

The role of South Africa's state-owned development finance institutions (DFIs) in building a democratic developmental state

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1. Introduction

South Africa's New Growth Path, as released by Minister Ebrahim Patel on 23 November 2010,¹ highlights the crucial role played by state-owned development finance institutions (DFIs) in creating jobs, raising shared economic growth and enabling pro-poor expansion of infrastructure. The contribution of DFIs has been under the spotlight due to the recent global financial crisis and the subsequent stunted economic growth, heavy job losses and factory closures. There has also been renewed public pressure for increased public service delivery, as well as the constant urgent imperative to accelerate equitable economic development.

In all the economically strong and socially equitable states, DFIs have acted as catalysts for accelerated industrialisation, economic growth and human resources development. Examples of such states are the Western European democratic welfare states, such as Germany and Sweden, or the first-generation East Asian developmental states, such as Japan, Singapore and South Korea. New-generation developmental states, such as China and Turkey, and democratic developmental states, such as India and Brazil, have also demonstrated the crucial role DFIs can play in transforming the economy. In all of these success stories, the intervention of DFIs was usually 'game-changing', in that it dramatically scaled up the growth paths of these economies.

South Africa urgently needs to accelerate its industrial development and economic growth rates, and to expand its human resources capabilities. This is necessary, not only to address the crippling economic and human development inequalities left by apartheid, but also to match the country's rapidly growing new BRICS partners – Brazil, Russia, India and China. South Africa also has to compete with other new rising, emerging markets, while catching up with the established industrial powers of the West.

This policy brief aims to identify what South African DFIs could do in this regard, by looking at lessons from successful DFI catalysts in other developmental states. Crucially, in all these successful economic transformations, the state provided the leadership, the long-term vision and the political will, for the DFIs and SOEs to be game-changers.

2. The mandate of a development finance institution

Traditionally DFIs provide development finance to address market failures and so complements both government resources and market financing. However, DFI's are now generally expected to address broader development policy objectives – not only limited to addressing market failures, such as private sector development, employment creation, income redistribution, import substitution, the development of poor groups or regions, as well as developing new industrial sectors or boosting weak ones (UN, 2005). In fact, it can be argued that the role of DFIs in developing countries has gone beyond addressing market failure to, more broadly, addressing development failure as such (Gumede, 2008; 2011).

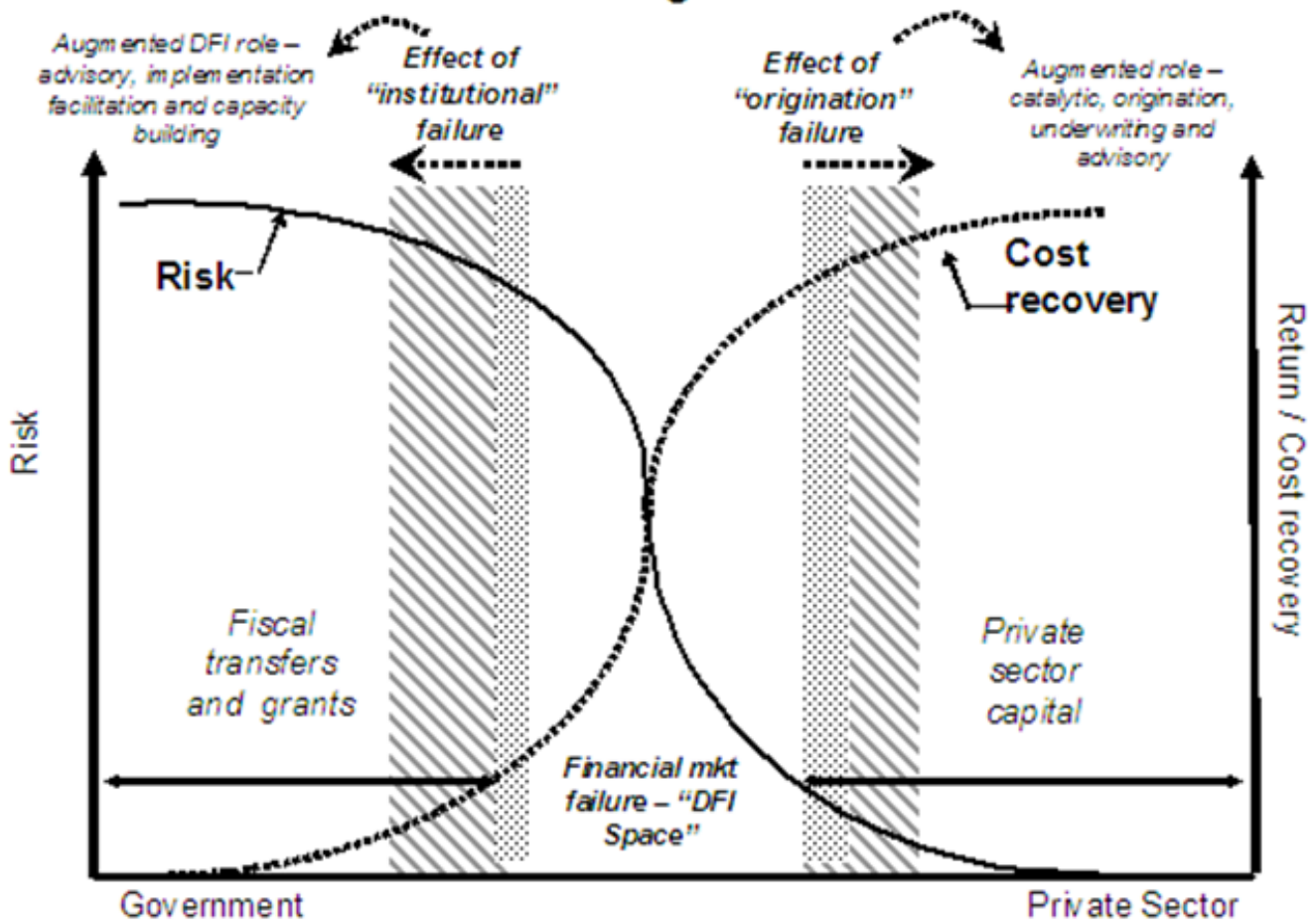
Development failure constitutes five different types of failure (Scott, 2008):

- Institutional failure occurs when organisations do not implement the services for which they are responsible.
- Capacity failure is generally due to a lack of appropriate skills in the public institutions managing development.
- Origination failure arises when the public and market players fail to originate innovative ideas for development, or to fashion an appropriate development vision, and are generally risk averse.
- Information failure exists when there is failure to overcome information asymmetry between the role players in development, which is necessary for coordinating investment between the private and public sectors.

¹<http://www.info.gov.za/view/DownloadFileAction?id=135748>

The diagram below explains the impact of the development failures listed above on the financial lending model.

Key Failures Impacting on Development Processes - Cues for Strategic Intervention ?



Note: Adapted by Scott (2008), this is an expansion on a diagram by B.M. Jackson in 1998, depicting the concept of financial market failure and the location of the intermediation gap, which defines a role for development finance.

- Failure to facilitate strategic partnerships means failure to establish a development partnership for growth between the public and private sectors.

3. The role of DFIs in successful developmental states

Successful DFIs do two things well: first, they perform their jobs as development finance institutions well, in that they finance development projects effectively, and second, they also play key roles, whether as facilitators, arrangers, ideas banks or financiers, in the broader industrialisation and economic development strategies of their countries. In some developing countries, including South Africa, DFIs may perform well as development finance institutions, but

not be as effective in helping to fashion their countries' broader national development strategies and objectives.

Those DFIs that have been most successful often go beyond what is expected of them, and provide the game-changing intervention that has altered the growth trajectory of their respective countries. Successful DFIs have accelerated industrialisation, economic growth and human development. The question South Africa's DFIs now face is: what kind of intervention will be 'game-changing' and irrevocably improve the country's transformation path?

The following examples illustrate selected interventions by DFIs in successful developmental states, which have

fundamentally altered the growth paths of these countries. By examining the concrete steps such DFIs have taken to accelerate their countries' growth trajectories, inferences can be drawn as to how DFIs can ensure they meet their developmental mandate. The lessons to be learnt from these case studies will be discussed in the final section.

3.1 DFIs provide counter-cyclical lending

The Brazilian Development Bank (BNDES) exemplifies the vital catalyst role a DFI can play through using the tool of 'counter-cyclical lending'. BNDES has used this tool to great effect, not only to overcome the negative impact of the 2008/9 global financial crisis, but also to use the response to the crisis to turn around the country's economy. The bank's counter-cyclical lending was aimed at creating new jobs, protecting existing jobs, expanding infrastructure, especially to underdeveloped areas, and building new industries. BNDES dramatically upgraded its credit lines, providing loans to finance private and public enterprises. Loans were mainly directed towards infrastructure and long-term investment, but also towards regional development and circulating capital for small and medium-sized enterprises (SMEs).

In the midst of the 'credit crunch' caused by the global financial crisis, the Asian Development Bank (ADB) also applied counter-cyclical lending. It set up a US\$3 billion fund to help member countries swiftly ramp up the fiscal spending needed to overcome the global economic crisis and to help sustain longer-term growth. Export-dependent Asia has been impacted negatively by the decreasing demand for its goods, primarily from the United States and Europe. Moreover, with the global downturn expected to be deeper and longer than was previously thought, economies in the region are likely to come under increased pressure. The ADB's Countercyclical Support Facility (CSF) provides short-term loans faster and more cheaply than the ADB's existing special programme loan facilities (ADB, 2009).

3.2 DFIs provide an enabling environment for enterprise and industry

In Mexico, the development bank Nacional Financiera (Nafin), one of six Mexican DFIs, focuses on financing small, risky businesses at the start of the supply chain. It offers online factoring services to small, medium and micro-enterprise (SMME) suppliers. The programme Cadenas Productivas (productive chains) works by leveraging the 'chains' that exist between big buyers and small suppliers. The big buyers are large, creditworthy firms that display low credit risk, whereas the suppliers are typically small, risky firms that generally cannot access financing from the formal banking sector. The programme allows these small suppliers to use their receivables from big buyers to acquire working capital financing, thereby effectively transferring

their credit risk to their high-quality customers in order to access additional – and cheaper – financing.

3.3 DFIs identify and develop strategic and longer-term profitable sectors, and steer long-term industrialisation

Many successful states have managed to diversify and upgrade their industrial base in the long term. Whether in developmental or democratic welfare states, DFIs have played a critical role in identifying potential future strategic sectors. They have steered long-term industrialisation by either developing new sectors or developing infrastructure generally.

Some of the new-generation developmental states have purposefully identified and developed new sectors with the potential for long-term industrialisation. In these states, DFIs have played key roles as financiers, partners, advisers, implementers and integrators (Scott, 2008:6). The Industrial Development Bank of India Limited (IDBI), for example, has been at the forefront of providing finance for industrial development in India. It has helped to identify the long-term growth potential of the country's information technology (IT) industry.

In Brazil, BNDES has been heavily involved in financing the industrialisation of the Brazilian economy to such an extent that, since 1950, not a single major undertaking in Brazil involving private Brazilian capital has come about without BNDES support. Lately, the Brazilian government has identified renewable energy as a strategic growth sector, and BNDES has been a trailblazer in green economy initiatives by financing renewable energy programmes (NewNet, 2011). As the world's largest sugarcane producer, Brazil has the largest and most successful ethanol industry in the world, where ethanol is produced from home-grown sugarcane (Trusted Sources, 2009).

BNDES has contributed greatly to this sector and has also partnered with Petrobras, the oil state-owned enterprise (SOE), in building the country's sugar-based ethanol industry. In identifying companies and projects to receive funding, BNDES pools existing companies in the sector and focuses on specific projects that advance ethanol biofuels, a process it refers to as 'consolidation in the ethanol sector' (BNDES, 2010). Research and development funded by BNDES have enhanced the processes involved in advancing Brazil's biofuel industry, which has also expanded into production using other natural resources.

The Korea Development Bank (KDB) and the Industrial Bank of Korea (IBK) have also played key roles in identifying new strategic industries. Once a new company starts production of a strategic product, the government places orders for the product and simultaneously restricts imports in order to protect the domestic market. The government

has been quick to provide the private sector with credit, foreign exchange and subsidies. So-called 'policy loans' are set at low rates of interest and are financed by development banks, using soft repayment terms. The development banks usually take equity in the new companies, but large private banks have also been compelled to make a proportion of their loan book available for such policy loans. Investment is financed by banks, with the government using finance from taxation, fiscal policy, tariffs, and judicious foreign borrowing.

3.4 DFIs help expand infrastructure development

The rebuilding of infrastructure was the key difference in the recovery of Europe under the US Marshall Plan on the one hand, and that of Japan, South Korea, Taiwan and other East Asian countries on the other hand, who received aid from the United States and the World Bank after World War II (Yoshida, 2000:64). In successful developmental states, infrastructure development goes beyond building transportation routes, for example, but is seen as a tool for long-term economic investment that is integral to a country's industrialisation. For infrastructure development measures in underdeveloped regions to be effective, they must be linked to 'other regional economic stimulus measures [to] complement the infrastructure investment and generate synergistic effects' (Yoshida, 2000:86). This comprehensive approach to infrastructure development is often missing in other less successful developing countries in Africa and elsewhere.

In East Asia, most of the fiscal stimulus packages to counter the effects of the 2008 global financial crisis have consisted of large investments in infrastructure, such as roads, ports, rail networks and basic needs, for example more efficient energy supplies, reliable water supply and sustainable environmental management (Abidin, 2010:1). In successful developmental states, DFIs are also at the centre of integrated planning for infrastructure as integrators. The role of an integrator is particularly important, 'mobilising and linking stakeholders, resources and initiatives' (Scott, 2008:6) and facilitating the integration of infrastructure development into broader economic development. DFIs do so by being the integrating connection in the infrastructure delivery system, linking different initiatives, resources, stakeholders and decision makers in both the public and private sectors. In most unsuccessful developmental states, especially in Africa, infrastructure development has rarely been integrated into broader economic development, but often occurs on a stand-alone basis.

The Development Bank of Japan Inc. (DBJ) and the Japan Bank for International Cooperation (JBIC) are examples of DFIs that have effectively served as financier, adviser, partner, implementer and integrator in infrastructure delivery. They have played a significant part in facilitating the integration of infrastructure planning both in Japan and

in the wider East Asian region. A regional case in point is the creation of the Delhi-Mumbai Industrial Corridor (DMIC). In this regional project, worth an estimated US\$90 billion, the DBJ is performing the fivefold role, particularly that of integrator. This project will create seven cities along the DMIC, aimed at becoming manufacturing hubs that will contribute to India's economic growth and development (Construction update.com, 2011).

3.5 DFIs promote and support their countries' national interests in the international arena

China has demonstrated how it used DFIs to promote the use of Chinese businesses and ensure that its national interests were met. During 2009/10, the state-owned China Development Bank (CDB) and the Export-Import Bank of the Republic of China (EXIM) lent at least US\$110 billion to governments and companies in developing countries, which is more money than the World Bank lent in the same period. China's continual financial assistance to Africa, Latin America and Southeast Asia has been motivated primarily by a strategic aspiration to secure and transport natural resources, be it iron, coal, steel or oil.

The Chinese government has made effective use of its DFIs, business community and SOEs as a diplomatic arm in extending its economic prowess. For example, the US\$5 billion China-Africa Development Fund (CADF) established in 2007 by the CDB to finance infrastructure, industrial and agricultural projects, also includes 'financing (concessional loans), grants, debt cancellations, and economic investments' (Lum et al., 2009). In an analysis by Erica Downs (cited in Lum et al., 2009), the CDB's 'cross-border deals provide Beijing with financial leverage over distressed borrowers to advance other Chinese interests'. This, according to Downs, is evident in the way the CDB uses its loans to promote other Chinese foreign policy objectives, such as supporting the international use of Chinese currency. As a result of the CDB's involvement in Chinese international relations and cooperation, the Chinese government now features in shaping and greatly influencing the economic policies of those nations in which it has vested interests. Through agreements entered into between China and these states, the CDB has been at the forefront of advancing China's diplomatic agenda.

In Japan, the DBJ is commissioned to steer the country's economic development. Since its inception in 1951, the main focus of the bank has been infrastructural and industrial development in the nation. The Japanese government and the DBJ have used the country's DFIs to increase exports to the region, thereby benefiting Japanese business. Since 1995, countries in the region have tended to obtain more of their technology licences from Japan than from anywhere else. In addition, all of them rely heavily on the technology embodied in machinery and equipment imported from

Japan to run their manufacturing industries. Between 1992 and 1995, Japanese multinational corporations, supported by the Japanese government and the DBJ, transferred more than US\$35 billion in foreign direct investment into Asia. Japanese banks also played a leading role as suppliers of capital to the region – in 1995 alone, they provided about US\$9 billion in yen loans to countries in Asia (Hatch, 1998).

3.6 DFIs play a part in institutional capacity building

Given the extensive resources, both financial and human, at the disposal of DFIs, they are crucial in addressing capacity failure in public institutions that manage development. DFIs in developing countries have a critical role to play in boosting capacity in the broader public sector. Furthermore, as DFIs are tasked with creating new markets and given the general lack of skills in developing countries, they will also need to be involved in capacity building in the clients to whom they are lending – from project preparation to, in some cases, implementation.

Industrial country DFIs, such as the Netherlands Development Finance Company (FMO) and the European Bank for Reconstruction and Development (EBRD), as a matter of course provide capacity to their project finance clients (Te Velde & Warner, 2007). They also offer capacity development support to the public institutions managing development. In South Africa, upscaling the roles of DFIs in the economic development process will mean that these institutions will also have to scale up their capacity development initiatives to clients, as well as the broader public sector, so as to ameliorate the increasing risks.

The Development Bank of Southern Africa (DBSA) has launched targeted skills development at municipal level through programmes, such as Siyenza Manje, to strengthen local government governance, infrastructure delivery and financial management. These kinds of initiatives for addressing institutional failures will have to be scaled up dramatically, given the deep-seated institutional and capacity failures of institutions in South Africa that are mandated to deliver public services, infrastructure and economic development.

3.7 DFIs provide leadership in development coalitions

At the heart of most successful developmental states has been a cooperative partnership between DFIs and SOEs on the one hand, and between DFIs and the private financial sector, on the other hand. It is essential to coordinate the application of private and public sources of finance in strategic investments, in order to achieve the country's development goals, promote structural change in the economy and put the country firmly on a new growth path. For this to happen, there needs to be an enabling environment for both the DFIs and the private sector financial entities to support such

strategic investments. DFIs are crucial in fostering such an enabling environment, and in coordinating the process of establishing public-private partnerships for development or growth.

Korea's KDB and IBK; Japan's DBJ and JBIC; India's IDBI and Brazil's BNDES are clear examples of how DFIs take the lead in joining together public-private sector partners for development, whether it is for developing specific sectors of the economy, for infrastructure development or for long-term industrialisation. Indeed, these DFIs highlight how the private and public sector can work together to address developmental challenges where the DFIs provide the facilitating leadership (UN, 2005:14).

3.8 DFIs serve as model corporate citizens

As part of their leadership role, DFIs can serve as model corporate citizens and persuade the private sector to follow suit (Heath & Norman, 2004). They can, for example, provide better training opportunities for their employees, as skills development does not feature highly in the South African private sector. DFIs could employ more women, disabled persons and people from historically disadvantaged communities where private sector companies do so reluctantly. Furthermore, DFIs could open up their supply chain to SMMEs and provide them with greater procurement opportunities. In order to perform their leadership role with integrity, DFIs will have to be transparent and professional, and adhere to good corporate governance. Unless they do so, they will not have the credibility to lead the private sector to pool financial and other resources for development purposes.

4. Conclusion and recommendations

For South Africa to upscale its growth path dramatically will demand game-changing initiatives from its DFIs to address development failure. The question is: which key factors may prevent South Africa's DFIs from effectively embarking on such significant initiatives? DFIs need to do the following in order to carry out their developmental mandate:

- (1) Clarify their governance environment and rationalise some DFIs. The mandates, functions and structures of DFIs should be reviewed in keeping with the changing demands on DFIs, and the new imperative for DFIs to align themselves with national imperatives. Their roles, functions and relationships with shareholders and oversight bodies will have to be refined. This will include reviewing the overarching policy and framework legislation, as well as strengthening oversight and corporate governance. DFIs should be rationalised vertically and horizontally across national and provincial spheres, and if necessary, some provincial and municipal DFIs may have to be merged.

- (2) Align DFIs more tightly with broader national economic policy. Most South African DFIs are not aligned with broader national economic policies, specifically national, sectoral, institutional and supply-chain programmes. There should be particular emphasis on putting DFIs (in tandem with SOEs) at the centre of long-term development planning.
- (3) Coordinate DFI activities. More effective coordinating mechanisms for DFIs are needed so that there can be better synergy between the activities and coherence of different DFIs. The DFI Forum is an example of the kind of body needed to coordinate DFI activities so as to avoid duplication and competition over scarce resources. As different DFIs are currently reporting to different national departments, regular and formalised interaction between different national departments and their DFIs will help to tighten coordination. The combined supply and procurement chains of both DFIs and SOEs should also be used more effectively to develop new markets, expand economic sectors and stimulate job creation.
- (4) Ensure greater coordination between DFIs and SOEs. There should be better coordination and alignment between DFIs and other state-owned enterprises, and a greater effort should be made to ensure that their investment activities are complementary. Such interaction should be formalised. Coordination should also take place at the level of the shareholder departments of DFIs and SOEs so as to maximise development impact.
- (5) Boost their capacity to enhance development impact. The capacity of DFIs will have to be boosted considerably, which includes improving corporate governance, risk management capacity, the effectiveness of boards, and the capacity of shareholder departments overseeing the DFIs.
- (6) Upscale 'counter-cyclical' funding significantly. The example of Brazil's BNDES counter-cyclical financing to overcome the negative effects of the global financial crisis should serve as an example for South African DFIs. What is needed is a better coordinated DFI counter-cyclical financing response; for example, the DBSA, IDC and Public Investment Commission (PIC) coordinating their approach in order to kick-start the economy.
- (7) Serve as integrators, financiers, advisers, partners and implementers in infrastructure development. Much of South Africa's infrastructure development since 1994 has focused on overcoming backlogs left by the apartheid regime. These efforts have tended to centre on individual and isolated infrastructure projects, which were often run by different state departments. There has also been little focus on maintaining infrastructure. Yet, the key to successful infrastructure planning is seen to be the provision of infrastructure as an integrated and synchronised system designed to change the pattern of overall development. This would shape society positively through providing economic opportunities in the long term. In South Africa, DFIs – in combination and coordination with SOEs – will have to synchronise the eradication of infrastructure backlogs, the maintenance of existing infrastructure and the long-term provision of infrastructure as a complete functioning system.
- (8) Lead the coordination and enhancement of the relationship between the private and public sectors. In successful developmental states a partnership exists between the public and private sectors in which resources, especially finances, are pooled for growth purposes.
- (9) Innovatively mobilise new sources of finance for development. Given the increasingly limited resources available for development, DFIs will have to become more innovative in mobilising resources, both locally and internationally. It may mean that DFIs should consider tapping into off-balance sheet and concessional finance. The government may also be expected to play a more active role in providing equity and guarantees; allowing for dividend retention; giving tax exemptions; and upscaling transfers. An option is that strong DFIs be allowed to hold selective deposits, such as those from municipalities. Another option is to replicate the Brazilian BNDES funding model and leverage the assets of the PIC better to enhance a broader national development impact.
- (10) Assist with capacity building within the state. Currently, the implementation capacities of many institutions in infrastructure service delivery and of key role players in economic development and public service delivery are limited. DFIs may have to upscale initiatives dramatically to address institutional failures within the state, particularly those at provincial and local government level. DFIs will have to analyse the country's developmental needs intelligently and proactively come up with scenarios to address these. DFIs are the repository of extensive skills, resources and research capacity, which should be better utilised for broader national strategic policy analysis. DFIs could possibly operate as think tanks, ideas banks and knowledge banks for the state.
- (11) Promote regional integration. DFIs are pivotally positioned to promote regional integration efforts,

which is crucial to the economic prosperity of the continent. DFIs will also have to lead the process to create a continent-wide free trade area. South African DFIs should be more proactive in integrating local

finance, donor aid and finance from the new emerging market countries into more long-term, sustainable infrastructure development, industrialisation and development of poorer regions.

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