the cards was assigned to Grupo Salinas. The beneficiaries of social programmes, including 2,000 adolescents working at the companies of Grupo Salinas within the "Youth Constructing Future" programme, automatically receive the card. Using the card, they can withdraw the money without fees at Banco Azteca, and in the retail chains Chedraui, Walmart, Soriana, Suburbia and LaComer at minimum spending levels and/or tied to special offers. "Credits to the Word" are issued through Banco Azteca, Banorte or Santander. To receive the credit, beneficiaries must open a bank account at one of these banks if they do not yet have one.



It is likely that the operations of the BB will continue to rely on collaboration with the private banks in the future. First, in July 2020 the Government cancelled a contract for over MXN 10.8 billion to install 8,000 ATMs at BB branches, officially because of a shortage of funding (Hernández 2020). According to media reports, the issue may also have been related to corruption and shifts in political loyalties inside AMLO's Morena Party, as the contract cancellation occurred simultaneously with the removal of the BB Managing Director (Maldonado 2020a).

Second, the first act of the new BB Director was a 40% cut in the bank's human resources budget, which involved a reduction of 1,200 staff contracted via outsourcing and wage cuts for the remaining staff (Maldonado 2020b). This too suggests funding problems. Third, beneficiaries are already used to receiving their benefits at the private commercial banks and these banks have a strong interest in maintaining the business of "Wellbeing" since it provides access to huge sets of personal data and portends potentially new banking clients. In the case of Grupo Salinas/Banco Azteca, it also ensures that the target group of costumers is drawn into their stores.

Considering the immense power of these financial institutions and business conglomerates, and AMLO's close alliance with Mexico's economic elites, it is doubtful that the current Government will somehow interfere in this business. It seems more likely that the BB will only be an alternative in remote rural areas, where it does not compete with commercial banks. But even there, Elektra seeks to profit from benefit recipients, developing a virtual store format to serve remote areas without physical buildings (Echeverría 2020).

## **EFFECTIVENESS OF THESE BANK ACTIONS**

Between January and July 2020, more than MXN 58 billion was distributed to more than 6.6 million individuals through social benefits programmes – 80% through pensions for the elderly and the dis-

abled, and scholarships for adolescents (Gob 2020e). Considering the devastating economic situation, and that the large majority of elderly, disabled and adolescents live in nuclear families, it is likely that the expansion of these programmes in the course of the pandemic also benefitted the families of these beneficiaries. However, this may be a side-effect of the programme rather than its intended goal, as there is no unemployment benefits scheme in Mexico.

According to the data provided by the BB, 808,014 “Credits of the Word” were issued in May and June 2020. Of these, 79% went to informal sector enterprises, 20% to formal sector enterprises (the large majority to enterprises with between 1 and 10 employees) and 1% to domestic workers. In Mexico, there are 4.8 million informal enterprises, which make up 75.2% of all enterprises and are, for the overwhelming majority, microenterprises (INEGI 2019, 6). This means that around 13% of informal enterprises have received the credit.

A survey by the statistical bureau noted that only 7.8% of all enterprises in Mexico reported that they have received some sort of support thus far during the pandemic (89% of which received it from the Government). However, it is also important to note that this survey includes large enterprises and does not exclusively refer to the credits offered by the BB (with some municipalities, such as Mexico City, also offering credits). In the same survey, of those who did not receive support, 37% say they did not know support was available. This seems somehow surprising considering the broad coverage of the topic in the media, including a daily one-hour press conference of the Secretariat of Wellbeing (Secretaría del Bienestar). Another 18% thought the support offered was too complicated to apply for and/or they applied but they did not receive it. Only 12% stated that they did not receive support because it was not necessary.

Some formal enterprise owners also report that they were denied the credit because they were not allowed to have any deregistering of staff members, even if they left voluntarily and before the

crisis (personal communication, small business owner in Mexico City, August 19, 2020). As regards informal enterprises, it is unclear as to which criteria were selected from the census.

Regarding the use of these credits, it is likely that the recipients mostly used the money to pay for essential costs, in particular rent, electricity and water, and social security for their employees and taxes if they were formal sector enterprises. In contrast to large corporations, which benefitted from tax reductions (INEGI 2020a) and the buying of bonds through the Mexican Central Bank in the course of the Covid-19 crisis, MSMEs have neither benefitted from exemptions from taxes or utility payments nor cash transfers. On the contrary, some small business owners report that, during the pandemic, their electricity was cut off due to outstanding bills (personal communication, small business owner in Mexico City, August 19, 2020). It is thus unlikely that entrepreneurs will use the credit in a productive way. The medium life span of a microenterprise in Mexico is 14 months (Aguirre 2010, 223). Of those that took credit before the crisis, 81% used it for buying supplies and 26% for paying off other credit (INEGI 2019). In fact, there have been media reports that Banco Azteca withholds money if the recipient of the Credit to the Word has an existing debt with them (Guerrero 2020).

Furthermore, it is instructive to think about the repayment of the credits. The demand for microcredit securities on financial markets assumes that the borrowers will receive sufficient income to be able to pay back the credits. Considering that 18 million Mexicans are beneficiaries of some kind of social benefit programme, it stands to reason that part of the funds distributed through these schemes will flow back to the BB in the form of debt and interest repayments. A microcredit scheme run by the previous Government was tied to the guarantee of repayments through the PROSPERA cash transfer programme by design. The BB had to incur major losses in 2019 due to a fallout rate of 85% in the microcredit programme, where credit repayment of the beneficiaries worked through discounts on payments of the PROSPERA programme, a

cash transfer scheme for poor women.

When PROSPERA was abandoned by the AMLO Government, the BB had to roll over the microcredits (Contrapeso Ciudadano 2019; El Sol de México 2020). What is more, PROSPERA (in the past, known under the names PROGRESA and OPORTUNIDADES) was itself financed through World Bank loans, i.e. the interest paid on microcredits were (supposed to be) financed through public debt. This illustrates not only that microcredits do not achieve their supposed goal of economic development and poverty reduction, as backed by a substantial amount of research (see for instance Bateman 2014), but also the absurdity of a social policy that is based on the financing of social benefits and microcredits through external debt.

## CONCLUSIONS

In this chapter I have analyzed the actions of the Mexican public commercial bank, the Banco del Bienestar, with respect to the economic and social crisis induced by Covid-19 in Mexico. It has become clear that, even if a bank is publicly (i.e. state) owned, it does not imply that it is free from class-based and class-divided interests. On the contrary, the analysis has shown that ‘public’ banking in Mexico has primarily served the private interests of a broad and very powerful coalition of actors comprised of the Washington institutions/Wall Street alliance, important fractions of the Mexican financial and corporate elite, the Mexican military and the reactionary left in the guise of President Andrés Manuel López Obrador.

In the context of the Covid-19 crisis, the policy of the BB has been focused on expanding its existing social benefit programmes and particularly its microcredit programmes. This approach is driven by the neoliberal agenda of financial inclusion and the World Bank narrative that linking the poor with the financial sector serves their economic wellbeing. While it serves the legitimacy of these actors, this narrative is highly problematic. First, the

programmes do not serve to increase the income of the poor and creation of productive assets, as stated by the World Bank, much less, as in the words of the President, to revive the *economía popular*. Rather, the debt-based programmes cement and increase the dependency of the poor on state welfare payments and credits. This is problematic, albeit not surprising.

In many ways, the Mexican public sector recovery strategy reinforces a centuries-old patriarchal and anti-emancipatory political culture in Mexico wherein legitimate political authority is based on the exchange of votes for social benefits (Albertus et al. 2012). After four decades of neoliberal financial crises that have steadily expelled larger segments of the population from livelihoods and living spaces (Sassen 2014), social benefits have essentially come down to upholding pure survival and the minimum of social reproduction.

President AMLO recently summarized this “moral economy” as follows:

Justice is to serve the humble people, the poor people. This is the role of the government. Even animals [animalitos] – which have feelings, it has been proven! – ... there is no way to say to a pet: ‘Go, find your food!’ They have to be given their food. (Andrés Manuel López Obrador, Daily Press Conference, March 29, 2020).

Second, what is even more worrying is that, through this policy, the state actively supports the further advance of social control and exploitative relations by a small financial and corporate elite in Mexico. One of the obvious effects of both the social benefit and the microcredit programmes is that the administering private banks, especially Banco Azteca, have materially benefitted through gaining access to the personal data of the poor, its explicit target consumer group. This is even more disturbing as Grupo Salinas executives control key positions in the state: The National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores)

under the Secretariat of Finance (Secretaría de Hacienda y Crédito Público) is run by a former high executive and co-founder of Banco Azteca; and the Secretariat of Education (Secretaría de Educación Pública), which is responsible for implementing financial education at schools, is run by the former long-standing director of Fundación Azteca. Less obvious but also deeply problematic is that the BB and the Mexican public banking system overall serves as bond between the poor and global financial markets. As pointed out by Soederberg (2013, 606), the poor have become attractive borrowers over the last two decades because financial investors see them as very reliable payers of high interest, and thus an investment vehicle that is resilient to economic crisis.

Part of Mexico's "moral economy" is that the Government appeals to the "solidarity" of the people when it comes to paying back the loans (Press conference of the Secretariat of Wellbeing, August 15, 2020). The current crisis has pushed millions more to the limits of survival. It is to be feared that through the "Bank of Welfare", the Covid-19 crisis has worked as a catalyst for the further ratcheting up the power of finance capital over the poor in Mexico. In order to transform the Bank of Welfare into a truly pro-poor public bank, progressive academics and policy advocates must address crucial issues such as the dissociation of public banking and public finances in general from financial markets and private banks.

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## Chapter 9

C. P. Chandrasekhar

# PUBLIC BANKS AND INDIA'S INEFFECTIVE COVID-19 CRISIS RESPONSE

India's experience with public banking and coronavirus spells a cautionary tale. At the time of writing India is, after the United States, the country with the second largest number of known Covid-19 infections. This is partly a reflection of the country's large population (1.4 billion). The proportion of people infected is relatively low, but the pandemic has overwhelmed India's hugely underfunded public health system and is devastating the economy. Public banks have been given the major responsibility for providing relief but they cannot play the supportive role that was possible in the past, because they have been so undermined, and in some cases even dismantled, over the last two decades.

India's response to Covid-19, which has been primarily monetary, therefore cannot succeed because the banks cannot do the heavy lifting required – in part because they have not been allowed to. Publicly owned banks still comprise the majority of the financial sector, but they are public in name and not in mandate. They are judged primarily by their ability to maximize earnings and profits, which means they can no longer follow the counter-cyclical or long-term goals they did in the past and on which the Covid-19 recovery depends.

Without a fiscal stimulus and autonomous spending to create demand, India's credit-growth policies will not work because the banks are reticent to lend. This is because they are already over-burdened with non-performing assets and fear this can only get worse, reducing profits and incomes still further. This is a problem both for India's recovery from coronavirus and for the future of public banking. The failure of the monetary policies to induce banks to lend will likely strengthen the case of those arguing for privatization as a means for banks to increase their capital. This would spell the end of India's public banking system – and a long and painful path out of coronavirus.

## INTRODUCTION

At the time of writing, India is, after the United States, the country with the second largest number of known Covid-19 infections. Given the country's large population of around 1.4 billion, the proportion of the population infected (5.4 million) is still relatively low. However, the pandemic has overwhelmed the hugely underfunded public health and hospital system, prompting the government to impose in panic one of the most severe nation-wide lockdowns, which had and continues to have a devastating impact on the economy. The government's response to the post-Covid economic crisis has fallen short, with the fiscal stimulus placed at a relatively low 1% of Gross Domestic Product (GDP). The dominant effort comes in the form of monetary policy measures – reduction in policy interest rates, injection of liquidity, easing of debt servicing terms and provision of guarantees to facilitate the flow of credit to select sectors.

Given this reliance on monetary policy, public sector banks that dominate India's commercial banking system have become crucial intermediaries in the transmission of the official stimulus. Taking on a social mandate of this kind is not new to the public banking system, which, after its expansion through nationalization in 1969, substan-

tially enhanced credit provision for growth; ensured that there was much greater financial inclusion with credit provided to neglected sectors, regions and sections; and achieved that without the periodic bank failures that characterized the pre-1969 period.

But much has changed since then, especially after 1991 when, based on the reports of two committees, the banking and financial policies were extensively liberalized. Underlying this transition was a decision to change the mandate given to public banks. If the earlier emphasis had been placed on realising socio-economic development objectives to which the profit objective was subordinated, now the demand was for better profitability and innovation in service provision. That not only changed banking behaviour over time, but the subordination of public banking to the needs of what was seen as a private investment-led growth strategy resulted in lending of a kind that increased the volume of bad assets on the books of the public banks. This has made it difficult to ensure that public banks can perform the role they have been given as part of the post-Covid relief and recovery strategy.

## **PRE-COVID CONTEXT – THE CHEQUERED HISTORY OF PUBLIC BANKING IN INDIA**

Ever since the nationalization of 14 major private banks in India in 1969, the country's banking system has been overwhelmingly publicly owned. The entry of many new private sector banks after the launch of neoliberal reform in 1991 has not radically altered that picture. This has meant that, for more than half a century now, the government's influence on banking behaviour and performance has been substantial. However, this has not played out the way that supporters of public banking might have expected.

This chapter shows that mandates matter as much as ownership, as does the macroeconomic environment in which public banks are embedded. This has strongly limited the role that public banks

could play in the relief and recovery efforts required for Covid-19. Banks are the first port of call of a nation's savings. Therefore, ownership and control over the banking system gives the State the power to influence and determine the allocation and use of the financial surpluses of a nation. Using that power, a government can facilitate investment and influence the allocation of financial resources in response to a recession, say, or in pursuit of a medium-term development agenda. The fact that the publicly owned banking system can serve as an instrument of countercyclical policy, expanding rather than reducing credit during a recession and targeting that credit to best aid recovery, is a major source of power. Has that source of power been used to advantage in the response to the ongoing Covid-induced crisis in India?

A feature of a predominantly publicly owned banking system is that the profit motive need not govern the allocation of credit, as would be the case under private ownership. Subordinating the profit motive to social objectives, the government may, for example, direct public banks to ensure adequate lending to farmers despite the risks stemming from monsoon dependence, or increase lending to small, dispersed rural borrowers, despite the higher transaction costs involved. That the private sector could not be persuaded to meet such requirements was clear from the fact that, prior to nationalization, banks in India had allocated just 2% of advances to the agricultural sector that contributed around 50% of national GDP, in violation of central bank guidelines.

Whether the State's influence, through public ownership, over the process of financial intermediation, proves socially beneficial depends in the final analysis on whether the government's policy agenda advances the interests of all or most of its citizens, or just a favoured few. In the immediate aftermath of bank nationalization, State ownership was indeed socially beneficial. Banking policy changed to ensure access to financial services to hitherto neglected sections and regions. The number of scheduled commercial banks (SCBs) in India rose from 74 in 1972 to 270 in 1990. The number

of branches of SCBs rose from 8,262 in 1969 to 32,419 in 1980, and 60,220 in 1991. As a result, the population per branch fell from around 75,000 in 1967 to 18,000 at the end of 1981 and 14,000 by March 1991. Furthermore, the share of rural branches in total SCB branches rose in tandem from 22% in 1969 to 58% in 1990.

At the end of March 2019, public sector banks accounted for 61% of the assets in the commercial banking system, private banks for 32%, and foreign and small finance banks for the rest. Among the 20 public sector banks, the largest – State Bank of India – accounted for 36% of their assets; and Bank of Baroda – the second largest public bank – for a distant 7.7%. Within the private sector, the three largest of the 22 banks – HDFC Bank, ICICI Bank and Axis Bank – accounted for 23.5%, 18.2% and 15.1% of total assets, respectively.

There also was a decisive shift in credit deployment in favour of the agricultural sector. The share of agricultural credit in total non-food credit rose sharply from 2% before nationalization to 9% in 1970-71 and close to 21% in the mid-1980s, before falling to 17% by the end of the 1980s. Small scale and other “priority sector” advances also rose, resulting in the increase in the share of priority sector advances in total credit from 22% in 1972 to as much as 45% at the end of 1980s. The share of small-scale units in total bank credit increased from 7% in June 1968 to 12% in June 1973, and thereafter was sustained in the range of 11 to 14% until the early 1990s. In summary, public ownership, the end of corporate control over banks and the turn to social control over banking resulted in dramatic progress in the direction of enhanced lending to productive sectors and to greater social inclusion.

The perspective that drove these changes in banking behaviour does not frame the government’s policy agenda anymore. With neo-liberal reform from the 1990s, the government’s stated (even if not realized) overall objective was transformed from one of advancing State-led development with redistribution to that of privileging and incentivizing private investment. This has influenced banking policy and the structure of banking. Not only is private presence in



the banking system increasing, but public banks are increasingly judged by their ability to maximize earnings and profit. However, despite these changes, the dominance of publicly owned banks is still a reality. This has meant that the public banking system continues to be used as a direct lever to implement the government's policy agenda. But with that agenda having changed, the role of public banks has changed as well.

## THE COVID-19 CRISIS AND INDIA'S PUBLIC BANKS

This changed role for India's public banking is clearly evident in the Covid-19 induced crisis that is ongoing. Public banking was ostensibly given the major responsibility, with flexibility to significantly increase lending supported by central bank injection of liquidity, permission to offer temporary debt service moratoria, and freedom to reschedule debt on improved terms of stressed corporates. However, this shift of a part of the onus of responding to the pandemic onto the banks occurred in a context where public banks were already burdened with large non-performing assets, because they had been persuaded to lend to large, capital intensive infrastructure projects, which proved commercially unviable, leading to defaults. In addition, with the fiscal stimulus offered by the government to counter the severe demand compression precipitated by the Covid-19 crisis and the lockdown response to it, entities looking for credit were unlikely to be in a position to meet the debt service payments when they fell due.

In the second quarter of 2020, India's GDP contracted by 24%, which is much larger than in many other economies severely affected by the Covid-19 pandemic. Despite the central government's claims to the contrary, there is no evidence that a V-shaped recovery would follow. The economy is likely to remain steeped in recession over the financial year 2020-21 (April-March), and that recession is likely to last into the following year as well.

One reason for the severity of the setback is the government's regressive and wrong policy response. Overall, the *additional* fiscal stimulus provided by the central government amounted to around a meagre 1% of GDP. This has also meant that the income and employment support provided by the government to the mass of workers deprived of their jobs and livelihoods has been woefully inadequate, worsening the deprivation of already marginalized sections and pushing many more people into poverty. This has meant that the supply-side shock that resulted from the sudden halt in economic activity triggered by the pandemic and the lockdown response to it has been worsened by massive demand compression. These circumstances warranted resorting to a large fiscal stimulus that the government has not been willing to deliver.

This is because a feature of neoliberal macroeconomic policy is fiscal conservatism, manifested in a combination of lenient direct taxation, controlled fiscal deficits and caps on the public debt. This fiscal conservatism also leads to the privileging of monetary policy instruments (interest rate reduction and liquidity creation) over pro-active fiscal intervention as a means to revive a flagging economy. The dependence on such instruments increases as tax concessions to incentivize private investment limit revenue growth, which in turn, given the self-imposed limits on deficit financed spending, reins in the stimulus provided by the government's spending.

With its embracing of neoliberalism, the Indian government too had veered in favour of monetary instruments even before the Covid-19 shock. So, when the impact of the Covid-19 pandemic and responses to it on an economy already descending into a recession triggered a massive contraction in economic activity, the fiscal response was limited, as noted earlier. The focus of the 'stimulus' – if it could be called that – was a set of monetary policy measures. The government has chosen to let the central bank, with its monetary policy instruments, do the heavy lifting. This does give the public banking system a major role. What is that role and how effective has it been?

## INDIA'S 'HEAVY LIFTING' – LIQUIDITY MEASURES TARGETED FOR RESCUE AND REVIVAL

The dominant component of the India rescue and revival package consisted of monetary measures involving a reduction in policy interest rates, injection of liquidity, easing of debt servicing terms and provision of guarantees for new debt provided to select sectors. Principally, public banks have been made the means of transmitting the effects of stimulus initiatives designed and implemented by the Reserve Bank of India, the country's central bank.

In the Reserve Bank of India's own words, its intervention began in March in order to “unfreeze financial market activity and revitalise financial institutions to function normally in the face of Covid-19 related dislocations” (Reserve Bank of India 2020, 101). Besides a series of policy rate or repo rate cuts, measures were adopted to inject cheap liquidity into the system. Swap auctions and open market operations to purchase securities were undertaken. The ability of commercial banks to lend was extended by reducing the cash reserve ratio (CRR) by 100 basis points – from 4% of net demand and time liabilities (NDTL) to 3% – effective March 28, 2020, for a period of one year, releasing liquidity amounting to INR 1.4 trillion (around US\$18 billion) into the market or 1.4% of total outstanding stock of non-food credit advanced by commercial banks. The limit on overnight borrowing by banks under the Marginal Standing Facility was also raised by 100 basis points from 2% of NDTL to 3%.

The central bank also adopted initiatives to push bank credit to specific categories of borrowers. Targeted Long-Term Repo Operation (TLTRO) auctions of three years' maturity totalling INR 1 trillion were held in March and April. To encourage credit flow and ease liquidity pressures, the RBI decided to conduct an initial round of TLTRO auctions that banks could avail of to obtain money at reasonable rates to invest in investment grade bonds, commercial paper and non-convertible debentures of corporates. In a second round, resources were

released for investment in paper sold by non-bank financial companies (NBFCs), which were facing difficulty in rolling over funds mobilized by issuing short maturity instruments and used for long-term lending. By design, at least 50% of the liquidity accessed through this auction was required to be directed to small- and mid-sized NBFCs and microfinance institutions (MFIs). The central bank also instituted a special liquidity facility for mutual funds of INR 500 billion in April to address the severe liquidity pressures faced by them in the aftermath of the closure of a set of six funds investing in debt securities operated by mutual fund major Franklin Templeton.

The central bank's initiatives were directed not only at the corporate and financial sectors, but at other sections of the economy too, such as agriculture, small industry and housing. To support them, special refinance facilities totalling INR 500 billion at the policy repo rate were established. (The repo rate too has been reduced by 1.15 percentage points since March 2020, to 4%, which is its lowest level since 2000). Of the refinance facilities, INR 250 billion was allocated to the National Bank for Agriculture and Rural Development (NABARD) to support lending by regional rural banks, cooperative banks and microfinance institutions. The Small Industries Development Bank of India (SIDBI) was allocated INR 150 billion, and the National Housing Bank (NHB) was provided INR 100 billion to support housing finance companies. While these still existing development banking institutions have been called upon to play a supplementary role, others like the Exim Bank of India have had to be supported. With foreign trade adversely affected by the onset of the pandemic, the Exim bank was unable to mobilize resources through foreign currency borrowing to sustain its operations. In May, the Reserve Bank of India extended a INR 150 billion line of credit available for 90 days and extendable for up to a year, so that the institution could mobilize dollar funding by entering into swap agreements.

In all of these initiatives, commercial banks were expected to mediate the stimulus by using the increased liquidity to provide

credit and transmit lowered interest rates to the final borrower. Interestingly, this use of commercial banks as intermediaries in the rescue and revival effort has been used by the government as well. Even before the Covid-19 pandemic, in the budget for 2019-20, the Finance Minister had announced a partial credit guarantee scheme (PCGS) to support non-bank financial companies (NBFCs) that were seen as facing a liquidity squeeze. To encourage credit flow to the sector, the purchase by *public sector banks* of highly-rated pooled assets of financially sound NBFCs up to a total amount of INR 1 trillion over the financial year was supported with a one-time guarantee to cover first loss of up to 10% of the pool. In December 2019, that guarantee was extended to low-rated NBFCs as well.

Post-Covid, in May this year, this scheme was restructured and extended, with a one-time partial credit guarantee of up to 20% of the pool (or double the earlier limit) for purchases totalling INR 450 billion by public sector banks of low-rated instruments (including unrated paper of maturity up to one year) issued by non-bank lenders. This guarantee is valid for 24 months and the scheme is to be in place till March 2021.

In addition to this partial credit guarantee scheme, in May 2020, the government announced an Emergency Credit Line Guarantee Scheme (ECLGS) under which a Guaranteed Emergency Credit Line (GECL) was to be provided to micro-, small- and medium-sized enterprise (MSME) borrowers, with a turnover of up to INR 1 billion, *holding outstanding credit of up to INR 250 million* from banks, financial institutions and NBFCs. Any past dues on the credit outstanding had to be of a duration less than or equal to 60 days as of February 20 for the unit to be eligible for a GECL. If these criteria were met, the unit could apply for an additional credit line without collateral equal to 20% of its past borrowing. The lender is given the benefit of a 100 credit guarantee from the government's National Credit Guarantee Trustee Company. Loans under the scheme have a tenure of four years with a debt service moratorium of one year on the principal amount. The total credit that can be provided under

the scheme was set at INR 3 trillion and the government promised to set aside a corpus of INR 416 billion over four financial years to fund the scheme.

This combination of schemes, besides sundry others not listed here, defined the rescue and revival package resting on credit from the financial sector, mainly public sector banks, that was pushed by monetary policy initiatives and government guarantees. With the additional fiscal stimulus placed at around 1% of GDP being grossly inadequate, this was the dominant element in the overall economic package designed as a response to the Covid-19 pandemic's effects in India. While elsewhere in the world the Covid-induced crisis had led to a rethink of the adherence to so-called 'fiscal prudence', India has largely continued with the embrace of monetary measures as a substitute for much-needed fiscal activism.

## **BANKING RISK AFTER THE DILUTION OF DEVELOPMENT BANKING**

An aspect of this monetary stimulus based on liquidity injection to provide relief from the sudden shock to the economy caused by coronavirus needs highlighting. Barring a small portion of the credit flow the liquidity infusion was expected to generate, which was partially or fully guaranteed by the government, the risk associated with providing that credit is to be carried by the banks, particularly public sector banks. This burden of increased risk was being placed on these banks at a time when the economic contraction is expected to result in large-scale debt default, if not outright bankruptcies. To reduce the intensity of such defaults, the central bank has allowed banks to offer a temporary moratorium on debt service payments until December 2020 and provided for a one-time debt restructuring scheme. The idea was partly to prevent bunched defaults requiring large loan loss provisions from eroding the capital and solvency of banks. It was in a period like this that the public banks were being required to take on additional risk.

This should not be a surprise. The transfer of the burden of risk associated with addressing a crisis from the treasury and the central bank to the public banking system is also a feature of neo-liberal macro policy. A major change brought about by neoliberal reform was the dismantling of the specialized development banking infrastructure India had built since Independence. In that immediate aftermath of Independence, the turn to and emphasis on development banking was explained by two features characterizing the Indian economy at that point in time: the inadequate accumulation of own capital in the hand of indigenous industrialists; and the absence of a market for long-term finance (such as bond or active equity markets), which firms could access to part finance capital-intensive industrial investment.

Post-independence policy perceived that banks per se could not close the gap for long-term finance, because there are limits to which banks could be called upon to take on the responsibility of financing such investments. Banks attract deposits from many small and medium (besides, of course, large) depositors, who have relatively short savings horizons, would prefer to abjure income and capital risk, and expect their savings to be relatively liquid, so that they can be easily drawn as cash. Lending to industrial investors making lumpy investments, on the other hand, requires allocating large sums to single borrowers, with the loans being risky and substantially illiquid. Getting banks to be prime lenders for industrial (and infrastructure) investment, therefore, results in significant maturity, liquidity and risk mismatches, limiting the role that banks can play in financing long-term productive investment. Other sources need to be found.

This was the gap that the state-created or promoted development-banking infrastructure sought to close. That infrastructure was created over a relatively long period of time and was populated with multiple institutions, often with very different mandates. Funds for the development banks came from multiple sources other than the 'open market': the government's budget, the surpluses of

the Reserve Bank of India and bonds subscribed by other financial institutions. Given the reliance on government sources and the implicit sovereign guarantee that the bonds issued by these institutions carried, the cost of capital was relatively low, facilitating relatively lower cost lending for long-term purposes. Therefore, until the 1990s, India was an exemplary instance of the use of development banking as an instrument of late industrialization.

Other countries, such as Brazil with its development banking behemoth BNDES, followed a similar trajectory. However, they continued to rely on these institutions even after adopting measures of financial liberalization. In fact, in China, the China Development Bank was a post-reform creation and a major player in the long-term financing market. The Indian government, however, chose to dismantle its development banking infrastructure as part of liberalization. In India, the all India development finance institutions, which with budgetary and central bank support and implicit sovereign guarantees were seen as distorting the playing field for commercial banks, were abolished. Some were allowed to atrophy whereas others like the IDBI and the ICICI were allowed to establish commercial banking arms (IDBI Bank and ICICI Bank), with which the parent development banking institutions were 'reversed merged'. However, the need for long-term funds, especially for private investment or public-private partnership projects in infrastructure, remained. In fact, the need for funding had increased because fiscal conservatism had resulted in reduced budgetary allocation for investments in these areas. The result was that the government had to get the public banks to provide the long-term financing needed for investments in these capital-intensive projects.

The share of infrastructure lending in the total advances of SCBs to the industrial sector rose sharply, from less than 2% at the end of March 1998 to 16% at the end of March 2004 and as much as 35% at the end of March 2015. So even as the volume of bank lending to industry rose, the importance of lending to infrastructure within industry has increased hugely. Sectors like steel, power, roads and



ports, and telecommunications were the most important beneficiaries. For commercial banks, which are known to prefer lending for short-term purposes, this turn to lending to infrastructure was a high-risk strategy. Unfortunately, with the pattern of growth under liberalization and the deceleration of the rate of growth in recent years, many of these projects have proved unviable, leading to debt defaults. The result has been a sharp spike in the ratio of non-performing assets (NPAs) to gross advances recorded in the books of the banks, especially the public banks. Government support, in the form of recapitalization funds, to deal with this problem has been far from adequate. This has made banks cautious and forced them hold back on lending to all but the best projects. It was in these circumstances that the new burdens associated with the post-Covid stimulus were placed on the public banks.

## **PUBLIC BANKS CANNOT DO THE HEAVY LIFTING ALONE**

For this reason and because the crisis is not on account of absence of credit but of absent demand, the monetary stimulus is proving ineffective. Six months down the line, it is clear that the assumption that the recovery could be driven from the supply side with cheap credit and inducements to lend (in the form of selective partial or full guarantees) was wrong, rendering the dominant aspect of the stimulus weak and ineffective. Even the presumption that infusion of liquidity would automatically result in increased credit supply and offtake has not been realized. Credit growth has not picked up because of the reticence of banks, already burdened with NPAs, to lend, in the absence – in the view of the banks – of sufficient demand for credit. In the period between April 1 and August 14, 2020, when all of the post-Covid monetary initiatives were implemented, credit outstanding had fallen by 1.5%. Over the year ending August 14, 2020, bank credit grew by 5.5%, as compared to 11.7% over the year ending mid-August 2019.

Besides failing to substantially increase credit disbursements as a 'means' to trigger a recovery, the supply side measures were also far less successful in getting banks to support the most stressed sectors experiencing liquidity shortages. This comes through from the relative success of the different TLTRO rounds that targeted different sectors. The most successful was TLTRO round one, in which liquidity was injected to encourage investment of the capital borrowed at the relatively low repo rate in investment grade corporate bonds, commercial paper and non-convertible debentures. Much of this money was picked up by large corporates like Reliance, India's largest business conglomerate, and engineering and construction major L&T looking to benefit from the low interest rate on borrowing supported by the scheme. According to reports, in the first round of TLTRO auctions, 27 corporates raised INR 266 billion against commercial paper and 18 raised INR 253 billion against medium- and long-term bonds (Gopakumar and Upadhyay 2020).

As compared to this, TLTRO 2.0, directed at stressed NBFCs and MFIs, received a tepid response. On offer in the initial auction under this scheme was a total of INR 250 billion for three years at the repo rate of 4.4%. The RBI received bids for only INR 128.5 billion, which is just above 50% of the offered sum. While some of this capital had to be used to buy low-rated paper issued by smaller NBFCs and MFIs, the cost of that credit was reportedly significantly higher for these entities than for the larger firms with AAA ratings. This obviously increases the probability of default, especially since revenues and surpluses of these firms have shrunk or disappeared as a result of the Covid-19 shock. With public banks already sitting on large NPAs, their reticence to lend, even when offered access to cheap capital was therefore understandable.

Increased lending through the GECL window of the ECLG Scheme to MSMEs has also been tardy. Announced on May 20, the scheme was to provide credit totalling INR 3 trillion to creditworthy MSMEs, backed with a full guarantee from the government. Close to three months later, as of August 18, public and private sector banks

had sanctioned loans of just over INR 1.5 trillion, or 50% of the provision. Disbursements by them were much lower at around INR 1 trillion. Since this was a scheme that was open to private banks to participate and since there was a full government guarantee, private banks too played a role – accounting for almost half the sanctioned loans. However, here again banks blame limited demand for credit as the explanation for indifferent performance. The slow offtake possibly explains the fact that, at the beginning of August, the government widened the scope of the scheme making units with outstanding loans of up to INR 500 million (as opposed to the earlier INR 250 million) eligible for credit. As a result, the number of eligible borrowers rose significantly and the maximum guaranteed credit that could be provided to a single borrower, set at 20% of that borrower's debt outstanding, increased from INR 50 million to INR 100 million. In addition, individual loans given to professionals like doctors, lawyers and chartered accountants for business purposes were also included in the scheme. This was clearly an effort to increase offtake of credit through the scheme, which was sluggish possibly because demand for credit in the midst of the crisis from smaller borrowers is low and the scheme is open only to entities with outstanding loans that had not defaulted on past borrowing.

## CONCLUSION

The message is clear. In the midst of a crisis and with no prospect of an immediate recovery, many firms would either fall in the category of those ineligible for additional credit by virtue of being considered uncreditworthy or would be reticent to take on debt given the uncertainty about their capacity to service that debt. In such circumstances, making credit the instrument to drive the recovery does not make sense, unless demand can be raised through autonomous spending of some kind. Such spending can only be undertaken by the government through its fiscal policy. The ineffectiveness

of the many monetary policy initiatives of the RBI to impart any buoyancy to the system only corroborates that perception. Meanwhile, however, public banks are faced with the prospect of a further rise in their non-performing assets. This would strengthen the case of those arguing that the government in India does not have the resources to recapitalize these banks and they must resort to equity sale to private investors to mobilize resources to meet capital adequacy norms. That would, in most cases, require the dilution of the government's stake to a degree that spells the end of a dominantly public banking system.

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## Chapter 10

Alfredo Schclarek Curutchet

# ARGENTINA'S COUNTERCYCLICAL CREDIT POLICY RESPONSE: MACROPRUDENTIAL REGULATION AND PUBLIC BANK CREDIT DURING COVID-19

**T**his chapter analyzes the countercyclical credit policy response in Argentina due to the Covid-19 pandemic. Specifically, the macroprudential regulations implemented by the Central Bank of Argentina (BCRA) to stimulate bank credits to micro-, small- and medium-sized enterprises (MSMEs) is examined. In addition, the specific credit response of the state-owned commercial bank, the Banco de la Nación Argentina (BNA), the biggest commercial bank in Argentina, is also scrutinized.

## INTRODUCTION

In this chapter, I analyze the countercyclical credit policy response in Argentina due to the Covid-19 pandemic. Specifically, I focus on studying the new credit lines to micro-, small- and medium-sized enterprises (MSMEs) that were put in place in Argentina in March 2020. The end date of this analysis is August 2020. Several other credit pro-

grammes and financial supports are being granted to individuals and enterprises in Argentina, but these are not analyzed here.<sup>1</sup>

I first examine the macroprudential regulations implemented by the Central Bank of Argentina (BCRA) to stimulate bank credits to MSMEs. I then present some figures for these credits for the entire banking system. Finally, I analyze some of the specific conditions and requirements for these new credit lines offered by the state-owned commercial bank, the Banco de la Nación Argentina (BNA), the biggest commercial bank in Argentina.

The reaction of the Argentinean authorities to the Covid-19 pandemic has been swift. There was a substantial disbursement of new credit lines to MSMEs until August 2020 of around US\$5.25 billion, equivalent to 1.45% of Argentina's Gross Domestic Product (GDP) in 2019. This countercyclical credit policy response has been possible thanks to the macroprudential regulations of the BCRA and the cooperation of both public and private banks, in particular the state-owned commercial bank BNA, given its large size in the banking sector (19%). Evidently, the credit needs from the Covid-19 pandemic by MSMEs are very large and the public banking sector is not large enough to face these credit needs on its own.

## MACROPRUDENTIAL REGULATION BY THE BCRA

Early in the Covid-19 pandemic outbreak, Argentina's monetary authority – the BCRA – put in place several macroprudential regulations to increase the credit supply to MSMEs. Specifically, in March 2020, the macroprudential regulations ruled that commercial banks would obtain several benefits, in terms of their reserve requirements and

<sup>1</sup> Besides the MSMEs' credits, the most important financial support programmes are the Ingreso Familiar de Emergencia (IFE), which focus on the unemployed and low wage earners, and the Programa de Asistencia de Emergencia al Trabajo y la Producción (ATP), which provides financial assistance to companies for paying salaries and zero interest credits to self-employed workers. For a list of additional financial support for MSMEs see MPD (2020).

other liquidity regulations, if they granted bank credits to MSMEs at a nominal annual interest rate of 24% (BCRA 2020a). Note that the nominal interest rate of 24% is negative in real terms because current annual inflation is 42.4% and the expected annual inflation rate by the end of the year is 31%. The MSMEs can use these funds for working capital, paying salaries and paying deferred checks.

Regarding the benefits to public and private commercial banks, it was ruled that there would be a reduction in the reserve requirements by an amount equal to 40% of the granted MSMEs credits. Because most of the reserve requirements in Argentina involve central bank deposits that pay no interest rate, the reduction in the reserve requirements means that banks can hold a higher proportion of interest paying assets. Thus, this macroprudential regulation stimulates MSMEs' credits.

Regarding the other liquidity regulations, it was ruled that the central bank bill holdings by banks would be reduced if they did not increase the granting of MSME credits. Note that, in Argentina, there are limits to banks' holdings of central bank bills (Leliqs), which are bills with a maturity of 28 days, issued by the BCRA and that pay a nominal annual interest rate of 38% (BCRA 2020b). The alternative for banks that want to hold highly liquid and short-term assets is to hold one day repos with the BCRA that pay a nominal annual interest rate of 19%, which is clearly a negative interest rate. In addition, they could also hold treasury bills with an annual interest rate of between 26% and 29%. Thus, this interest rate differential for the assets holdings of banks stimulated MSME credits.

The macroprudential regulations were further strengthened in June 2020, when it was ruled that it was mandatory for both private and public banks to lend to MSMEs that had received a special guarantee by the Ministry of Productive Development, through the Fondo de Garantía Argentino (FOGAR) (BCRA 2020c). In addition, banks were not only allowed to lend to MSMEs but also to both private and public hospitals, clinics and other health providers, which



used the credit to buy health supplies and equipment, and to other large private companies that used the credit to buy machinery and equipment produced by MSMEs.

The total number of MSME credits granted by the whole banking sector up to the third week of August 2020 was 241,000 and the total disbursements were AR\$390 billion (Argentine pesos) (equivalent to around US\$5.25 billion), equivalent to 1.45% of Argentina's 2019 GDP (BCRA 2020d). A total of 13% of those disbursements were made to MSME credits that had a FOGAR guarantee. In addition, the usage of the total disbursements was distributed as follows: 47% for working capital; 30% to cover deferred checks; 17% for salary payments; 2% health supplies and equipment; and 4% for other needs. In addition, 40% of the total disbursements were granted by private domestic-owned banks, 32% by foreign-owned banks and 28% by state-owned banks.

## **CONDITIONS AND REQUIREMENTS OF MSME CREDIT LINES BY THE BANCO DE LA NACIÓN ARGENTINA**

The Banco de la Nación Argentina (BNA) is Argentina's largest commercial bank, with total assets of US\$22 billion, which represent 19% of the entire banking system. It has 639 bank branches across the country and is owned by the national government. Its total loans participation in the banking system is 17.7% and its total deposits participation is 22%.

BNA implemented five different credit lines related to the MSMEs' credits mandated by the macroprudential regulation of the BCRA, analyzed above (BNA 2020).<sup>2</sup> All of these credit lines offer a fixed nominal interest rate of 24% and are AR\$ (Argentine pesos)

<sup>2</sup> Note that these five different credit lines follow what was specified by the macroprudential regulation of the BCRA. There is no official information on whether the other banks in Argentina offered all these five credit lines or only a subset of them. As discussed below, from visiting the webpages of several banks, the BNA was the only one that had clear and thorough information on the different credit lines.

denominated. However, they have different conditions and requirements, which are analyzed below. The five credit lines are:

**1. Credit line for MSMEs (Línea de asistencia a MiPyMES para Capital de Trabajo – Gastos de Evolución):**

This credit line is for MSMEs from all economic sectors. The usage of the funds is for working capital. The maximum amount of the credit is up to two and a half months of sales. The term of the credit is 18 months with the German amortization system,<sup>3</sup> with monthly, quarterly or biannual payments of capital and interests. In the case of a guarantee from a Mutual Guarantee Society, the term of the credit is 24 months. This credit line requires sufficient guarantees accepted by the bank.

**2. Credit line for homeworking (Teletrabajo):**

This credit line is for MSMEs from all economic sectors. The usage of the funds is for buying goods and installation services, that are necessary, for both the enterprise and its workers, for homeworking and home offices. The maximum amount of the credit is up to AR\$3,000,000 (US\$40,500). The term of the credit is 36 months with the German amortization system, with biannual payments of capital and interests. This credit line requires sufficient guarantees accepted by the bank.

**3. Credit line for salary payments with guarantee by FOGAR (Pago de Haberes con aval de FOGAR):**

This credit line is for MSMEs from all economic sectors that are clients of BNA with a salary payment agreement. The usage of the funds is for salary payments. The maximum amount of the credit is one payroll. The term of the credit is 12 months with the German

<sup>3</sup> The German amortization system is characterized by constant instalments in each period of time, except for the first installment, which is related to the interest paid in advance. The interest decreases as loan periods pass and the amortized capital increases over the life of the loan.

amortization system, with quarterly payments of capital and interests. This credit line has the guarantee of FOGAR.

#### **4. Credit line for work cooperatives (Asistencia a Cooperativas de trabajo):**

This credit line is specially orientated to work cooperatives that are registered in the National Institute of Social Economy (INAES) or have a MSME certification. The usage of the funds is for working capital. The maximum amount of the credit is established for each cooperative by the INAES. The term of the credit is 15 months. This credit line has the guarantee by FOGAR.

#### **5. Credit line SMEs plus (Pyme Plus):**

This credit line is for all micro- and small-sized enterprises that have no credit with the banking system. The usage of the funds is for working capital. The maximum amount of the credit is AR\$250,000 (US\$3,380) for micro enterprises and AR\$500,000 (US\$6,760) for small enterprises. The term of the credit is 12 months with the German amortization system, with quarterly payments of capital and interest. This credit line has the guarantee by FOGAR.

Although there are no official figures yet about the total disbursements of the new credit lines to MSMEs by the BNA, the Asociación de Bancos de la Argentina (Adeba) estimated that, by April 2020, the total disbursements by the BNA were AR\$21,828 million. This represented 15.5% of the total disbursements by all banks at that time. The BNA was the second bank, after Banco Galicia (18.4%), that disbursed the most at the time.<sup>4</sup> Moreover, the BNA has been

<sup>4</sup> Of the biggest banks in Argentina, the ones that under-performed relative to their importance in the banking system were several foreign-owned banks, such as HSBC, ICBC and Banco Patagonia, and the state-owned banks Banco de la Provincia de Buenos Aires and Banco Ciudad de Buenos Aires. Among the ones that over-performed were several private domestic-owned banks, such as Banco Galicia, Banco Macro, Banco Supervielle and Banco Comafi, and the cooperative bank Banco Credicoop. Note, however, that these are estimates made in April 2020 and the relative performances have improved through time. See the Adeba estimations in Telam (2020).

actively promoting the new credit lines to MSMEs to its customers and non-customers. The information about the five different credit lines to MSMEs available on its web page is the most complete and detailed in comparison to other banks.<sup>5</sup> Thus, it is clear that the BNA has led the implementation of the new credit lines to MSMEs and the countercyclical credit policy response in Argentina.

## CONCLUSION

The reaction of the Argentinean authorities to the Covid-19 pandemic has been swift. The new credit lines to MSMEs, which were put in place in March 2020, have been very helpful in terms of dealing with the consequences of the Covid-19 pandemic for MSMEs. In particular, they have provided MSMEs with working capital. There has been a substantial disbursement of the new credit lines to MSMEs up to August 2020 of around US\$5.25 billion, equivalent to 1.45% of Argentina's GDP in 2019.

In terms of total credit to the private sector, including the new credit lines to MSMEs, the annual real growth rate was 5.6% in June 2020, registering the second consecutive month with a positive annual real growth rate, after 20 months without positive growth rates (Argentina has been suffering several currency crises since April 2018 and has been in recession since then).

At first, until April 2020, state-owned commercial banks – in particular the BNA – and private domestic-owned banks were faster in their credit response with new credit lines to MSMEs. However, foreign-owned banks picked up their lending in the following months. Up until August 2020, 40% of the total disbursements were granted by private domestic-owned banks, 32% by foreign-owned

<sup>5</sup> Web pages were visited for the following banks: BNA, Banco Galicia, Banco Santander, Banco de la Provincia de Buenos Aires, Banco Macro, BBVA, Banco Ciudad de Buenos Aires, HSBC, ICBC, Banco Supervielle, Banco de la Provincia de Córdoba and Banco Credicoop.

banks and 28% by state-owned banks. These shares are slightly different if compared to the distribution of total outstanding credit by February 2020, when 31.3% of total outstanding credit corresponded to private domestic-owned banks, 31.5% to foreign-owned banks and 37.2% to state-owned banks. Still, we are at an early point in the Covid-19 pandemic and probably more credit will be needed by MSMEs.

It is too early to reach any conclusions about whether the credit response by these three types of banks have over- or under-performed relative to their importance in the banking system. Moreover, as the Covid-19 pandemic has progressed, and its economic consequences have become more evident, many public banks – including the BNA and the BICE (Banco de Inversión y Comercio Exterior, a public development bank) – have started offering additional credit lines related to the Covid-19 pandemic. This means that, in order to assess the credit response of these three types of banks in future, we not only have to take into account the new credit lines to MSMEs analyzed in this chapter, but also these other credit lines related to the Covid-19 pandemic.

The main conclusion of this analysis is that the swift countercyclical credit policy response has been possible thanks to the macroprudential regulations of the BCRA and the cooperation of both public and private banks, in particular the state-owned commercial bank BNA, given its large size in the banking sector. The macroprudential regulations put in place by the BCRA generated a broad credit response by the whole banking sector, including all the three types of banks, that reached an extensive segment of MSMEs in Argentina. What is clear is that the credit needs from the Covid-19 pandemic by MSMEs are very large and the public banking sector alone is not big enough to face these credit needs by itself. However, it is also true that there is a need to strengthen further the public banking sector in Argentina, especially its development bank, BICE.

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## Chapter 11

Marco Carreras  
Stephany Griffith-Jones

# NATIONAL AND MULTILATERAL DEVELOPMENT BANKS DURING THE 2020 PANDEMIC: THE ROLE OF IADB AND CDC DURING THE FIRST PHASE OF COVID-19

**T**his chapter focuses on the strategic role played over the first few months after the beginning of the Covid-19 pandemic by a Multilateral Development Bank – the Inter-American Development Bank (IADB) and a National Development Bank – the UK CDC Group. We also present an overview of the mandates, loan portfolios, services and clients of the two banks prior to the Covid-19 response, and how these adapted in light of the crisis in 2020.

## INTRODUCTION

Before analyzing two public development banks, the IADB and CDC, we would like to emphasize the key difference between development banks (DBs) and commercial banks. A key difference between development banks and purely commercial banks is that the main (and usually only) aim of commercial banks and other private investors is to



maximize risk-adjusted expected returns, often short-term ones. Thus, they generally do not aim to pursue development goals. Their focus is on minimizing risks that may lead to financial losses or reduce profits. While commercial banks need to manage the full range of economic, environmental and social risks, they generally only do so to the extent that these risks have an impact on their financial returns.

In contrast, DBs have a double mandate. They mainly aim to maximize sustainable and inclusive development impacts (including economic, environmental and social impacts), while maintaining some financial profits or avoiding financial losses. A key point to make here is that for DBs the main goal is to achieve a high level of development impact – making a major contribution to meeting the Sustainable Development Goals (SDGs). Although important, achieving a good financial return is somewhat secondary to the dominant aim of development impact. In addition, DBs should evaluate investments over a longer period as their liability structure and projects have a long-term horizon, and because sustainable development results need to be evaluated over a longer timeframe to be sustained.

The Inter-American Development Bank (IADB) played a major role during the first phase of the Covid-19 pandemic, disbursing more than US\$7 billion, in response to Covid-19, over the first 10 months of 2020. The UK CDC (Commonwealth Development Corporation) Group also reacted quickly to offset the negative consequences since the beginning of 2020, disbursing over US\$650 million in its Covid-19 response, over the first few months of 2020, to primarily increase liquidity in the markets and to invest in long-term projects for the recovery phase.

This chapter is structured as follows: it begins by briefly discussing the background about the IADB, its history, shareholders, sources of funding, usual clients, services and loan portfolios, to then focus on the short-term measures put in place to address the consequences of the Covid-19 pandemic. Then, the same analysis is presented for the CDC Group, first briefly discussing the background of the bank and then focusing on the bank's short-term Covid-19 reaction.

## INTER-AMERICAN DEVELOPMENT BANK (IADB)

Since World War II, Latin American representatives had been appealing for a regional aid and financing programme of substantial proportions, along similar lines to the Marshall Plan. Probably the most coherent and concrete of these Latin American proposals was created at the 1954 Inter-American Economic and Social Meeting at Quintadinha, inspired by Raul Prebisch and the thinking of the UN Economic Commission for Latin America and the Caribbean (ECLAC). The main proposals included the creation of an Inter-American bank. This, and other proposals, as well as similar ones repeated later, were consistently rejected by representatives of both the Truman and Eisenhower Administrations. The violence that Vice-President Nixon met on his Latin American tour, as well as the likely triumph of the Cuban Revolution, seems to have sparked off a concrete response from Washington. In 1958, the American Administration accepted some of the Latin American proposals, the main one being to establish and fund an Inter-American Development Bank. This was followed in 1961 by the launching by President Kennedy of a large US aid programme for Latin America.

The IADB was officially founded in 1959, and headquartered in Washington, D.C. Ownership is divided between 48 countries, although only 26 countries can borrow money from the bank. In terms of voting shares, the first largest shareholders are the US with 30%, followed by Brazil and Argentina both with 11.35% apiece, then Mexico with 7%. Overall, the 26 borrowing members have 50.01% of the voting shares of IADB (see IADBa). Until recently, the President of the IADB was always a Latin American citizen and the Senior Vice-President was a US citizen, giving a strong voice to the Latin American borrowing countries. This tradition was broken, however, when a US citizen was appointed as President of the IADB in 2020.

The largest borrower is Brazil, followed by Mexico and Argentina. The IADB is part of the IADB Group, which also includes the

Multilateral Investment Fund (MIF) and IDB Invest, both of which invest in private companies.

The mandate of the bank is “to foster the economic and social development of the IDB’s borrowing member countries, both individually and collectively” (see IADBb). In this light, reduction in poverty and inequality and sustainable development are among IADB’s top priorities. In 2019, the Institutional Strategy of IADB was approved by the Governors, ratifying three strategic priorities: i) Social inclusion and equality; ii) Productivity and innovation; iii) Regional economic integration. The Institutional Strategy also indicates that these priorities need to be combined with actions that highlight gender equality, inclusion, environmental sustainability and institutional capacity.

The financial instruments currently offered by IADB are: i) Loans; ii) Guarantees; iii) Non-reimbursable Grants; iv) Equity investment; and v) Technical cooperation. All these instruments can be combined by IADB. Table 11.1 highlights the number of funded projects and total disbursement of IADB over the last five years (period 2015-2019), by type of instrument.

**Table 11.1: IADB disbursement from 2015–2019, by type of instrument**

| <b>Instrument</b>       | <b>Total disbursement<br/>(US\$ billion)</b> | <b>Number of<br/>approved projects</b> |
|-------------------------|--|--|
| Loan operations         | 53.43  | 573                                    |
| Container*              | 21.21  | 49                                     |
| Non-reimbursable grants | 1.25   | 84                                     |
| Technical cooperation   | 1.23   | 2408                                   |
| Guarantee               | 0.41   | 6                                      |
| Equity                  | 0.14   | 35                                     |
| <b>Total</b>            | <b>77.6</b>                                  | <b>3,155</b>                           |

Source: Authors’ own elaboration using IADB data. \*Containers ‘contain’ a combination of instruments.

Over the last five years, IADB provided finance for US\$77.6 billion, with 69% of the overall financial resources distributed through loan operations. Technical cooperation instruments are the most recurrent type of instrument used, with more than 2,400 approved projects over the last five years, although the amount is only equal to 1.5% of the overall amount disbursed by IADB.

Table 11.2 gives an overview of the three sectors reporting the highest number of approved projects over the period 2015-2019, by type of instrument.

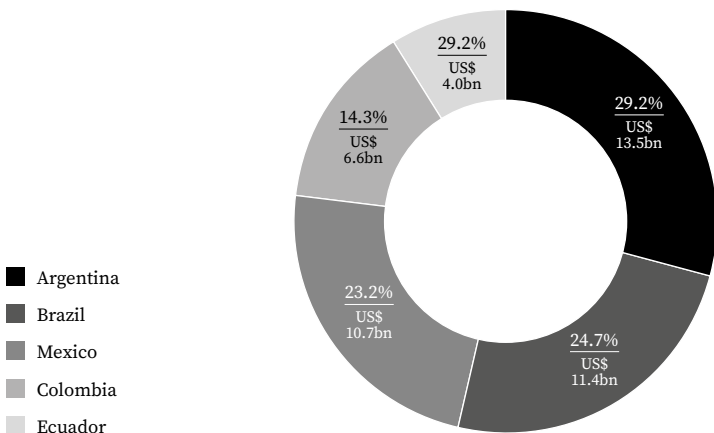
**Table 11.2: IADB top three sectors of interest over the last five years, by type of instrument**

| Loan operations                    | Container                          | Non-reimbursable grants           | Technical cooperation              | Guarantees                        | Equity                            |
|------------------------------------|------------------------------------|-----------------------------------|------------------------------------|-----------------------------------|-----------------------------------|
| Reform, Modernization of the State | Financial Markets                  | Health                            | Reform, Modernization of the State | Energy                            | Private Firms and SME Development |
| Trade                              | Transport                          | Energy                            | Social Investment                  | Environment and Natural Disasters | Energy                            |
| Energy                             | Reform, Modernization of the State | Agriculture and Rural Development | Environment and Natural Disasters  | Urban Development and Housing     | Agriculture and Rural Development |

Source: Authors' own elaboration using IADB data.

Reform and modernization of the state, energy, environment and natural disaster, and agriculture and rural development are among the top sectors of interest for IADB. Over the last five years, these sectors have received funding for several projects through different instruments. Looking at how IADB financial resources are distributed among countries, Figure 11.1 reports the top five country recipients over the period 2015–2019.

**Figure 11.1: Top five country recipients of IADB financial resources over the last five years, in US\$ billion**



Source: Authors' own elaboration using IADB data.

| Country   | % Total disbursement 2015-2019 |
|-----------|--------------------------------|
| Argentina | 17.4%                          |
| Brazil    | 14.7%                          |
| Mexico    | 13.8%                          |
| Colombia  | 8.5%                           |
| Ecuador   | 5.2%                           |

Over the last five years, Argentina, Brazil and Mexico are the countries that have received more than US\$10 billion each, with Brazil receiving almost 30% of what was received by all top five countries combined. Colombia and Ecuador have received, respectively, US\$6.6 billion and US\$4 billion over the last five years.

## Loan operations

IADB issues loans to the public sector, through Sovereign Guaranteed Loans (SGL) and to the private sector through Non-Sovereign Guaranteed Loans (NSGL). Table 11.3 gives an overview of the three sectors that have received the highest number of loan approvals over the last five years, by type of loan issued.

**Table 11.3: IADB top three sectors of interest over the last three years, by type of loan**

| Sovereign Guaranteed Loans         | Non-Sovereign Guaranteed Loans    |
|------------------------------------|-----------------------------------|
| Reform, modernization of the state | Private firms and SME development |
| Social investment                  | Agriculture and rural development |
| Transport                          | Financial markets                 |

Source: IADB website.

While the majority of approved SG loans were addressed towards reforms and modernization of the state, together with social investments and transport, NSGLs for the private sector have been mainly directed towards support for private firms, agriculture and rural development, and financial markets. Looking at the type of financial resources offered to both the public sector, IADB offers three lending categories of SGLs, characterized by different types of instruments:

- i. **Investment lending:** to support the acquisition of goods, works and services to promote social and economic development and in case of natural disasters.
- ii. **Policy-based lending:** to support policy reforms and/or institutional changes, prior to approval from IADB.
- iii. **Special development lending:** to support countries during macroeconomic crises.

In addition to the three lending categories described above, the IADB can also guarantee loans issued by private financial in-

stitutions and directed to public sector projects. Currently, IADB offers two types of guarantees: i) Partial Credit Guarantees, to partially cover the risk of repayment for private financial institutions; and ii) Political Risk Guarantees to cover for the risk of non-compliance and non-repayment of sovereign or other public institutions.

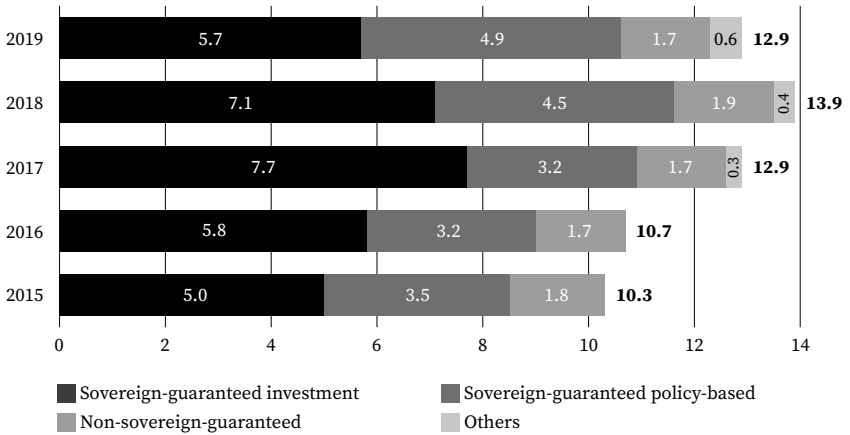
For the private sector, the IADB offers the financial resources in the form of NSGLs for investments for transactions generally in all sectors, subject to an exclusion list. There are currently four instruments issued by the bank:

- i. **A/B Loans and Syndications:** loans to attract and engage with co-funders.
- ii. **Small enterprises:** to support participation in local markets of small- and medium-sized enterprises (SMEs).
- iii. **Social Entrepreneurship Programme:** to support sustainable solutions to socioeconomic issues.
- iv. **Opportunities for the Majority Initiative:** to promote sustainable business models.

Over the last five years, IADB overall disbursement in SG and NSG loans has been equal to US\$60 billion. Figure 11.2 shows the total amount of approved loans over the last five years, by type of loan disbursed by IADB.

SG loans account for most of the amount disbursed by IADB, generally more than 80% of the overall number of loans funded by the bank. Among SG loans, SG Investment are the instruments accounting for the highest amount disbursed, although these are very similar to the amount disbursed with SG policy-based instruments.

Figure 11.2: *Loan approvals over the last five years by category of loan, in US\$ billion*



Source: IADB Annual Report 2019.

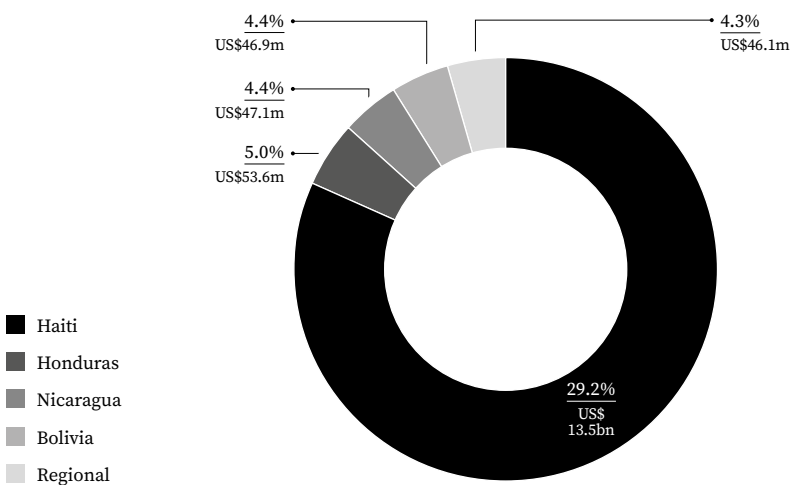
### Non-reimbursable grants

IADB issues non-reimbursable funds for technical cooperation programmes that can be financed by either IADB's own financial resources or from funds received from other institutions. Currently, there are four different programmes through which IADB distributes non-reimbursable grants:

- **IADB Grant Facility:** to provide financial support for Haiti, established in 2007.
- **Trust Fund Grantees:** grants for the relatively less developed countries, for both public and private sector organizations.
- **IADB Lab Grants:** administered by IADB Lab, member of the IADB Group, to support small-scale targeted investment for both public and private sector organizations.
- **Social Entrepreneurship Programme:** for private, non-profit, community-based organizations and public local development institutions.



Figure 11.3: *Top 5 recipients IADB grants over the last five years*



Source: Authors' own elaboration using IADB data.

| Country   | % Total grant disbursement 2015–2019 |
|-----------|--------------------------------------|
| Haiti     | 70.0%                                |
| Honduras  | 4.3%                                 |
| Nicaragua | 3.8%                                 |
| Bolivia   | 3.8%                                 |
| Regional  | 3.7%                                 |

Among the top five recipients of IADB grants, Haiti is the country that has received most of the financial resources, equal to US\$874 million or 82% of the disbursement for the top five recipients. Honduras, Nicaragua and Bolivia are the other countries in the ranking, together with regional programmes involving more than one country, receiving a similar amount of resources equal to US\$50 million each.

### Technical cooperation

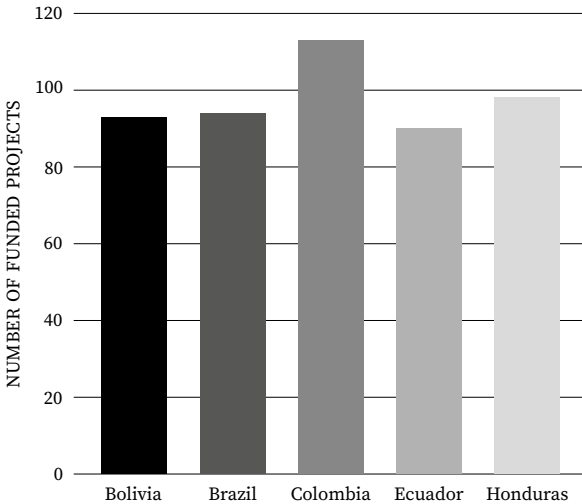
The IADB also offers financial resources to achieve objectives in line with the mandate of the bank – reduction of poverty, capacity building, etc. To do so, the IADB provides the funds for technical cooperation activities, through the Fund for Special Operations (FSO), in three different forms:

- **Non-reimbursable resources:** generally targeted at the relatively least-developed countries.
- **Reimbursable resources:** in the form of non-sovereign guaranteed loans.
- **Contingent recovery resources:** to provide financial resources that will be reimbursed if a loan from any other source is obtained.

The majority of the resources for technical cooperation disbursed by IADB over the last five years have been distributed over several regional programmes involving more than one country. The total number of funded projects for the period 2015-2019 has been equal to 786 approved projects, for an overall amount of US\$501.1 million. Figure 11.4 shows the countries with the highest number of funded projects for technical cooperation over the last five years, together with the total amount received.

Focusing the attention on countries only, and excluding regional programmes, over the period 2015–2019 Colombia has been the country receiving the highest number of approved projects – 113, and the highest amount received – US\$82.3. Among the other top five recipients, Bolivia, Brazil, Ecuador and Honduras have reported a similar number of funded projects, although the overall amount received differs between countries, with Brazil receiving US\$72 million and Ecuador and Bolivia receiving slightly more than US\$30 million.

Figure 11.4: *Top recipients of IADB technical cooperation resources over the last five years*

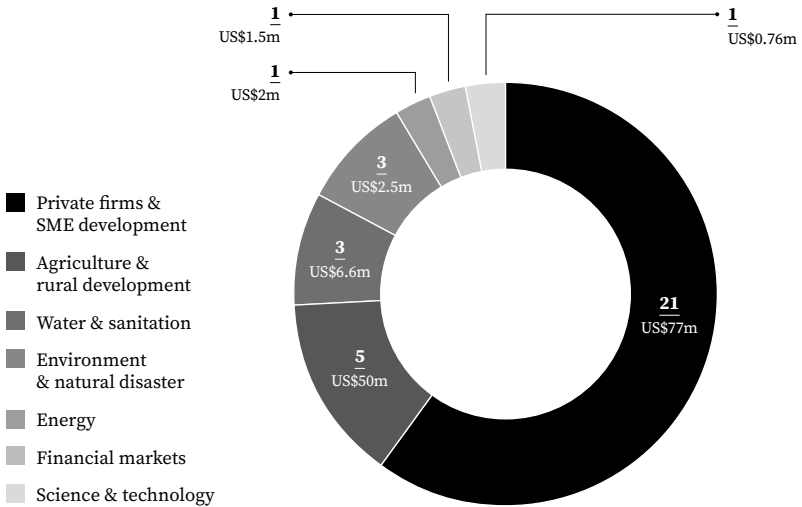


Source: Authors' own elaboration using IADB data.

### Equity investment

Due to the mandate of the bank, the IADB cannot directly invest in equity. However, other members of the IADB Group, such as IDB Invest and the Multilateral Investment Fund (MIF), can make direct equity investments and in equity funds. Over the period 2015–2019, IADB Group made 35 investments in equity to a total value of US\$140.3 million. Figure 11.5 presents the economic sectors where equity investments were made by IADB.

**Figure 11.5: Number of equity investments over the last five years, by economic sector**



Source: Authors' own elaboration using IADB data.

The highest number of funded equity investment projects made over the last five years have been directed towards “Private firms and SMEs development”, with an overall disbursement equal to US\$77 million. Furthermore, energy is the second sector for IADB equity investment, with only five funded projects that have attracted investments of US\$50 million. Finally, financial markets, water and sanitation, science and technology, and environment have received marginal resources, equal to an overall disbursement of roughly US\$13 million.

## IADB AND COVID-19

In light of the Covid-19 pandemic, the IADB is generally operating according to four aims:

1. Strengthening health systems.
2. Helping fund non-conditional transfers – more resources to vulnerable people.
3. Providing liquidity to ministries of finance.
4. Funding to SMEs.

Being aware that the recovery will not be linear, while discussing the potential recovery plan, there is a need to keep the disbursement for social expenditure at the same time as increasing the disbursement for infrastructure and green transformation; for Latin America, another sector of primary importance is the food industry, which will need adequate financial resources. For the short and medium term in Latin America, the social component will need primary attention. Counter-cyclical finance is seen as crucial both for urgent short-term expenditures, as well as for longer term investment, to help minimize damaging effects for long-term development.

At the moment, the IADB has increased both policy-based loans – to supply more liquidity – and non-conditional transfers. In light of Covid-19, the IADB also began a ‘fast-track’ procedure to facilitate the approval of projects, with a 66% time reduction, leading to procedures that allow the bank to issue a loan in one and a half months or maximum two. On the other hand, equity investments are now more complicated, due to the uncertainty brought by the Covid-19 pandemic. The three instruments mainly used by IADB during the initial phase of the Covid-19 pandemic – Investment Loans; Policy-based Loans; Special Development Lending – have been mainly directed towards the following areas of intervention:

- Immediate public health response.
- Vulnerable populations.

- Productivity sector & employment.
- Multiple priority areas.
- Public policy and fiscal management.
- Special development lending.

Table 11.4 illustrates the overall IADB disbursement since the beginning of the Covid-19 pandemic, by area of intervention.

**Table 11.4: IADB disbursement in response to Covid-19, by area of intervention**

| Areas of intervention               | Disbursement (US\$ million) |
|-------------------------------------|-----------------------------|
| Vulnerable populations              | 2,000                       |
| Productivity sector & employment    | 1,900                       |
| Public policy and fiscal management | 1,200                       |
| Special development lending         | 1,200                       |
| Immediate public health response    | 666                         |
| Multiple priority areas             | 250                         |
| <b>Covid-19 Response Total</b>      | <b>7.2 billion</b>          |

Source: Authors' own elaboration using IADB data.

The main focus of IADB intervention over the first phase of the 2020 pandemic has been towards the areas of “Vulnerable populations” and “Productivity sector & employment”, both receiving financial resources for US\$2 billion dollars (US\$1.9 billion for the latter). Among the other areas of IADB intervention, “Public policy and fiscal management” and “Special development lending” have both received US\$1.2 billion. Looking at a country level, Table 11.5 illustrates the amount of financial resources received, and areas of intervention, by country.

**Table 11.5: IADB country breakdown operations in response to Covid-19**

| Country             | Loan size (US\$ million) | Areas of intervention  |
|---------------------|--------------------------|--|
| Brazil              | 1,750                    | Vulnerable populations; Productivity sector & Employment   |
| Argentina           | 970                      | Immediate public health response; Productivity sector & Employment                               |
| Bolivia             | 580                      | Vulnerable populations; Productivity sector & Employment   |
| Uruguay             | 555                      | Vulnerable populations; Productivity sector & Employment; Public policy & Fiscal management      |
| El Salvador         | 550                      | Immediate public health response; Public policy & Fiscal management; Special development lending |
| Panama              | 550                      | Productivity sector & Employment; Special development lending                                    |
| Costa Rica          | 515                      | Vulnerable populations; Special development lending  |
| Dominican Republic  | 500                      | Public policy & Fiscal management; Special development lending                                   |
| Ecuador             | 344                      | Productivity sector & Employment; Multiple priority areas  |
| Paraguay            | 210                      | Public policy & Fiscal management  |
| Mexico              | 154                      | Productivity sector & Employment   |
| Honduras            | 146                      | Immediate public health response; Productivity sector & Employment; Special development lending  |
| Guatemala           | 100                      | Vulnerable populations   |
| Trinidad And Tobago | 100                      | Public policy & Fiscal management  |
| Haiti               | 87                       | Immediate public health response; Vulnerable populations   |
| Nicaragua           | 43                       | Immediate public health response   |
| Suriname            | 20                       | Immediate public health response   |
| Bahamas             | 19                       | Vulnerable populations   |
| Belize              | 18                       | Immediate public health response; Vulnerable populations   |
| Barbados            | 0                        |  |
| Chile               | 0                        |  |
| Colombia            | 0                        |  |
| Guyana              | 0                        |  |
| Jamaica             | 0                        |  |
| Peru                | 0                        |  |
| Venezuela           | 0                        |  |
| <b>Total</b>        | <b>7.21 billion</b>      |  |

Source: Authors' own elaboration using IADB data and IADBc.

As of October 2020, Brazil has been the largest recipient of financial resources disbursed by IADB since the beginning of the Covid-19 pandemic, receiving US\$1.7 billion towards the areas of ‘Vulnerable populations’ and ‘Productivity sector & Employment’. Argentina is the second largest recipient of IADB funds, receiving roughly US\$1 billion invested in the areas of public health and productivity sector, and employment.

Finally, we compare the disbursement of IADB over the first 10 months of 2019 and 2020, looking at whether the bank supplied any additional resources during the Covid-19 pandemic compared to the same period in the previous year. Table 11.6 shows the overall 2019 and 2020 disbursement of IADB, by type of instrument.

**Table 11.6: Comparison of IADB disbursement in 2019 and 2020, by type of instrument**

| Instrument              | Jan 1, 2019 – Oct 21, 2019        |                             | Jan 1, 2020 – Oct 21, 2020        |                             |
|-------------------------|-----------------------------------|-----------------------------|-----------------------------------|-----------------------------|
|                         | Total disbursement (US\$ billion) | Number of approved projects | Total disbursement (US\$ billion) | Number of approved projects |
| Loan operation          | 7.45                              | 68                          | 19.62                             | 154                         |
| Container*              | 2.59                              | 11                          | 6.46                              | 16                          |
| Technical cooperation   | 0.17                              | 348                         | 0.23                              | 451                         |
| Non-reimbursable grants | 0.15                              | 12                          | 0.37                              | 30                          |
| Equity                  | 0.02                              | 4                           | 0.01                              | 4                           |
| <b>Total</b>            | <b>10.38</b>                      | <b>443</b>                  | <b>26.69</b>                      | <b>655</b>                  |

Source: Authors’ own elaboration using IADB data. \*Containers ‘contain’ a combination of instruments.

The IADB reacted quickly to the challenges brought about by the Covid-19 pandemic in 2020, increasing both the number of funded projects and the amount disbursed compared to the same period in 2019. Looking at loan operations in particular, IADB almost tripled its disbursement and more than doubled the number of funded projects.



## THE COMMONWEALTH DEVELOPMENT CORPORATION (CDC)

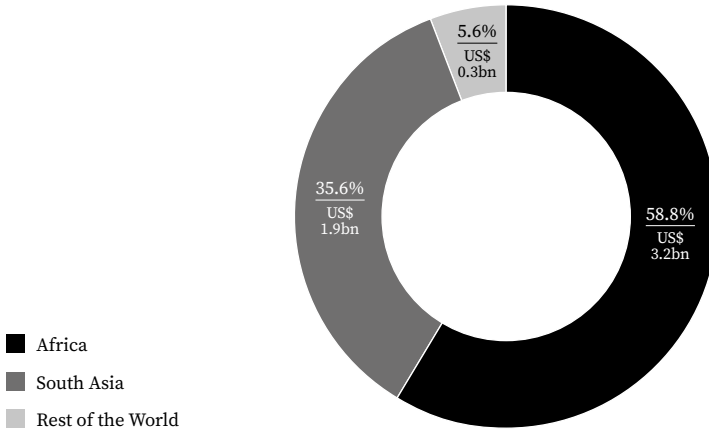
The CDC Group plc (CDC, hereafter) – formerly the Colonial Development Corporation, Commonwealth Development Corporation and Capital for Development Corporation – is the UK development bank. It was 100% owned by the Department for International Development (DfID) until 2020, when DfID was merged with the Foreign Commonwealth Office into the Foreign, Commonwealth & Development Office (FCDO). Although it is entirely owned by the UK Government, CDC’s operations and investment decisions are independent.

The CDC was founded in 1948 and has changed its structure and mandate over the years. The current mandate of the bank is to “[...] solve the biggest global development challenges by investing patient, flexible capital to support private sector growth and innovation. It is the world’s first impact investor with over 70 years of experience of successfully supporting the sustainable, long-term growth of businesses in Africa and South Asia” (CDCa).

Figure 11.6 shows the overall disbursement of the CDC from 2015–2019, by geographical area and Table 11.7 reports the country breakdown of the overall exposure of the CDC.

Almost two-thirds of the funds disbursed by the CDC over the last five years have been invested in the African continent, while almost all the remaining financial resources went to the South Asian continent and only 5% was disbursed in other countries. Looking at the countries where the CDC invested more resources, India accounts for 27.6% of the overall CDC investments, followed by four African countries – Nigeria, Kenya, South Africa and Côte d’Ivoire – each accounting for around 5% of the overall CDC investments.

Figure 11.6: *CDC disbursement over the last five years, by geographical region*



Source: Authors' own elaboration using CDC data.

Table 11.7:  
*Country breakdown,  
total portfolio*

| Country       | % investment |
|---------------|--------------|
| India         | 27.6%        |
| Nigeria       | 6.8%         |
| Kenya         | 4.9%         |
| South Africa  | 4.8%         |
| Côte d'Ivoire | 4.5%         |

Source: CDC website (CDCb).

The financial resources disbursed by the CDC are generally for long periods, often for more than 10 years, and are aimed at increasing the capital flows in underdeveloped markets, particularly in fragile sectors or in those with the highest growth potential (CDCc). In line with the Sustainable Development Goals (SDGs) and the Addis Ababa Action Agenda, the strategic priorities identified in the CDC Strategic Framework 2017–2021 are the following:

**Developmental:** The main developmental goal of CDC is to eradicate poverty through the creation of decent jobs, in line with SDGs 1 and 8. However, other broader impacts that are expected as a result of CDC investments are the removal of market constraints in energy and infrastructure, promoting access to essential goods and services – health and education – and increasing capital flows to support the process, with particular focus on women’s empowerment and climate change.

**Responsible:** Particular attention is also paid to the quality of the investments, with standards defined in the ‘Code of Responsible Investing’, which reports the guidelines for environmentally, socially and business responsible investments. To achieve the targets, CDC provides financial resources under the principle of additionality, both in financial terms – do not supply resources that are already offered in the market – and in terms of value – to provide value beyond the capital itself, as technical assistance.

**Innovative:** The CDC invests in long-term projects with higher developmental impacts aiming to create new markets and reinforce existing ones. These investments, which come at greater risk and where capital markets perceive a risk that’s too high to commit, are funded by the CDC with the provision of concessional capital, always in light of the principle of additionality.

**Enduring:** The CDC operations are independent from the UK Government and are in line with the Investment Policy and the Code of Responsible Investing set by DfID – now FCDO. The activity of the CDC is primarily based on five principles that aim to guarantee

the self-funding of the institution and the long-term sustainability: i) Accountability; ii) Proficiency; iii) Independence; iv) Continuity and stability; v) Financial regulation

The CDC works under the principle of capital preservation and therefore cannot undertake operations like first loss guarantees, which could break the capital preservation. As a consequence, the CDC does not offer provision against losses and is not allowed to borrow on the capital markets. This implies that the CDC can either participate in funds that invest in projects – intermediate investments – or can raise funding from government grants and resources coming from the aid budget.

To maximize the impact of the intervention, the CDC channels funds through regional development banks, like the TDB (Trade and Development Bank) in Africa, as well as commercial banks, as both know the local/regional clients better, leading to less information asymmetry.

Table 11.8 presents the type of instruments used by the CDC, with relative disbursement and number of approved projects over the period 2015–2019.

**Table 11.8: CDC disbursement from 2015–2019, by type of instrument**

| Instrument                 | Disbursement (US\$ million) | Number of approved projects |
|----------------------------|-----------------------------|-----------------------------|
| Direct equity              | 1,803.7                     | 39                          |
| Intermediated investment   | 1,496.2                     | 525 (54 funds)              |
| Direct debt                | 1,313.2                     | 39                          |
| Trade finance              | 550                         | 3                           |
| Direct debt, direct equity | 227.4                       | 3                           |
| Co-investments equity      | 7.9                         | 1                           |
| <b>Total</b>               | <b>5.4 billion</b>          | <b>610</b>                  |

Source: Authors' own elaboration using CDC data.

Direct equity investments are the CDC instrument with the highest disbursement from 2015–2019, with US\$1.8 billion distributed over 39 projects only. Intermediate investments, as previously discussed, are types of operations where the CDC invests in funds that eventually invest directly in companies; from 2015–2019, the CDC invested in 54 funds that led to investments in 525 projects proposed by companies, for an overall amount of US\$1.5 billion.

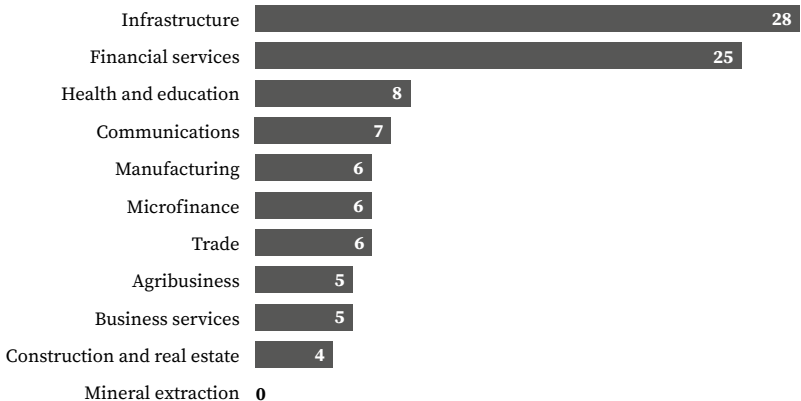
Direct debt operations are the third type of instrument in terms of disbursement, with around US\$1.3 billion disbursed by the CDC over the last five years. Finally, trade finance, combined operations of direct debt and direct equity and co-investment equity represent the minority of CDC investments, with less than US\$1 billion disbursed over the last five years. Among CDC direct operations, hence excluding intermediated investments, we can see from Figure 11.7 that 50% of CDC resources are invested in direct equity operations. This is a significant share of the overall disbursement, but is still lower than in the past, when the CDC used to have 80% of its direct transactions in equity. Although riskier than other types of commitments, equity investments allow the CDC to have a greater engagement with the companies. However, these imply a riskier and more volatile portfolio. The seven priority sectors of intervention identified by CDC are presented in Table 11.9, together with the share of budget allocated in 2019.

Looking at the sectorial breakdown of the 2019 disbursement in Table 11.9, more than half of the resources invested by the CDC have been directed towards financial services, while almost a quarter was granted for investments in infrastructure. However, it should be noted that many of the funds channelled to financial services would have been on-lent to other sectors. Food and agriculture and health both accounted for 3% of the overall CDC spending in 2019 while the category ‘Other’ also including projects with more than one sector of intervention, have accounted for 17% of the total disbursement. Looking at the composition of the overall CDC portfolio in Figure 11.7, infrastructure is the sector where the CDC has the greatest exposure, closely followed by the financial services sector.

**Table 11.9: Sectorial breakdown of CDC operations, 2019**

| Areas of intervention        | Share of disbursement |
|------------------------------|-----------------------|
| Financial services           | 53%                   |
| Infrastructure               | 23%                   |
| Food and agriculture         | 3%                    |
| Health                       | 3%                    |
| Education                    | 1%                    |
| Manufacturing                | 0%                    |
| Construction and real estate | 0%                    |
| Other                        | 17%                   |
| <b>2019 Disbursement</b>     | <b>1.66 billion</b>   |

Source: CDC website (CDCd).

**Figure 7: Total CDC underlying portfolio, by sector (%)**

Source: CDC Annual Accounts 2019.

## THE CDC AND COVID-19

Finance and support from institutions like the CDC have been critical during the Covid-19 pandemic and will be so for the rebuilding process. To achieve better alignment and coordination with other institutional actors, the CDC currently works in collaboration with the group of European Development Finance Institutions, the EDFI and with other institutions such as UNICEF for the distribution of medical products in lower and middle-income countries through a CDC subsidiary, MedAccess.

In light of the Covid-19 pandemic, the CDC identified three areas of focus: ‘preserve’, ‘strengthen’ and ‘rebuild’ (Covid-19 briefing document 2020, CDCe).

**Preserve:** provide working capital and technical assistance to the most affected sectors.

**Strengthen:** channel liquidity to local banks to be distributed to the domestic supply chains.

**Rebuild:** invest in long-term projects for the recovery phase.

Over the first nine months of 2020, the CDC disbursed more than US\$650 million: US\$400 million to increase liquidity in the markets under the ‘Strengthen’ pillar, together with health, social and finance programmes in Asia and Africa and US\$250 million under the ‘Rebuild’ pillar to invest in long-term projects for the recovery phase.

As a first response to the Covid-19 pandemic, the CDC also issued two new technical assistance and support facilities: the “Covid-19 Business Response Facility”, for the healthcare sector and the distribution of basic goods and pharmaceuticals; and the “Covid-19 Emergency Technical Assistance Facility”, to provide technical assistance and expertise during the pandemic crisis (CDCf). Using both facilities, over the three rounds in April, July and September, the CDC funded 50 projects for an overall amount of £4.5 million (CDCg).

During a pandemic crisis with high levels of uncertainty, there is greater emphasis on loans, as they are perceived to be easier to roll out. Equity instruments, on the other hand, are harder to roll out, come with higher costs and time of approval, and are also harder to price given the context of uncertainty. Hence, debt instruments are the preferred mechanism in the initial phase of Covid. At the same time, in situations where companies are already highly indebted, increased debt would imply too much leverage for companies. In conclusion, Table 11.10 compares the amount disbursed by the CDC over the first nine months of 2020 compared with the overall amount disbursed in 2019.

**Table 11.10: Comparison of CDC disbursement in 2019 and 2020**

|                                       | 2019 | Jan 2020 – Sep 2020 |
|---------------------------------------|------|---------------------|
| CDC total disbursement (US\$ billion) | 1.66 | 0.65                |

Source: Authors' own elaboration using CDC data and CDC website.

From January to September 2020, the CDC provided technical assistance to companies and disbursed more than US\$650 million in the form of liquidity and investment as first response measures in light of the Covid-19 pandemic (CDC Covid-19 Briefing Report – see CDCh). The financial resources disbursed over the first nine months of 2020, equal to 40% of the overall disbursement in 2019, represent an important first step in supporting companies; nevertheless it is very likely that additional financial resources will be necessary in the near future to allow for the countercyclical role that Development Finance Institutions (DFIs) are required to fulfil.

In this sense, it becomes important for the CDC, like other bilateral DFIs, to be capitalized soon and at a significant level, to meet the challenges both of Covid and of green and inclusive development.



## CONCLUSION

Since the beginning of the Covid-19 pandemic, the IADB and the CDC have been very active, disbursing financial resources and providing technical assistance for governments and companies in the short term. The increase in activities seems far more significant in the case of the IADB. There is, however, the need to expand the activities of both these financial institutions, to cope with the future social and economic challenges that the Covid-19 pandemic will bring over the next months, as well as supporting the important structural transformation to more dynamic, greener and more inclusive economies.

In order to increase their activity, there is a need to take into consideration the nature, mandate and structure of these financial institutions. The IADB, as a Multilateral Development Bank with several states as shareholders, has a wider spectrum of duties around its own shareholders' country-specific and general priorities, both in the short and long term. The CDC, as a development finance institution owned by the UK that is geared towards funding the private sector in poorer countries, has a different mandate and mission, and therefore faces different challenges. The type of instruments they use are also different, in that the IADB mainly uses loans, whilst the focus of CDC instruments is on equity.

However, both banks face major challenges in terms of fulfilling their mandates. Therefore, it seems key in both cases that their capital is significantly increased to allow them to fulfil their roles properly, and at sufficient scale.

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## Chapter 12

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# THE ROLE OF PUBLIC CREDIT PROGRAMMES IN MITIGATING THE ECONOMIC EFFECTS OF THE COVID-19 PANDEMIC: BRAZIL'S EXPERIENCE

**T**his chapter's objective is to examine the role that public institutions play in mitigating the social and economic effects of Covid-19 in the context of transformations under way in the Brazilian financial system. During the pandemic, subsidized loans granted by both public and private banks were supported exclusively with resources from Brazil's Federal Government. With regard to these resources provided, our investigation did not find substantial differences between the actions of public and private banks. However, these subsidized loans represent only a small fraction of total loans granted during the pandemic, which means that the financing of the economy was mostly sustained by private banks through interest rate adjustment and market mechanisms. On the one hand, small- and medium-sized enterprises (SMEs), which are the primary source of job creation, did not receive sufficient affordable financial support. On the other hand, Brazil's Federal Government obtained support to modify the country's Constitution to adopt the controversial non-conventional monetary policies (NCMP). Among other decisions adopted by the Central Bank, the NCMPs offered

important support for private banks and financial funds. In sum, the secondary role played by public banks during the pandemic crisis is in line with the neoliberal policy adopted by the Government, despite the evidence that such policies tend to deepen chronic Brazilian social inequality.

## INTRODUCTION

Brazil's Ministry of Health announced the country's first case of Covid-19 on February 26, 2020. Beginning in the second half of March, several major cities adopted social distancing measures to curb the pandemic. The Federal Government's response to the economic effects of Covid-19 focused on three areas: (i) providing emergency funds to low-income families; (ii) postponing or eliminating selected taxes and fees, and; (iii) offering credit and increasing liquidity in the country's financial system.

This chapter examines the role played by public financial institutions in mitigating the pandemic's social and economic effects in the context of the ongoing changes to Brazil's financial system. The investigation includes: (i) details of credit lines and financing conditions; (ii) identification of the segments benefitting from these changes; and (iii) a description of the government measures vis-à-vis the behaviour of the financial market.

The investigation found that private financial institutions have been primarily responsible for the supply of credit during the Covid-19 pandemic, inasmuch as governmental aid programmes cover only a fraction of the country's credit demands, and private financial institutions operate some of the credit lines supported by public resources. Furthermore, Brazil's National Congress, by adopting the 106th amendment to the country's constitution, allowed for the adoption of so-called non-conventional monetary policies. Thus, banks were allowed to take out loans from Brazil's Central Bank backed by private securitized credit portfolios and

corporate debt securities. Similarly, public banks have bought credit portfolios from private medium-sized banks and quotas from debt funds, with the purpose of increasing economic liquidity.

All these public measures are in line with the principles of the macroeconomic policies adopted after 2015, which focus on reducing state intervention in the country's economy. This contrasts with Brazil's experience during the 2008 economic crisis, when public banks provided credit to support economic development (Vasconcelos et al. 2018; Deos and Mendonça 2017).

In April, the Federal Government released measures to expand private banks' liquidity a few weeks after the first lockdowns, whereas Government loan programmes only reached small firms in June. Central Bank statistics show that loans have been granted mainly to large companies, and small- and medium-sized businesses have been facing credit restrictions, usually related to their credit history or lack of sufficient guarantees. Such firms have also had to contend with higher interest rates in the loans provided by private banks. Although Brazil's benchmark interest rate has continued to fall in recent years due to the country's economic slowdown, credit costs remain higher in light of the challenges imposed by the Covid-19 crisis.

The movement of credit markets undoubtedly depends on other Government policies, especially policies for direct income transfers and productive investments intended to restore economic development. However, Government policy seems to depend on a market-based approach, meaning that Brazil may face high unemployment rates and low economic growth for the foreseeable future.

This chapter is organized into four sections. The first outlines the methodological approach. The next gives details related to lines of credit provided by Brazil's Federal Government to illustrate both the scope and the beneficiaries of Government aid programmes. The third section analyzes Brazil's domestic credit supply, highlighting the role played by public banks. The last section presents the conclusions.

## CONTENDING VIEWS AND METHODOLOGY

The predominant neoliberal view of the role of public banks in the economy is based on the theory of financial repression adopted by Shaw (1973) and McKinnon (1973). They argue that savings allocation is artificially distorted by the actions of public banks, which in turn leads to inefficient financial markets and obstructed economic growth. According to these authors, the state should only guarantee the security, stability and predictability of the financial system so as to reduce costs and risks for economic agents. Still within the orthodox economic field, Stiglitz (1993) allows for some governmental intervention in specific situations, such as in the case of a lack of long-term credit supply, or in order to avoid banking insolvency during systemic crises.

Economists not aligned with neoliberalism, such as Mazzucato and Penna (2016), argue that Stiglitz's approach restricts knowledge regarding the role of public banks. They believe that Stiglitz's interpretation regarding the theory of market failures is static and limited, since it focuses exclusively on a cost-effective perspective, which in turn implies a specific design for public institutions. From Stiglitz's perspective, the use of public banks as a countercyclical economic tool is unjustifiable. Mazzucato and Penna emphasize the market and value creating the potential of public banks and patient finance.

Castro (2008), an economist from the institutionalist school of economics, argues that the financial system must contribute to economic development without creating imbalances or weaknesses in financial markets. She defends the use of public banks to mitigate the effects of economic crises. Similarly, Yeyati et al. (2007) show that, in periods of economic uncertainty, private banks usually cut the supply of credit as a defensive measure. Supported by the principles of Keynesian and institutionalist lines of economic thought, their research discusses the supply of credit to businesses and individuals. In methodological terms, it focuses on small and medium-sized firms because of their

important roles in job creation, as well as on governmental measures directed toward firms of this size. A detailed accounting of credit lines in Brazil only exists for those managed by the large public banks (see Box 12.1), although, at a regional level, the country depends on other medium-sized public banks. Both public and private financial institutions operate most of the measures related to the Federal Government's credit provisions. In some cases, public banks manage credit funds operated by private banks. This chapter analyzes government measures introduced between March and July 2020.

## THE PROFILE OF GOVERNMENT CREDIT PROGRAMMES

The current configuration of Brazil's financial system has its roots in reforms that took place in the 1960s and 1990s. In the 1960s, the Federal Government undertook a wide-ranging reform that included measures ranging from the creation of the country's Central Bank to the design of specialized institutions and mechanisms focused on long-term funding. The primary changes of the 1990s included the internationalization of Brazil's financial system, support for private banks and the privatization of several regional public banks.

Regarding private institutions, in the 1990s Brazil's Federal Government created PROER (Programme for the Stimulation of Restructuring and Strengthening the National Financial System – Programa de Estímulo a Reestruturação e ao Fortalecimento do Sistema Financeiro Nacional), a programme dedicated to supporting private banks through the acquisition of toxic assets and the creation of guarantee funds so as to support specific banking products. Also in the 1990s, the Federal Government created the PROES (Programme for Incentivizing the Reduction of the Public Sector in Baking Activity – Programa de Incentivo a Redução do Setor Público Estadual na Atividade Bancária) with the intention of privatizing or closing public banks created by individual Brazilian states (see Vidotto 2005; Araujo 2001; Araujo and Cintra 2011).



### Box 12.1: *Large Brazilian Public Banks*

**Banco do Brasil (Bank of Brazil – BB)** was created as a public bank during Brazil's colonial period, and it served as the country's monetary authority until the 1960s, when the Central Bank was created. In 1996, the Federal Government's privatization programme opened its capital. Currently, the Federal Government is the bank's majority shareholder, while remaining shares are divided between domestic (23.9%) and foreign (25.6%) investors. Banco do Brasil is one of the main institutions responsible for rural credit in Brazil (see Graner et al. 2019).

**The Caixa Econômica Federal (Federal Economic Fund – CEF)** was also created as a public bank during the colonial period, but its importance was accentuated in the 1980s, when it assumed primary responsibility for operating Brazil's housing credit programme, as well as for major investments in urban infrastructure and basic sanitation. Today, Brazil's Federal Government holds 100% of stocks in CEF, which is responsible for approximately 70% of the country's housing-related credit.

**Banco Nacional de Desenvolvimento Econômico e Social (National Bank for Economic and Social Development – BNDES)** is a fully public bank and it was created in the 1950s to support long-term investments. In the 1990s, BNDES became the primary operator of Brazil's privatization policy. BNDESpa is the subsidiary of BNDES for operating large investments through the acquisition of shares or private securities. In the 2000s, the Federal Government undertook a major capitalization of BNDES (Torres Filho and Costa 2013), but beginning in 2016, the expansion of BNDES credits was reversed. In 2019, BNDES transferred US\$32 billion to the Treasury (BNDES 2019), which is the equivalent of 65% of the World Bank's disbursements (US\$49 billion) during the same period (World Bank 2020).

The measures announced by Brazil's Federal Government to mitigate the economic effects of the pandemic have affected individuals as well as companies. Banks have offered short-term lines of credit and have postponed loan payments to individuals. In addition to offering companies new lines of credit and postponing loan payments (see Table 12.1), public banks have bought credit portfolio from medium-sized banks. Similarly, BNDES has bought quotas from debt capital funds oriented to provide credit to small- and medium-sized firms. BNDES and the CEF (Caixa Econômica Federal) are management guarantee funds for supporting credit operations made by both public and private financial institutions. Finally, health institutions, as well as municipal and state governments, have been supported by credit lines with interest rates below market rates.

Table 12.1: *Credit Postponement measures*

| Institution | Beneficiaries | Product name (1)   | Benefit   |
|-------------|---------------|--|---|
| BNDES       | Firms         | Direct, indirect and mixed operations (all credit lines)         | Postponing debts (principal and interest) until September, 2020. Original loan conditions are preserved |
| CEF         | Firms         | Working capital and real estate production (real estate funding) | Postponing debts (principal and interest) for 90 days. Original loan conditions are preserved           |

| Institution | Product name (1)   | Benefit  |
|-------------|--|--|
| CEF         | Check cashing loans<br>( <i>Cheque especial</i> )<br>regarding new loans   | Interest rate reduction (for 90 days) from 4.95% p.m. to 2.90% p.m.  |
|             | Check cashing loans<br>( <i>Cheque especial</i> )<br>regarding early debts | Interest rate reduction (for 90 days) from 7.7% p.m. to 2.9% p.m.  |
|             | Short-term loans<br>( <i>CDC Salário</i> )<br>regarding new loans          | Interest rate reduction (for 90 days) from 2.29% p.m. to 2.17% p.m.  |
|             | Short-term loans<br>( <i>Crédito Consignado</i> )<br>regarding new loans   | Interest rate reduction (for 90 days). During this period, fees charged begin at 0.99% p.m. These fees may vary depending on the guarantees. In Jan 2020, the average interest rate was 1.56% p.m. |
|             | Short-term loans<br>( <i>Penhor</i> ) regarding pledges                    | Interest rate reduction (for 90 days) from 2.10% p.m. to 1.99% p.m.  |

Sources: CEF and BNDES websites; legislation related to aid programmes; legislation provided by monetary authorities.

Brazil's Federal Government has directed most of its aid packages towards small- and medium-sized enterprises, although Government aid programmes have also supported large companies. Credit lines are classified in three categories: (i) support for employment (BRL 17 billion); (ii) support for agricultural activities (BRL 34 billion); and (iii) support for working capital (BRL 21 billion).

In terms of employment support, the Federal Government created the PESE programme (Programme for Emergency Employment Support – Programa Emergencial de Suporte ao Emprego) in order to finance payroll expenses to firms with annual revenues between BRL 360,000 and BRL 10 million. For a period of four months, companies can take out loans of up to two monthly minimum wages per employee. BNDES is the official manager of the PESE programme, but other public and private commercial banks are also allowed to operate this credit line.

BNDES manages and is the direct operator for medium-sized and large companies with annual revenues above BRL 10 million. Other public and private banks provide loans supported by the PESE programme for businesses of all sizes. The interest rate charged by the PESE programme (3.75%/year) is below market rate (usually above 11%/year) and the Federal Government will share losses on these loans (85%) with bank operators (15%).

The PESE programme was launched in April, but by the end of June only 12.5% (or BRL 4.3 billion) of its original resources had been contracted (Bacen 2020). Monetary authorities and the media argued that most small business did not have sufficient guarantees or good enough credit history to take out PESE loans (see Datt 2020; CN-Covid-19 2020). Despite the obstacles that these firms face, most may have chosen to dismiss their employees instead of taking out loans to support their payrolls. According to the Government's statistics bureau (IBGE 2020), 8.9 million jobs were lost between the first quarter (Jan-March 2020) and the second (April-June 2020). In addition, a survey conducted by SEBRAE/FGV (2020) showed that 12% of small firms laid off their employees. In July 2020, BRL 17 billion from PESE's original budget (BRL 34 billion) was transferred to the PRONAMPE programme, which will be discussed further below.

In relation to agricultural activities, Brazil's Department of Agriculture or MAPA (the Ministry of Agriculture, Stockbreeding and Supplies – Ministério da Agricultura Pecuária e Abaste-

cimento) released new credit for two existing rural funding programmes: PRONAF (National Support Programme for Family Agriculture – Programa Nacional de Apoio a Agricultura Familiar) and PRONAMP (Support Programme for Midsize Rural Producers – Programa de Apoio ao Médio Produtor Rural). PRONAF is dedicated to small rural producers, while PRONAMP is oriented towards midsize producers. The programmes' interest rates range from 4% to 6%/year, depending on the size of the specific rural producer. The credit limit is BRL 20,000 for small producers and BRL 40,000 for midsize producers. Farmers also have the option to postpone payments on contracts signed before the pandemic (MAPA 2020).

In recent years, Government-provided credit lines with controlled interest rates have been replaced by loans based on market rates. Servo (2019) shows that the share of controlled interest rate loans declined from 92.6% to 71.6% between the periods of 2014/15 and 2018/19. In addition, Zaia (2020) reports that market interest rates for rural producers have increased during the Covid-19 crisis. These rates were between 6.5% and 8.7%/year before the crisis, but now they may be as high as 10.5%/year.

Concerning working capital credit lines, Brazil's Federal Government instituted PRONAMPE (National Programme Supporting Small and Microbusinesses – Programa Nacional de Apoio as Microempresas e Empresas de Pequeno Porte), a loan programme oriented toward small businesses with annual revenues between BRL 360,000 and BRL 4.8 million. PRONAMPE's credit limit is 30% of a business's total revenue for 2019. The financing term is 36 months, and lenders have an additional grace period of eight months. The interest rate is based on the SELIC (the Brazilian benchmark interest rate) plus 1.25%/year. Intermediary banks may charge administrative fees, which are to be negotiated between borrowers and lenders. In August 2020, the SELIC was 2.0%/year. Loan funding is provided by operator banks, but loans are 100% guaranteed by a governmental fund called FGO (Operator Guarantee Fund – Fundo

Garantidor de Operações), managed by Banco do Brasil. Around 90% of the resources from the first phase of PRONAMPE (BRL 15.9 billion) were contracted in the programme's first few weeks. In July 2020, another BRL 17 billion was transferred to FGO from the PESE programme.

Public banks have also expanded their own credit lines, but these loans are more expensive than those provided by governmental aid programmes. BNDES made BRL 5 billion available to businesses with annual revenues of up to BRL 300 billion, and another BRL 2 billion to companies with annual revenues above BRL 300 billion. The costs of these loans depend on lenders' profiles (see Table 2). Costs include a fixed interest rate for BNDES (from 1% to 1.5%/year), in addition to a variable interest rate (TLP or SELIC), in addition to interest rates charged by intermediary banks based on borrowers' credit histories and the guarantees they offer. The TLP (Long-Term Rate – Taxa de Longo Prazo) is a long-term interest rate, based on a fixed interest rate plus an inflation adjustment. The total cost of BNDES loans may reach 11%/year (Datt 2020). BNDES has also provided BRL 2 billion to healthcare institutions. The total cost is determined by the SELIC rate plus 1%/year (BNDES fees), and an additional 4.26%/year (risk component).

The CEF has been offering working capital credit lines guaranteed by a fund called FAMPE (Guarantee Fund for Small and Microbusiness – Fundo de Aval às Micro e Pequenas Empresas). Its interest rates are between 1.19% p.m. and 1.59% p.m. (per month), equivalent to a range of 15% to 20%/year. The CEF also makes working capital credit lines without FAMPE available, for which its interest rates begin at 0.57% p.m. to 1.51% p.m., depending on borrowers' risk profiles (see Table 12.2).

**Table 12.2: Additional public financial institution resources for firms**

| Institution    | Amount*        | Target companies  | Benefits   | Financing cost**  |
|----------------|----------------|---|--|---|
| BNDES          | BRL 5 billion  | Companies with annual revenue up to BRL 300 million   | Financing up to BRL 70 million<br>Term: 60 months.<br>Grace period: 24 months            | Interest Rate = TLP or SELIC*<br>BNDES fees = 1.25%/year<br>Intermediation rate = direct negotiation between lenders and borrowers            |
| BNDES          | BRL 2 billion  | Companies with annual sales above BRL 300 million   | Financing up to BRL 200 million<br>Term: 48 months.<br>Grace period: 12 months           | Interest Rate = SELIC*<br>BNDES fees = 1.5%/year (without job guarantee) or 1.1%/year (with job guarantee)<br>Risk rate = direct negotiation. |
| BNDES          | BRL 2 billion  | Non-profit healthcare institutions and companies responsible for producing equipment and derived inputs | Financing up to BRL 150 million<br>Term: 60 months.<br>Grace period: from 3 to 24 months | Interest Rate = TLP***<br>BNDES rate = 1.0%/year<br>Risk rate = 4.26%/year  |
| PESE Programme | BRL 17 billion | Small and medium-sized firms' annual revenue from BRL 360,000 up to BRL 10 million)                     | Financing of payroll up to two minimum wages (per employee) for 120 days                 | Interest Rate: 3.75%/year   |
| CEF            | Not available  | Small and medium-sized businesses   | Working capital credit line not supported by guarantee fund                              | Interest Rate: from 0.57% p.m. to 1.51% p.m.  |

|                     |                     |  |   |  |
|---------------------|---------------------|--|---|--|
| CEF/FAMPE           | BRL<br>12 billion   | (MEI)<br>Autonomous<br>workers – annual<br>income up to<br>BRL 81,000;<br>(ME) Micro-firms<br>– annual revenue<br>up to BRL 360,000<br>(EPP) Small firms<br>– revenue up to<br>BRL 4.8 million | Financing of<br>working capital<br>supported by<br>guarantee fund<br>(FAMPE)<br>Term: from 24 to<br>36 months.<br>Grace period:<br>from 9 to 12<br>months | MEI = 1.59% p.m.<br>ME = 1.39% p.m.<br>EPP = 1.19% p.m.  |
| PRONAF E<br>PRONAMP | BRL<br>34 billion   | Small rural<br>producers<br>(PRONAF) and<br>Medium rural<br>producers<br>(PRONAMP)   | Credit lines up<br>to BRL 20,000<br>(PRONAF) or up<br>to BRL 40,000<br>(PRONAMP)  | PRONAF =<br>4.6% / YEAR<br>PRONAMP =<br>6.0% / YEAR  |
| PRONAMPE            | BRL<br>15.9 billion | Small businesses<br>with annual<br>revenues<br>between BRL<br>360,000 and BRL<br>4.8 million   | Loans provided<br>by public or<br>private banks,<br>with controlled<br>interest rate. The<br>loans are entirely<br>backed by public<br>funds (FGO)        | Interest Rate:<br>TLP or SELIC*<br>BNDES fees:<br>1.25% / YEAR<br>Administration<br>fee: direct<br>negotiation |

Sources: CEF and BNDES websites; legislation related to the aid programmes; legislation provided by monetary authorities.

Notes: \* The amounts indicated represent those made available by the banks, and not the sum of the loans contracted. \*\* Administrative fees charged by banks are not included. \*\*\* In August 2020, the SELIC rate was 2.00%/YEAR, while the TLP rate was 1.78%/YEAR plus inflation.

In an effort to increase economic liquidity, the Federal Government has supported private financial institutions. BNDESpar, which is a subsidiary of BNDES, made BRL 4 billion available for purchasing quotas from debt capital funds. These purchases are limited to BRL 500 million per fund, and BNDESpar is allowed to buy up to 90% of the total quotas. Debt capital funds that benefit from BNDESpar resources must steer their credit operations toward small- and medium-sized firms with annual revenues of up to BRL 300 million (BNDESpar 2020) (see Table 12.3).

During the 2008 crisis, resources were transferred to major banks



in response to a single account holder's perception regarding the vulnerability of small- and medium-sized banks. However, this migration of resources did not increase credit offers for the entire economy, because major banks retained a significant portion of these resources (Schiozer and Oliveira 2013). To avoid the situation that occurred in 2008, that CEF made BRL 30 billion available to purchase credit portfolios from private midsize banks to reinforce their financial health. Small- and medium-sized banks play an important role in offering credit to small and medium-sized companies (see Table 12.3).

Both initiatives – the purchasing of quotas and portfolios respectively from debt capital funds and midsize banks – are among the typical policies directed to the financial market. According to Brazil's Federal Government, the deconcentration process is a way to increase the competition and efficiency of the financial system. As such, policies to support midsize banks and other financial institutions are among the Government's strategies. However, this is not the only way to increase the competition in the financial system. The increase of credit supply by public banks under competitive conditions may be an important stimulus to improve the behavior of private financial institutions.

Additionally, the Federal Government created the PEAC programme (Special Programme for Access to Credit – Programa Especial de Acesso ao Crédito) in order to offer complementary guarantees to borrowers through a fund guarantee called FGI (the Investment Fund Guarantee – Fundo Garantidor de Investimentos), which is managed by BNDES. FGI was designed for businesses with annual revenues of up to BRL 300 million, and its coverage may comprise up to 30% of loans for small business, and up to 20% of loans for midsize firms. The Federal Government justified the guarantee funds it made available by invoking obstacles faced by small- and medium-sized businesses in accessing banking credit. In late April 2020, a SEBRAE/FGV survey (2020) showed that only 14% of small firms were successful in contracting loans within Brazil's banking networks.

In addition to credit lines and guarantee funds supported by

public resources, the Federal Government is offering fiscal incentives to private financial institutions. In July 2020, the Government created a working capital credit programme called CGPE (Giro Capital for Business Preservation – Capital de Giro para a Preservação de Empresas), which is directed toward firms with annual revenues of up to BRL 300 million. The CGPE programme does not include public resources, and it will be operated by public and private banks. Its interest rates and other loan parameters will be negotiated directly between borrowers and lenders. However, banks are allowed to seek reimbursement for some of their losses related to CGPE operations through two federal taxes: the Imposto de Renda Pessoa Jurídica (Corporate Income Tax) and the Contribuição Social sobre Lucro Líquido (Social Fund for Liquid Profits).

**Table 12.3: Public financial institutions' indirect measures to expand the credit supply**

| Institution | Amount*        | Target companies  | Expected benefits  |
|-------------|----------------|---|--|
| BNDES       | BRL 4 billion  | Purchase of quotas from private credit funds directed to small and medium-sized firms with annual revenues up to BRL 300 million                            | Increase economic liquidity  |
| CEF         | BRL 30 billion | Purchase of credit portfolio from midsize financial institutions related to payroll loans ( <i>crédito consignado</i> ) and automobile loans                | Increase economic liquidity and reinforce balance sheets for midsize banks |
| PEAC        | BRL 20 billion | Firms with annual revenue from BRL 360,000 and BRL 300 million. The guarantee coverage is limited to 30% of loan to small business and 20% to midsize firms | Increase credit offerings to small and medium-sized firms                  |

Sources: CEF and BNDES websites; legislation related to the aid programmes; legislation provided by monetary authorities.

Notes: \* The amounts indicated represent those made available, not the sum of the loans contracted.

In accessing banking credit, small and medium-sized businesses not only face a lack of guarantees, they also must contend with higher interest rates. A report by Infinity Asset Management (Menezes 2020) shows that interest rates negotiated in Brazil are among the highest in the world.

Brazil's Central Bank classifies credit lines into two distinct categories: market credit lines (or free lines) and targeted credit lines. Interest rates and other parameters for market credit lines are freely negotiated between lenders and borrowers, whereas funding for targeted credit lines are regulated by the state, meaning that the Government can define interest rates and other parameters. Most of the targeted credit lines are made available through public banks, but some are provided by private banks in accordance with definitions set by Brazil's monetary authorities. According to governmental policy, targeted credit lines may be provided with or without controlled interest rates. Targeted loans with controlled interest rates may be contracted by individuals or firms, and their costs are usually below the market rate.

Since 2017, the benchmark interest rate (SELIC) has decreased as a result of low economic growth, which has had important impacts in market interest rates. In June 2020, the market interest rate for working capital lines was 11.2%. This is lower than the average 2019 rate (16.4%). In June, the interest rate charged by BNDES through its working capital lines decreased from 6.6% to 4.1% in response to federal government mandates. The same occurred in relation to investment credit lines provided by BNDES (see Table 12.4).

Table 12.4: *Interest rates according to credit line\**

| Credit lines   | 2019 average    | Jan/20 | Feb/20 | Mar/20 | Apr/20 | May/20 | Jun/20 |     |
|--|-----------------|--------|--------|--------|--------|--------|--------|-----|
| <b>Market credit lines - /YEAR percentages</b>                                     |                 |        |        |        |        |        |        |     |
| Anticipation of receivables (trade notes)  | 18.3            | 17.2   | 15.2   | 14.5   | 14.9   | 14.5   | 12.2   |     |
| Anticipation of receivables (credit card bills)                                    | 14.1            | 10.0   | 8.9    | 8.3    | 9.2    | 7.8    | 6.8    |     |
| Anticipation of receivables (check cashing)  | 33.1            | 30.8   | 30.7   | 30.0   | 27.7   | 25.4   | 25.2   |     |
| Working capital  | 16.3            | 16.0   | 15.1   | 15.0   | 13.6   | 12.4   | 11.2   |     |
| <b>Targeting credit lines (with controlled interest rates) - /YEAR percentages</b> |                 |        |        |        |        |        |        |     |
| Rural producers  | 6.8             | 6.2    | 5.3    | 5.4    | 5.4    | 5.6    | 5.2    |     |
| Real estate industry   | 10.0            | 9.4    | 9.1    | 8.6    | 8.8    | 8.6    | 8,8    |     |
| BNDES  | Working capital | 12.1   | 16.3   | 13.3   | 11.0   | 6.7    | 6.6    | 4.1 |
|  | Investment      | 9.3    | 10.4   | 8.3    | 8.4    | 7.4    | 8.2    | 6.5 |
|  | Agribusiness    | 7.4    | 7.4    | 7.3    | 7.8    | 7.1    | 6.7    | 7.5 |

Sources: Central Bank/press release (Bacen 2020a).

Notes: \* Rates are calculated based on different types of credit. They represent the weighted average of the respective portfolios.

Finally, the Federal Government is also negotiating aid programmes to large companies through BNDES (see Neder 2020; ANEEL 2020; Rittner 2020a; Rittner 2020b). The Federal Government may release BRL 4 billion to urban transport companies. According the ANEEL (the National Electric Energy Agency – Agência Nacional de Energia Elétrica), Brazil's energy regulation agency, a pool of banks (BNDES included) released BRL 14.8 billion to energy distribution companies in an at-

tempt to mitigate losses related to the pandemic crisis.

In summary, the Federal Government is offering credit lines at below market rates through public and private banks to small- and medium-sized businesses, in addition to improving guarantee funds managed by public banks in order to increase private banks' supply of credit to firms with difficulties accessing financing. In other words, public and private banks utilized resources made available by Brazil's Federal Government to attend to the credit necessities of businesses. Therefore, these financial institutions acted only as operators of public resources. The final borrowers benefitting from federal programmes are indifferent as to whether their financing is obtained through a public, semi-public or private bank. In the case of the CGPE programme, public and private banks used their own resources in credit operations. However, any eventual losses that banks sustain in operations supported by CGPE will be compensated through fiscal renunciation. The question here, then, is whether these initiatives are sufficient to attend to small- and medium-sized firms. The following section will present statistics regarding the amount of credit made available to firms and individuals by the public and private sectors during the pandemic.

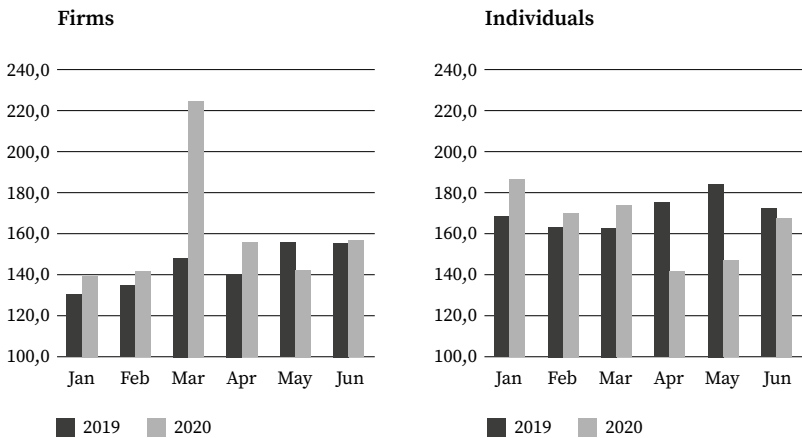
## **THE ROLE OF GOVERNMENTAL CREDIT PROGRAMMES IN BRAZIL'S FINANCIAL SYSTEM**

Keynesian and post-Keynesian economists (Keynes 1973; Minski 1986) argue that periods of uncertainty are marked by liquidity preference: the supply of credit decreases and interest rates rise due to defensive decisions made by financial institutions. Thus, the key question is: how are governmental measures impacting Brazil's financial system during the Covid-19 pandemic crisis?

In March 2020, when social distancing measures were initiated in several Brazilian cities, credit concessions to firms and individuals moved in different directions. In March, credit operations

to firms grew 59.7%, from BRL 140.8 billion to BRL 224.8 billion. However, beginning in April, these concessions returned to levels observed in 2019. In contrast, credit concessions to individuals decreased by approximately 20% in April and May, before returning to 2019 levels in June, probably as a reaction to the economic reopenings taking place in certain major cities (see Figure 12.1).

Figure 12.1: *Credit concessions in the first half of 2019 and 2020\**



Source: Central Bank/press release (Bacen 2020a).

Notes: \* In BRL billion as of 2020, June. Inflator: IPCA.

Loans contracted by firms and individuals have similar values in terms of total concessions. In June, total loans contracted by individuals accounted for BRL166.2 billion, while those made to firms totaled BRL 155.7 billion. Targeted operations with controlled interest rates to individuals are concentrated in housing programmes, while loans with controlled interest rates to firms are oriented toward rural and BNDES programmes. Despite the growth that occurred beginning in March, the share of targeted loans to firms in June (BRL 15.1 billion) accounted for approximately 10% of the total concessions made to firms (BRL 155.7 billion) (see Table 12.5).

**Table 12.5: Concessions by beneficiary and type of credit (BRL billion)**

| Month       | Total | Individuals<br>Free +<br>Targeted<br>Resources | Firms |                   |                       |
|-------------|-------|--|-------|-------------------|-----------------------|
|             |       |  | Total | Free<br>resources | Targeted<br>Resources |
| <b>2019</b> |       |  |       |                   |                       |
| Jan/19      | 283.8 | 159.8  | 124.0 | 116.6             | 7.4                   |
| Feb/19      | 284.1 | 155.0  | 129.1 | 121.3             | 7.8                   |
| Mar/19      | 297.3 | 155.4  | 141.9 | 134.7             | 7.1                   |
| Apr/19      | 304.3 | 168.7  | 135.7 | 129.2             | 6.5                   |
| May/19      | 329.3 | 177.8  | 151.5 | 143.7             | 7.8                   |
| Jun/19      | 318.3 | 166.5  | 151.8 | 141.5             | 10.2                  |
| <b>2020</b> |       |  |       |                   |                       |
| Jan/20      | 322.5 | 184.0  | 138.5 | 133.1             | 5.4                   |
| Feb/20      | 308.7 | 167.9  | 140.8 | 135.4             | 5.4                   |
| Mar/20      | 396.8 | 172.0  | 224.8 | 216.3             | 8.5                   |
| Apr/20      | 296.0 | 140.6  | 155.4 | 143.7             | 11.7                  |
| May/20      | 287.2 | 145.5  | 141.8 | 127.4             | 14.3                  |
| Jun/20      | 321.9 | 166.2  | 155.7 | 140.6             | 15.1                  |

Source: Central Bank/Press release (Bacen 2020a).

The total of targeted credit operations grew during the pandemic crisis. The sum of targeted operations between March and June 2020 was BRL 48.553 million. During the same period in 2019, these amounts reached BRL 31.662 million. Compared to 2019, approximately 45% of the new targeting operations were granted by BNDES. BNDES's working capital concessions grew from BRL 122 million to BRL 1.76 trillion between the periods of March-June 2019 and March-June 2020. Other credit lines with controlled interest rates also showed relevant growth: rural credit increased to 42.4% and real estate credit grew to 75.7% between the periods of March-June 2019 and March-June 2020 (see Table 12.6).

Table 12.6: Targeted resource concessions to firms according to financing lines (BRL millions)

| Month       | Rural credit |              |                  | Real State funding |              |                  | BNDES resources |                 |            |                 | Others |       |
|-------------|--------------|--------------|------------------|--------------------|--------------|------------------|-----------------|-----------------|------------|-----------------|--------|-------|
|             | Total        | Market rates | Controlled rates | Total              | Market rates | Controlled rates | Total           | Working capital | Financing  |                 |        | Total |
|             |              |              |                  |                    |              |                  |                 |                 | Investment | Agro-industrial |        |       |
| <b>2019</b> |              |              |                  |                    |              |                  |                 |                 |            |                 |        |       |
| Jan/19      | 7,357        | 1,099        | 373              | 1,472              | 129          | 323              | 452             | 57              | 4,043      | 557             | 4,657  | 776   |
| Feb/19      | 7,756        | 1,367        | 1,144            | 2,511              | 110          | 435              | 545             | 13              | 3,538      | 244             | 3,795  | 904   |
| Mar/19      | 7,148        | 1,505        | 430              | 1,935              | 113          | 366              | 479             | 5               | 3,820      | 157             | 3,982  | 752   |
| Apr/19      | 6,459        | 2,154        | 1,040            | 3,194              | 138          | 417              | 555             | 23              | 1,615      | 161             | 1,799  | 912   |
| May/19      | 7,837        | 2,919        | 604              | 3,523              | 121          | 366              | 487             | 91              | 2,540      | 268             | 2,899  | 929   |
| Jun/19      | 10,218       | 2,278        | 3,197            | 5,475              | 293          | 503              | 796             | 3               | 2,676      | 220             | 2,899  | 1,049 |
| <b>2020</b> |              |              |                  |                    |              |                  |                 |                 |            |                 |        |       |
| Jan/20      | 5,406        | 753          | 697              | 1,450              | 293          | 396              | 689             | 10              | 1,054      | 173             | 1,237  | 2,030 |
| Feb/20      | 5,438        | 1,035        | 1,160            | 2,195              | 170          | 297              | 467             | 11              | 1,620      | 102             | 1,733  | 1,042 |
| Mar/20      | 8,476        | 1,983        | 1,791            | 3,774              | 436          | 849              | 1,285           | 21              | 1,747      | 196             | 1,964  | 1,452 |
| Apr/20      | 11,749       | 2,683        | 1,900            | 4,583              | 469          | 710              | 1,179           | 132             | 4,208      | 224             | 4,564  | 1,423 |
| May/20      | 13,226       | 2,379        | 1,700            | 4,079              | 543          | 784              | 1,137           | 650             | 5,456      | 240             | 6,346  | 2,574 |
| Jun/20      | 15,102       | 2,581        | 2,177            | 4,758              | 370          | 559              | 929             | 957             | 5,136      | 156             | 6,249  | 3,165 |

Source: Central Bank/Press release (Bacen 2020a).



In addition to the regular channel of communications regarding monetary statistics (Bacen 2020a), the Central Bank created a new channel (Bacen 2020b) to divulge resources and measures related to the Covid-19 pandemic. Statistics from the new channel were first published on March 16, when most Brazilian cities began their lockdowns. Through to July 24, most loans were provided by private financial institutions to major companies. Only 15% of total loans (BRL 598.4 billion) were supported by public banks. Table 12.7a shows that major public banks lent BRL 38.9 billion to large companies, which is slightly more than the amount made available to small businesses (BRL 32.5 billion), whereas midsize firms borrowed BRL 16.4 billion from public banks.

**Table 12.7a: New credit concessions between March 16 and July 24**

| Financial institution        | New credit concessions (BRL million) |                   |                |                |
|------------------------------|--------------------------------------|-------------------|----------------|----------------|
|                              | Large companies                      | Midsize companies | Small business | Total          |
| Large institutions – public  | 38,955                               | 16,444            | 32,495         | 87,894         |
| Large institutions – private | 238,251                              | 41,868            | 43,862         | 323,981        |
| Other institutions           | 108,683                              | 52,353            | 25,503         | 186,539        |
| <b>Total</b>                 | <b>385,889</b>                       | <b>110,665</b>    | <b>101,860</b> | <b>598,414</b> |

Source: Banco Central do Brasil (BACEN 2020b).

During the same period, BRL 195.2 billion went toward renewing existing loan contracts. Major public banks were responsible for 25% of total loan renewals (BRL 49.4 billion), and the majority of their renewals benefited small and medium-sized businesses. Among major private banks, renewals were mainly directed to large companies (see Table 12.7b). Additionally, the deferral of installments reached BRL 59.9 billion. Major public banks were responsible for 21% of total postponements, which mainly benefited small businesses (see Table 12.7c).

Table 12.7b: *Loan renewals between March 16 and July 24*

| Financial institution        | Loan renewals (1) (BRL million) |                   |                |                |
|------------------------------|---------------------------------|-------------------|----------------|----------------|
|                              | Large companies                 | Midsize companies | Small business | Total          |
| Large institutions – public  | 8,450                           | 18,970            | 21,967         | 49,387         |
| Large institutions – private | 82,051                          | 17,369            | 13,123         | 112,543        |
| Other institutions           | 20,433                          | 8,767             | 4,118          | 33,318         |
| <b>Total</b>                 | <b>110,934</b>                  | <b>45,106</b>     | <b>39,208</b>  | <b>195,248</b> |

Source: Banco Central do Brasil (BACEN 2020b).

(1) Include operations with new resources.

Table 12.7c: *Postponement of payments between March 16 and July 24*

| Financial institution        | Postponements (BRL million) |                   |                |               |
|------------------------------|-----------------------------|-------------------|----------------|---------------|
|                              | Large companies             | Midsize companies | Small business | Total         |
| Large institutions – public  | 2,176                       | 3,443             | 7,054          | 12,673        |
| Large institutions – private | 11,743                      | 9,801             | 6,127          | 27,671        |
| Other institutions           | 2,788                       | 14,235            | 2,555          | 19,578        |
| <b>Total</b>                 | <b>16,707</b>               | <b>27,479</b>     | <b>15,736</b>  | <b>59,922</b> |

Source: Banco Central do Brasil (BACEN 2020b).

Through to July 29, loans provided through the Federal Government's programmes totalled BRL 31.5 billion, which represents a small fraction of the country's financial markets' total credit operations (BRL 598.4 billion) between March and July 2020. PRONAMPE's credit line was the most in-demand among govern-

ment programmes, due to its attractive costs (see Table 12.8a). BNDES and the CEF were responsible for 51.2% of total concessions related to Federal Government programmes, while private banks contributed 29.7% of total concessions. Banco do Brasil, which is a semi-public institution, provided 18.2% of the total amount of public credit programmes (see Table 12.8b).

**Table 12.8a: Federal Government loans according to programmes\***

| Credit Line    | BRL million   |               | Contracted by available |
|----------------|---------------|---------------|-------------------------|
|                | Available     | Contracted    |                         |
| BNDES/FGI      | 20,000        | 4,139         | 20.7%                   |
| FAMPE          | 12,000        | 1,880         | 15.7%                   |
| PESE (2)       | 17,000        | 4,529         | 26.6%                   |
| PRONAMPE/FGO** | 32,900        | 18,696        | 56.8%                   |
| <b>Total</b>   | <b>81,900</b> | <b>29,244</b> | <b>35.7%</b>            |

Source: Economic Ministry (Ministério da Economia, 2020).

Notes: \* Concessions from April 8 to July 29. \*\* In July of 2020, BRL 14 billion was transferred from the PESE to PRONAMPE programme.

**Table 12.8b: Federal Government credit programmes according to operators\***

| Institution   | Concessions   |               |
|---|---------------|---------------|
|   | BRL million   | Percentage    |
| <b>Public banks</b>                                 | <b>16,169</b> | <b>51.2%</b>  |
| Caixa Econômica Federal                             | 9,476         | 30.0%         |
| BNDES (2)   | 6,475         | 20.5%         |
| Banco Desenvolvimento de Minas Gerais               | 215           | 0.7%          |
| Banco Desenvolvimento do Rio Grande do Sul          | 3             | 0.0%          |
| <b>Semi-public banks (1)</b>                        | <b>6,013</b>  | <b>19.0%</b>  |
| Banco do Brasil                                     | 5,740         | 18.2%         |
| Banco da Amazonia                                   | 257           | 0.8%          |
| Banco do Nordeste                                   | 16            | 0.1%          |
| <b>Private banks</b>                                | <b>9,395</b>  | <b>29.7%</b>  |
| Itau  | 5,183         | 16.4%         |
| Banco cooperativo do Brasil (cooperative credit)    | 1,248         | 4.0%          |
| Santander   | 957           | 3.0%          |
| Sistema de Crédito Cooperativo (cooperative credit) | 835           | 2.6%          |
| Bradesco  | 792           | 2.5%          |
| Banrisul  | 362           | 1.1%          |
| Viacredi  | 18            | 0.1%          |
| <b>Total</b>  | <b>31,580</b> | <b>100.0%</b> |

Source: Economic Ministry – Ministério da Economia (2020) (1) Concessions from April 8 to July 29 (2) include working capital credit lines.

Notes: \* Data from the semi-public banks were separated from the ones from the public banks. In some cases, the semi-public banks may operate as a private bank in response to the shareholders' demands.

New concessions for families contracted between March 16 and July 24 totalled BRL 273.8 billion. These loans were granted in almost equal measure by large public and private banks (BRL 99.0 and 88.5 billion, respectively). Another BRL 122.3 billion was used to renew loans taken out by families. In some cases, such renewals included granting additional resources. Additionally, the postponement of payments related to credit agreements with families reached BRL 41.7 billion (BACEN 2020b).

Finally, the Central Bank made BRL 1.274 trillion – equivalent to 17.5% of Brazil's Gross Domestic Product (GDP) – available to increase the liquidity of the country's financial system (BACEN 2020b). Some of these measures are common in financial crises, such as loosening mandatory requirements on reserves (BRL 135 billion) and on term deposits (BRL 70 billion). However, by adopting constitutional amendment number 106 on May 7, 2020, Brazil's National Congress allowed the Central Bank to operate with public and private bonds in the context of so-called non-conventional monetary policy. Thus, the Central Bank made BRL 91 billion available to debentures (private debt securities) operations and BRL 670 billion to loans backed by Letras Financeiras (private debt securities), all guaranteed through credit operations.

The Central Bank also created the NDPGE (Novo Depósito a Prazo com Garantias Especiais – New Term Deposit with Special Guarantees), which is a debt security supported by the FGC (Fundo Garantidor de Créditos – Credit Guarantee Fund). Through the NDPGE small- and medium-sized banks may attract investors to support their credit lines. The Central Bank estimates in BRL 200 billion the effects over the credit supply derived by the NDPGE (see Table 12.9).

**Table 12.9: *Conventional and non-conventional Central Bank measures***

| Measures   | BRL billion  |
|--|--------------|
| Reduction in reserve requirement ratio on time deposits (from 31% to 25%) and regulation enhancement on liquidity coverage ratio (LCR) | 135          |
| Additional reduction on reserve requirements on term deposit   | 70           |
| More flexibility on LCA regulation (LCA = debt securities)   | 2            |
| Reduction of requirements related to targeting resources (housing programme)   | 56           |
| Loans backed by <i>Letras Financeiras</i> guaranteed by credit operations  | 670          |
| New Term Deposit with special guarantee (NDPGE)  | 200          |
| One-year term repos backed by federal securities   | 50           |
| Loans backed by <i>debentures</i>  | 91           |
| <b>Total</b>   | <b>1,274</b> |

Source: Central Bank (BACEN 2020b).

Many countries used non-conventional monetary policies (NCMP) during the 2008 subprime crisis, but the effects of such policies are controversial. On the one hand, defenders of NCMP argue that the reduction of distortions on secondary markets may stimulate the supply of credit, thereby resulting in positive effects on labour markets and economic growth (Meinusch and Tillmann 2016; Anderson and Gascon 2009). On the other hand, studies suggest that its effects may not be sustainable in the long term (Gambacorta et al. 2014). Additionally, experiences from Japan show that NCMP have contributed to increases in income inequality (Saiki and Frost 2014).

## CONCLUSION

In recent years, the Government's attention has been directed almost exclusively to the reformulation of judicial and constitutional orders to reinforce fiscal austerity policies. In this context, the role played by public banks during the pandemic could not be any more different. Loans made with Brazil's Federal Government resources only attended to a small fraction of these demands. Both public and private banks intermediated in these subsidized loans. Final borrowers were indifferent as to whether their financing was obtained through a public or private bank. Such operations may even be advantageous to certain private banks given the low risks involved and the potential to attract new clients.

Pronouncements of authorities from Brazil's Central Bank and the Ministry of the Treasury highlight the virtuosic role played by private financial institutions. However, this chapter shows that the private financial institutions were supported in many ways by the Brazil's Federal Government during the pandemic crisis. Actions are in progress to replace public funding systems by private ones.

A series of measures aimed at the long-term strengthening of private financing is underway, with the secondary market for private titles playing a standout role. Additionally, Brazil's Federal Government obtained support to modify the country's constitution to make the adoption of controversial non-conventional monetary policies (NCMPs) viable. While NCMPs were already in effect in April 2020, loans supported by the Government only reached small businesses in July 2020. There is no doubt that the measures adopted by Brazil's Central Bank were favourable for investment funds and banks.

However, BNDES' financing capacity is continually being reduced because of the transfer of resources to the Federal Government, as well as modifications in its interest rates over the long term. Semi-public banks, especially the Bank of Brazil, already act in accordance with private sector logic. Brazil's congress is debating

Provisional Measure 995, which opens lucrative segments of business under the CEF's control to the private sector.

The economic recovery depends on other Government policies, especially policies for direct income transfers and productive investments. However, during the pandemic, while the primary sectors responsible for job creation did not receive enough financial support, a series of measures adopted by Brazil's Federal Government have benefited the financial sector. In accessing banking credit, small- and medium-sized businesses not only face a lack of credit, they must also contend with higher interest rates. In this context, Brazil may face high unemployment rates and low economic growth for the foreseeable future.

Although a full discussion of the transformations under way in the Brazilian financial market is beyond the scope of this chapter, this review of the measures adopted by Brazil's Federal Government and its peculiarities allow us to see that the market-based approach is not the answer to the current crisis.

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## Chapter 13

Godfrey Yeung

# THE PUBLIC BANKS AND PEOPLE'S BANK OF CHINA: CONFRONTING COVID-19 (IF NOT WITHOUT CONTROVERSY)

**T**he outbreak of Covid-19 in Wuhan and its subsequent domino effects due to the lock-down in major cities have had a devastating effect on the Chinese economy. China is an interesting case to illustrate what policy instruments the central bank can deploy through state-owned commercial banks (a form of 'hybrid' public banks) to buffer the economic shock during times of crisis.

In addition to the standardized practice of liquidity injection into the banking system to maintain its financial viability, the Chinese central bank issued two top-down and explicit administrative directives to state-owned commercial banks: the minimum quota on lending to small- and medium-sized enterprises (MSEs) and non-profitable lending. Notwithstanding its controversy on loopholes related to such lending practices, these pro-active policy directives provide counter-cyclical lending and appear able to provide short-term relief for SMEs from the Covid-19 shock in a timely manner. This has helped to mitigate the devastating impacts of the pandemic on the Chinese economy.

## INTRODUCTION

The outbreak of Covid-19 leading to the lock-down in Wuhan on January 23, 2020 and the subsequent pandemic had significant impacts on the Chinese economy. China's policy response regarding the banking system has helped to mitigate the devastating impacts of pandemic on the Chinese economy.

Before we review the measures implemented by the Chinese government, it is important for us to give a brief overview of the roles of two major group of actors (institutions) in the banking system. In China, the People's Bank of China (PBoC) is the central bank. It is responsible for formulating and implementing monetary policy (including setting minimum reserve requirements and interest rates, and money supply and exchange rate targets) to ensure the stability of the financial system (Yeung et al. 2017).

There are numerous financial institutions but the key banks in terms of equity and market share are five state-owned commercial banks (SOCBs): the Industrial and Commercial Bank of China (ICBC); Bank of China (BOC); China Construction Bank (CCB); Agricultural Bank of China (ABC); and the Bank of Communications (BOCOM). The state is the largest equity owner, although all SOCBs have been listed in the Stock Exchange of Hong Kong between 2005 and 2010 and function like private commercial banks elsewhere, especially in their daily operations at the local/branch level.

What makes the SOCBs different is that the PBoC can issue administrative directives on SOCB lending due to the nature of its hybrid ownership structure (Yeung forthcoming). Importantly, the most senior executives at the SOCBs are appointed by the central government: they could be former senior executives from another SOCB or seasoned officials transferred from the PBoC and other government development banks (Agricultural Development Bank of China, China Development Bank and Exim Bank of China). One could therefore argue that the senior management at the SOCBs'

headquarters could prioritize the status of the national economy over profit-maximization in their decision-making processes, including the conception of ‘corporate strategies’, i.e. SOCBs could be functioning more like ministries in the central government than private commercial banks. There is also an impression that SOCBs have a lending bias favour for the state-owned enterprises as both are ultimately owned by the Chinese government. This impression could, however, be partially reconciled by the lack of credible financial credit records among private entrepreneurs in China (see Yeung 2009).

The PBoC has issued a number of administrative directives since January 2020 and we will focus on two of the most important ones: liquidity supports and quotas on low-cost lending, and non-profitable lending. A brief and very preliminary review of the effects of such lending directives will be presented.

## **COUNTER-CYCLICAL LENDING MEASURES: SUPPORTS AND QUOTAS ON LOW-COST LENDING**

After the first Covid-19 case in Wuhan was reported in December 2019 and the subsequent outbreak of the coronavirus spread across the country, the PBoC implemented a series of measures to stabilize the economy in China through two related policies: to maintain the liquidity in the banking system and to provide low-cost lending.

Liquidity is crucial for the financial viability of the banking system during times of crisis. Commercial banks tend to be much more conservative to preserve their scarce capital with the expectation of a (much) higher non-performing loan ratio. Potential borrowers, especially the small- and medium-sized enterprises (SMEs), could find their credit lines cut or even their existing loans recalled by banks due to their deteriorating balance sheets and diminishing market value of their collateral. Capital injection by the central bank is a common policy instrument to maintain the liquidity in the



banking system, with the expectation that commercial banks are more willing to grant loans to credible companies.

Instead of increasing the money supply by purchasing government and corporate bonds, as per the US Federal Reserve, the PBoC improves liquidity through adjusting its regulatory requirements, specifically the reduction of reserve requirement ratio (RRR). The RRR is the minimum percentage of a commercial bank's deposits that are held in cash or cash-like assets in order to reduce the chance of bank run or failure due to mass customer withdrawals. A lower RRR allows banks to provide more credits and this in turn improves liquidity in the banking system. The PBoC reduced the RRR by 0.5% during the beginning of the outbreak in January 2020 (see Table 13.1). To maintain ample market liquidity, the PBoC has since cut the RRR twice, in March and again in April 2020, and subsequently pumped a total of CNY 1.75 trillion (US\$245 billion) into the banking system. Moreover, the PBoC reduced the reverse bond repurchase agreement rate in February and March and the loan prime rate (LPR, the benchmark interest rates charged by commercial banks for their most creditworthy customers) in February and April 2020.

To further improve liquidity in the banking system, the Chinese government issued two explicit instructions to SOCBs to provide credits to privately-owned SMEs. A number of SMEs have already been under tremendous financial pressure due to the ongoing trade friction between the US and China. In spite of the above-mentioned policies, however, new lending fell significantly: from CNY 3.34 trillion (US\$468 billion) in January to CNY 906 billion (US\$127 billion) in February 2020. Importantly, short-term business lending, normally used by SMEs, contracted by CNY 396 billion in February 2020 (SCMPa 2020).

About one month after the lock-down of Wuhan started on January 23, 2020, the State Council and PBoC instructed the SOCBs to grant at least 30% of their loans to SMEs in the first half of 2020 (see Table 13.1). As part of this important initiative, the PBoC provided a

preferential LPR at 0.25% lower to SOCBs for their lending to farms, agriculture firms and small businesses in February 2020. Moreover, SOCBs were eligible for additional government funding for loans, if they should charge a lower interest rate to borrowers at no more than 0.5% mark-up from the LPR.

**Table 13.1: Major capital injection measures implemented by the PBoC in the first half of 2020**

| Date   | Institutes           | Measures  |
|--------|----------------------|---|
| Jan 6  | PBoC                 | <ul style="list-style-type: none"> <li>Reduced RRR by 0.5%: 12.5% for SOCBs &amp; 10.5% for small- and medium-sized banks</li> </ul>  |
| Feb 1  | PBoC & CBIRC         | <ul style="list-style-type: none"> <li>Allow banks to sell coronavirus relief bonds</li> </ul>  |
| Feb 3  | PBoC                 | <ul style="list-style-type: none"> <li>Reduced the seven-day reverse bond repurchase agreement rate from 2.50% to 2.40% &amp; the 14-day tenor from 2.65% to 2.55%</li> <li>Resulted in an injection of CHY 1.2 trillion (US\$168 billion)</li> </ul>   |
| Feb 20 | PBoC                 | <ul style="list-style-type: none"> <li>Reduced the one-year LPR from 4.15% to 4.05% &amp; five-year LPR from 4.8% to 4.75%</li> </ul>   |
| Feb 25 | State Council & PBoC | <ul style="list-style-type: none"> <li>Provided CHY 800 billion (US\$112 billion) for small business lending</li> <li>SOCBs have to grant at least 30% of their loans to small businesses in the first half of 2020</li> <li>Three government-run policy banks to lend CHY 350 billion (US\$49 billion) to small businesses at preferential rates</li> <li>LPR for farms and agriculture firms &amp; small businesses reduced from 2.75% to 2.5%</li> <li>Banks are eligible for additional government funding for loans no more than 0.5% higher than the LPR</li> </ul> |
| Mar 16 | PBoC                 | <ul style="list-style-type: none"> <li>Reduced RRR by another 0.5-1%, results in an injection of CHY 550 billion (US\$77 billion) into the banking system</li> </ul>  |

|         |                      |  |
|---------|----------------------|--|
| Mar 30  | PBoC                 | <ul style="list-style-type: none"> <li>Reduced the seven-day reverse repurchase agreement rate to 2.2%, resulted in an injection of CHY 50 billion (US\$7 billion) into the banking system</li> </ul>                  |
| Mar 31  | State Council        | <ul style="list-style-type: none"> <li>PBoC provided a credit line of CHY 1 trillion (US\$140 billion) to small lenders</li> </ul>   |
| Apr 3   | PBoC                 | <ul style="list-style-type: none"> <li>Reduced RRR of small- and medium-sized banks to 6%, resulted in an injection of CHY 400 billion (US\$56 billion) into the banking system</li> </ul>                             |
| Apr 15  | PBoC                 | <ul style="list-style-type: none"> <li>Reduced the one-year MLF loans to financial institutions from 3.15% to 2.95%, resulted in an injection of CHY 56.1 billion (US\$7.9 billion) into the banking system</li> </ul> |
| Apr 20  | PBoC                 | <ul style="list-style-type: none"> <li>Reduced the one-year LPR to 3.85% &amp; five-year LPR to 4.65%</li> </ul>   |
| June 1  | PBoC                 | <ul style="list-style-type: none"> <li>CHY 400 billion (US\$56 billion) to acquire 40% of unsecured loans made to SMEs with maturities of at least six months made between March 1 &amp; December 31 2020</li> </ul>   |
| June 17 | State Council & PBoC | <ul style="list-style-type: none"> <li>Instructed banks to sacrifice CHY 1.5 trillion (US\$210 billion) in profits in 2020 to provide low-cost loans to small businesses</li> </ul>                                    |

Sources: Compiled from State Council February 27, 2020; CBIRC June 3, 2020, SCMPc and SCMPe, 2020.

Notes: CBIRC (China Banking and Insurance Regulatory Commission): the regulatory authority of banking and insurance institutions; RRR (reserve requirement ratio): cash or cash-like assets that banks are required to hold in reserve to maintain the liquidity; LPR (loan prime rate): a lending reference rate set monthly by 18 banks for their most creditworthy customers. Banks have to link their LPR quotations to the rate of MLF (hence, the lower costs loans) since August 2019; MLF (medium-term lending facility): a funding facility that the PBoC extends to commercial banks.

## COUNTER-CYCLICAL LENDING MEASURES: PROVISION OF NON-PROFIT MAKING LOANS

The lock-down of Wuhan and its domino effects have had devastating effects on the Chinese economy. The economy shrank by 6.8% in the first quarter of 2020 in spite of all the pro-active policies to improve the liquidity and the provision of low-cost loans to businesses. The possibility of a collapse of more than 18 million private enterprises (most of them SMEs and single proprietor businesses that employ some 200 million people) could result in massive unemployment, since SMEs account for 60% of industrial output and employ 80% of employees in China. As only one fifth of privately-owned SMEs were ever granted a bank loan before the pandemic (Yeung forthcoming), the reduction of the RRR and LPR appears to be unable to provide sufficient lending to private enterprises.

In June 2020, the State Council and PBoC issued another set of strong policy measures to the SOCBs to ensure the provision of low-cost lending to SMEs. Under the ‘Document 6’, the PBoC acquired 40% of unsecured loans made to SMEs with maturities of at least six months made between March 1 and December 31, 2020 (see Table 13.1). By effectively taking over almost half of such loans to SMEs, the PBoC freed up CHY 400 billion (US\$56 billion) of liquidity in the banking system.

Another more important and unprecedented policy directive involves the most explicit instruction given to the SOCBs since partial privatization in the 2005-2010 Stock Exchange of Hong Kong listing. Following on from the May 2020 open call from Premier Keqiang Li on the duties of SOCBs, PBoC Governor Gang Yi openly said: “Financial institutions are urged to sacrifice profits to benefit corporate borrowers, helping reduce their borrowing costs” (SCMPe 2020). Specifically, the PBoC instructed the SOCBs to sacrifice up to CHY 1.5 trillion (US\$210 billion) in profits in 2020, equivalent to 75% of their profits in 2019, to provide low-cost loans to SMEs. Moreover,

the SOCBs have had to reduce their various fees to customers, defer loan repayments and grant unsecured loans to SMEs to help them survive the economic downturn.

This measure is not administratively feasible or even financially viable for conventional private commercial banks in developed or developing countries. This unusual instruction on lending issued by the PBoC could be reconciled by the hybrid nature of the SOCBs, for which the Chinese state still holds the majority of the equity. Ownership here translates into effective control, should state authorities choose to exercise it. Due to the hybrid nature of its property rights, the state can deploy the SOCBs to provide counter-cyclical lending to contain economic shocks from the Covid-19 pandemic in a timely manner (see Yeung 2009 and forthcoming).

The aggressive policy lending in China appears to have created a (short-term) stimulus effect on the economy: Gross Domestic Product (GDP) grew by 3.2% in the second quarter of 2020 and the urban unemployment rate fell from 6.2% in February to 5.7% in June 2020 (NBS July 17, 2020). Such aggressive lending by the SOCBs, however, has its drawbacks.

## **EXPLOITATION OF LENDING LOOPHOLES**

The SOCBs have been lending aggressively to fulfill their lending quotas and this unavoidably has led to cases of abuse. Under the policy directives of the PBoC, SOCBs have been granting loans at unusually high levels of leverage, which increased from the usual 50 to 90% of the collaterals, and at below the benchmark interest rate of 4.35% (SCMPb 2020).

An unknown proportion of loans intended for improving the liquidity for SMEs were granted to shell corporations and diverted for speculation on real estate illegally (SCMPb 2020). Such exploitation of the lending policy from the SOCBs appears to have contributed to the rising property prices in major cities, especially the Shenzhen

special economic zone in southern China. The property prices in Shenzhen increased at the fastest rate among Chinese cities at 1.6% between February and March 2020, during the peak of the Covid-19 outbreak in China (SCMPb 2020). It is also estimated that the prices of new properties in 100 major cities in China increased by 15% year on year during the first quarter of 2020 while GDP fell by 6.8% simultaneously (SCMPd 2020).

There is no reliable way to estimate the extent of such exploitation of the lending policy in Shenzhen or China. According to official figures, bank lending in Shenzhen reached CHY 315.8 billion (US\$44 billion) in the first quarter of 2020 (an increase of CHY 71.8 billion from the same period in 2019, while there was a reduction of lending nationwide), and around 80% were to corporate entities. The PBoC has since instructed SOCBs to control such lending, including the close inspection of using property as the collateral for new loans (SCMPb 2020).

## CONCLUSION

The top-down administrative directives adopted by the PBoC has had an impact on stimulating economic growth during the Covid-19 pandemic in China (although this has not been without controversy). Liquidity in the banking system is one of the keys for the provision of low-cost lending. What makes the Chinese case interesting is that the PBoC issued two very explicit directives to the SOCBs: the minimum quota on lending to SMEs and the non-profitable lending. These pro-active policy directives provide counter-cyclical lending and appear able to provide short-term relief for SMEs from the Covid-19 shock in a timely manner.

Nonetheless, the potential cost inefficiency of such capital injection in the long-term cannot be ignored. Another pertinent issue revealed by the recent counter-cyclical lending is the ‘publicness’ of the SOCBs: to what extent could such lending be classified as policy

lending by public banks? The hybrid ownership structure of SOCBs illustrates the limitations of conventional typology of public and private banks in the financial system. Perhaps it is the time for us to re-examine the meanings of public banks.

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## CHAPTER 14

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# COVID-19 AND MEASURES TO SUPPORT ENTERPRISES AND LOCAL AUTHORITIES IN ITALY: THE ROLE OF CASSA DEPOSITI E PRESTITI

**T**his chapter focuses on the strategic role Cassa Depositi e Prestiti (CDP) is playing in response to the Covid-19 crisis. After an overview of the mandate and business of this public development bank, the chapter highlights the adverse impacts of the Covid-19 pandemic on the Italian economy and the extraordinary measures set up by CDP to support the country. These measures, in line with the mission of the bank, are specifically targeted towards enterprises and local authorities and are aimed at supporting liquidity needs to cope with the health emergency, as well as providing financial resources for meeting working capital requirements and sustaining investments and exports.

## INTRODUCTION

Cassa Depositi e Prestiti (CDP) is a joint-stock company under public control owned by the Italian Ministry of Economics and Finance (83%), with several banking foundations owning the remaining shares.<sup>1</sup> Founded in 1850, CDP is a ‘National Promotional Bank’<sup>2</sup> with the explicit mandate of fostering sustainable development, supporting growth in different business areas and boosting employment. According to the ‘Articles of Association’, the specific corporate objectives of CDP are granting financing to: i) the State, the regions, local authorities, public entities and public law bodies; and ii) public or private entities, with the exclusion of natural persons. The overall aim of the bank is to support initiatives for company growth and invest in research, development, innovation, protection and leveraging of cultural assets, promotion of tourism, environment, energy efficiency, sustainable development and the green economy.

CDP pursues its mandate using several financial instruments, such as loans, guarantees, mezzanine finance and risk-sharing instruments. In recent years, it has also set up equity instruments, such as venture capital and seed funds to finance start-ups and young firms, as well as strategic equity investments in companies of national interest. It offers non-financial services as well, such as technical and administrative assistance, advisory services and

<sup>1</sup> In December 2003, CDP was transformed into a joint-stock company with the State’s assets and shareholdings transferred to CDP S.p.A. and assigned to a ‘separate account system’. In line with other European national promotional banks, only part of the banking regulations were applied to CDP, that is the provisions of Part V of the Consolidated Banking Act (Legislative Decree No. 385, September 1, 1993) applicable to intermediaries registered in the special list of Article 107 of the cited Decree.

<sup>2</sup> National Promotional Banks – also referred to as ‘development financial institutions’, ‘state investment banks’, ‘promotional banks’ – are “legal entities carrying out financial activities on a professional basis which are given a mandate by a member state or a member state’s entity at central, regional or local level, to carry out development or promotional activities” (European Commission 2015).

training programmes. CDP may finance end-customers directly (first-tier lending) or through financial intermediaries that in turn lend on to end-customers (second-tier lending).

On the liability side, CDP typically relies on a mixture of funding sources, such as loans from other financial development institutions, debt instruments issued on capital markets and funding from European programmes. CDP also indirectly relies on deposit funding raised via postal saving products. In line with the rationale for the existence of development banks – i.e. overcoming market failures, stimulating innovation paths and improving institutional frameworks (Yeyati et al. 2007; Gutierrez et al. 2011; Luna-Martinez and Vicente 2012; Mazzuccato and Penna 2016; Eslava and Freixas 2016; Frigerio and Vandone 2020) – CDP typically funds projects with high risk (which is usually the case for start-ups), high-tech or new industries, providing long-term ‘patient’ capital to promote strategic investments for economic development (e.g. infrastructure projects, export, housing, etc.) or for socially challenging projects (e.g. climate finance, renewable and environmental-friendly energy, food security initiatives). In doing so, CDP plays a counter-cyclical role in times of crisis by sustaining growth and employment when private commercial banks typically disintermediate their credit activity because of deteriorating asset quality, capital shortages, deleveraging and higher risk aversion.

In the aftermath of the economic and financial global crisis of 2008-09, together with many other European development banks, CDP has been called on by European policy-makers to share the management of European Union (EU) financial instruments and to play a primary role in restructuring the economy, channelling leveraged funds into the market, boosting innovation, supporting socio-economic and environmental challenges, and implementing financial instruments and programmes set up to reverse the low level of investment by EU firms, in particular start-ups and small- and medium-sized enterprises (SMEs) (European Commission 2014,

2015). Accordingly, in recent years CDP has significantly increased assets, co-financed a rising number of projects and investment platforms, fostered the growth of venture capital across Italy and enlarged the business volume in resource efficiency, digital infrastructure and innovation. As a result, CDP's total assets have increased from €287 billion in 2011 to €448 billion in 2019 (an increase of 56%), while total loans increased from €220 billion to €311 billion in the same period (a 41% increase).

CDP also operates with sufficient profitability: in 2019, the CDP profit before taxes was around €5 million, with a return-on-equity of close to 10%. In recent years, the issue of profitability has become relevant for development banks. Indeed, although it is well recognized that development banks, unlike private banks, have goals that go beyond profitability, given the limited fiscal space available in Member States in the aftermath of the global crisis, development banks are increasingly expected to combine their socio-economic goals with conditions of efficiency and profitability in order to “stand on their own feet” and secure a reasonable level of financial strength and stability without continued capital injections by government.<sup>3</sup>

In fact, the relevance of economic and financial sustainability is now explicitly stated as a key principle in the statute of CDP, as for many other development banks (e.g. Nordic Investment Bank, NRW Bank). Furthermore, strengthening the economics of projects is also crucial to leveraging additional financing for blended programmes and public-private partnership arrangements.

<sup>3</sup> Specifically, in outlining the best practices development banks should follow, the European Commission pointed out that “National Promotional Banks prove to work best where they focus on economically viable projects and operate with sufficient profitability (albeit below private operators’ cost of equity) to maintain financial soundness without continued capital injections by the government (profits mostly being retained to bolster future lending capacity)” (European Commission, 2015, p5). Misallocation of resources and destruction of value due to political interference and inefficiencies has historically been one of the major concerns related to the action of state-owned banks ((Hart et al. 1997; Kornai 1979; La Porta et al. 2002; Shleifer and Vishny 1994, 1997).

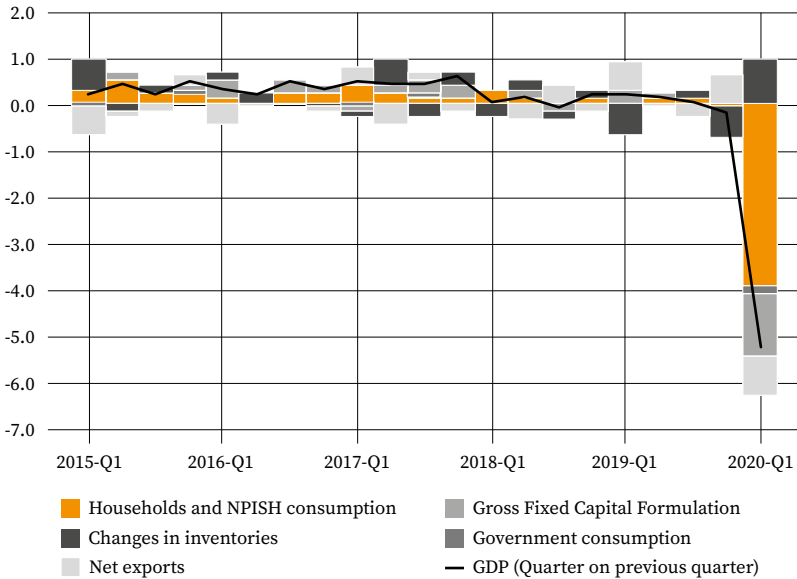
These programmes are attracting growing interest as a way to develop solutions for the delivery of long-term public goals. As explained below, CDP's role in mobilizing liquidity for enterprises, especially SMEs, has been particularly relevant in response to the Covid-19 crisis, given the strong dependency of these small-size firms on bank financing and their inability to directly access the capital market.

## THE IMPACT OF COVID-19 IN ITALY

The first Italian Covid-19 case was announced on February 21, 2020. By June 2020, the country counted more than 230,000 positive cases and more than 33,000 deaths (Istat 2020c). The total number of deaths, compared to that observed in the same period of 2019, increased everywhere in the country. There were strong peaks in some territories and a higher concentration of death among people aged over 65, particularly amongst men.

From an economic perspective, the Covid-19 pandemic and the adverse impact of its containment measures – including the interruption of 2.2 million firms' activities (39% of the total Italian firms, 65% of exporting firms) and 4 million workers (44% of the workforce) – has caused a dramatic fall in economic activity (Istat 2020d). The pandemic has also had a strong impact on foreign demand, international tourism and investment plans, with repercussions on employment, household income, spending decisions and demand for a wide range of goods and services. Overall, GDP fell by 6% in the first quarter of 2020 and is expected to decline by 10% by the end of 2020 (see Figure 14.1).

Figure 14.1: *The GDP quarterly change and contribution, Italy*



Source: Istat 2020b.

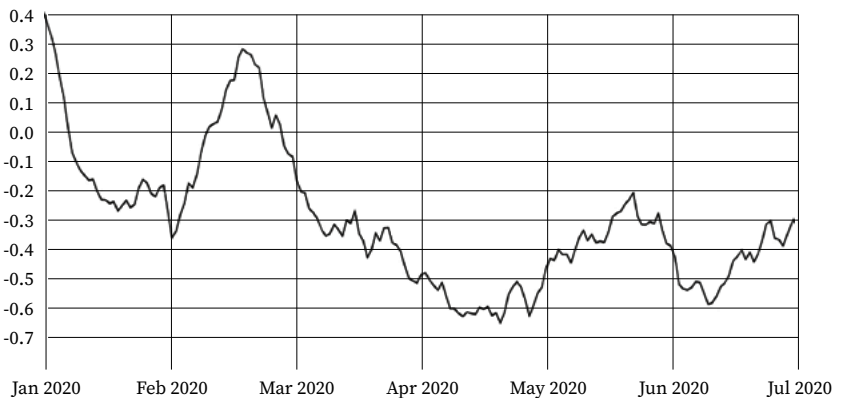
Qualitative indicators, such as business and consumer confidence indexes, also crashed heavily. In particular, the business confidence climate index slumped from 98.8 before the beginning of the pandemic down to 53.7 in May 2020. Although decreases occurred in all the four components of the index, it has been particularly strong in market services (e.g. transportation and storage, accommodation and food service activities, advertising, rental and leasing, scientific research and development, business support activities, sport amusement and recreation activities), with a 60% reduction from January to May 2020 (see Table 14.1). By the end of August, the index slightly recovered, although well below pre Covid-19 levels.

Table 14.1: *Business confidence climates*

|                        | Jan   | Feb   | Mar   | Apr  | May   | Jun  | Jul   | Aug   |
|------------------------|-------|-------|-------|------|-------|------|-------|-------|
| Manufacturing          | 98.8  | 99.1  | 86.4  | n.a. | 72.3  | 80.9 | 85.3  | 86.1  |
| Construction           | 142.7 | 142.3 | 139.0 | n.a. | 108.4 | 124  | 129.7 | 132.6 |
| Market services        | 98.9  | 98.6  | 75.2  | n.a. | 39.1  | 52.2 | 66    | 74.7  |
| Retail trade           | 105.9 | 106.7 | 94.8  | n.a. | 68.3  | 80   | 86.7  | 94    |
| Total confidence index | 98.5  | 98.9  | 79.2  | n.a. | 53.7  | 66.8 | 77.0  | 80.8  |

Source: Istat 2020a.

As for consumer confidence, the Social Mood Index of people's perception of the crisis began decreasing in mid-February and continued on a downward trend to the end of May (see Figure 14.2), mainly due to expectations of unemployment and deterioration in income. Financial markets also collapsed, with a reduction of 10,000 basis point in the FTSE MIB Index (Milano Italia Borsa) – the benchmark stock market index for the Italian stock exchange – in a few days, and a huge increase in volatility (see Figure 14.3).

Figure 14.2: *Social Mood Index*

Source: Istat, 2020d.



Figure 14.3: **FTSE Milano Italia Borsa (MIB) Index**

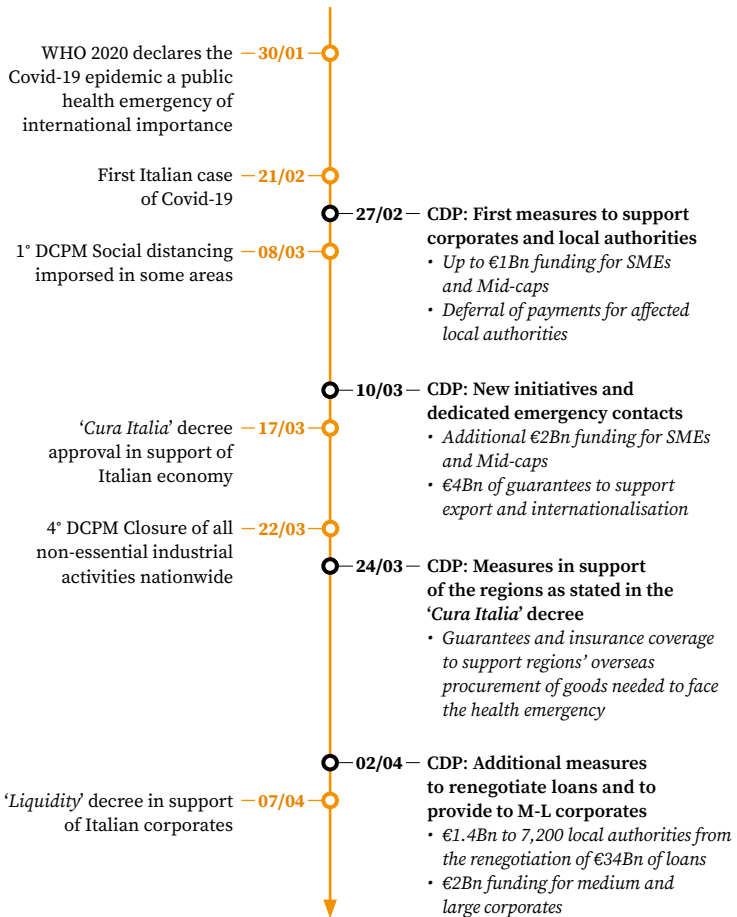


Source: Borsa Italiana, website.

## CDP AND COVID-19: KEY ACTIONS

Since the beginning of the Covid-19 pandemic in Italy, the CDP, together with the Italian Ministry of Economics and Finance, has been at the forefront, putting several extraordinary measures in place to support public entities, local bodies, infrastructure and enterprises. Less than a week after the first case of Covid-19 was announced, the CDP set up the measures to support enterprises and local authorities (see Figure 14.5).

Figure 14.4: **CDP's key actions to support enterprises and local authorities**



Source: Cassa Depositi e Prestiti, 2020c.

There are a variety of measures and instruments adopted by the CDP to support the economy in response to Covid-19. These measures, in line with the mission of the bank, are specifically targeted towards enterprises and local authorities (Cassa Depositi e

Prestiti 2020a, b). As far as enterprises are concerned, measures are aimed at supporting temporary liquidity needs, meeting the working capital requirements of Italian businesses, supporting investments, relaunching exports and diversifying reference markets. As for local authorities, measures are aimed at enabling regions to receive immediate financial resources, payment moratoria, guarantees and insurance coverage with the ultimate goal of receiving necessary supplies in the shortest time possible to cope with the health emergency. The following sections summarize these actions.

### **Moratoria and deferral of instalments, renegotiation of loans**

Moratoria, deferral of instalments and renegotiation of loans are intended to free up resources that can be promptly used to face balance-sheet tightness due to the pandemic and to finance expenses that cannot be postponed to overcome the health emergency phase. These measures are especially relevant for the budgets of local entities (municipalities, metropolitan cities, provinces, unions of municipalities and ‘mountain’ communities), regions and autonomous provinces that are facing liquidity tension due to the combined effect of the increase in expenses related to the epidemiological emergency coupled with the likely reduction in tax revenues. They are expected to allow approximately 7,200 entities to free up resources in 2020, with up to €1.4 billion in support, reflecting about 135,000 loans for a total debt residual of €34 billion (Cassa Depositi e Prestiti 2020b, e). Renegotiation of loans, accompanied by a similar measure taken by the private Italian banking system, also target enterprises. To access these measures firms are required to have a healthy balance sheet before 31 December 2019 (Cassa Depositi e Prestiti 2020f).

### **Insurance and guarantees**

Insurance and guarantees are designed to guarantee loans from banks and to provide insurance coverage to support exports. For en-

terprises, the main goal is to facilitate the supply of loans by banks to finance working capital needs (e.g. raw materials, warehouse stocks, half-processed products) and to cope with the shock that hit the national and international production chain and the temporary delays in collecting the proceeds of existing orders. Insurance coverage is aimed at guaranteeing big foreign players, especially in the oil and gas sector, infrastructure, energy and agrifood, to boost their purchase of Italian goods and services.<sup>4</sup>

For local authorities the main goal is to guarantee loans from banks and other financial institutions and to provide insurance coverage to support procurement oversees (direct and indirect) sought by Italian regions to buy the goods needed to face the health emergency, such as medical equipment, accessories for individual protection, diagnostic devices and other non-medical goods.

### **Provision of liquidity**

Provision of liquidity, mainly targeting enterprises (Cassa Depositi e Prestiti, 2020b), have the goal of supplying new funding to SMEs, medium and large enterprises. Funding is provided both in the form of first-tier lending (directly to the end-customer) and second-tier lending (to banks and financial intermediaries that in turn lend on to end-customers). For medium and large companies, the CDP supplies short-term and medium- to long-term loans to support staff costs, investments or working capital in production facilities and business activities located in Italy. Loans are also aimed at supporting temporary liquidity needs, mainly in investment research, development, innovation, protection and enhancement of cultural heritage, promotion of tourism, environment, energy efficiency, promotion of sustainable development and green economy.

<sup>4</sup> According to CDP's documents, the process is carried out entirely online with pre-stabilized financial documentation, rapid resolution times and a pre-stabilized pricing on the basis of a risk/return metrics/profiles agreed upon with the bank and paid for either upfront with the finalization of the loan agreement or in a 'running mode' with each interest payment according to the contract.

Loans may also be co-financed by the private banking system, with a CDP share of greater than €5 million and a maximum duration of six years (with a grace period of up to 24 months),<sup>5</sup> and counter-guaranteed by the State until 31 December 2020.<sup>6</sup> To be eligible to apply for this type of financing, companies must have an annual turnover of more than €50 million, and be able to demonstrate losses due to the Covid-19 emergency, equal to at least a 10% reduction in turnover compared to the same period of the previous year

As for SMEs, lending to support investments and working capital needs is granted to banks that, in turn, supply loans to enterprises at lower interest rates compared to the market. Funding from CDP to banks has a maturity from three to 15 years, and banks are required to grant new finance to enterprises with a maturity from one to 10 years (Cassa Depositi e Prestiti 2020f). To ensure the highest possible transparency, CDP asks the banks to indicate, in the loan agreement with the company, the cost at which the funding is obtained from CDP and the maturity, thus giving evidence of the margin applied by the bank to enterprises.

## THE COVID-19 SOCIAL RESPONSE BOND

In April 2020, the CDP also launched the Covid-19 Social Response Bond to support Italian enterprises and local authorities that had been adversely affected by the pandemic. The bond totals €1 billion and was subscribed to by institutional investors (53% domestic

<sup>5</sup> The amount of the CDP share is expected to be no greater than the highest value of the following: 25% of 2019 revenue, as indicated in the approved budget or tax declaration, or twice the company's 2019 staff costs, as indicated in the budget or the certified data, if the company has not yet approved the budget.

<sup>6</sup> Counter guarantee has the following coverage percentages: 90% of the loan amount for companies with less than 5,000 employees in Italy and turnover of up to €1.5 billion; 80% of the loan amount for companies with a turnover of between €1.5 billion and €5 billion or with more than 5,000 employees in Italy; 70% for companies with a turnover of more than €5 billion.

investors, 47% foreign investors) and divided in two tranches with the following features: €500 million, three years, 1.5% fixed annual coupon; €500 million, 7 years, 2.0% fixed annual coupon.

Funds raised through the Covid-19 Social Response Bond are intended to provide both immediate relief in the context of the current emergency and to support, in the medium to long term, overall economic recovery. In line with the UN's Sustainable Development Goals 3 and 8 (i.e. to "Ensure healthy lives and promote well-being for all at all ages" and "Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all") the bond's targeted initiatives include easing access to credit for Italian SMEs that have been severely affected by the pandemic and supporting public administrations and local authorities in strengthening and intensifying local healthcare capacity. Initiatives to be financed may include helping corporates, mainly SMEs, to access banking and financial services, also through direct lending, providing local authorities with financial support in their efforts related to healthcare, social and economic measures, financing the construction, development, maintenance or renovation of healthcare facilities, medical equipment and technologies for the improvement and protection of public health (Cassa Depositi e Prestiti 2020c).

## CONCLUSION

Although it is too early to evaluate the effectiveness of the measures that have been put in place by CDP in the face of the Covid-19 crisis, it seems that the bank's engagement has been strong, prompt and relevant. The CDP is playing a key role in providing liquidity to enterprises and local authorities, as well as implementing financial instruments and programmes to contribute to reversing the current drop in the level of investment and consumption. With the preferred creditor status and other risk-sharing mechanisms, the CDP is also creating the conditions to work as a catalyzer of private fi-

nance towards supporting investments and stimulating a response to the health emergency.

The extraordinary measures put in place by CDP to face the Covid-19 pandemic are a clear example of the unique role public banks can play in facing negative extreme events and mitigating market failures. With the injection of liquidity, guarantees, debt and equity instruments, CDP is assisting with the health emergency and sustaining growth and employment, whereas private banks are mostly disintermediating their credit activity because of higher risk aversion, capital shortages and deleveraging.

This countercyclical role of public banks has already come to light in response to the global financial crisis, when CDP started playing a primary role in restructuring the economy, channelling leveraged funds into the market, boosting innovation and supporting socio-economic and environmental challenges. Indeed, in the last few years CDP has provided long-term ‘patient’ capital to promote strategic investments for economic development, such as infrastructure projects, export and social housing, or for socially challenging projects such as climate finance, renewable and environmentally-friendly energy and food security initiatives.

Public bank financial support overcomes funding gaps stemming from a private sector that is reluctant to provide funding to socially valuable projects, which may prove unprofitable, at least in the short term, due to the impossibility of monetizing positive externalities. CDP has also funded several projects with high risk, which private banks do not finance if there are difficulties in evaluating the business, and in the innovation process, where expected returns take time or if there is a lack of guarantees and collateral.

Given the growing relevance and role of development banks in Europe, the 2015 Communication to the European Parliament and the Council of the European Commission pointed out that “Member States that do not yet have a national promotional bank may consider setting one up” (European Commission 2015, 2).

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## Chapter 15

Victoria Stadheim

# PUBLIC BANKING IN PANDEMIC TIMES: PORTUGAL'S CAIXA GERAL DE DEPÓSITOS

**I**t is widely acknowledged that public banks have the potential to play an anti-cyclical role in times of economic crisis. As lending by private banks dries up, public banks step in. The world is currently confronting a twin crisis: a pandemic that has generated a profound recession. Within this public health and economic crisis, what role do state-owned banks play? This chapter examines how *Caixa Geral de Depósitos* (CGD) has responded to the crisis in Portugal. It shows that the CGD acted swiftly when faced with a pandemic. It launched its own initiatives and it played a role within the Portuguese Government's response. Some of the most important measures were the debt moratoria, various credit lines and a series of steps to facilitate the digitalization of finance. These measures helped to accommodate the lockdown and to mediate its economic effects on families and businesses. Despite this, the bank's initiatives need to be understood within the competitive – and indeed profit seeking – logic in which the CGD operates. Further research is required to investigate the extent to which CGD's response differed from that of the private banks.

## INTRODUCTION

Portugal has a brief but relatively recent history of a large state presence in the banking sector. Almost the entire financial system was nationalized in the mid-1970s, but by the mid-1990s, most of it had returned to private ownership (Antão et al. 2009, 432; Rosa 2014, 180). Bank ownership and control have played a central role in social and economic change in Portugal, whether of an authoritarian or socially progressive character. Today, the country's only remaining state-owned bank is *Caixa Geral de Depósitos* (hereafter referred to as CGD or Caixa), which is fully owned by the national government.

It is widely acknowledged that public banks have the potential to play an anti-cyclical role in times of economic crisis (Yeyati et al. 2007). As lending by private banks dries up, public banks step in. For example, the World Bank's *Global Survey of Development Banks* highlights that most development banks in Latin America, Africa, Asia and Europe scaled up their lending at a time when private banks held back in the period between 2007 and 2009 (Luna-Martínez and Vicente 2012). The world is currently facing a pandemic that has generated a profound recession. As states around the globe sought to contain the virus, lockdowns and workplace closures led to violent interruptions in capital accumulation.

The lockdowns and social distancing measures worldwide have had a huge impact on work and production. In April 2020, full or partial lockdowns affected 81% of the world's workforce (ILO 2020, 1). As workers were prevented from going to work, production plummeted, and as people were subject to compulsory or voluntary social distancing, demand collapsed too. Millions have been thrown into unemployment, and according to the International Labour Organization (ILO) (2020), "nearly half of global workforce [is] at risk of losing livelihoods". The Organisation for Economic Co-operation and Development (OECD) (2020, p.8) warns that, "By the end of 2021, the loss of income exceeds that of any previous recession over the last 100 years

outside wartime, with dire and long-lasting consequences for people, firms and governments”.

Within this public health and economic crisis, what role do state-owned banks play? This chapter examines the CGD’s response to the pandemic crisis in Portugal. It is still early in the crisis, however, so the analysis is necessarily a preliminary note that addresses some of the bank’s measures.

The chapter is structured as follows. The first section gives an overview of public banking in Portugal. The second provides historical background of the CGD. The third section gives an overview of the manifestations of the pandemic in Portugal and outlines some of the Government’s measures to contain the virus and counter the recession. The fourth section situates the CGD within the Government’s response and outlines some of the bank’s own initiatives.

## PUBLIC BANKING IN PORTUGAL

After a military coup in 1926, *Estado Novo* was formally established by the Constitution of 1933: an authoritarian regime based on corporatism, nationalism, fascism and a revival of colonialism (Chilcote 2010, 78). During this period, a monopolistic/duopolistic national bourgeoisie controlled the bulk of finance and industry. This part of the bourgeoisie was dominated by seven capitalist groups (Costa et al. 2010; Rosa 2014). Some started in industry and expanded into finance (“industrial business groups”), and others did the reverse (“bank-centred business groups”) (Ferreira da Silva et al. 2015). Through these owners, finance and industry were connected.

Portuguese colonialism was at the heart of the *Estado Novo* dictatorship. A new phase of imperialism had started in the 1890s, and after its decline in the 1920s, it was restored by the Colonial Act, which was included in the 1933 Constitution (Lains 1998, 466-467, 485). Several of the economic groups replicated their diversification process from Portugal when establishing economic activities in the

colonies (Ferreira da Silva et al. 2015).

The 1974, the Carnation Revolution brought an end to the dictatorship. It began as a peaceful coup-d'état by the Movement of the Armed Forces (MFA) on April 25 of that year. Initially, there was no plan for a transition to socialism. The objectives were to achieve democracy and to end the colonial wars. The situation soon polarized, however, and the revolutionary demands radicalized. A failed coup was attempted in March 1975 but failed. This led to the appointment of the Revolutionary Council, which called for "bold measures against the capitalist elite that control finance and much of industry" (Noronha 2013, 1). Within three days, the entire banking system was nationalized, except for credit unions and those that were foreign owed. This happened with the help of delegates from bank workers' trade unions, who had pushed for nationalization and occupied banks (Noronha 2013, 1; Rosa 2014, 180). This step was justified with reference to social and economic policies. In the words of the Revolutionary Council's Decree-Law 132-A/75, the banking system was to be converted into a "fundamental lever of command over the economy in order to create growth and employment". During this brief historical period, credit allocation was coordinated by the Bank of Portugal, with the bank workers' unions playing a role in this process (Noronha 2013).

The Constitution of 1976 stated that "all the nationalisations put into effect after 25 April 1974 are irreversible conquests of the working classes". However, in the 1980s, several constitutional revisions opened the door to the re-privatization of banking and insurance. In 1988, state-owned enterprises (SOEs) could be transformed into joint stock companies with up to 49% private capital. In 1989, a constitutional revision allowed SOEs to be fully privatized, except in certain sectors. The stated objectives were to enhance firms' competitiveness, to reduce the role of the state in the economy, to reduce the public debt and to strengthen the entrepreneurial capacity (Rosa 2014, 184-186). In the words of Miguel Cadilhe, who was Minister of Finance 1985-1990, "The objective is to strengthen and pro-

mote the Portuguese entrepreneurial class through privatisation” (Mortágua and Costa 2015, 7).

The speed at which the Portuguese banking system was privatized was remarkable (Antão et al. 2009, 432). In the words of Pinho (1997, 6) “the 1985-1995 period witnessed an impressive change in ownership structure as a result of the creation of new private-owned Portuguese banks, the entry of many reputable foreign institutions but, most importantly, as a result of privatisations”. The constitutional revisions of the 1980s also gave rise to what Rodrigues and Reis (2012, 196) call “the most intense cycle of privatization in the EU”. During those years Portugal’s revenue from privatization was equivalent to 23% of Gross Domestic Product (GDP) in 2000 prices. This was twice as much as other “big privatisers” like the UK (Rodrigues and Reis 2012, 196). The transfer to private ownership first focused on the financial sector, but then spread to other sectors (Baer and Nogueira Leite 2003, 749). Most of banking was privatized in the beginning of the 1990s, and the process was largely completed by 1995. As this transition progressed, the market share of banks under public ownership decreased from 74% to 24% between 1990 and 1996, and remained stable thereafter (Antão et al. 2009, 432).

## CAIXA GERAL DE DEPÓSITOS

The CGD has been state owned since its foundation in 1876 and remains 100% so (Antão et al. 2009, 432; CGD 2019, 331; DBRS 2020). It was modelled on the *French Caisse Générale des Dépôts et Consignations* and its initial purpose was to mobilize private savings. It also collected fiscal and administrative deposits required by law. Soon after its creation, the CGD came to dominate the Portuguese banking system. Between the 1890s and World War One, it was by far the largest institution as far as deposits are concerned. In contrast to a specialized banking system, the CGD served as a development bank for industry, agriculture and civil construction. It also played

an important role vis-à-vis activities in the colonies. Until the late 1920s, in a context of budget deficits, an important function was to finance public expenditure through purchases of public debt (CGD; Reis 1997, 255-268).

In 1929, 90% of the CGD's deposits went towards financing the public sector's needs, but a series of reforms soon transformed its role. António de Oliveira Salazar, who at the time was a Minister of Finance, played a central role in this transition. As a dictator and Prime Minister (1932-1968), he was committed to budgetary discipline and austerity, and the 1929 reforms sought to reverse the CGD's role in channelling resources into the public sector (CGD; Reis 1997). These reforms also restructured the bank and changed its name to *Caixa Geral de Depósitos, Crédito e Previdência*, which administered two autonomous institutions: *Caixa Nacional de Crédito* (CNC) and *Caixa Nacional de Previdência* (CNP). The CNC was responsible for credit for industry and agriculture whilst the CNP covered a range of social security schemes for public sector employees (CGD; Reis 1997, 255-268). The CGD continued to be an important economic instrument through which the *Estado Novo* regime promoted the "national interest" (Reis 1997, 255-268). In Salazar's view, "the reconstruction of the country [could] not be achieved without a strong credit structure – in the metropole and in the colonies" (Salazar 1930, quoted in Reis 1997, 261).

At the end of the dictatorship, the *Lei Orgânica* changed the CGD's legal framework. So far, it had been subject to the same rules as the public administration, but it was now transformed into a public enterprise. Its management came to comply with guidelines for business management. This made it increasingly aligned with other financial institutions (CGD). During the Revolution, following the nationalizations provoked by the coup attempt in March 1975, CGD became part of "Grupo Estado", along with other banks and companies that were now under state ownership (Rosa 2014, 180-182). In 1993, the CGD's governance once again changed. It became a joint stock company with the state as an exclusive owner of its

shares (CGD). The CGD is currently a universal bank (CGD 2019, 370). It is the largest retail and commercial bank in Portugal, and it is part of the CGD Group, which comprises many financial institutions in Portugal and abroad. Some of these include *Caixa Gestão de Ativos*, SGFI, *CGD Pensões Caixa Banco de Investimento*, *Caixa Capital* and *Caixa Imobiliário*. The CGD is a leader in several markets and has a 29% market share of individual deposits (CGD 2019, 6, 16; DBRS 2020). It is a profit-seeking institution and, in 2019, its profits amounted to €776 million – 57% higher than the 2018 level. This was the first time in nine years that it was able to pay dividends to its shareholder, the state, which received €200 million that year (CGD 2019, 8; O Minho 2020).

Like private banks, CGD is subject to external assessments by credit rating agencies. In 2019, several of these improved their assessment of the bank. DBRS upgraded it by one notch, to BBB, whereas Fitch changed it from BB to BB+ (CGD 2019, 6; O Minho 2020). The CGD Group is highly internationalized and has a presence in France and in Portugal's former colonies. Among the institutions that are fully or partly owned by the CGD Group are *Banco Caixa Geral* (Brazil), *Banco Nacional Ultramarino* (Macao), *Banco Comercial do Atlântico* (Cape Verde) and *Banco Caixa Geral* (Angola) (CGD 2019, 16).

In the context of the 2008-09 financial crisis, the CGD played a role in state interventions in finance. It was instrumental in the rescue operation that saved the private bank *Banco Português de Negócios* (BPN). The BPN's nationalization in 2008 was one of ten bank nationalizations in Europe that year (Assembleia da República 2009, 214). Despite a small market share, it was justified on the grounds of “systemic risk”. The BPN was integrated into CGD, which administered it during its time under public ownership (Moura e Silva 2013, 130; Torres 2009, 61). It remained under state ownership between November 2008 and March 2012. The “toxic assets” of the BPN were separated out and placed under public ownership (Cabral 2015; Assembleia da República 2012; Mortágua 2015). The healthy part of the bank, on the other hand, which was later given the nickname “BPN bom” was



privatized and purchased by Banco BIC, with Angolan capital. Its privatization “on an accelerated schedule” was part of the structural adjustment programme that Portugal underwent in the context of the crisis in the Eurozone (IMF 2011, 8).

Over the last decade, the CGD has been subject to restructuring. When Portuguese authorities were compelled to request a rescue package from the European Commission (EC), the International Monetary Fund (IMF) and the European Central Bank (ECB) in 2011, the creditors sought to include the CGD’s privatization in the structural adjustment programme. However, this was averted (Cardoso 2016). Instead, the insurance arm of the CGD, *Caixa Seguros*, was among the state-owned enterprises that were listed for sale (IMF 2011, 45). This CGD has regularly been recapitalized, and this last happened in 2017-2018.

In the context of the last recapitalization, the CGD was required to implement a “strategic plan”, which Portuguese authorities have drawn up with the European Commission (Cavaleiro and Vicente 2020; CGD 2019, 6). The restructuring plan (2017-2020) included a scaling down of international operations, a reduction in the number of branches, and a reduction in non-performing assets. In 2016, its ratio of non-performing loans was three times higher than the current level of 4.7% (CGD 2019, 6; DBRS 2020). It was compelled to sell its subsidiaries in Spain and South Africa in 2019 (Cavaleiro 2019; DBRS 2020; Fernandes 2019). As part of the strategic plan, CGD was also required to sell off *Banco Caixa Geral – Brazil* and reduce its ownership in banking in Cape Verde. However, this has been disrupted by the Covid-19 pandemic (Cavaleiro and Vicente 2020; CGD 2019, 7; DBRS 2020; Relvas 2020).

## THE COVID-19 PANDEMIC IN PORTUGAL

In the European context, Portugal fared quite well in the early stages of the Coronavirus pandemic. Portugal’s initial ‘success’ is likely

to reflect resolute action at an early stage. The school system was closed on 16 March and a lockdown was imposed before any Covid-19 deaths had been recorded. Subsequently, the border with Spain was closed by mutual agreement and connections through air, river and rail were suspended. The country entered a state of emergency on 18 March, which lasted until early May (Jones 2020; Mamede et al 2020; Peixoto et al. 2020; Presidência 2020; Worldometers 2020).

Like elsewhere in Europe, the situation is getting worse, and total deaths now amount to 2,297 (as of late October 2020). The number of active cases was contained between the end of May and the end of August, but thereafter started to increase and, at the time of writing, is at its highest level so far. Deaths also started to creep up from the second half of September and Portugal entered a “state of calamity” in mid-October (Direção-Geral da Saúde 2020; Worldometers 2020).

Covid-19 and the measures to contain the virus brought profound disruptions to production and demand. Portugal is now in recession. In the first quarter of 2020, GDP contracted by 2.3% year-on-year and in the second quarter it shrunk by 16.5% (Ataíde 2020; European Commission 2020). Before the pandemic, the country had been in growth for six years, but industrial slowdown in Germany had already been a cause of concern (Ribeiro 2019; World Bank 2020). The *form* of Portugal’s recovery from the previous crisis also came to shape the pandemic induced recession. In a Fast and Exceptional Enterprise Survey conducted by Statistics Portugal and the Bank of Portugal in mid-April, 80% of respondent enterprises reported a decrease in turnover resulting from the pandemic. The most frequently cited causes were the absence of clients and orders and the restrictions that accompanied the state of emergency (Instituto Nacional de Estatística 2020a). The hospitality sector was hard hit (European Commission 2020). By the end of April, almost 60% of firms in the accommodation and food sector had shut down temporarily (53.9%) or indefinitely (5.5%) (Mamede et al. 2020). Portugal’s economic recovery from the previous crisis was in part

driven by tourism, and this came to shape the economic effects of Covid-19. Tourism was the most severely affected sector, as visits plummeted by nearly 100% in April, compared with the previous year (European Commission 2020). Despite an easing of restrictions, tourism was practically in suspension also in May, when overnight stays by non-residents dropped by over 98% year-on-year (Instituto Nacional de Estatística 2020b). Faced with international travel restrictions and quarantines in other countries, much of the tourist season was lost.

To facilitate the lockdown and to counter the recession and its social impact, the Portuguese Government implemented a large anti-cyclical programme, much like other Western countries. These measures can be grouped into: 1) liquidity and access to credit; 2) employment retention and training; 3) extended social protection; and 4) taxation and social security contributions. Taxation measures included deferral of various taxes paid by companies and the self-employed in situations such as compulsory closure or a turnover loss of more than 20%. It also included reductions and deferral of social security contributions depending on firm size, sector and losses. A furlough scheme sought to retain jobs. This was conditional on avoiding dismissal of workers. The extension of social protection included cash benefits to pay for care of children or grandchildren to facilitate self-isolation; financial support for workers who cared for children due to school closure; automatic extension of unemployment benefits; and a new benefits scheme for informal workers with no prior history of paying social contributions (Mamede et al. 2020, 18-19).

A whole series of credit and debt related measures were launched. These targeted companies as well as individuals. A €13 billion scheme approved by the European Commission financed grants and state guarantees on loans to for investments and capital needs. This included a €6.2 billion credit line with state guarantees channelled through the banking system. It was oriented towards industry (€4.5 billion), tourism (€900 million), restaurants (€600

million) and travel agencies (€200 million). A €400 million credit line was oriented towards the companies that were most severely hit by the pandemic and another credit line was directed towards micro-enterprises in tourism (€60 million). Subsidized credits were offered to operators in the fishing and aquaculture sector (€20 million) and a €25 million support package targeted start-ups and social innovation (Mamede et al. 2020, 18). A debt moratorium was among the “exceptional” measures to protect families and companies’ access to credit. The moratorium, which was passed through Decree-Law no. 10-J/2020, was the result of a close collaboration between *Banco de Portugal* and the banking system. It allowed the suspension of debt and mortgage repayments and included the principal and interest. The scheme required that the mortgage financed their permanent home. It was initially for a period of six months, until 30 September 2020, but was subsequently extended until September 2021 (Bank of Portugal 2020a).

During the state of emergency and thereafter, there was a ban on terminating rental contracts due to delayed rent caused by income loss (Governo de Portugal 2020). Cancellation of essential services such as water, electricity, gas and electronic communication was also banned during this period (Diário da República 2020). In other words, individuals and families were protected against evictions and from having essential services cut off. The banking system played an important role in operationalizing many of the above measures.

## CAIXA GERAL DE DEPÓSITOS AND COVID-19

The World Health Organization (WHO) declared that Covid-19 was an international pandemic and a public health emergency on March 11, 2020. Two days later, the CGD communicated its commitment to support Government policies through a credit line (CGD 2020a). Subsequently, it launched a broader set of initiatives. It stated that, “without compromising measures that are being approved

by national and European authorities, CGD has decided to implement a series of measures that ... will be carried out at the request of its customers” (CGD 2020b). This was immediately after Portugal entered a state of emergency. In the context of the pandemic, it was decided that the CGD would not transfer dividends to its only shareholder – the state in 2020. The Vice-Chair and Executive Officer abstained from bonuses.

Many of CGD’s actions towards individuals and firms can be broadly divided into three categories: 1) debt moratoria and a flexible stance towards debt repayment; 2) credit lines; and 3) digitalization of finance and measures to support financial transactions that reduced the risk of Covid-19 transmission. These were the CGD’s initiatives, but they were in line with legislation that was about to come through.

Concerning credit lines, CGD announced that “as part of the state package to support companies to minimise the impact of the new coronavirus on the economy” it would make a new credit line available for enterprises. On March 13, a total of €200 million was reserved for micro-enterprises, small enterprises and medium-sized firms. The credit line was supported by state guarantees. The rationale was to offer support and to accommodate “abrupt reduction in demand in many sectors of economic activity” (CGD 2020a). Subsequently, new measures were introduced and CGD announced that it would “keep in operation, with great simplification of processes and speed of decisions, all the financing lines that CGD has, satisfying the needs of customers in time and capacity”. Additionally, it would reinforce existing credit lines, and create new ones to assist companies with the acquisition of IT and telecommunications to facilitate teleworking (CGD 2020b). In April, the CGD launched a new €400 million credit line exclusively for microenterprises (TVi24 2020). These constitute the vast majority of Portuguese firms. Currently, the credit line *Linha de Apoio à Economia Covid-19* offers loans with six years maturity for up to €50,000 for microenterprises and €250,000 for small firms. The conditions include not having

been in difficulty before December 31, 2019, having seen a drop in business volume of more than 40% and committing to maintaining permanent jobs until the end of 2020 (CGD 2020c). Another credit line with state guarantees – *Linha de Apoio ao Setor Social COVID-19* – is available for companies and charities in the area of social assistance and solidarity (CGD 2020d).

A second set of measures concerned debt moratoria and a flexibilization of debt repayment vis-à-vis companies and individuals. On the day Portugal entered a state of emergency, the Government held a press conference where the Minister of Finance, Mário Centeno, outlined the “possibility of constituting a moratorium on capital and interest”. The details were yet to be decided. At the time, it was not mentioned that this would also cover families, but this was later included (Melo 2020). The CGD immediately announced the introduction of initiatives along these lines. Vis-à-vis companies, the CGD accepted readjusted monthly debt repayments for a period of up to six months. Additionally, companies in the tourist sector were offered an extension of up to five years on the maturity of any debts. For individual customers with mortgages or personal credit, CGD would consider the suspension of capital repayments for a period of up to six months (CGD 2020b). When the Decree Law that outlined the moratorium came into force, CGD was legally required to offer moratoriums on capital and interests to its customers. In CGD’s own assessment (2020e, 7), it was “quick to react in making prompt adjustments” to the legislative changes. Additionally, CGD has a private moratorium. This compliments the legally required moratorium. It covers mortgage debt and personal credit that is not included in the Government’s moratorium. There are several private moratoria in Portugal, and these have been designed in the context of guidelines provided by the European Banking Authority. The CGD offers the one that is promoted by the Portuguese Banking Association (APB). Private banks also offer private moratoria (Bank of Portugal 2020b, 84-85; CGD 2020f). Furthermore, *Caixa* was proactive in signalling its willingness to extend the moratoria beyond

the initial six months covered by the Decree-Law (O Minho 2020). By July 28, the CGD had approved 48,326 moratoriums: 36,604 to individuals (€3,063 million) and 12,222 to companies (€3,919 million) amounting to €6,982 million (Sapo 2020).

A last set of measures concerned a digitalization of finance and of support of socially distant financial transactions. *Caixa* waived small merchants' fees for Automatic Payment terminals with bills below €7,500 per month. To facilitate payment by card rather than cash, it would maintain the practice of not changing the fixed component of the merchant service charge for transactions with a small value. Individual account holders would benefit from free transfers through digital channels during the "crisis period". For account holders without a debit card, Caixa would waive the debit card fee for the first year. Finally, the CGD stressed its commitment to protect the most vulnerable groups, through an exemption from commissions for customers with an income of up to 1.5 times the minimum wage and young people up to the age of 26 (CGD 2020b).

The bank evaluates its digital efforts successfully and highlights that the number of digital customers in the domestic market increased to 1.76 million (CGD 2020). According to the bank's own evaluation, "the Covid-19 pandemic enabled CGD to consolidate its leading position as the digital bank of Portuguese citizens, in its almost immediate provision of distance solutions designed to facilitate access to the bank and maintain customer proximity" (CGD 2020e, 8). This points towards a simultaneous digitalization of finance and a support of transactions that reduce the risk of Covid-19 transmission.

## CONCLUSION

On the eve of the pandemic, the CGD wrote that "2020 is likely to be an especially complex year owing to the, as yet, uncertain impact of Covid-19" and that "the progress achieved over the last few years

enables us to claim that Caixa is currently ready and in a position to make an important contribution to minimising the pandemic's effects on economic actors and Portuguese society, as has been the case on several occasions over its 144 years of existence" (CGD 2019, 7). There is no doubt that the CGD's response to the Covid-19 pandemic has played a role within the Government's public health management and its anti-cyclical programme. Along with the rest of the banking system, the CGD was legally required to provide "exceptional" support to companies and firms. In relieving families of their immediate debt obligations, it facilitated the lockdown and mediated the social impacts of income loss. The CGD also acted proactively. It passed measures before they were required by law and signalled its commitment to extending the moratoria.

However, some of these measures should be understood within the market imperatives and the regulative framework within which the public bank operates. While the moratorium is socially inclusive, it is also a financial stability measure. Defaults on debt represented a major risk, and the moratoria protected creditors as much as obligors. For the banks, it was important that these were not classified as "non-performing loans" within the European framework. This was the case for the CGD and for private banks. The moratoria flexibilized debtors' contractual obligations vis-à-vis creditors and it simultaneously helped the banks to avoid a large amount of non-performing loans in their portfolio (Bank of Portugal 2020, 83-85; Melo 2020). This may explain why *Caixa*, as well as the private banks, implemented private debt moratoria. Various associations including *Associação Portuguesa de Bancos*, *Associação de Instituições de Crédito Especializado* and *Associação Portuguesa de Leasing, Factoring e Renting* promoted these (Bank of Portugal 2020, 83-85).

Finally, it should be pointed out that some of the GCD's initiatives that concerned a digitalization of finance and of support of socially distant financial transactions were compatible with the bank's identity as a profit-seeking public bank. The bank positively



evaluated its improved position in the market for digital customers. However, further research is required to examine how different the CGD's response was from that of the private banks.

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## Chapter 16

Ali Riza Güngen

# TURKEY'S PUBLIC BANKS AMID THE COVID-19 PANDEMIC

**T**urkey's public banks have fulfilled critical functions during the Covid-19 pandemic. By extending cheap credit to households and small and medium-sized enterprises, public banks partially mitigated Turkey's economic slump in 2020. However, hardwiring public banks to extend supportive loans amid turbulent times has prevented them from addressing other policy challenges and providing equity-centred responses that focus on social and environmental issues. The use of Turkey's public banks during Covid-19 pandemic is a testament to the need for democratizing the social content of public banking.

## INTRODUCTION

Public banks still occupy an important place in the global financial system despite decades of financial transformation and the animosity of neoliberal state managers in many countries. In the aftermath of the 2008-09 international financial crisis, interest grew in the opportunities provided by the financial capacities of public financial institutions. In recent years, public banks have been critical in providing financial support to infrastructural investments, yet many scholars have associated such banks with corruption and the mismanagement of public funds. To be sure, policy-makers have used and abused pub-



lic banks to win support across electoral cycles. Yet this is not always or inherently so. Public banks also hold great potential for achieving public policy objectives. New multilateral and national development banks have been founded globally with multiple objectives – ranging from greening the economy to funding large-scale infrastructure projects.

Public banks are used for a range of purposes across the globe. The ways they function reflect the contending interests and political projects of different social groups and classes (Marois and Güngen 2016). Turkey's public banks are no exception. Their activities ultimately depend on the social-political pressures and the capital accumulation regime in which they are situated (Yalman et al. 2019).

The Covid-19 crisis came as an unanticipated shock. Turkey's economy was still suffering from the effects of the country's 2018-19 economic crisis when the Covid-19 pandemic hit hard in spring 2020. In response, authorities implemented partial lockdowns and public health measures from April onwards. But even before these measures, the country was experiencing one of its highest unemployment rates. As capital outflows from the global south reached historic proportions in March and April, surpassing the levels of the 2008-09 economic crisis, the Turkish Lira (TRY) depreciated rapidly. High levels of foreign exchange-denominated debt in Turkey's non-financial sector, as well as the dependence of economic activity on easy access to financial sources, pushed policy-makers to replicate the measures they took during the 2018-19 crisis. Turkey's public banks thus became more critical than ever in responding to the emerging downturn.

## **TURKEY'S PUBLIC BANKS IN TIMES OF CRISIS**

Throughout Turkey's contemporary history, the country's public banks have been used to stabilize the economic system and facilitate developmental projects. In the twenty-first century, they have evolved into profit-seeking enterprises, yet they are still important

in supporting households and small and medium-sized enterprises (SMEs). This history and the public banks' actions over the last couple of years provide a blueprint for understanding their uses during the Covid-19 pandemic.

Before the 1980s, public banks in Turkey mainly focused on mobilizing scarce domestic resources. They had specific mandates such as supporting industrial production by funding SMEs (Halkbank) or agricultural production by providing cheap credits to farmers (Ziraat Bank). The post-1980 neoliberal transformation, however, eroded such developmentalist activity. The ratio of total loans to special loans for segments that were negatively affected by the neoliberal transition started to decline in the late 1990s (Marois and Güngen 2016). Despite the declining ratio of special loans, the duty losses (that is, government-assigned losses tied to programme lending) arising from cheap credit provisioning continued to increase, since successive governments did not transfer the necessary amounts to public banks. Turkish authorities increased the risks of public banks in the late 1990s by not repaying these financial losses. This undermined decades of otherwise relatively stable operations.

Turkey's currency and banking crisis of 2001 paved the way for a neoliberal restructuring of the banking system. Despite keeping elements of a distant developmentalist past, incoming market reformers, above all economist Kemal Derviş *made* the public banks in Turkey evolve into explicitly profit-oriented institutions (Marois and Güngen 2013 and 2016). Financial losses arising from cheap credits extended to large social segments are now directly paid by the Turkish Treasury in the same month they are incurred. By their new name, these "income losses" have been relatively insignificant, except for the 2008-09 economic crisis and the post-2018 period.

Despite neoliberal 'depoliticization' processes, the public banks have become instrumental for political projects of successive Justice and Development Party (AKP) governments. After failing to privatize these financial institutions in the early 2000s, state managers have explicitly used public banks in the last decade to garner

further electoral support by expanding Islamic finance and funding large-scale infrastructural projects.<sup>1</sup>

**Table 16.1: Public banks in Turkey as of 2020**

| Bank, type and year established                        | Ownership profile and explanation   |
|--|---|
| Ziraat Bank;<br>Commercial (1863)                      | 100 % belongs to the Turkey Wealth Fund   |
| Halkbank;<br>Commercial (1938)                         | 75.3 % belongs to the Turkey Wealth Fund; remaining shares belong to individuals and legal entities   |
| Vakifbank;<br>Commercial (1954)                        | 37.46 % belongs to Ministry of Treasury and Finance, 35.99 % to the Turkey Wealth Fund, 16.15 % to individuals and legal entities; remaining shares belong to Turkish Foundations and Bank's pension fund |
| Development and Investment Bank;<br>Development (1975) | 99.08 % belongs to Ministry of Treasury and Finance; 0.92 % to individuals and legal entities   |
| Eximbank;<br>Development (1987)                        | 100 % belongs to Ministry of Treasury and Finance   |
| İller Bank;<br>Development (1933)                      | Belongs to municipalities and special provincial administrations  |
| Ziraat Katılım;<br>Participation (2015)                | 99.99 % belongs to Ziraat Bank, 0.01 % to other subsidiaries of Ziraat Bank   |
| Vakif Katılım,<br>Participation (2015)                 | 100 % belongs to General Directorate of Turkish Foundations   |
| Emlak Katılım;<br>Participation (2019)                 | 100 % belongs to Ministry of Treasury and Finance   |

Source: Banks Association of Turkey (2020), Public Disclosure Platform website and bank websites.

Note: The Turkey Wealth Fund (TWF) is a 100% state-owned sovereign wealth fund. Participation banks are financial institutions that operate according to the principles of Islamic finance. They are categorized separately in official documents.

<sup>1</sup> The Government founded two public participation banks in 2015 (see also Table 16.1). The AKP aims to attract more Islamic finance and efficiently fund the development of “strategically important industries”.

Public bank funding, for instance, may provide implicit state backing to a respective business venture. Turkish infrastructural projects funded in this manner over the last decade enjoy the ability to access new sources from international financial markets at relatively advantageous terms. In that sense, public banks have been used to channel financial resources to business groups close to the AKP. It would be one-sided, however, not to emphasize their importance in mitigating the ravages of neoliberalism. For large sections of society, public banks continue to help alleviate the economic woes stemming from the socially traumatic consequences of Turkey's economic fluctuations.

In the main, however, public banks in Turkey over the last two decades have increasingly carried the stamp of an authoritarian neoliberal mentality, if in contradictory ways (Güngen 2020). While AKP governments have attempted to reimpose financial discipline on households and SMEs during and in the aftermath of recurrent crises, public banks have also provided supportive credits, especially during those turbulent times. The social content of public banking has included practices that have benefited small producers and indebted households, although the lenders' activities are hardwired to disproportionately benefit corporations.

Providing financial access and support to SMEs and households has helped large sections of society to tread the troubled waters of the Turkish economy, even as it has also stabilized and reproduced Turkish capitalism by giving more help to corporations. The interesting aspect of these Janus-faced interventions has been the persistent profitability of Turkish public banks. Contrary to neoliberal tenets, public banks have outperformed private banks in terms of their return on asset ratios over most of the twenty-first century so far. During the crisis years (2008-09 and 2018-19), income loss payments jumped radically, temporarily eroding profitability. However, more often than not, annual profits have contributed more to the national budget than total compensation for their income losses. That said, the lack of democratic oversight still raises questions as to the most effective use of these public banks.

**Table 16.2: Assets and loans of the biggest public banks in Turkey**

|  | 2012  | 2013  | 2014   | 2015   | 2016   | 2017   | 2018   | 2019   |
|--|-------|-------|--------|--------|--------|--------|--------|--------|
| <b>Ziraat Bank</b>                     |       |       |        |        |        |        |        |        |
| Total Assets (billion USD)             | 92.65 | 99.05 | 109.01 | 106.61 | 105.57 | 121.03 | 107.94 | 116.67 |
| Gross loans and advances (billion USD) | 42.80 | 55.47 | 65.36  | 68.77  | 72.31  | 87.50  | 77.58  | 81.51  |
| Return on Assets (%)                   | 1.68  | 1.73  | 1.77   | 1.91   | 2.02   | 2.14   | 1.82   | 1.17   |
| Return on Equity (%)                   | 17.82 | 17.39 | 18.09  | 17.80  | 19.49  | 17.21  | 20.33  | 19.49  |
| <b>Halkbank</b>                        |       |       |        |        |        |        |        |        |
| Total Assets (billion USD)             | 61.20 | 66.25 | 67.79  | 65.63  | 67.49  | 82.70  | 73.72  | 78.82  |
| Gross loans and advances (billion USD) | 39.07 | 42.13 | 46.49  | 46.17  | 48.00  | 57.44  | 50.92  | 53.72  |
| Return on Assets (%)                   | 2.63  | 2.28  | 1.53   | 1.34   | 1.19   | 1.47   | 0.77   | 0.54   |
| Return on Equity (%)                   | 26.35 | 22.94 | 15.67  | 13.31  | 12.53  | 17.28  | 9.74   | 7.43   |
| <b>Vakifbank</b>                       |       |       |        |        |        |        |        |        |
| Total Assets (billion USD)             | 60.58 | 65.21 | 70.15  | 64.63  | 62.15  | 74.04  | 65.49  | 72.86  |
| Gross loans and advances (billion USD) | 40.72 | 43.49 | 47.99  | 45.37  | 44.84  | 52.17  | 45.39  | 50.29  |
| Return on Assets (%)                   | 1.58  | 1.41  | 1.11   | 0.85   | 1.36   | 1.61   | 1.49   | 0.90   |
| Return on Equity (%)                   | 13.63 | 13.10 | 11.27  | 8.77   | 14.50  | 17.92  | 17.33  | 11.05  |

Source: BankFocus Database (August 2020).

The use of public banks by policy-makers during the 2018-19 crisis should be understood within this context. Against a backdrop of global financial tightening, Turkey faced a credit crunch in 2018 and an economic crisis in 2018-19 (Akçay and Güngen 2019). The public banks were at the forefront of response measures. State managers

used the public banks to help maintain currency stability and resurrected their historical legacies for supporting SMEs and crucial sectors via a newly designed National Industry project. Ultimately, there were three main ways that Turkish policy-makers used the public banks during the 2018-19 crisis: debt restructuring, countercyclical lending and securitization.

Credit campaigns have been effectively and recurrently used by state managers to stimulate the economy. Public banks played their part in restructuring corporate loans and household debt in 2018-19, essentially displacing debts in time. For example, the maturity period for consumer credits was extended to 60 months in February 2019 (CBRT 2019). The Banking Regulation and Supervision Agency (BRSA) also revised credit card instalment regulations to enable more instalments. In early 2019, state managers first ordered Ziraat Bank (the biggest bank in Turkey, public or private) and then other public commercial banks to restructure credit card debt at lower-than-market rates. While household debt restructuring was mainly the task of public banks during the 2018-19 crisis, US\$20 billion in corporate debt was restructured in 2018 as a result of negotiations between large corporations and various Turkish banks, both public and private.

The countercyclical lending capacity of public banks also benefited distressed firms during the 2018-19 crisis. The income losses arising from targeted campaigns provide a proxy to estimate the extent of these campaigns. Indeed, income loss transfers increased 26.5% in real terms from 2018 to 2019. Turkey's public banks led the credit expansion in the first half of 2019 and the last quarter of the year, repeating their active role in extending commercial credits during the 2008-09 crisis. The credit expansion and the income loss payments during the pandemic, however, surpassed the volumes of previous campaigns (further elaborated below).

After converting the Development and Investment Bank (Kalkınma ve Yatırım Bankası, a public development bank) into a lender exempt from regulations in October 2018, state managers

flexed their new muscle in December 2018 to issue asset-backed securities. The state provided a guarantee for investors via the Development and Investment Bank. Private banks shifted long-term future revenues from mortgage-backed securities and received new liquidity. The volume of securitization was just TRY 4.15 billion, but the two rounds of securitization during the crisis made it easier for private banks to access fresh liquidity.

In brief, the credit policies of public banks were effective in keeping thousands of small firms afloat. At the same time, countercyclical lending bought time for the AKP to wait for a change in global financial conditions. Public banks contributed to economic stability through supportive loans and countercyclical measures both during the 2018-19 crisis and the previous instances of turbulence.

Ironically, the Turkish public banks have grown used to mitigating the economic instability and social damages brought about by neoliberal policies. Such public sector mitigation, however, accompanies the AKP's constant commitment to market-based financial deepening. The public banks formed a buffer against the further contraction of economic activity. At the same time, they provided an opportunity for many non-financial corporations to postpone financing needs. This provides context for the actions of and limitations to public banks during the Covid-19 pandemic.

## THE COVID-19 PANDEMIC AND BANK ACTIONS

The first Covid-19 case in Turkey was officially reported in the second week of March 2020.<sup>2</sup> Unsurprisingly, the partial lockdowns and the social distancing measures, together with curfews in 31

<sup>2</sup> As of mid-August, the number of Covid-19 patients exceeded 250,000, while the death toll had reached 6,000. After April, the number of active cases declined gradually to around 10,000. However, the excess mortality data for Istanbul and the problems in reporting and contact tracing imply that the death toll is much higher than the official figures show.

provinces in April and May resulted in a huge economic slump. During this time, public banks emerged at the forefront of the support provided to low-income households and SMEs.

Since the start of the pandemic, the country has been extremely vulnerable to capital flows, as the foreign exchange reserves of the Central Bank of the Republic of Turkey (CBRT) (excluding the swaps with other central banks and domestic banks) were already depleted by March 2020. Turkey also witnessed the biggest drop in labour force participation in its history.<sup>3</sup> The initial response by policy-makers was to announce the Economic Stability Shield Package on March 18, 2020. By June, the total value of the Covid-19 response package by President Recep Tayyip Erdoğan administration had reached almost TRY 300 billion<sup>4</sup> (equivalent to around 6% of Gross Domestic Product – GDP).<sup>5</sup>

The Erdoğan administration expanded fiscal spending amid the pandemic, and the CBRT revised its open market operations limit. Buying more government debt in the secondary market helped the Unemployment Insurance Fund offload large volumes of government debt. The fund's resources were of vital importance for the easing of short-term allowances, which was extended to 3.2 million people in April and May. CBRT regulations and the revised asset ratio calculations imposed on commercial banks also directly helped

<sup>3</sup> Since people were not looking actively for jobs in April and May, while short-term allowance payments placed more than 3 million workers into a grey zone, the pandemic did not result in the highest official unemployment rate in the country's history. Still, the number of unemployed, and the number of those not seeking a job but ready to start, seasonally employed and time-related underemployed exceeded 10 million in total in April-May 2020. In those months, the labour force population also dropped below 30 million (see Turkstat, 2020).

<sup>4</sup> US\$1 is approximately TRY8.4.

<sup>5</sup> The figure by June was TRY 498 billion (including deferred payments and other credit campaigns), according to the International Monetary Fund's Covid-19 response tracker. The Ministry of Treasury and Finance announced the size of the Economic Stability Shield Package as TRY 600 billion in late May (adding an unknown multiplier effect to boost the number). By early June, the actual volume of the measures as part of the package was TRY 207 billion in credit support, TRY 14 billion in short-term allowance payments (including payments through all of June), TRY 5 billion in cash assistance and TRY 66 billion in deferred premiums payments.



the Treasury set new records of domestic borrowing. Monetary and fiscal expansion during the slump, particularly amid the backdrop of capital outflows, put additional pressure on the Turkish Lira. Similar to practices during the 2018-19 crisis, public banks were used to intervene in the currency markets. It was not possible to halt the currency's depreciation under such financial distress, but state managers could mobilize the public banks to slow down the speed of the fall, providing breathing room for Turkish corporations who had heavy foreign exchange debts.<sup>6</sup>

Erdoğan's administration provided additional cash assistance to low-income households. According to official figures, more than 5 million households received one-time cash support (TRY 1,000 per household, or US\$140 at the time). The insufficient cash assistance was topped up with supportive loans. These loans were provided by the biggest three public banks, Ziraat Bank, Halkbank, and VakıfBank. From April 1, 2020, until the reopening of the economy in mid-June, almost 7 million individuals applied for basic needs credit (with limits up to TRY 10,000). The interest rates were less than half the market rate and required no payments in the first six months, helping people to avoid the initial impact of the crisis.

Apart from the 'basic needs credit', public banks extended cheap credit to 180,000 SMEs and 1.1 million shopkeepers. The dramatic rise in the credit volume in Turkey in April and May was achieved partly by the contributions of the Credit Guarantee Fund (CGF), through which the Turkish Treasury assumed part of the counterparty risk. The CGF-supported credit volume doubled during the pandemic and reached TRY 330 billion, the lion's share of which consisted of public bank credits to SMEs. The CGF was also used to provide surety for individual credits during the pandemic.

<sup>6</sup> There are no official figures on the scope and details of such intervention in the currency markets. The currency intervention by the Central Bank and the public banks from early 2019 to mid-2020 is estimated to have exceeded US\$100 billion (Reuters, 2020). The net foreign exchange position of public banks fell US\$8 billion from mid-March to early August 2020.

**Table 16.3: Summary of public bank actions during the Covid-19 pandemic (March 2020-July 2020)**

| <b>Public Bank</b>                   | <b>Action</b>                           | <b>Explanation</b>   | <b>Volume</b>     |
|--------------------------------------|---|--|-------------------|
| Public commercial banks              | Basic needs credit                      | Cheap consumer credit for low-income households                            | TRY 37 billion    |
| Public commercial banks              | Support for shopkeepers                 | Cheap credit for shopkeepers   | TRY 25 billion    |
| Public commercial banks              | Credit for SMEs                         | Cheap credit for SMEs  | TRY 145.6 billion |
| Public commercial banks              | New support package                     | Stimulating consumption to support tourism, automotive and housing sectors | not known         |
| Public commercial banks              | 'Nefes' credits                         | Cheap credit for SMEs  | not known         |
| Eximbank and public commercial banks | Rediscount credit                       | Support for FX earning industries  | TRY 30 billion    |
| Eximbank                             | Stock financing support                 | Credit Guarantee Fund supported loan for exporters                         | not known         |
| Halkbank                             | Postponing loan repayments for 6 months | Support to artisans and shopkeepers  | not known         |
| Development and Investment Bank      | Investment credit                       | Support for new investment   | TRY 20 billion    |
| İller Bank                           | Postponing loan repayments for 3 months | Measure against declining revenues of municipalities                       | not known         |

Source: Bank websites. Public commercial banks include Ziraat Bank, Halkbank and VakifBank. Halkbank postponed loan repayments initially for three months in March, then extended the period for another three months in July. Ziraat Bank and VakifBank provided credit restructuring opportunities for commercial credits, but the restructurings did not necessarily decrease payments or increase credit maturity.

İller Bank is a specialist public banking institution that transfers funds allocated to municipalities from general budget revenues. As a result of the presidential decision to make capital injections to İller Bank in 2019, İller started to impose a deduction on the funds transferred to the municipalities. In late March 2020, this practice was suspended for three months, providing much-needed support to already declining municipal revenues. İller Bank, however, did not postpone municipal loan repayments at first. Only after negotiations and a request from the Union of Municipalities of Turkey did İller change its policy and postpone municipalities' loan repayments for three months (TRT Haber 2020). This support was critical in preventing municipal service disruptions. However, İller did not subsequently increase municipal borrowing limits.

In June 2020, the Turkish public banks joined the 'Nefes Kredisi' campaign (which literally translates as "credit to take a breath"). This was initially launched by the Union of Chamber and Commodity Exchanges of Turkey and Denizbank (a private commercial bank). Turkish public banks have been instrumental in reopening the economy as policy-makers devised new retail loan campaigns on June 1 to stimulate the tourism, automotive and housing sectors. Framed as a 'New Support Package', these cheap credits mainly targeted household consumption. The package also included a specific loan for domestic small-scale producers that was supported by lower interest rates and required no repayments in the first six months.

On most occasions, the credit support to SMEs and households were provided via campaigns that included all three public commercial banks. A campaign or contribution to a programme related directly to public health has not occurred, since Turkish health authorities have preferred to paint a picture of success from the beginning of the pandemic. Still, public banks made generous contributions to the solidarity campaign launched by the Presidency. TRY 2.1 billion was amassed in the 'Biz Bize Yeteriz' solidarity campaign. The initiative was mainly a political manoeuvre to consolidate the AKP's electoral base. The CBRT donated TRY 100 million to the President's campaign;

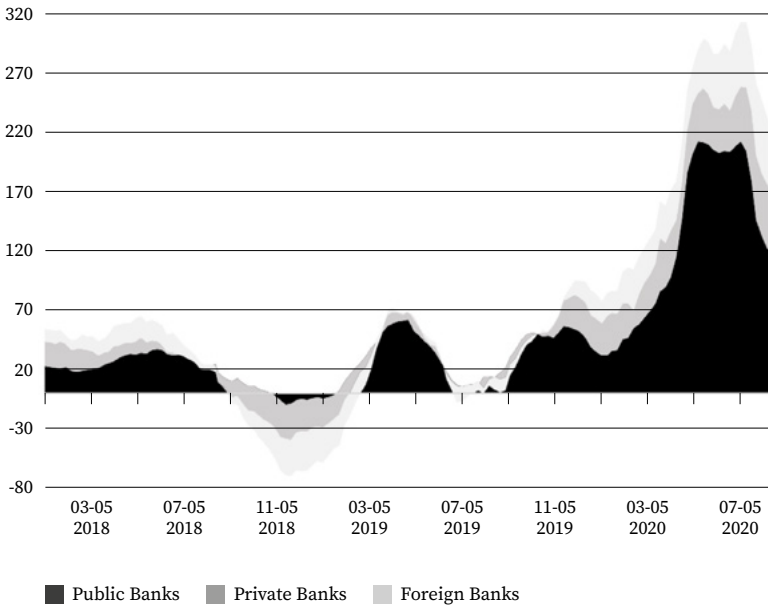
Ziraat gave TRY 62.3 million, Halkbank TRY 56 million and VakifBank TRY 50 million. According to the campaign's website, these donations have been added to the budget for social transfers.

The major support for export-oriented firms and new investment during the pandemic has been via the CBRT's revised credit programme. The TRY 60 billion credit to be extended for FX-earning industries was allocated as rediscount credits on March 31, 2020. Two months later, one-third of the credit was converted to investment credits to be provided by the Development and Investment Bank, with the remaining rediscount credit to come mainly from Eximbank (a public export-import bank) and the public commercial banks (CBRT 2020).

Although it was a contravention of the CBRT's law, the provision of these investment credits was promoted as a response to the pandemic and a new boost to Turkey's sustainable development policies. Once again, it was a continuation of the previous crisis management experience. Authorities had previously designed special financing opportunities for sectors producing intermediary goods (reportedly to minimize the current account deficit), using public banks to give export-oriented firms long-term loans in 2019 at favourable rates.

The BRSA revised banking sector regulations in April 2020 (and once again in May 2020) to promote further lending. Public banks were already conforming with the new asset ratio calculations, since they boosted credit volume from the beginning of the pandemic onwards. As a result of these policies and public bank actions, Turkey experienced the biggest credit expansion in its history in spring 2020 (see Figure 16.1). The speed of credit expansion led by the public banks was most striking in May and June. The credit volume of public banks increased from TRY 800 billion to almost TRY 1.1 trillion from mid-March to mid-August. During this period, TRY credit volume of public banks increased by 37%, while the ratio of increase was 17% in the case of private banks and 22% in the case of foreign banks. The increases in credits of private and foreign banks would have been much lower had it not been for the BRSA regulations to push more lending.

Figure 16.1 *Turkish Lira credit flow (quarterly change, TRY billion, January 2018 to August 2020)*



Source: BRSA (2018-2020).

In short, the main response to the economic slump was to foster credit expansion – something that has partially mitigated the 2020 slump. However, the participation of public banks in credit campaigns did not foster cooperation with other public service providers.<sup>7</sup> The institutions at the forefront of the fight against the pandemic did not take loans from Turkey’s public banks but applied to other

<sup>7</sup> Having said this, we can expect an increase of cases in which public service providers and the public banks jointly apply multilateral financial institutions for not only responding medical emergencies but also supporting post-slump recovery. At the time of writing, the Development and Investment Bank, with the backing of the Ministry of Treasury and Finance, applied for a US\$300 million loan from the Asian Infrastructure Investment Bank’s Covid-19 credit facility (Dünya 2020).

facilities in the spring of 2020. For example, the Turkish Health Ministry preferred to apply for a €200 million loan from European Bank for Reconstruction and Development (EBRD) to build a pandemic hospital in Istanbul and to finance purchase of ventilators and ICU monitors, and other emergency medical equipment (EBRD 2020).

## CHALLENGES AND PROBLEMS

The Turkish economy suffered severe damage in the 2018-19 crisis. Only by using public banks did authorities manage to mitigate the impact of the crisis for large segments of society. They have resorted to a similar strategy during the Covid-19 pandemic. Despite the success in providing temporary support and alleviating the economic slump by helping low-income households and SMEs, this strategy has had its down sides.

Apart from a few exceptional years, Turkey's public banks have consistently outperformed private banks in the post-2001 period (Marois and Güngen 2019). This seems to have changed in recent years. In both 2018 and 2019, the return on asset ratios of public banks (1.2% and 0.7%, respectively) remained significantly below the sectoral average (1.5% and 1.3%, respectively) (BAT 2019; BAT 2020). Turning public banks into cure-alls for Turkey's financial woes not only damaged their performance but also created new controversies. For example, public banks breached their legal limit of open foreign exchange position in July 2020. This stems from the recurrent use of public financial resources during the pandemic to slow down the Turkish Lira's depreciation. State authorities also started to use public banks in July 2020 to help the Treasury borrow in US dollars from the domestic market at lower interest rates. This represents a further restraint on public bank actions, since their resources are increasingly being directed to avoid short-term currency fluctuations rather than addressing health challenges or supporting new investments.

The public banks' greatest problem therefore rests in the undemocratic and unaccountable way in which they are allowed to function. Although the retail loan campaigns and loans that support industrial activity prevented financial distress for some households and SMEs, the risks assumed by public banks cannot be traced easily and discussed openly. The financial muscle possessed by these public institutions could have been used better to provide equity-centred responses. The basic needs credit, for example, opened the doors of the financial system to Turkey's low-income and informal labourers. Nevertheless, this was a sort of financial inclusion based on growing indebtedness despite the lower-than-market interest rates of the loans. In addition, the postponement of loan repayments and credit support to low-income households provide only a temporary solution. Although presented as elements of success in the fight against the Covid-19 pandemic, the financial support for Turkey's labouring classes has largely remained minuscule in comparison to relief packages in other countries. During the first five months of the pandemic, the capacity of the public banks has not been harnessed for equity-centred responses, but instead for state-sponsored credit expansion.

Both as a result of the 2018-19 economic crisis and the Covid-19 pandemic, public banks' non-performing loans have increased to historic proportions. This has not, however, resulted in immediate financial problems for the public banks, as the Treasury automatically compensates for the public banks' income losses each month. Nevertheless, the swelling losses led to dramatic increases in the amount of funds transferred: The income loss payments to public banks in March 2020 was three times as high as the payments of March 2019. The cash transfers from the Treasury jumped from TRY 1.9 billion (March-July 2019) to TRY 3.5 billion (March-July 2020), raising questions about the sustainability of the support provided by public banks to the economy in general.

The official owner of the public commercial banks, the Turkey Wealth Fund (TWF), injected TRY21 billion core capital in May into

them as previous loans and recurrent credit expansion was decreasing capital adequacy ratios. The TWF, whose capital injection helped it increase its ownership shares in Halkbank and VakifBank, declared this injection a part of its operations to support financial deepening and the prospective financialized use of Turkey's public banks. In that sense, the Covid-19 pandemic responses and the TWF's design may eventually lead to a further erosion in the social mandates of the public banks, barring a coordinated response by social forces. This might provide a new challenge to the credibility of public banks in the post-pandemic environment.

## CONCLUSION

During the Turkish economy's drift into new economic troubles after 2013, the political initiatives of AKP Governments have further chipped away at the historic social mandates of the country's public banks. While funding for huge infrastructure projects boosted economic performance, the achievement of high rates of GDP growth was eventually dependent on the tempo of capital inflows. After the coup attempt of 2016, and particularly during the 2018-19 crisis, AKP Governments (and from 2018 onwards, Erdoğan's presidential administration) committed themselves to bailing out indebted SMEs and kick-starting credit expansion. The makeshift arrangements did not increase the export capacity of Turkish firms or generate further employment, let alone reduce social inequality.

The uses of public banks during the first five months of the Covid-19 pandemic (early March to early August in the Turkish context) have not addressed health challenges. They also have not involved projects focusing on environmental and social issues. That said, we can speak of multiple uses of public banks in both the 2018-19 economic crisis and the 2020 economic slump. By using the public banks, the Erdoğan administration has attempted to stabilize the TRY, provide cheap credits (for both households and distressed



SMEs) and enhance a reportedly new developmental framework (to boost the competitiveness of the economy). The coming years will show whether the simultaneous pursuit of these goals and focus on repeatedly restarting credit expansion works as a strategy. It is still too soon to tell.

In the absence of a collective political will to reclaim Turkey's public banks, the social content defining the performance of these institutions has been shaped to a great extent by a combination of the AKP's political projects and economic survival attempts, as well as by structural global financial conditions. Echoing the AKP Governments' actions during previous crises, the Erdoğan administration succeeded in re-imposing financial discipline through new credit campaigns spearheaded by public banks and mitigating the negative social impacts of the 2020 slump at the same time.

In Turkey, the social content of public banking amid the AKP's economic policies pushed these financial institutions evermore towards responding to the credit needs of various social segments. However, it was this same push that allowed policy-makers to use public banks to nurture political alliances crosscutting various social segments. It was also this social and political environment that prevented the use of public banks' capacity to address more challenging issues such as environmental degradation and social inequality. The Covid-19 pandemic has highlighted this limitation in Turkey, as well as the effective use of public banks to offer temporary economic relief. A pro-public and democratic turn to public banking is required to turn this deteriorating situation around.

Current uses of Turkey's public banks provide no space for transparency and accountability mechanisms. The way public banks have been used in Turkey in recent years attempts to revitalize economic activity by offering cheap loans. The crisis atmosphere in which these institutions have operated in recent years makes it even more challenging to propose alternative and progressive uses for these institutions. However, public bank actions in Turkey during the Covid-19 pandemic showed the importance of democratizing public

banks' social content. There is an urgent need to reclaim public financial institutions, in a way that subordinates them to democratic decision-making and serves public interests. Their financial capacity should not only provide temporary relief to large social segments but should also be used for providing equity-centred responses during public health crises and economic turbulence.

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## Chapter 17

Ellen Brown

# COVID-19 AND PUBLIC BANKS IN THE UNITED STATES: A MOMENT OF OPPORTUNITY?<sup>1</sup>

**N**ew regulations introduced by the United States (US) Federal Reserve are intended to improve liquidity in the American economy as part of a set of Covid-19 economic relief measures at the federal level. The real winners from these changes appear to be private commercial banks, however, which have been taking advantage of new rules to lend to powerful institutions that are able to buy up assets at dramatically reduced prices. Cash-strapped states and local governments, meanwhile, are being told they will not be bailed out. However, the Federal Reserve changes also provide a remarkable opportunity for lower tiers of government to establish new public banks, with the aim of creating critical sources of funding for local authorities and businesses, offering a potential silver lining to an otherwise crushing Covid-19 experience in the US.

## INTRODUCTION

The US Congress seems to be at war with the states. Only US\$150 billion of its nearly US\$3 trillion coronavirus relief package – a mere

<sup>1</sup> This is an edited version of an article first published in Common Dreams (2020).

5% – has been allocated to the 50 states; and they are not allowed to use these funds where they are needed most, to plug the holes in their budgets caused by the mandatory shutdown. On April 22, 2020, Senate Majority Leader Mitch McConnell said he was opposed to additional federal aid to the states, and that his preference was to allow states to go bankrupt (New York Times, 2020).

No such threat looms over the banks, which have done extremely well in this crisis. The Federal Reserve has dropped interest rates to 0.25%, eliminated reserve requirements and relaxed capital requirements. Banks can now borrow effectively for free, without restrictions on the money's use. Following the playbook of the 2008-09 bailout, they can make the funds available to their Wall Street cronies to buy up distressed Main Street assets at fire sale prices, while continuing to lend to credit cardholders at 21%.

If there is a silver lining to all this, it is that the Fed's relaxed liquidity rules have made it easier for state and local governments to set up their own publicly-owned banks, something they should do *post haste* to take advantage of the Fed's very generous new accommodations for banks. These public banks can then lend to local businesses, municipal agencies and local citizens at substantially reduced rates while replenishing the local government's coffers, recharging the Main Street economy and the government's revenue base.

## A COVERT WAR ON THE STATES

Payments going to state and local governments from the Coronavirus Relief Fund under the CARES Act may be used only for coronavirus-related expenses. They may not be used to cover expenses that were accounted for in their most recently approved budgets as of March 2020. The problem is that nearly everything local governments do is funded through their most recently approved budgets, and that funding will come up painfully short for all of the states due to increased costs and lost revenues forced by the coronavirus

shutdown. Unlike the federal government, which can add a trillion dollars to the federal debt every year without fear of retribution, states and cities are required to balance their budgets. The Fed has opened a Municipal Liquidity Facility that may buy their municipal bonds, but this is still short-term debt, which must be repaid when due. Selling bonds will not fend off bankruptcy for states and cities that must balance their books.

States are not legally allowed to declare bankruptcy, but Senator McConnell contended that “there’s no good reason for it not to be available.” He said, “we’ll certainly insist that anything we borrow to send down to the states is not spent on solving problems that they created for themselves over the years with their pension programs” (Leo Weekly, 2020). And that is evidently the real motive behind the bankruptcy push. McConnell wants states put through a bankruptcy reorganization to get rid of all those pesky pension agreements and the unions that negotiated them. However, these are the safety nets against old age for which teachers, nurses, police and firefighters have worked for 30 or 40 years. It is their money.

It has long been a goal of conservatives to privatize public pensions, forcing seniors into the riskier stock market. Lured in by market booms, their savings can then be raided by the periodic busts of the ‘business cycle,’ while the more savvy insiders collect the spoils. Today political opportunists are using a crushing emergency that is devastating local economies to downsize the public sector and privatize everything.

## **FREE MONEY FOR BANKS: THE FED’S VERY LIBERAL NEW RULES**

Unlike the states, the banks were not facing bankruptcy from the economic shutdown; but their stocks were sinking fast. The Fed’s accommodations were said to be to encourage banks to “help meet demand for credit from households and businesses.” However, while the banks’ own borrowing rates were dropped on March 15 from an

already-low 1.5% to 0.25%, average credit card rates dropped in the following month only by 0.5% to 20.71%, still unconscionably high for out-of-work wage earners.

Although the Fed's accommodations were allegedly to serve Main Street during the shutdown, Wall Street had a serious liquidity problem long before the pandemic hit. Troubles surfaced in September 2019, when repo market rates suddenly shot up to 10%. Before 2008, banks borrowed from each other in the fed funds market; but after 2008 they were afraid to lend to each other for fear the borrowing banks might be insolvent and might not pay back the loans.

Instead the lenders turned to the repo market, where loans were supposedly secured with collateral. The problem was that the collateral could be 'rehypothecated' or used for several loans at once; and by September 2019, the borrower side of the repo market had been taken over by hedge funds, which were notorious for risky rehypothecation. The lenders therefore again pulled out, forcing the Fed to step in to save the banks that are its true constituents. However, that meant the Fed was backstopping the whole repo market, including the hedge funds; an untenable situation. So it flung the doors wide open to its discount window, where only banks could borrow.

The discount window is the Fed's direct lending facility that is meant to help commercial banks manage short-term liquidity needs. In the past, banks have been reluctant to borrow there because its higher interest rate implied that the bank was on shaky ground and that no one else would lend to it. But the Fed has now eliminated that barrier. It said in a press release on March 15, 2020:

The Federal Reserve encourages depository institutions to turn to the discount window to help meet demands for credit from households and businesses at this time. In support of this goal, the Board today announced that it will lower the primary credit rate by 150 basis points to 0.25% ... To further

enhance the role of the discount window as a tool for banks in addressing potential funding pressures, the Board also today announced that depository institutions may borrow from the discount window for periods as long as 90 days, prepayable and renewable by the borrower on a daily basis. (Board of Governors of the Federal Reserve System, 2020)

Banks can get virtually free loans from the discount window that can be rolled over from day to day, as necessary. The press release said that the Fed had also eliminated the reserve requirement – the requirement that banks retain reserves equal to 10% of their deposits – and that it is “*encouraging banks to use their capital and liquidity buffers* as they lend to households and businesses who are affected by the coronavirus” (emphasis added). It seems that banks no longer need to worry about having deposits that are sufficient to back their loans. They can just borrow the needed liquidity at 0.25%, ‘renewable on a daily basis.’ They do not need to worry about ‘liquidity mismatches,’ where they have borrowed short to lend long and the depositors have suddenly come for their money, leaving them without the funds to cover their loans. The Fed now has their backs, providing ‘primary credit’ at its discount window to all banks in good standing on very easy terms. The Fed’s website states:<sup>2</sup>

Generally, there are no restrictions on borrowers’ use of primary credit... Notably, eligible depository institutions may obtain primary credit without exhausting or even seeking funds from alternative sources. Minimal administration of and restrictions on the use of primary credit makes it a reliable funding source.

<sup>2</sup> Federal Reserve. The Primary & Secondary Lending Programs. <https://www.frbdiscountwindow.org/pages/general-information/primary-and-secondary-lending-programs> (accessed November 3, 2020).



## WHAT STATE AND LOCAL GOVERNMENTS CAN DO: FORM THEIR OWN BANKS

On the positive side, these new easy terms make it much easier for local governments to own and operate their own banks, on the stellar model of the century-old Bank of North Dakota (Mother Jones, 2009). To fast-track the process, a state could buy a bank that was for sale locally, which would already have Federal Deposit Insurance Corporation (FDIC) insurance and a master account with the central bank (something needed to conduct business with other banks and the Fed). The state could then move its existing revenues and those it gets from the CARES Act Relief Fund into the bank as deposits. Since there is no longer a deposit requirement, it need not worry if these revenues get withdrawn and spent. Any shortfall can be covered by borrowing at 0.25% from the Fed's discount window. The bank would need to make prudent loans to keep its books in balance, but if its capital base were to be depleted from a few non-performing loans, that too apparently need not be a problem, since the Fed is "encouraging banks to use their capital and liquidity buffers." The buffers were there for an emergency, said the Fed, and this is that emergency.

To cover startup costs and capitalization, the state might be able to use a portion of its CARES Relief Fund allotment. Its budget before March 2020 would not have included a public bank that could serve as a critical source of funding for local businesses crushed by the shutdown and passed over by the bailout. Among the examples given of allowable uses for the relief funds are such things as "expenditures related to the provision of grants to small businesses to reimburse the costs of business interruption caused by required closures," (US Department of the Treasury, 2020). Providing below-market loans to small businesses would fall into that general category.

By using some of its CARES Act funds to capitalize a bank, the local government can leverage the money by 10 to 1. Equity of

US\$100 million can capitalize US\$1 billion in loans. With the state bank's own borrowing costs effectively at 0%, its operating costs will be very low. It can make below-market loans to creditworthy local borrowers while still turning a profit. This can be used either to build up the bank's capital base for more loans or to supplement the state's revenues. The bank can also lend to its own government agencies that are short of funds due to the mandatory shutdown. The salubrious effect will be to jumpstart the local economy by putting new money into it. People can be put back to work, local infrastructure can be restored and expanded, and the local tax base can be replenished.

The coronavirus pandemic has demonstrated not only that the US needs to free itself from dependence on foreign markets by rebuilding its manufacturing base, but that state and local governments need to free themselves from dependence on the federal government too. Some state economies are larger than those of entire countries. Governor Gavin Newsom, whose state ranks as the world's fifth largest economy, has called California a "nation-state." A sovereign nation-state needs its own bank.

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## Chapter 18

Diana Barrowclough

# SOUTH-SOUTH PUBLIC FINANCE: A RAPID REVIEW OF COOPERATION AND RESILIENCE TO FACE COVID-19

**T**his chapter provides a “rapid review” of four major South-South public banks and public funds to give a flavour of how regional financial cooperation in the South is offering resilience in the face of Covid-19. It draws on the experiences of the Islamic Development Bank (IsDB), the Asian Infrastructure Investment Bank (AIIB), the New Development Bank (NDB) and the Latin American Reserve Fund (FLAR) to show how South-South public banks and public funds responded quickly to the Covid-19 crisis. These Southern-owned and Southern-led public financial institutions have not received the same attention as those from the world’s largest economies nor global public lenders like the World Bank and International Monetary Fund (IMF), but they are nonetheless making an important contribution to supporting countries in the South. Very quickly after the start of the pandemic, they upped their support to members, increasing the scale of finance available, broadening the scope of lending, adapting loan terms and conditions, and augmenting loan efficiency by facilitating country-to-country sharing of expertise, group procurement pol-

icies and partnerships with other firms, banks and governments. They have changed the definition of what constitutes an emergency and reappraised the role of social and human capital with respect to infrastructure. Their response to Covid-19 suggests that even more can be achieved in the future, if they continue to strengthen the strategic partnerships at the heart of South-South cooperation and use their solidarity to support moves towards a more inclusive global financial architecture.

## INTRODUCTION

South-South public banks and funds responded quickly to the Covid-19 crisis, scaling up the finances available and adapting their approach to help their members fight the economic and health impacts of Covid-19. The term South-South has come to denote forms of cooperation between developing countries such as regional or multilateral financial institutions where the majority ownership lies with governments in the South, the motivation is often one of ‘solidarity’ and the orientation of services is firmly with countries in the South. These Southern-led public financial institutions have not received the same attention as those from the world’s largest economies nor the global public lenders, like the World Bank and IMF. They are, nonetheless, making an important contribution to supporting the South. Very quickly after the start of the pandemic, these institutions upped their support to members – increasing the scale of finance available, broadening the scope of lending considerably, adapting loan terms and conditions, and augmenting loan efficiency by facilitating country-to-country sharing of expertise, group procurement policies and partnerships with other firms, banks and governments. They have changed the definition of what constitutes an emergency and reappraised the role of social and human capital with respect to infrastructure.

This chapter gives a brief “rapid review” of four major public banks and funds to give a flavour of how regional cooperation in the South is offering resilience in the face of Covid-19. This includes the Islamic Development Bank (IsDB), the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB) as Southern-led public banks that are profoundly changing the nature of the development finance landscape. It also includes the Latin American Reserve Fund (FLAR) as a foreign exchange reserve fund that helps its member countries withstand exchange rate fluctuations and balance of payments distress. It is not a bank, but it has many bank-like qualities. All these institutions have been part of the broader and most significant trend in the financial sector this century, whereby South-South banks, funds, credit swaps and bond issuances are bringing trillions of dollars and technical expertise to complement what is available through the Bretton Woods institutions, adding a new voice for the South that is more commensurate with its economic weight (Barrowclough et al. 2020). Their response to Covid-19 suggests that even more can be achieved in the future, if they continue to strengthen the strategic partnerships at the heart of South-South cooperation and use their solidarity to support moves towards a more inclusive global financial architecture (UNCTAD 2020a).

## **SOUTHERN NEEDS AND THE IMPACT OF COVID-19**

Developing countries have been the hardest hit by Covid-19 (UNCTAD 2020a, 2020b). They are especially vulnerable to the economic shock waves caused by the rapid fall in commodity prices, the collapse in trade, tourism revenues and remittances, and they typically lack the macroeconomic ‘automatic stabilizers’ of unemployment support and other social services found in richer countries. They also have under-resourced public health systems and limited provision of public water and sanitation, and less ability to pay the

rapidly rising prices of Covid-related medical supplies and equipment. This is not to say they are doing nothing, but compared to the advanced economies, their governments have less fiscal space with which to boost expenditure and their central banks have fewer options to boost liquidity without severely risking their currencies. Public development banks in the South are playing a role, but with much less fire-power and while struggling to meet a multiplicity of needs with lower levels of capitalization and less ability to raise funds on international capital markets on long-term and favourable terms.

Developing countries can of course turn to the legacy Bretton Woods institutions and these did quickly scale up their resources to meet the new Covid-19 needs. The IMF has pledged more than US\$1 trillion and the World Bank more than US\$27 billion (World Bank 2020a, 2020b). The major multilateral regional banks, such as the African Development Bank and the Asian Development Bank, have also announced special Covid support (while these banks may be Southern-oriented they are not described as South-South because they have a significant number of Northern countries as members and co-owners).

Many developing countries have turned to these global funders of last resort. Yet these Bretton Woods institutions have not scaled up nearly as much as has been needed. According to the Overseas Development Institute (ODI), lending by the World Bank, the AfDB and the ADB increased by only 29% in response to Covid, which is a much smaller magnitude than their response during the global financial crisis. Moreover, this increase is planned for only one year, and most lending has gone to middle-income developing countries with only 5% directed to the lowest-income countries with the greatest needs. Finally, these loans come with the same conditionalities and structural adjustments that are typical of World Bank or IMF lending, and of which many developing countries are already wary. There is a demand for Southern-led alternatives.

## RESPONSES OF SOUTHERN-LED PUBLIC BANKS AND FUNDS TO COVID-19

The many individual initiatives launched by South-South public banks and funds are beyond the scope of this “rapid review”. The following pages aim rather to highlight some of the experiences of four public banks – the Islamic Development Bank, the New Development Bank, the Asian Infrastructure Investment bank (AIIB) and the Latin American Reserve Fund. In doing so, it seeks to draw out elements that are particularly relevant for public banking in the Covid-19 context and beyond.

### **The Islamic Development Bank**

The Islamic Development Bank (IsDB) is a global Southern-led public bank and all of its 57 member countries are potentially eligible for its Covid-19 support package geared towards health and livelihood resilience. Announced in April, the package is worth US\$2.3 billion – just over a quarter of the bank’s average lending per annum. Arrangements were made quickly, and by May the IsDB had already made plans with 27 members, accounting for more than half of the total package, to cover loans, provide loan guarantees, support import finance, provide pre-export finances and to support health systems, food production and social safety nets.

The rapid response was financed mostly by a re-allocation of committed reimbursements, in particular the Reverse Linkages programme, which was suspended for 2020 and its funds re-tooled for IsDB’s Covid-19 (IsDB 2020). Another US\$1.5 billion was raised by the bank’s issuance of what it calls “the first ever Covid Sukuk” (an Islamic finance form of bond) and the rest arranged in partnership with other multilateral development banks. Notably, Sukuk bonds must have a tight integration between the funds raised and the real economic activities that underlie it, which in this case is healthcare, sanitation and making finance available for Islamic small- and me-



dium-sized enterprises. This response thus constitutes a somewhat different profile from the bank's usual lending, which is heavily oriented towards energy projects and with a smaller proportion going to finance, transport and agriculture. Since its inception, health services have accounted for just 3% of total IsDB approvals, so 2020 represents a big change.

The IsDB's Covid-19 package, called the Strategic Preparedness Response Programme, is divided into three pillars. The *Response* pillar focuses on fast disbursement of finances to pay for healthcare and facilities, and for food. An example is the loan of US\$36.6 million to Yemen. Of this, US\$20 million went to financing the setting up of 32 specialized Covid-19 treatment centres and to increasing laboratory testing capacity in two medical universities (including providing them with the medical equipment needed for treating severe cases of Covid-19 and providing personal protection equipment for health workers). As is typical with South-South lending (Barrowclough et al. 2020), technical support is a feature and in this case the IsDB created a partnership for the first time with the World Health Organization to help coordinate and support activities. This cooperation is significant given the extra difficulties inherent in Yemen, which was suffering problems of conflict, hunger, disease, displacement and economic collapse even before the pandemic. The IsDB Respond pillar is further supported through the Reverse Linkages division of the bank, which facilitates country-to-country cooperation between members to share expertise. For example, ministries of health and medical experts from Turkey, Indonesia and Malaysia have shared knowledge with other IsDB members alongside the flows of finance.

The second pillar, *Restore*, focuses more on medium-term investments to strengthen the health sector and economy more broadly, and in this case, IsDB interventions are directed to small- and medium-sized enterprises, and to trade in an effort to restore strategic value chains that were interrupted or blocked by the pandemic fallout. Finally, the third pillar, *Restart*, has a long-term focus on cat-

alyzing investment in infrastructure and enhancing value chains, notably aimed at attracting private sector partners.

In disbursing the loans, some IsDB funds fell under specific pillars while others involved all three pillars and multiple partners. Such is the case, for example, with the US\$30 million fund established for Senegal formed in collaboration with a reverse linkage programme that included technical cooperation and exchange of knowledge, technology and other non-financial resources with the private sector, and cooperative agreements with the United Nations Children's Fund (UNICEF) and other United Nations (UN) agencies to help with service delivery. Partnerships with governments are also on the table for IsDB Covid loans. The IsDB aims to provide Islamic financing instruments that can be coordinated and integrated with governments' fiscal policies to form social safety nets and other pro-poor policies.

### **The New Development Bank**

The New Development Bank (NDB) – formerly known as the BRICS bank of Brazil, Russia, India, China and South Africa – had to be flexible when Covid-19 struck as their existing policy framework did not support the special needs the crisis provoked among its members. When established in 2014, its mandate was to mobilize “resources for infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries, complementing the existing efforts of multilateral and regional financial institutions for global growth and development.” With an initial subscribed capital of US\$50 billion, the NDB became operational in 2016 and swiftly started to build a robust and diversified infrastructure portfolio, making headlines because of its big and fast lending to projects in member countries. However, Covid-19 related urgent needs did not fit its usual profile, requiring a change in approach.

In February 2020, the NDB announced its readiness to support its members against Covid-19 and gave its first Covid-19 loan to Chi-

na in March 2020 for CNY7 billion. This was financed in part by a special Coronavirus Bond issue, denominated in the local currency and was used to finance healthcare and local authority budgets for three regions of China. Because this loan did not fit the normal lending policy purpose, a special case waiver was needed. By April, a second special case waiver was needed to lend US\$1 billion to India. By this time, it was obvious that the Covid-19 pandemic and the impact of lockdown measures were going global. On June 10, the NDB announced a new Fast Track Covid Emergency Assistance Response Facility with up to US\$10 billion of financing available, divided into US\$5 billion earmarked for health and social assistance and US\$5 billion for economic recovery. A few weeks later it also announced a new emergency response protocol (see NDB 2020) so that subsequent loans to South Africa and Brazil did not need a waiver.

The changes in policy are interesting because they denote a new way of looking at “emergencies.” In the past, emergency referred narrowly to natural disasters or, in some specific cases, to post-conflict settings – both of which typically still required infrastructure-related project finance for physical reconstruction and restoring assets and reviving production. In the Covid-19 fallout, borrowers were needing assistance with relief and social assistance as well – needs that are usually part of government welfare or social support and for which the NDB was not primarily designed. As the Covid-19 disaster spread, the NDB had to change and adapt.

### **The Asian Infrastructure Investment Bank**

In the first days of March, the Asian Infrastructure Investment Bank (AIIB) announced a US\$5 billion Covid-19 Crisis Recovery Facility to help public and private sector clients manage through the pandemic. Like the NDB, the AIIB also widened the scope of its lending beyond the long-term infrastructure purpose for which it had been originally established in 2016. Within a month, requests from members for funding were so high that the AIIB doubled its Covid-19 facility to US\$10 billion.

The AIIB was clear about the need for rapid action that went beyond its initial infrastructure profile because of the lessons learned during the Asian and global financial crises. In these crises, investment in public gross fixed capital plummeted to just 2% of Gross Domestic Product (GDP) from highs of 6%, and the AIIB feared this would happen again due to Covid-19, setting back development momentum and gains thus far.

The AIIB saw a strong need to protect key infrastructure development at a time when private sector risk aversion would be high and as public capacity for investment was increasingly constrained. Covid-19 would undoubtedly put added fiscal pressures on government budgets. Based on its clients' feedback, the AIIB felt it was imperative to broaden the scope of its response and noted three key areas where its members needed help immediately: to alleviate healthcare pressures, through providing health infrastructure and pandemic preparedness; to provide liquidity, through on-lending facilities and credit lines to address working capital and liquidity shortages; and to ensure governments received immediate fiscal and budgetary support so they could focus on addressing the human and financial impacts of Covid-19 (AIIB 2020).

In order to meet these “urgent and extraordinary” needs, which are very different from the normal work of the AIIB, it was necessary for the institution to adapt and to work closely with other international financial institutions to create a network of support options, especially for the most vulnerable economies. It approved a range of measures to make it easier to “seamlessly” partner with other development banks (AIIB 2020). It also identified some priorities for future lending in the longer term, which in addition to the more conventional infrastructure and telecommunications services, included the need for proper health infrastructure such as clean water and sanitation, which were seen as key parts of health security and epidemic preparedness.

Without proper investments in public health infrastructure, developing countries will remain vulnerable to further outbreaks.

This was considered especially essential in the Asian context of megatrends towards urbanization and an ageing population. As is known, Covid-19 affects the elderly more than young people, and in Asia the number of senior citizens over 65 years old is projected to double within the next 20 years. According to the AIIB, “It is clear that health infrastructure needs to be expanded and the Covid-19 crisis further underscores this” (AIIB 2020). To this end, the AIIB has approved, among other projects, financing for many water and sustainable cities projects across Asia, and AIIB-funded water, sanitation and drainage infrastructure is already on track in Pakistan, Bangladesh, India and Egypt.

### **The Latin American Reserve Fund (FLAR)**

Finally, the Latin American Reserve Fund (FLAR) is also notable for its rapid response to the Covid-19 crisis. In April 2020, FLAR met with other regional financial institutions and the IMF to discuss responses to help its members in distress. Many countries in Latin America are dependent on commodity exports, for which prices had fallen sharply. Their economies were highly exposed to fluctuations in the US dollar. On top of this, many members have large populations and high levels of poverty, as well as under-financed health systems. By May, FLAR had borrowed significantly on international capital markets to augment its capacity to support members in need by 60%, taking its lending potential up to US\$6.8 billion without having to increase the subscribed capital of its members, as they had done in 2012. Compared to the FLAR’s two previous experiments with bond issuances, which totalled just US\$400 million, this is comparatively massive. It is also an important signal of solidarity, if only for the fact that, until now, the Fund historically carried zero debt (FLAR 2020).

The FLAR also significantly changed its terms on offer, reflecting the gravity of the pandemic and its impact. Before Covid-19, the rules were that Balance of Payments loans to members were limited to a maximum of three years with one additional year’s grace, and for a maximum amount of 2.5 times the paid-up capital of each

member (rising to 2.6 times in the special cases of member countries Bolivia and Ecuador). Since Covid-19 struck, FLAR has adjusted these parameters and the maximum loan per member rose to five years plus three years' grace – an extremely large change. This was made in recognition of the fact that the hit to productive capacity and to exchange rates throughout the region are not likely to recover quickly (FLAR 2020). Hence, the FLAR needed to enhance its support to member governments.

## CONCLUSION

This chapter has very briefly touched on some of the ways in which Southern-led banks and funds are working together to face the Covid-19 pandemic. The public financial institutions have contributed to the creation of a broader and more diverse range of Covid-19 relief options for Southern governments. In each case, the public banks and funds scaled up lending. Moreover, each institution provided the needed financing rapidly and on flexible and favourable terms. These public institutions notably lent directly to governments to provide essential breathing space in a time of crisis. In the process, the IsDB, NDB, AIIB and the FLAR showed the ability to adapt quickly and dynamically to changing needs and circumstances. Significantly, the scope of their lending shifted to include social support and non-physical infrastructure in ways that went beyond their conventional mandates.

These Southern public banks and funds demonstrate the capacity to play a meaningful role in facing the Covid-19 emergency. This is a signal they could have play a central role in building forward better for a green and just transition to sustainable development. They will each face constraints and challenges in doing so. Still more finance is needed, and there is the continued paradox of a glut of surplus finance in some parts of the world and a shortage in others. Another challenge is that, once the Covid-19 crisis

has passed, it will be important that their performance evaluators, their government owners and the public in general properly value the social and developmental lending these institutions have undertaken in response to the pandemic. Profitability or returns on assets in conventional terms will have little utility in building forward better. At the same time, as ever, these public institutions should not be idealized. Public banks can only be as good as their members and society makes them be. Substantive accountability and transparency will be important in the post-Covid reckoning that is sure to come.

Finally, while South-South initiatives can do a lot to provide some relief and support for recovery, they cannot do it alone and cannot be expected to substitute for what else is needed – which continues to be a better financial system globally, and with true multilateral support. The experiences briefly described in this review hint at what could be done in terms of international coordination and cooperation for the future crises that are inevitable, and to help ensure a better recovery for the next time.

## ACKNOWLEDGEMENTS

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## Chapter 19

Association of African Development Finance Institutions

# THE IMPACT OF COVID-19 ON AADFI MEMBERS<sup>1</sup>

**T**his chapter summarizes actions taken by the Association of African Development Finance Institutions (AADFI) to combat the economic impacts of Covid-19, as of April 2020. AADFI has 60 member institutions throughout Africa.

## INTRODUCTION

Covid-19 has presented great health and socio-economic challenges across the globe. Its impact will be more precarious in emerging and developing countries, particularly in Africa, given the continent's weak health infrastructure and poor development indices – high unemployment, fragility and social unrest. The Covid-19 pandemic will, therefore, constitute a big challenge towards achieving the Sustainable Development Goals (SDGs) in Africa.

Unsurprisingly, the capacity of African Development Finance Institutions, particularly the National Development Finance Institutions (NDFIs), to provide solutions to the numerous development

<sup>1</sup> This is an edited version of a report originally published by the Association of African Development Finance Institutions (AADFI) in April 2020. It is available online at: <http://www.adfi-ci.org/>. Reproduced with the permission of the AADFI, Abidjan, Côte d'Ivoire.

challenges of the continent has been further weakened as the pandemic compounds their existing challenges.

It is on this premise that the Association of African Development Finance Institutions (AADFI) surveyed African NDFIs to ascertain the impact of the pandemic on their operation and what solutions could be provided.

## **CONSEQUENCES OF COVID-19 ON NATIONAL DFIS (NDFIS)**

### **Macroeconomic effect**

Most African countries will grapple with their financial positions as revenue earning nosedived in the wake of the pandemic. For instance, the crash in oil price from over \$60/barrel at the beginning of the year to under \$30/barrel as a result of Covid-19, and the decline in commodity prices, have both led to a huge shortfall in the revenue of commodity exporting countries. Generally, most member countries would face revenue challenges to finance their budget and fight the pandemic.

Moreover, as these countries grapple with supply and demand shocks, decline in travel, investment and remittances, inflation is likely to spike in the short term, with a fall in the value of their currencies. This may result in the high cost of funds, liquidity constraints, challenges in mobilizing suitable financing and incapacitation of National DFIs to lend or fund the completion of projects.

Furthermore, there would be a stoppage in production, and a likely tendency of most economies to slip into recession, with the disappearance of several small businesses and the emergence of high levels of corporate debt. The consequences of these will manifest in job losses and high unemployment, and worsened social unrest in most African countries.

### **Re-direction of funds meant for DFIs by the government**

As countries contend with the huge financial resources required to

fight the Covid-19 pandemic in the face of a liquidity squeeze, most African governments are redirecting resources meant for development projects to the health sector to help mitigate the pandemic. This further deprives the NDFIs of the funding that would have gone towards financing micro-, small- and medium-sized enterprise (MSME) projects and creating jobs.

Consequently, NDFIs will face higher business risks, a reduction in business opportunities and a decline in operation due to the shutdown of MSMEs' business activities, a scaling back of business growth plans and lower profit margins, if not outright operating losses for the current financial year. Furthermore, NDFIs will witness drastic shrinking in their balance sheet and pressure to redirect their existing funding portfolio towards responding to Covid-19.

Despite the above constraints, National DFIs would still be expected to play a countercyclical role and support their governments to develop effective fiscal and business stimulus packages.

## CONSEQUENCES FOR NDFI'S LENDING ACTIVITIES

### **Lower-investment inflow**

There will be a slowdown in business activities, thus reducing the level of investment inflow and leading to a contraction in NDFIs' projected earnings. Nonetheless, a greater shift in DFIs' financing priorities to agriculture, medical and pharmaceutical products is expected.

A possible decrease in the number of requests for new credit will eventually hinder DFIs' contribution to job creation. In addition, challenges related to restrictive measures, impacting directly on specific sectors funded by some national DFIs – such as catering, transport, hotels, trading and other small businesses – will all translate to massive job cuts.

### **Funding and liquidity challenges**

It is unlikely that governments will channel funds to DFIs for fi-

nancing MSMEs in the near future, as governments' priorities have shifted to fighting the pandemic. The level of funding from development partners targeting job creation in Africa may shrink.

With the challenge of a funding shortages, most DFIs will be forced to scale down lending activities (credit rationing) and funding shortages for ongoing projects leading to time and cost overruns, as well as increased risk of project failure; and lower profitability of operation due to a lower volume of lending activities and possible provisioning on classified loans.

As most businesses funded by NDFIs struggle for survival, supporting these businesses may also increase the risk on DFIs' liquidity – the prudential limit being breached with a significant constraint on the capacity to offer financial support on the scale that will likely be required to help economic recovery.

It is expected that most DFIs providing guarantees may face a certain risk of cascading calls on guarantees for projects in progress and previously approved. Also, in a context of strict limitation on granting new credits at the level of lending banks, guarantee requests addressed to guarantee institutions will be rare.

### **Deterioration in asset quality**

As businesses and projects funded by DFIs get stressed, and in a good number of cases some projects will halt, it is envisioned that most DFIs will face the risk associated with cash flow cycle, decline in revenues and high default rates in loan re-payments in the coming months, based on business analysis and payment deferment. Thus, the anticipated surge in Non-Performing Loans is projected to be about 60% arising from the MSME difficulties in servicing their loans.

Moreover, a decrease in return on DFIs' assets, an increase in counterparty risk, an increase in the level of provisions induced by the outstanding payments recorded, resource scarcity (fewer opportunities to access resources at moderate cost) and poor project financing capacity will be evident. The impact of these will weaken

the viability of projects under implementation, and negatively affect most DFIs' profitability and financial sustainability.

### **Business operation and business continuity**

The risk of exposure of staff to Covid-19 and the need to adopt protective measures in line with the established protocol will redefine the way DFIs operate henceforth. Already, as in most institutions, there is a re-configuration of the approach to working in terms of flexibility and teleworking.

The situation will also result in a change in client and staff engagement models and possible delays in project evaluations and diligences due to travel restrictions, especially for national DFIs with cross-border projects.

## **AFRICAN NATIONAL DFIS RESPONDING TO COVID-19**

Therefore, African DFIs should take their response to the pandemic as a measure of their strengths and weaknesses in designing innovative development products.

Business strategies and processes are being revised in most national DFIs in the wake of the disruptions brought by the pandemic. This includes a review of the contingency plan and re-engaging with stakeholders, including existing clients, to understand the expected impact of the pandemic on their activities. The result in most cases indicated that at least 40% of clients expect the current challenges to impact their ability to meet upcoming debt obligations. Thus, NDFIs are reviewing their clients' liquidity position and evolving a payment deferment for up to six months and above.

Some institutions have incorporated the impact of Covid-19 into their short- and medium-term strategy. They have created a dedicated fund for Covid-19 to support the financing of business in the health industry and to facilitate the procurement of essential supplies and finished goods specifically geared toward mitigating Covid-19.

### **Protection of employees**

All member DFIs took proactive measures to keep employees safe and have implemented a business continuity plan, as work is now mostly done remotely.

### **Downward revision of budget**

The cut in business activities and expected negative impact on cash inflow have compelled most NDFIs to review their operating budget downward, with up to a 30% slash across the board; and to reduce their total expenditures by up to 25% in the first instance, with a view to adopt further cuts in other non-critical expenses depending on macroeconomic outlook over the next three to six months.

### **Portfolio review**

Portfolios have also been revised to establish anticipated credit risks per sector and per client to devise survival strategy, activate contingency funding plans and explore the possibility of getting funds to absorb the effects of Covid-19.

Besides, projects are being prioritized with an emphasis on strong financial viability and, in some cases, on a less risky asset to optimize limited financial resources. Some projects may have to be sold off, according to some DFIs, to reduce financial stress and create the capacity to complete the most viable projects.

### **Review of credit term**

Most institutions have revised credits terms to about a 180-day moratorium on existing credit facilities for households (extendable to 360 days) and other loan conditions relaxed to ease affordability challenges as a proactive measure to avoid loans going bad.

NDFIs are reengineering their balance sheet projections while also requesting their lenders to grant a moratorium to cushion the liquidity impact.

DFIs are, however, expected to apply the instruments of debt relief selectively to reward their historically well performing clients

and thus to reduce the impact of the pandemic on the present and future NPL Ratios. As bad as the situation is, stronger DFIs may also be shaken, but the pandemic should *not* lead to the demise of DFIs.

The pandemic creates an opportunity for DFIs to prove their relevance to governments in Africa through strategic planning and the introduction of innovative approaches to the delivery of their mandates.

## **SUPPORT REQUIRED BY NDFIS IN ADDRESSING COVID-19 CHALLENGES**

- Concessional debt funding, grants, provision of credit guarantee, liquidity support and a downward review of the term for credit lines obtained from multilateral banks in order to rescue businesses, support projects in the agricultural (transport, production, storage, energy, seed distribution, road maintenance) and pharmaceutical sectors to save existing businesses and jobs.
- The need to engage with governments for capital injections into national DFIs, channel development funds and funds provided by development partners through the national DFIs to be directed to appropriate sectors to stimulate economic activities.
- A waiver on limitations to the restructuring of credit facilities that may be at risk; temporary capital and liquidity relief to provide DFIs with enough time to build up capital buffers; and a postponement of compliance requirements such as single obligor limits for one year.
- The need for relevant technical assistance and capacity building in the following areas, among others, are required to reinforce capacity in member institutions:
  - Business Continuity Plan (BCP).
  - Stress testing framework covering finance, technology,



risk management etc.

- Crisis management and risk assessment during crisis for DFIs.
- Fintech, digital banking and management of remote teams.
- The need to share knowledge across institutions, during and after the crisis, on how DFIs are responding to ensure the survival of the funded MSMEs and institutions.
- National governments should take their DFIs into confidence by involving them in development policy formation, passing special financial support to businesses through them as part of measures to institutionalize such support and equip DFIs for future response to emergencies.

## Chapter 20

Association of Development Financing Institutions  
in Asia and the Pacific

# THE IMPACT OF COVID-19 ON ADFIAP MEMBERS<sup>1</sup>

**T**his chapter summarizes actions taken by the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) to combat the economic impacts of Covid-19, as of August 2020.

ADFIAP is the focal point of all development banks and other financial institutions engaged in the financing of development in the Asia-Pacific region. Its mission is to advance sustainable development through its members. Founded in 1976, ADFIAP currently has 87 member institutions in 36 countries.

## INTRODUCTION

Like many organizations during this pandemic, the Association of Development Financing Institutions in Asia and the Pacific

<sup>1</sup> This is an edited version of a report prepared by the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) Secretariat's Information Office in August 2020. Founded in 1976, ADFIAP currently has 87 member institutions in 36 countries and territories with its permanent Secretariat in Makati City, Metro Manila, Philippines. Reproduced with the permission of ADFIAP.

(ADFIAP) has been following and monitoring the evolving situation on the impact of Covid-19 on our members and their respective countries. As an association, our approach to meeting the challenges brought about by this crisis was two-fold: (a) *internally*, to strengthen the capability of the Secretariat team; and (b) *externally*, to sustain our interaction with our members and the community we are in during these trying times.

## ADFIAP INTERNAL INITIATIVES

Internally, the initiatives we have undertaken revolve around four Ps (4Ps), as follows:

1. *Pivot to digital*: We have beefed up our operational and member communication capabilities. Operationally, we have accelerated using a cloud-based platform for membership engagement and events management. We took an inventory of our unique content with the intention of converting this into e-learning and certification programmes. For member communications, we used various platforms for our virtual events (e-meetings, webinars, e-conferences), e-newsletters, emails, surveys and technical support efforts.
2. *Partner to hit the ground running*: We quickly partnered with our members and other same-purposed organizations to deliver online training and knowledge-sharing programmes. This gave us a fast track to offer virtual events to our members in a short time while we gain more experience and build our own capability in this regard.
3. *Pump-prime staff for up-skilling*: We have provided our staff with the opportunity to add new skills alongside our move to digitalization. Our goal is to undertake staff training sessions on creativity, critical thinking and cognitive flexibility – disciplines that require an open mind and passionate determination to succeed in this ‘new normal’ environment.

4. *Plan for a turnaround*: We have gone back to the basics of thinking of our members first – maintaining relevance, harnessing relationships and sustaining resources. *Relevance* is about sticking with our purpose, mission and unique value proposition. *Relationship* is about building and nurturing engagement with our members. *Resources* (human and financial) are about pursuing new opportunities and generating revenues. As we say, we need to be ‘in the trenches’ with our members during this crisis.

## ADFIAP EXTERNAL INITIATIVES

Externally, the initiatives we have undertaken are as follows:

1. We have *surveyed* our members on what they are doing/have done during the pandemic, which we have compiled in two special edition e-newsletters on Covid-19 and which were disseminated to members and other stakeholders.<sup>2</sup>
2. We have *organized* and *partnered* with our members and in other networks for at least 20 virtual events to date (webinars, e-forums, etc.) for members on various relevant issues and topics revolving around Covid-19.
3. We have provided *voice* and *visibility* to the association and our members in various international forums regarding their work on Covid-19 responses as well as on their contributions to the achievement of the United Nations Sustainable Development Goals (SDGs) and the climate agenda.
4. We have *communicated* and *worked* regularly with our regional counterpart development finance institutions (DFI) associations covering Africa, Latin America and the Middle East under the World Federation of Development Finance Institutions (WFDFI) on information exchange and practice-sharing activities.

<sup>2</sup> Available online at: <https://www.adfiap.org/resource/publications/>.

## **NATIONAL DFIS' RESPONSES TO CALLS FOR ACTION DURING THE PANDEMIC: THE ADFIAP EXPERIENCE**

The Covid-19 pandemic has pushed the world economy towards recession. As a stop-gap measure, national governments have introduced liquidity measures to keep their economies moving. Since this was not enough to produce a sustained economic recovery, national development finance institutions (NDFIs) have stepped up efforts to help in the rebuilding and recovery process. Such is the experience of ADFIAP member NDFIs.

The countercyclical role of NDFIs in financing development initiatives was apparent through the relief packages that they have undertaken. NDFIs also provided sector-specific financing stimulus to micro, small and medium-sized enterprises (MSMEs), to local governments, as well as to the health and education sectors. With business activities and employment rate on the decline, loan payment holidays and other relief measures were also instituted by NDFIs. Below we highlight what ADFIAP member NDFIs have undertaken to face the health and economic crisis upfront and prepare for its aftermath.

### **Stimulus assistance to micro, small- and medium-sized enterprises (SMEs)**

The Business Development Bank of Canada (BDC) has mobilized up to US\$40 billion in additional lending and guarantee programme support to help ease access to credit for entrepreneurs impacted by Covid-19. The BDC also provided additional relief measures for qualified businesses of up to \$2 million working capital with flexible terms and payment postponements for up to six months and reduced rates on new eligible loans.

Similarly, the Land Bank of the Philippines (LANDBANK) launched a loan programme for small and medium-sized enterprises, microfinance institutions and cooperatives to recover from the

adverse effects of the Covid-19 pandemic. Through the 'I-RESCUE' (Interim Rehabilitation Support to Cushion Unfavorably-affected Enterprises by Covid-19) Lending Programme, LANDBANK provides assistance through credit and loan restructuring under more flexible terms and conditions.

In the Philippines, the Small Business Corporation (SB Corp) has set up a PHP 1 billion Enterprise Rehabilitation Financing facility for micro and small businesses.

For its part, the Small Industries Development Bank of India (SIDBI) provided liquidity support to MSMEs impacted by Covid-19 through conduit microfinance institutions to ensure operational continuity and to promote onward lending to the MSME sector.

Tekun National Malaysia has crafted the 'Tekun Business Rehabilitation Scheme' (TBRS), a financing scheme offered to microenterprises whose businesses were affected by the Covid-19 pandemic.

### **Strengthening MSMEs**

The DFCC Bank of Sri Lanka and the Ceylon Chamber of Commerce (CCC) jointly organized a webinar entitled 'Banking Services and Solutions for Business Recovery Offered by DFCC Bank During and After Covid-19' to financially guide small and medium-sized enterprises (SMEs) through the current pandemic, and to help SMEs identify relevant gaps and challenges. The Esquire Financing in the Philippines offered tips for small businesses to overcome Covid-19 and suggested some strategies for SMEs to maintain financial health during the pandemic.

### **Boost to the local economy**

Indonesia's PT Sarana Multi Infrastruktur has made a loan of IDR 1.4 trillion available to the West Java Provincial Government in order to restore the West Java economy affected by the Covid-19 pandemic.

### **Support to the health sector**

The China Development Bank has adopted a multi-pronged ap-

proach to combatting Covid-19 by providing more than CNY 20 billion in emergency loans for epidemic prevention and control, offering a special working capital loan facility to help epidemic-affected enterprises resume work and production, and by supporting the country in combating the pandemic while bolstering economic and social development.

Likewise, the Development Bank of the Republic of Belarus has provided financial assistance to the Republican Medical Response Organization Center for the purchase of medicines, medical devices, medical equipment, personal protective equipment and so on. The Development Bank will continue to support healthcare organizations to ensure a healthy environment for everyone.

The KfW of Germany has financed over 320,000 Covid-19 tests and the purchasing of other medical equipment for the Indian health system to a total sum of €15 million to help effectively contain the pandemic on the subcontinent.

The Islamic Development Bank (IsDB) partnered with the United Nations Office for Project Services (UNOPS) to support IsDB member countries in combatting Covid-19 through emergency procurement services of medical supplies and equipment.

The Royal Insurance Corporation of Bhutan Ltd. has offered life insurance of Nu 100,000 to those in the frontline who may lose their lives fighting Covid-19.

### **Assistance to the education sector**

The Land Bank of the Philippines has offered a direct ‘study-now-pay-later’ student loan programme for Covid-impacted families. Under the loan programme, parents and guardians/benefactors of students enrolled for the upcoming school year can now directly apply for loans of up to PHP 300,000 to cover students’ tuition. On the other hand, the personnel of the Al-Amanah Islamic Investment Bank of the Philippines has extended assistance to stranded students for their food and other basic needs during the pandemic.

### **Relief on loan payments**

Cognizant of the difficulty that their clients are faced with during the pandemic, the following NDFIs have provided a moratorium on loan payments and provided other relief measures:

Agrobank (Malaysia), Bhutan Development Bank, Bhutan Insurance Limited, CARD (Philippines), Development Bank of the Philippines, Fiji Development Bank, National Pension and Provident Fund of Bhutan, North Eastern Development Finance Corporation (India) and Pag-IBIG Fund (Philippines).

### **Push for digital banking**

The Land Bank of the Philippines has urged its clients to use the Land Bank's electronic and digital platforms to serve banking needs while the country is under a state of calamity due to the pandemic. Convenient banking can be enjoyed through use of the Land Bank's 2,196 ATMs and 159 Cash Deposit Machines nationwide, including online and electronic banking services, and cashless payments through Land Bank Mastercard credit card and Visa Debit Card.

## **LOOKING TO THE FUTURE**

Looking ahead to the 'new normal', NDFIs need to be prepared in crisis management with continuous development and updating of recovery options linked with their liquidity position to ensure solvency. As the financing business shifts away from traditional concepts, data and real-time information-driven analytics will now be the backbone of the new operating model of NDFIs.





## Chapter 21

European Association of Public Banks

# EAPB STATEMENT ON THE ROLE OF PUBLIC BANKS IN THE CONTEXT OF THE COVID-19 CRISIS<sup>1</sup>

The European Union (EU) has been quick to react, thanks to its experience with the 2008/09 financial crisis, by effectively loosening the rules on national spending. However, it must be ready to organize a long-term response to the Covid-19 crisis. After easing the lockdown restrictions and starting up the economy in most of the EU countries, economic activity is still low. In addition, many companies still need liquidity to start their business again. Others will need a re-capitalisation to maintain their business. Once the first phase of the crisis is overcome, fiscal financial stimulus will also be required over the recovery phase.

All EU resources of the Next Generation EU and the next Multi-annual Financial Framework (MFF) need to be mobilized to ensure a quick recovery while putting the European economy on a sustainable path. Despite the huge costs stemming from the immediate need to recover from the Covid-19 crisis, the EU should be careful not to cut investments in those sectors, which are very important for the future of the EU. It is also crucial to provide local authorities

<sup>1</sup> This is a revised report written by the European Association of Public Banks (EAPB) on the Covid-19 crisis, first published in July 2020, and reproduced with the permission of EAPB. The EAPB has 91 member institutions in the region.

and small- and medium-sized enterprises (SMEs) with the funding they need in a long-term perspective.

The network of European, national and regional promotional banks and municipal funding agencies has been an essential asset in dealing with the economic consequences of the Covid-19 pandemic. Because of the complexity of the situation and the different needs, National Promotional Banks (NPBs) are uniquely equipped to provide the necessary mix of financial products and associate the private sector. About €1 trillion of public support measures have been provided by public promotional banks.

The unprecedented challenges that the European economy is facing must be tackled with all available means and tools at our disposal, ranging from public grants, subsidized loans to guarantees, equity measures and moratoria on loans.

The European financial sector will emerge from the Covid-19 crisis with more non-performing loans and weaker capital and liquidity positions. Consequently, the normal regulatory framework should not be reintroduced without appropriate transition periods in order to allow banks that have taken advantage of the capital relief to support the real economy sufficient time to rebuild their capital.

## INTRODUCTION

The Covid-19 pandemic is a shock of unprecedented magnitude and uncertain duration. Many fear that the supply shock in a big part of the economy, coupled with a broader demand shock, could trigger a contractionary spiral. Financial relief to businesses is essential – both to allow them to cope during the period of lockdowns and social distancing, and to ensure that they recover afterwards.

This is why this emergency situation has called for unprecedented credit guarantees provided by governments to make sure banks keep lending. It is, however, clear that, due to the unusual nature of the shock, it will often irreparably damage small businesses and

other parts of the economy, e.g. the retail sector, cultural and creative industry, tourism and so on. Even subsidized loans may be too much of a future burden for small firms to maintain employment if they face the consequences that periods of (nearly) complete shut-down bring about. In these cases, equity or grants are also necessary, either to bridge the crisis or to restructure the company if it fails to limit social hardship through public aid.

## IMMEDIATE EU RESPONSE AND NPB COORDINATION

While the main financial power remains at the level of national governments, especially those of the largest Member States, it is important to recognize the speed with which the European Commission has reacted to mitigate the economic consequences, e.g. by quickly cutting down EU-level restrictions by activating the suspense clause of the Stability and Growth pact, by introducing a temporary state aid framework allowing for larger support of companies with Member State coffers, and by introducing temporary changes in regulation to promote incentives for credit expansion via the Capital Requirements Regulation (CRR) quick fix.

To be able to react with such speed, the EU has benefited from its experience with the 2008 response to the financial crisis. The second advantage compared to the 2008 financial crisis has been the well-established cooperation framework of European, national and regional promotional banks and funding agencies. Additionally, the Juncker Plan has been implemented to create growth and is to be followed by InvestEU, with a crucial participation of NPBs. All this has created synergies, joint procedures and (often digital) communication channels that can be used in the current crisis. Within days the EAPB organized multiple exchanges with all important actors and helped build and deploy the necessary instruments.

Building on past experience, the European Investment Bank (EIB) Group has quickly mobilized available European Fund for

Strategic Investments (EFSI) funding, to be deployed in close cooperation with NPBs. This was complemented by the re-direction of unused EU Structural Funds, taking up the advice of NPBs on how to cut administrative burden in record-speed legislative procedures, together with the European Parliament and Member States.

## **ROLE OF PUBLIC BANKS IN THE COVID-19 CRISIS**

Because of the complexity of the situation and different needs, NPBs are uniquely equipped to provide the necessary mix of financial products and assist the private sector. Benefiting from the quick adaptations of the EU, the national and regional promotional banks and funding agency members of the EAPB have taken measures in response to the Covid-19 crisis, fulfilling their role as counter-cyclical state instruments. Their high-level intervention capacities have been fully available to participate actively in Europe's economic recovery.

National governments and promotional banks, together with commercial banks, have worked hard within the joint on-lending system over the last months to ensure the supply of credit to the economy – from SMEs to large companies. All parties involved have also worked to ensure that self-employed persons would be able to benefit from aid. By considerably expanding certain well-established programmes and procedures, banks have rapidly made available support for the financing of enterprises in temporary difficulties.

Investments – and above all working capital – can now be financed by the intermediary banks in a speedy process, while promotional banks were able to lower interest rates significantly. We believe the schemes are fulfilling their counter-cyclical function. In many cases, promotional banks disbursed funding directly to beneficiaries. Many of our members have made use of the possibility of a 100% guarantee coverage for the immediate provision of working capital loans, in order to respond to the request by the intermediary

banking sector to minimize its risk exposure. Almost €1 trillion has been made available to be distributed by NPBs (a total of about 3 trillion Euros of aid measures – all public support measures included – has been notified to the European Commission (EC) as of end July 2020). That is, about a third of total public support measures have been provided by public promotional banks (see Annex 1 for specific individual NPB schemes notified).

All public bank members, be they promotional or commercial, have moreover played an important role by putting in place key measures: maintaining physical access by keeping large number of branches open; enabling online requests for payments and interest deferrals; increasing account limits to maintain customers' solvency; and finally, providing enterprises with in-depth advice on liquidity, financial planning and subsidies.

## PHASE OF RECOVERY PRIORITIES – NEED FOR LONG-LASTING REGULATORY ADAPTATIONS AND TARGETED EU ACTION

Once the first phase of the crisis is overcome, financial stimulus will also be required over the recovery phase. After easing the lockdown restrictions and starting up the economy in most of the EU countries, the economic activity is still low. And many companies still need liquidity to start their business again. Others will need a re-capitalization to maintain their business. Therefore, the EU and Member States will need to continue to stimulate employment and economic activity, without aggravating health-related risks.

### **Priority 1: New MFF/Next Generation EU Recovery instrument: Need for strong funding mechanisms for companies and public sector investment for the sustainable and digital agenda**

EAPB members welcome the new EC proposal for the Multiannual Financial Framework (MFF) and the agreement of the European Council from 21 July 2020. The agreement by Heads of State on the

creation of the Recovery Instrument, with a mix of loans and grants totalling €750 billion, is a historic move for the EU. However, despite the huge costs stemming from the immediate need to recover from the Covid-19 crisis, the EU should be careful not to cut investments in those sectors that are very important for the future of the EU. We advocate a rapid conclusion of the negotiations on the MFF, the rules concerning Structural Funds/Cohesion policy and on an ambitious InvestEU Programme. It is essential to provide both legal certainty and adequate funding for the 2021-2027 programming period – not only for promotional banks but also for the final beneficiary. Due to the lockdown restrictions, many projects are delayed or more support is needed.

In order to really be capable of supporting the recovery, the EU budget should be *made more investment oriented*. Now is the right time to do even more in the areas of, for example, infrastructure, energy, innovation and mobility. Promotional banks should be enabled to continue support programmes set up with the help of Structural Funds and EU guarantee facilities – under COSME, InnovFin and EFSI – also after 2020 in order to ensure continuity and reliability in support. The InvestEU financial products should offer adequate flexibility (for example, in terms of risk assumption or scope) and allow for combination with other funds. This will enable intermediaries to offer tailor-made solutions in line with different needs of final beneficiaries following the crisis.

The focus has been rightly put on SME financing (and in justified cases larger companies) as those were the first economic victims of the Covid-19 crisis. It was important for the EU to reallocate all available funding to short-term liquidity aid to European firms (e.g. working capital, credit lines). For the recovery fund now to be a success, *the access to liquidity for SMEs must be maintained and operationalized in an unbureaucratic and timely manner*, using proven cooperation partners and distribution networks. In this perspective, we have very much appreciated the intention to include national promotional banks in the envisaged pan-European guarantee fund operations. Any new

funding and EIB Group operations must be developed in close cooperation with the national and regional promotional banks and funding agencies in the respective Member States in order to ensure the highest possible impact and additionality. Moreover, the new products should be complementary to existing ones and avoid the crowding-out of financial support programmes at national/regional level.

Also, while businesses, and in particular SMEs, have been a natural target for support measures during the first phase of the crisis, *the public sector* must be taken on board over the months to come in strategic recovery planning. In the medium to long term, keeping the public sector up to speed will be a crucial key to pushing the recovery forward. With the public sector going into a savings or even austerity mode, many of the positive dynamics may be lost. Therefore, finding the right balance between the private and public sectors in the allocation of resources will be a very delicate task. If we do not get this right, the recovery will suffer. We now hear from a number of municipalities and regions across Europe that they would be happy to execute and even reinforce existing investment plans. Investment needs are immense and diverse: immigration, demographic change, urbanization and the green transformation are just a few examples. We expect lending to municipalities and regions to continue to increase sharply over a number of years. However, if they were to get into financial difficulties – for example, if the national government does not compensate for Covid-19 related income losses (in particular due to the loss of business taxes) and added expenditures – the investment plans would quickly be delayed or even rendered unviable. This would in turn be very negative for the economy as a whole. Therefore, *quick compensatory injections into the budgets of municipalities and regions* are crucial at this point in time to ensure their continued investment capacity. Public banks and municipal funding agencies will play their role in this area as well.

The funding priorities mentioned above will also require further *adaptations to State aid regulations*. We welcome the EC initiatives to support equity measures in the temporary framework.



Many of these measures would be beneficial as part of a permanent framework, such as the simplified rules for subordinated loans. State aid rules should also encourage the set-up and promotion of tele-medicine as part of services of general economic interest. As we fear that the aftermath of the pandemic will be perceptible for some time, it should be also examined whether the measures of the Temporary Framework could be extended beyond December 31, 2020.

### **Priority 2: Proportionality for public development credit institutions and promotional loans in regulation**

We highlight the importance of considering possible exit scenarios for all the relief measures. Banks will emerge from the Covid-19 crisis with more non-performing loans and weaker capital and liquidity positions. Consequently, the normal regulatory framework should not be reintroduced without appropriate transition periods in order to allow banks that have taken advantage of the capital relief to support the real economy sufficient time to rebuild their capital. This is particularly salient for public banks, since they cannot simply turn to the capital markets to raise capital but can only raise capital through retained earnings.

Furthermore, it will be important to strengthen proportionality for those promotional banks and municipal funding agencies, which are under European Central Bank (ECB) supervision and/or those directly and indirectly subject to EU regulation moving forward. Last, but not least, future regulatory projects should also be reviewed as a matter of principle and accompanied by thorough, up-to-date impact analyses that adequately balance the benefits and costs of these projects. We would like to share our thoughts and further details on necessary quick fixes and future Capital Requirements Regulation (CRR) and other regulatory changes, i.e. beyond the current 'quick fix' that could mitigate the impact of the current Covid-19 pandemic. For this purpose, please see Annex 2 for a list of measures that would be crucial in our view.

### **Priority 3: Sustainable finance**

A third key priority of the financial services agenda for our members is sustainable finance. As 80% of EAPB members provide funding to green projects, and many are leading issuers of green and sustainable bonds, the further progress of EU activities in this area, with the action plan on sustainable finance at the core, will be of great importance for us. Moreover, the challenge Covid-19 represents to our healthcare and social systems must be approached as the right opportunity to boost the social component of sustainable finance and concentrate on developing the concept of social bonds. Once again, some EAPB members already have solid experience as social bond issuers and stand ready to share their experience.

### **Priority 4: An actively engaged European Central Bank**

The role of the European Central Bank (ECB), already determinant during the 2008 crisis, has been of fundamental importance in the Covid-19 crisis. What types of assets central banks can/will buy within quantitative easing programmes can rather substantially alter the dynamics of key parts of the credit market – not least when it comes to the issuing of actors of, or linked to, the public sector. In this context, we look forward to continuing our excellent dialogue with the *ECB*, both on supervisory but also monetary policy issues.

## ANNEX 1: NPB COVID-19 MEASURES NOTIFIED AND PUBLISHED (STATUS JULY 22, 2020)

| National Promotional Bank (and policies)  | Euros (bn) | Source |
|---|------------|--------|
| Altum SA.56722 Latvia, Covid-19: Loan guarantee scheme and subsidized loan scheme   | 0.25       | EC     |
| BGK: SA.56876 Poland, Polish anti-crisis measures – Covid-19 – guarantee scheme, Polish Development fund (with BGK): repayable advances for SMEs (SA.56996), large enterprise liquidity loans (SA.57306) + damage compensation and liquidity (SA.57054) + equity measures (SA.57055) + interest rate subsidies (farmers) (SA.57568) | 44.14      | EC     |
| BPI France (Groupe CDC), SA.56709 – Covid-19: Plan de sécurisation du financement des entreprises, SA.56868: Garanties des préfinancements des entreprises exportatrices, + SA.57219 (cautions export)  | 311.1      | EC     |
| Bulgarian Development Bank Guarantee scheme (SA.56933)  | 0.255      | EC     |
| CDP, Italy  | 10         | IMF    |
| CMZRB, Czech Republic: loan guarantees (SA.57195)   | 5.5        | EC     |
| Finnvera, Finland, Scheme of state guarantees and subsidized interest rates   | 2          | EC     |
| HBOR, Croatia: Loan scheme (SA.56957) + support to the maritime, transport, transport infrastructure, tourism, and related sector (SA.5771)   | 1.08       | EC     |
| Hungarian Development Bank (SA.57121 + amendment) + SA.57064  | 0.9        | EC     |
| ICO: SA.56803 Spain, Covid-19 - Guarantee scheme to companies and self-employed   | 20         | EC     |

|  |                 |                   |
|--|-----------------|-------------------|
| INVEGA: Lithuania/ <u>Interest subsidy scheme + guarantee scheme</u> + loans in road freight transport (SA.57066) + rent compensation (SA.57135) + guarantees and loans for tour operators, accommodation and catering service provider (SA.57665)   | 0.736           | EC                |
| KfW and German Regional Promotional Banks: SA.56863, Federal framework for subsidized loans 2020, SA.56790 €45 bn, Federal Framework 'Small amounts of aid 2020' - Covid-19, SA.56787, Covid-19: Bundesregelung Bürgschaften 2020, SA.56714 - Covid-19 measures, new measures approved on <u>11 April</u> : 100% guarantees + R&D (SA.57100,€5 bn) | 550             | <u>IMF, press</u> |
| Kredex: SA.56804 Estonia, Loan guarantee scheme + SA.57028   | 2.75            | EC                |
| Malta Development Bank: SA.56843, Covid-19 Loan guarantee scheme + interest rate subsidy scheme (SA.57163) + loan to Mediterranean Investments Holding (SA.57574)  | 0.77            | EC                |
| <u>PMV, Belgium, loan guarantee</u> + SA.57246 (subordinated loans) + Credendo Bridge Guarantee (export, SA.57187), SOWALFIN and Co. (Walloon region guarantees, SA.57083)   | 4.28            | EC                |
| SID Bank (and others), Slovenia, SA.56999 +SA.57143 + SA.57724   | 4.272           | EC                |
| Slovakia: EXIMBANKA (SA.57483, SA.57484, SA.57485)   | 1.8             | EC                |
| <b>TOTAL</b>   | <b>€960,855</b> |                   |

## **ANNEX 2: EAPB VIEWS ON NECESSARY REGULATORY ADAPTATIONS**

With regard to regulatory aspects, EAPB generally welcomes the adaption of a number of regulatory and prudential rules to ensure a greater impact of private sector bank lending and public support instruments. In particular, the Capital Requirements Regulation (CRR) quick fix will lead to capital relief and help banks to provide more urgently needed loans. However, we see leeway for these rules to be supplemented by further regulatory changes that effectively curb the known crisis-intensifying effects of prudential regulation and provide administrative relief.

### **No ‘punitive’ contribution to the resolution fund when participating in promotional loan programmes**

When calculating the contribution to the resolution fund, participation in promotional loan programmes should not be ‘penalized’ with a higher bank levy.

In order to fix this, EAPB would propose to amend Delegated Regulation (EU) 2015/63 on the calculation of the EU bank levy to the effect that:

- Passing-through promotional loans to an end customer or of trustee loans has a contribution-neutral effect
- Promotional loans from promotional banks, which have been excluded from the leverage ratio exposure measure in accordance with Art. 429a CRR 2, can also be deducted from the leverage ratio when the latter is used as a risk indicator for calculating the contribution to the Single Resolution Fund

More generally, EAPB would propose a BRRD Quick-Fix in order to bring forward relief measures already decided in BRRD 2 (removal of the Combined Buffer Requirement (CBR) from MREL) similar as it has been done in the CRR quick fix.

**Avoid constraints through leverage ratio disclosures**

The current leverage ratio disclosures requirements apply as a constraint to banks due to market scrutiny. We recommend bringing forward the date of application of the proportional calculation of the leverage ratio agreed under the CRR 2 (such as promotional loans by promotional banks in accordance with Art. 429a CRR 2) so that this applies not only starting in June 2021 but also in the current disclosure requirements. Such a measure would increase the effectiveness of the policy responses to the Covid-19 crisis.

**Avoid pro-cyclical effects in banking regulation**

Risk-sensitive capital requirements have pro-cyclical effects. This correlation has been known for a long time, but has so far only been tackled in banking regulation with regard to an advantageous economic development. For example, the countercyclical capital buffer ensures that banks build up additional capital buffers in times of good economic development associated with high credit growth in order to be prepared for a downturn. However, risk-sensitive capital requirements also have the effect of compounding the cycle in bad times especially when capital buffers are not sufficiently above minimum capital requirements and raising new capital is difficult. This risk is particularly acute in the event of unexpected macroeconomic shocks that lead to a significant decline in overall economic production or demand within a short period or that affect both supply and demand, as during the Covid-19 crisis. It is foreseeable that this crisis will – in spite of extensive government countermeasures and supervisory flexibility – lead to rating downgrades and loan defaults even for companies that would have been considered economically sound under normal circumstances. This entails the risk of a corresponding increase in capital requirements and thus a reduction in the banks' lending possibilities, which in turn could further intensify the economic downturn and make it more difficult to grant urgently needed new loans during the economic recovery phase. A staged series of measures is proposed below, which, depending on the course of the

crisis, could be taken to address this problem.

As the European Banking Authority (EBA) has rightly noted, European banks are entering this crisis with sound capital ratios. It is of the utmost importance that this capitalisation is not reduced unnecessarily during the crisis. This is already in the banks' own interest. It is therefore important for us to stress that we do not argue in favour of reducing banks' capital in absolute terms during the crisis, but to introduce counter-cyclical measures that would offset a sharp undesirable increase in capital requirements due to their risk sensitivity, which would increase the scale of the crisis and hinder the subsequent economic recovery.

The EAPB believes that we need to create new powers for the Commission or competent authorities to be prepared for a possible intensification of the crisis. Whether these powers will ultimately be used is open at this stage. However, we think that they should be available in case of urgency.

### **Empowerments for the Commission to adopt counter-cyclical measures (Art. 459 CRR)**

Member States may impose additional Common Equity Tier 1 capital requirements on institutions in economic upturns with strong credit growth for loans extended in the country concerned in the form of a countercyclical capital buffer of up to 2.5% of RWA. This is intended to provide the banks with provisions in the event of an economic downturn. In the course of the relief granted in the Covid-19 crisis, numerous national supervisory authorities have reduced the respective countercyclical capital buffer. This is to be welcomed.

However, it should also be possible to temporarily reduce prudential requirements in times of significant macroeconomic shocks. The EAPB would propose to entrust the Commission with a role in making temporary adjustments to the framework in exceptional situations that mirrors the mandate for a delegated act, laid down in Article 459 of the CRR.

Article 459 empowers the Commission to impose stricter re-

quirements than those in the CRR in clearly specified areas and for a period of one year. The exercise of this empowerment is backed by stricter accountability rules requiring the Commission to submit regular reports to the European Parliament and Council.

The EAPB would propose to extend this empowerment in a well-framed manner in order to allow the Commission to adopt exceptional well-targeted relief measures. This would help to address emergencies such as a potential credit crunch due to a sharp increase in capital requirements or a significant macroeconomic shock triggered by a second infection wave. These exceptional relief measures should at the least include the prudential requirements explicitly mentioned in Article 459.

Furthermore, the impact of credit defaults and deteriorated ratings on capital requirements could be mitigated in exceptional emergency situations and under the discretion of competent authorities or the Commission.

In the internal ratings-based approach (IRBA), rating downgrades and defaults lead to an increase in capital requirements, primarily via three channels:

1. Rating downgrades and the associated increase in the probability of default (PD) via the risk weight functions for exposures to sovereigns, banks and corporates (Art. 153 CRR), and retail customers (Art. 155 CCR) affect the amount of capital to be held. However, this effect decreases as the PD increases, ultimately becoming negative.
2. This is because institutions using the IRBA must form a separate, increasing provision for expected losses. Within the scope of the value adjustment comparison (Art. 159 CRR), banks must compare the expected losses with the value adjustments made and deduct any shortfalls from equity. In this way, an increase in PD or a default (leading to the highest possible PD of 100%) leads to a consumption of regulatory capital, either through the creation of additional value adjustments or the deduction of capital.



3. Finally, yet importantly, defaults also have an impact on the capital position of institutions via the provisions on the minimum coverage of non-performing exposures (so-called 'NPL backstop' (Art. 47a CRR). Accordingly, defaulted loans must be regarded as 'non-performing' in accordance with Art. 47a para. 3 part a CRR. For such loans, the banks may, over time, then have to set up additional risk provisions, depending on the collateralisation.

Therefore, the EAPB would propose the following measures:

1. Banks could be allowed to adjust their PD estimates to partially or fully offset the impact of a non-cyclical economic shock that negatively affects the risk factors of the PD estimate for a short period of time (no longer than two years). Such an adjustment of PD estimates should be permitted where the risk quantification would otherwise be inaccurate and disproportionately conservative: for example, because the crisis is likely to be followed by a strong economic recovery.
2. In this sense, it could also be considered to modify the requirements in Art. 185 part E of the CRR for a certain period. According to this provision, banks must increase their PD estimates if the actual default rates differ so significantly from the estimated PD that the validity of the estimates is called into question. Institutions may be allowed to choose not to adjust PD estimates in the short term, but to base them on long-term experience and expectations.
3. Finally, yet importantly, a countercyclical factor could also be included in the risk weighting function, which slows down the increase in capital requirements as PD increases in certain economic situations.

Consideration could be given to repealing the NPL backstop requirements in a severe non-cyclical crisis, or at least to extending the period within which provisions must be built up.

If, in view of the course of the crisis, the above-mentioned measures do not appear to be sufficient, the Commission should have

the discretion to suspend temporarily (e.g. three months):

- The requirement of a timely review of ratings upon the disclosure of material information about the borrower (Art. 173 para. b of CRR).
- And the default criteria:
  - “putting the credit obligation on non-accrued status” (Art. 178 para. 3 part a of CRR).
  - “recognition of a significant specific credit adjustment” (Art. 178 para. 3 part b of CRR).
  - and “distressed restructuring” (Art. 178 para. 3 para. 3 part b of CRR).

Alternatively, similar powers could be entrusted to competent authorities under the condition that they are applied in a uniform manner within the EU.

### **Postpone first-time application of the CRR II**

In order to relieve the burden on institutions, the remaining first dates of application of the CRR II should also be postponed to a point in time when the economic recovery is already clearly noticeable among companies, private households and banks. In our opinion, the postponement should not only cover those new regulatory requirements that come into force on 28 June 2021, but should also apply to the new reporting requirements for market risk regulations (FRTB), which are to be applied for the first time from the reporting deadline of 31 December 2020.

The implementation of the CRR II will not only lead to considerable administrative burdens in the institutions, but also to considerable future capital burdens. This would have to be taken into account in the capital planning already at this point in time and could thus prevent the banks from providing loans during the crisis.

### **No negative impact of legacy instruments on the recognition of existing own funds instruments and eligible liabilities**

In view of the discussions initiated by EBA on “legacy capital in-

struments”, there is an urgent need for legislative clarification in the CRR (Articles 28, 52, 63 and 72b CRR). Legacy instruments held by the institutions should remain harmless to the recognition of existing own funds instruments and eligible liabilities after the end of the transitional provisions of Articles 484 ff. CRR. Legacy instruments contribute to loss coverage in times of crisis. Institutions are often unable to call or redeem them and it would further reduce their capital base. If existing own funds instruments are no longer recognized because the institution continues to hold legacy instruments, the banks’ scope for lending would be further reduced.

### **Recovery package**

Targeted adjustments of MiFID/MiFIR and the Prospectus Regulation can help to stimulate the capital market in the EU and generate additional funding for crisis management. In this respect, we support the planned proposals of the European Commission and the High-Level Forum on capital markets union.

### **Provisioning schedule for government-guaranteed NPEs**

EAPB welcomes the new treatment for government-guaranteed NPEs that removes the build-up phase for the first seven years under the CRR quick fix. However, the new prudential treatment has not removed our key concern, being that provisioning has to take place even if the guarantor is acting to its commitment, and payments are received according to schedule.

First, the guarantee cannot be called upon as long as the borrower is paying according to schedule. Nevertheless, such a loan might classify as an NPE, for instance, due to a pulling effect or when it is assumed unlikely that the borrower will repay. Hence, there can be a mismatch between when the guarantor has to act on its commitment and when a loan classifies as an NPE. As such, the provisioning schedule is applicable for exposures that are expected to be covered by the guarantor.

Second, a guarantor can either indemnify a lender by direct

payment of the covered amount (lump sum) or indemnify the lender according to the original repayment schedule of the loan. The latter being a common occurrence among EAPB members. While in such an event, payments are received according to schedule, technically according to art. 47a of the CRR the exposure should be classified as NPE as the classification relates to the borrower and not to the guarantor.

Given the long-term nature of the loans, the repayment schedule will exceed the provisioning schedule and hence provisioning will be required though payments according to the schedule are received and are expected to be received from the guarantor who is acting to its commitments.

As such, the need for a provision exists even if the cover is an unfunded credit protection and the issuer of the cover continues to perform its commitments.

EAPB would recommend to exempt the covered part of a non-performing exposure from prudential provisioning as long as the borrower is paying on time or the cover is valid unfunded credit protection granted by the guarantor who is performing as scheduled.

### **Restrictions on dividends for public stakeholders**

EAPB would like to draw your attention to the special situation of certain promotional banks/funding agencies when it comes to the restriction of distributions during the Covid-19 pandemic and especially the recent ESRB advice to extend the dividend suspension period until the end of 2020.

We feel that the rationale for the recommendation to not pay out dividends over 2019 does not hold for those promotional banks/funding agencies that pay dividends to their public stakeholders. Promotional banks/funding agencies are generally well-capitalized banks and – where paid out – dividends are generally paid out of profits (and not reserves). Hence, in these cases the distribution of dividend does not deplete available capital, nor does the dividend payment stem from a relaxation in prudential requirements.

Secondly, the suspension of dividends is at odds with the aim to mitigate the economic impact of the pandemic on local authorities. These dividends are usually at the benefit of local public authorities, being the entities that are combatting the health and economic crisis we are currently facing. It is part of the public mission of promotional banks/funding agencies to support their public shareholders, especially in difficult times like these and therefore feel that given their public ownership the rationale for the recommendation does not hold for promotional banks/funding agencies.

## Chapter 22

Latin American Association of  
Development Financing Institutions

# RESPONSES OF LATIN AMERICAN DEVELOPMENT BANKS TO THE ECONOMIC CRISIS PRECIPITATED BY COVID-19<sup>1</sup>

**T**his chapter summarizes actions taken by the Latin American Association of Development Financing Institutions (ALIDE) to combat the economic impacts of Covid-19, as of June 2020.

ALIDE is the international organization that represents Latin American and Caribbean development banking. It was created in 1968 and represents 42 public banks in 22 countries in the region, with permanent headquarters in Lima, Peru.

## INTRODUCTION

Even with more knowledge of the economic effects, the international crisis caused by the Covid-19 pandemic shows an uncertain

<sup>1</sup> This is an edited version of a report originally published by the Latin American Association of Development Financing Institutions (ALIDE), San Isidro, Peru, in June 2020 and is available online at <https://www.alide.org.pe/en/>. Reproduced with the permission of the ALIDE. The original document was prepared by Romy Calderón, Head of the Economic Studies and Information Programme, and Javier Carbajal, Principal Economist, ALIDE.

picture. It is estimated that it will be much greater than the 2008 crisis and a little less than the Great Depression of 1929. Although the latter depends, according to the International Monetary Fund (IMF), on whether the base scenario is met – that is to say, that there is some control and the productive apparatus gradually begins to reactivate in the second half of the year.

In the April *World Economic Outlook* Report itself, the IMF maintains that, in the 1929 Depression, the world economy fell 10% and developed countries by 16%. In the 2008 financial crisis, the world economy went from a growth rate of 2.8% in 2008 to -0.6% in 2009. The Fund's current estimates project a contraction of the world economy of -3% and -6% if the current situation continues throughout the year, and an additional -6% if it goes until 2021. If the picture does not worsen, in 2021 there could be a jump in growth of 5.8%. For Latin America and the Caribbean, it is estimated at -5.2% in 2020 and 3.4% in 2021.

## MEASURES TAKEN BY THE DEVELOPMENT BANKS

The measures taken by the development banks are, for the most part, in line with government stipulations and focus on the smallest production units. However, given the nature of this unprecedented crisis, the health sector has been given significant attention, which has not been the case in past crises. This refers to the enterprises or institutions that provide health services and companies that produce health supplies, as well as technological solutions for monitoring and controlling Covid-19.

This crisis constitutes a major challenge to economic policy-makers and particularly to our development finance institutions, as the countries' financial policy instruments. Development banks are revealing their unique importance to the countries in these difficult times, insofar as compliance with their three significant roles is concerned: counter-cyclical measures; resource

decentralization and distribution; and support for the production system and employment.

It is in this context that the presence and actions of development banks, as agents of public financing policy, take on even greater importance in the fulfilment of their counter-cyclical role, without losing sight of a longer-term vision and a continuous policy of income distribution.

In the immediate term, development banks have had to help countries mitigate the financial crisis by making larger amounts of resources available to the production and social sectors. In that way, the financial institutions have granted new credit lines to the industrial, agricultural, social housing, small- and medium-sized enterprises (SMEs), foreign trade and infrastructure sectors, among others, drawing on their own resources and funds supplied by the state to do so. At the same time, they have implemented the following measures:

- Raised the borrowing limit of financial intermediaries to provide them with more plentiful resources.
- Granted guarantees for bonds issued by enterprises.
- Provided infrastructure funding.
- Renegotiated debts and extended debt terms.
- Offered loans at preferential rates to specific segments, such as to small urban and rural enterprises, and for the purchase of social housing, and operated with new enterprises like financial technology companies (fintechs).

## **CROSS-CUTTING MEASURES TAKEN BY DEVELOPMENT BANKS**

The measures taken by the development banks, in keeping with government stipulations, are of two kinds: cross-cutting and sector-specific. As the crisis advanced, the focus was placed increasingly on the latter. Examples of this are in health, services, social housing and agriculture.



Foremost among the *sector-specific* measures taken are continuous contact with customers plagued by potential problems arising from the impairment of their economic activity, namely in agriculture, tourism, hotel services and trade, among others. Actions include revision and amendment of interest payment methods; capital extension and downward interest rate adjustment; valuation of new operations, with longer terms, lower rates and grace periods; and revision of credit guarantees and records in order to grant a working capital line on more favourable terms.

Examples of the *cross-cutting* measures taken by development banks include the following:

- Assignment of new credit lines to their customers with terms of up to three years and a maximum of one year of grace. In these cases, the loan amounts are generally set in accordance with the size of the payroll and the working capital needing financing.
- Postponement and deferral of instalment due dates in the cases of personal loans and loans to independent workers and to micro- and small-sized enterprises (MSEs). The terms range up to three years and the interest rates are lower than those charged for the original loans. In some cases, the interest is partially subsidized by the state on a temporary basis. The Banco Nacional de Costa Rica (BNCR) expected in March alone to readjust the repayments of 107,305 loans. In Paraguay, the Agencia Financiera de Desarrollo (AFD) hopes to provide assistance to some 50,000 MSEs, drawing for that purpose on funds of some US\$93 million (for renegotiating operating capital and/or investment loans, with terms of up to seven years, including two years of grace). The Brazilian Banco Nacional de Desenvolvimento Econômico e Social (BNDES) announced the suspension of payments of up to US\$6 billion in loan principal and interest in March alone.
- Temporary suspension of mortgage payments for home purchases, together with the reduction of mortgage loan interest

rates. By way of example, the Caixa Económica Federal (CEF), Brazil's foremost mortgage bank, has offered home building and development companies the possibility of pausing the payment of financing contracts by diluting the difference over the lifetime of the loan. In Ecuador, the Banco de la Seguridad Social (Biess) has started to restructure and refinance its mortgage loans to allow for loan terms of up to 30 years with as much as 18 months of grace. Mexico's Sociedad Hipotecaria Federal (SHF) implemented a US\$363 million programme, more or less, to stabilize construction loan portfolios, with a view to extending outstanding loan periods in order to moderate the effects of the drop in sales. Bridge loans that have not been extended are granted an additional loan term of up to 12 months, while in the case of bridge loans that have been extended one or more times, the additional extension is six months. As for the Banco Hipotecario del Uruguay (BHU), the institution decided to reduce the May mortgage payments by 50% for all of its customers with outstanding mortgage loans and promise to purchase agreements.

- Specific loans for acquiring *new technology* to equip people for teleworking.
- Loan guarantees for MSEs covering up to 100% of the loan (in Argentina's case and between 80-98% in that of Peru, depending on the size of the firm). Argentina offers 25% loan coverage to medium and large enterprises. Peru expects, through its Reactiva Perú guarantee programme – the largest in the country's history, equivalent to 4% of Gross Domestic Product (GDP) – to assist some 350,000 companies. Costa Rican enterprises hold individual Fondo Nacional de Desarrollo (Fonade) guarantees covering 90% of their loans. Peru has also created the Fondo de Apoyo Empresarial a las MYPE (FAE-MYPE) (MSE Support Fund), administered by Corporación Financiera de Desarrollo (Cofide), providing coverage ranging from 90-98% of the loan amount. This can be applied to debt refi-

nancing or reprogramming or to new working capital loan applications for terms of up to 36 months including a six-month grace period. The Fund started operating with resources totalling some US\$88.2 million, from which some 50,000 MSEs were expected to benefit. The subsequent increase in its capital to US\$265 million has tripled the Fund's potential.

- Securities issuance guarantees for SME debt instrument issues in the stock market.
- Loans for the tourism sector, inasmuch as tourism is one of the sectors most heavily impaired, governments have provided, as a contingency measure, for financial instruments to mitigate the effects in an effort to safeguard jobs. In Paraguay, Banco Nacional de Fomento (BNF) is authorized to grant each applicant up to 10 times its monthly payroll, which is to be repaid in a single capital and interest payment at the end of the loan term, with a grace period of 12 months.
- Loan guarantees to support entrepreneurs in the tourism and bars and restaurants industry, one of the sectors hardest hit, whose sales have dropped for the most part to almost zero. The financing is provided for working capital purposes, with maximum terms of up to three years, with six months of grace.
- Expansion of the credit available to micro-, small- and medium-sized enterprises (MSMEs) through banking and non-banking financial intermediaries.
- Widening of the capital supply to cover the everyday needs of enterprises, by broadening the scope of existing credit lines. In March, Brazil's BNDES announced a total capital injection of roughly US\$11 billion).
- Freezing and opening of new financing lines for state, provincial or municipal governments in order to give them liquidity. Banco de Desarrollo del Ecuador (BDE) started restructuring the debts of subnational governments by suspending loan obligations for a 90-day period. Similar measures have been taken in Brazil.

In Colombia, Financiera del Desarrollo (Findeter) grants direct credits with compensated lending rates to eligible territorial entities and sectors for use in financing projects and activities to fight the effects of the coronavirus and impede its spread. It is necessary for the territorial entities obtaining those loans to comply with borrowing regulations. The resources are to be invested in transportation, health, housing, education, energy development, drinking water and basic sanitation, among other areas. The re-discount credits enjoy long terms, grace periods and favourable interest rates. The funds are intended for use in financing investments and working capital in the public and private sectors at a moment when liquidity is paramount for facing up to the challenges and needs created by Covid-19.

- Increase in contractual values without any obligation to provide real guarantees but only personal ones. At the same time, loan operation rates and fees are reduced and maximum limits are set in accordance with the size of the enterprise or customer.
- Automatic extension of microloan payments, and only if a customer is not interested in extending their payments do they have to notify the bank. A case in point is Banco do Nordeste de Brasil (BNB)'s 'Crediamigo' Programme. The BNB currently serves about 200,000 microloan customers and 5,000 microenterprises. Mexico's Sociedad Hipotecaria Federal (SHF), in serving this same segment, allocated US\$83 million for home improvement microfinancing by non-bank financial intermediaries with a financial product for loans of up to US\$1,032, which enjoy the guarantee of Fondo Nacional de Garantías a la Vivienda Popular.
- Relationships with national and international lenders, to make it possible to postpone debt payments and immediately increase outstanding credit lines, so that funds already available for financing can be increased and channelled to borrowers from banks.

- Some national and international development institutions in Brazil and their association, the Brazilian Development Association (ABDE), are working with the federal and state governments *to create alternatives* for the programmes to mitigate the effects of the coronavirus. Both seek to reduce the damaging effects on public health and the negative consequences for the already impaired national economy.
- Provision of credit lines with special terms to help health sector *enterprises* of all sizes. Resources are made available for working capital and for investment in the purchase of raw materials with which to manufacture products in heavy demand – face masks, alcohol gel, tissues – and to add to the existing stock, to prepare hospital beds and hire temporary staff, among other things.

In Chile, Corfo and the Ministry of Science, Technology, Knowledge and Innovation, with the assistance of the Government Laboratory, launched the “Covid-19 Innovation Challenge.” This contest aims to speed up the implementation of innovative solutions and/or those involving scientific technology, in order to prevent the contagion of health workers caring for patients suspected of being, or known to be, infected with Covid-19.

Bancóldex, for its part, can offer direct loans at compensated interest rates to finance projects for that purpose. Entities seeking to obtain such loans must also certify that these loans will be used to finance projects to fight Covid-19.

- Establishment of working groups and joint efforts with sector institutions and those serving entrepreneurs directly, together with public policy coordination, to protect enterprises so that the country can return to the economic development agenda as rapidly as possible.
- Assistance with the financing of professionals in the creative economy, who are among those most adversely affected by the necessary social distancing policy. The spaces where creative industries have operated have been closed since the

very beginning of the pandemic and persons working in areas like the performing and audiovisual arts, advertising, literature and heritage, among others, have lost their main source of livelihood.

- Credit lines at preferential rates for the undertakings of population segments like young people, women, senior citizens, native citizens, peoples of African descent, rural dwellers, immigrants and the disabled, among others. The Instituto Nacional de Fomento Cooperativo (Infocoop) in Costa Rica offers an example of this.
- Opening of savings accounts for all persons needing to receive government vouchers (*bonos de ayuda*) for families without any income, either because they are living in poverty, have lost their jobs, or have been left without any earnings due to the situation.
- Assistance to export firms. The government of Costa Rica announced the start-up of the '*Alivio*' ('Relief') initiative that will provide roughly US\$53.34 million in non-reimbursable funding. The recipients will be 200 SMEs with export potential that are working in the agricultural, food, industrial and service sectors. The support of technical personnel will be facilitated, so that the chosen enterprises can enjoy the financial and commercial coaching of advisers to overcome the crisis and strengthen their operations. The non-reimbursable funds can be used to purchase production supplies, rent machinery and for the partial payment of wages and salaries. They cannot, however, be allocated for the payment of the salaries of management or legal representatives, the payment of debts, the purchase of machinery or the rental of buildings. The aim is to serve only those companies that are best equipped to survive despite the situation. In Peru, a transfer of some US\$294 million was authorized to the '*Creacer*' Fund, which is being managed by Cofide. This fund offers coverage for loans to MSMEs and export firms for fixed

capital investments or working capital.

- Progressive adaptation of Basle III implementation because of its pro-cyclical effect, with a view to limiting its negative impact on the delivery of short- and medium-term liquidity.
- Boosting of platform development and operation, in order to link up enterprises with the markets. In Chile, Corfo and Ser-cotec created the web platform [todosxlaspyμες.cl](http://todosxlaspyμες.cl) to support the country's entrepreneurs, as a direct channel of communication between SMEs and consumers. 'Todosxlaspyμες' will have access to and highlight a venue for collaboration in which the smallest enterprises can promote their efforts and get in contact with all of their potential customers, in the expectation of increasing their sales.
- Funding of financial intermediaries. In Mexico, Nafin and Bancomext manage a programme of roughly US\$2.523 billion through financial intermediaries to contribute to enterprise liquidity. This programme makes it possible to lengthen loan terms or provide longer grace periods to creditors. New loans are considered for the purpose of supporting working capital needs and providing stock market guarantees and loans to improve the liquidity situation of borrowers. These guarantee, fully or in part, the payment of capital and interest on the issuance of commercial paper, stock market certificates or any other instrument used in national or foreign stock exchanges. Stock market guarantees make it possible to improve the ratings given by rating companies to stock issued for financing equipment operations, technological development projects, production and development of infrastructure, environmental improvements, liability restructurings and asset securitization (accounts receivable, promissory notes, remittances and mortgages, among others).
- Coronavirus Fund. In Uruguay, the Banco República committed to allocating US\$150 million to the Solidary Covid-19 fund created for that purpose, as part of the contribution from the

Bank's profit in 2019.

- Fintech as new channels for resource intermediation to MSMEs. With the authorization of the National Monetary Council, Brazil's BNDES began to transfer funds through financial technology service enterprises. The fintechs register with the BNDES online credit application platform. They will start operating with bank resources, heating up the competition in this market and helping the money reach those in need. The benefits of this initiative, according to BNDES, are: the financial inclusion of enterprises that experience problems in obtaining loans; deconcentration of banks; competitiveness in the financial sector; innovation; entrepreneurial empowerment; and more efficient financial resource distribution.

## **ALIDE AND THE TRANSFER OF KNOWLEDGE AND SPECIALIZED INFORMATION**

Governments in the region, together with their development finance institutions, are taking a series of measures to offset the adverse effects of the crisis produced by the Covid-19 pandemic. All of the countries are working to develop tools and financial instruments and to find out what other countries and institutions are doing to help their customers.

For that reason, we in ALIDE have been asking our members for information and have been processing data identified from other sources to create the most complete and up-to-date database possible and to make it available to interested parties at a single platform on our website. We also give weekly reports to our community of development finance institutions.

ALIDE is a participant in the SAFIN Network belonging to the International Fund for Agricultural Development (IFAD), both an international financial institution and a specialized United Nations



agency that reports and on occasion orients institutions toward better study and financing of agricultural and rural development.

## **DEVELOPMENT BANK OBSERVATORY HELPS IN DEALING WITH CRISIS**

On ALIDE's website, we have created *THE OBSERVATORY* of the specific efforts and measures of multilateral and regional organizations and development finance institutions to help the production and social sectors cope with this crisis (<http://www.alide.org.pe/acciones-de-la-banca-de-desarrollo-frente-a-la-crisis/>). Reports, notes and contributions of development banks are collected in this observatory with regard to actions being taken to mitigate the crisis.

## **SMALLHOLDER AND AGRI-SME FINANCE AND INVESTMENT NETWORK (SAFIN)**

This is an inclusive partnership of actors operating in different parts of the ecosystem for purposes of investment in agri-food and rural SMEs, with a focus on access to financing and complementary services.

At present, the network is being coordinated by a team from the International Fund for Agricultural Development (IFAD) and consists of more than 30 institutions from the private, public and philanthropic sectors. These include governments, different types of financial suppliers and intermediaries, development banks and farmers' organizations.

ALIDE participates actively in the SAFIN Network through its involvement in virtual forums and meetings and by exchanging viewpoints and providing information and occasionally guidance to institutions for better study and financing of the agricultural and rural sector.

## LOOKING TO THE FUTURE

In short, these are but some of the measures carried out by development banks, which, as is to be expected, will follow the course of economic and social events on a daily basis in order to take the measures that are deemed necessary, appropriate and effective in confronting the crisis. The final aim is to ensure the well-being of the enterprises and of Latin American society as a whole.

With this purpose in mind, and in order to help entrepreneurs, the development banks are committed to taking swift action in making resources available to both individuals and enterprises, particularly MSMEs and lower-income sectors. It is the role of development banks during economic downturns to act counter-cyclically by adopting simple, rapid and effective alternatives.

The immediate aim is to give families liquidity by transferring resources allocated by the government through social assistance programmes, to them and to the business sector. This will target above all the enterprises that are most vulnerable and have less economic backing with which to weather a crisis as serious as the one we are confronting today.

The development banks cannot do this on an individual basis but must join with the other national financial institutions and regional and multilateral lending institutions in coordinated efforts. In this way, it will be possible to complement the funding structure of existing financial intermediaries, both local and international, thus making it possible for them to execute short-, medium- and long-term programmes.



Covid-19 has dealt a devastating economic blow around the world. From individuals who can no longer afford to pay for food, to SMEs unable to cover their rent, to national governments struggling with their balance of payments and skyrocketing health expenditures, the economic impacts of Covid-19 have been sweeping in scope and depth. Although little discussed in the mainstream media, public banks have been on the front lines of dealing with this economic and health crisis, playing a critical role in stemming financial collapse, supporting households and communities, and channeling resources towards essential health and public services. Public banks provide supportive credit, fiscal assistance, expert advice and macro-economic stability in ways that private financial institutions are often unable or unwilling to do. This book offers detailed case studies of public bank actions from around the world, critically examining their policy responses to Covid-19. We identify 'best practices' in dealing with the current crisis as well as highlighting the changes needed to make public banks more equitable, democratic and sustainable in the future.

