

## **Development Banks: Their role and importance for development**

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Among the institutions whose role in the development of the less developed regions is well recognised but inadequately emphasised are the development banks. Playing multiple roles, these institutions have helped promote, nurture, support and monitor a range of activities, though their most important function has been as drivers of industrial development.

All underdeveloped countries launching on national development strategies, often in the aftermath of decolonisation, were keen on accelerating the pace of growth of productivity and per capita GDP. This was the obvious requirement for alleviating poverty and reducing the developmental gap that separated them from the developed countries. To realise this goal, they considered industrialisation to be an important prerequisite. This stemmed from the perspective that modern economic growth was a process characterised by an increase in the share of employment in the non-agricultural sector, and within the latter by a change in the scale of productive units, the growth of factory production and a shift from personal enterprise to the impersonal organisation of economic firms.

Besides the apparent universality of this trajectory across countries, a range of arguments were advanced to justify the centrality afforded to modern factory industry. First was the conclusion derived from trends in consumption styles across the globe and embodied in rudimentary form in Engels' Law that the demand for non-food commodities in general and manufactures in particular grows and diversifies as incomes increase. Growth must therefore be accompanied by a process of diversification of economic activity in favour of manufactures. Second was the belief that, given the barriers to productivity increase characteristic of predominantly agrarian economies, the diversification in favour of industrial production is an inevitable prerequisite for a rapid increase in per capita income. Third was the view that beyond a point even agricultural growth is predicated on the availability of a range of manufactured inputs, particularly, chemical fertilisers. Fourth was the evidence that dependence on primary production places a nation at the losing end of the shifting terms of exchange in international trade, necessitating industrialisation as a device aimed at garnering additional benefits from trade and overcoming external vulnerability. And, finally, the idea that given the 'learning by doing' characteristics of industrial capability, delaying entry into the spectrum of industrialisers makes entry more difficult as time goes by.

Industrialisation recommended itself also because of the benefits associated with late entry. There already existed a range of productive techniques in the form of a shelf of blueprints that can in principle be accessed. Late industrialisers, as the cliché goes, need not reinvent the wheel. Nor are they excessively burdened by outmoded capital stock that is yet to be written off, which is the penalty paid by the early starter. This makes the prospect of exploiting the benefits of the productivity increases associated with factory production even more encouraging. It was this set of factors that appeared to justify a strategy of development based on the rapid growth of factory production.

### *Capital requirements*

The difficulty, of course, was that the take-off led by factory-based industrialisation required substantial investment. On the one hand, given the advances in technology between the period when current day developed countries had launched on industrialisation and the point in time when less developed countries had the option to launch on a trajectory of industrial development, the investment required to establish or expand particular activities was greater than what would have been required earlier. Moreover, catching-up requires not merely

establishing or expanding particular activities but engaging in a whole cluster of them, since some crucial requirements for development like infrastructural services of different kinds (roads, power, communications and the like) cannot be imported from abroad and because not all traded goods can be imported given the finite volume of foreign exchange available to individual economies. If larger sums of capital are required for investment in each of a cluster of activities, the total investment requirement would indeed be high.

This creates a special problem in the so-called “mixed economies”, where the private sector is expected to play an important role. Backwardness implies that the investor classes would include only a few individuals who would have adequate capital to undertake the required investments. Their “own capital” would have to be substantially backed with credit. And such credit would not be backed with adequate collateral, other than the assets created by the investment itself.

Moreover, many of these investments involve long gestation lags and take long to go into commercial production and return a profit. Most savers, on the other hand, would not like to lock up their capital for long periods especially in projects that are inevitably “risky”. This would imply that in the market for finance there is bound to be a shortage of long term capital, with savers looking for investments that are more short term, are “liquid” in the sense that they can without too much difficulty be exchanged for cash, and are not too risky.

Further, even to the extent that long term capital is available it would be less than willing to enter certain areas if driven purely by private incentives. Hence, the allocation of investment may not be in keeping with that required to ensure a certain profile of production needed to accelerate growth. For example, it is known that certain sectors—infrastructure being the most obvious—are characterised by significant “economy-wide externalities”. That is, their presence is a prerequisite for and a facilitator of growth in other sectors. But the infrastructural sector is characterised most often by lumpy investments, long gestation lags, higher risk and lower monetary returns. Hence, if private rather than social returns drive the allocation of financial savings, these sectors would receive inadequate capital, even though their capital-intensive nature demands that a disproportionate share be diverted to them. This “short-termism” can result in inadequate investment in sectors with long-term potential from the point of view of growth. Given the “economy-wide externalities” associated with such industries, inadequate investments in them would obviously constrain the rate of growth.

#### *Role for the state*

Thus, even in late-industrialising economies providing an important role for the private sector, state intervention is crucial. And appropriate financial policies are an important component of such intervention. Realizing a growth-oriented pattern of production of goods and services requires the state to guide the allocation of investment, using a range of mechanisms such as directed credit and differential interest rates, besides public investment financed with taxation. Even in developing countries that successfully adopted outward-oriented industrialisation strategies or a more mercantilist strategy of growth based on rapid acquisition of larger shares in segments of the world market for manufactures, the relevant segments were in practice identified by an agency other than individual firms. Experience indicates that the state has the capacity to assess and match global opportunities and economy-wide capabilities. Through its financial policies, the state must ensure an adequate flow of credit at favourable interest rates to firms investing in these sectors, so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the means to sustain themselves during the long period when they expand market share. Financial policies were an important component of the strategic policies pursued by countries like South Korea and Taiwan on the way to competitive

success. These included interest rate differentials and bank financing of private investment, resulting from the channelling of corporate finance through a still largely regulated banking system. Since one of the objectives of these actions is to guide investment to chosen sectors, the rate of interest on loans to favoured sectors may have to be lower than even the prime lending rate offered to the best borrowers, judged by credit-worthiness. That is, differentials in interest rates supported with subsidies or enabled by cross-subsidization is part of a directed lending regime.

Finally, even if credit is available, private expectations of “normal” returns on capital and additional premia to cover risk may be such that the cost of such capital maybe too high for investment in certain crucial sectors. If credit is to facilitate investment, it must be available at terms that can be borne by the returns likely to be earned by investors in different sectors. If it is not, then again investment and growth will be constrained.

Thus, state intervention is needed because the relationship between financial structure, financial growth and overall economic development is indeed complex. If the financial sector is expected to autonomously evolve and is left unregulated, market signals would determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This could result in the problems conventionally associated with a situation where private rather than overall social returns determine the allocation of financial savings and investment. It could also limit the flow of savings to sectors that are a pre-requisite for industrialisation because of their “externality effects” as noted above.

Secondly, if only private financial intermediaries are relied upon, the sheer availability of long-term finance may be inadequate. Many factors influence the incentives to invest and, therefore, the level and structure of intended investments. However, some or a substantial share of those intentions may remain unrealized, even when potentially viable, because of lack of access to the capital needed to finance such investments or the insurance needed to guard against unforeseen risk. This has obvious implications for growth. Hence, the financial structure matters, even if not as the principal driver of investment and growth.

As noted elsewhere (United Nations, 2005), left to themselves, private financial markets in developing countries usually fail to provide enough long-term finance to undertake the investments necessary for economic and social development. As a result, firms in developing countries often hold a smaller portion of their total debt in long-term instruments than firms in developed countries. Private institutions may fail to provide such finance because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances, failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned (Stiglitz, 1994).

### *Development banking*

Given these features, the financial sector must be designed to include institutions, sources of finance and instruments that can bridge the significant mismatches in the expectations with regard to maturity, liquidity, risk and interest rates between savers and investors. One way to deal with this problem is to encourage the growth of equity markets. This is seen as attractive because, unlike in the case of debt, risk is shared between the financial investor and the entrepreneur. This enhances the viability of the firm in periods of recession. However, the evidence shows that even in developed countries equity markets play a relatively small role in

mobilizing capital for new investments. Even where markets are active, it is the secondary market that is of significance.

An important institutional innovation in many late-industrialising developing countries was the creation of what are broadly called development banks, which most often are public or joint sector institutions. Development banks are in the nature of “universal banks” undertaking a wide range of activities besides those undertaken by commercial banking institutions.

Commercial banks, which mobilise finance through savings and time deposits, acquire liabilities that are individually small and protected from income and capital risk, are of short maturity and are substantially liquid in nature. On the other hand, the credit required for most projects tends to be individually large, subject to income and capital risk and substantially illiquid in nature. Consequently, commercial banks conventionally focus on providing working capital credit to industry. This is lent against the collateral constituted by firms’ inventories of raw materials, final products and work-in-progress. Though this can involve provision of credit in relatively large volumes, with significant income and credit risk and a degree of illiquidity, it implies a lower degree of maturity and liquidity mismatch than lending for capital investment. This makes traditional commercial banks less suited to lending for capital investment.

To cover the shortfall in funds required for long-term investment, developing countries need to and have created development banks with the mandate to provide long-term credit at terms that render such investment sustainable. They tend to lend not only for working capital purposes, but to finance long-term investment as well, including in capital-intensive sectors. Having lent long, they are very often willing to lend more in the future.

Since such lending often leads to higher than normal debt to equity ratios, development banks to safeguard their resources closely monitor the activities of the firms they lend to, resulting in a special form of “relationship banking”. Often this involves nominating directors on the boards of companies who then have an insider’s view of the functioning and finances of the companies involved. In case of any signs of errors in decision-making or operational shortcomings, corrective action can be undertaken early.

Since very often lending begins at the stage of the formulation of project itself, development banks are also involved in decisions such as choice of technology, scale and location. This requires more than just financial expertise, so that development banking institutions build a team of technical, financial and managerial experts, who are involved in the decisions related to lending and therefore to the nature of the investment. This close involvement makes it possible for these institutions to invest in equity as well, resulting in them adopting the unconventional practice of investment in equity in firms they are exposed to as lenders. This would in other circumstances be considered an inappropriate practice, since it could encourage development banks to continue lending to insolvent institutions since they are investors in the firms concerned and may suffer significant losses due to closure.

Given their potential role as equity investors, development banks provide merchant banking services to firms they lend to, taking firms to market to mobilise equity capital by underwriting equity issues. If the issue is not fully subscribed the shares would devolve on the underwriter, increasing the equity exposure of the bank. Firms using these services benefit from the reputation of the development bank and from the trust that comes from the belief of individual and small investors that the banks would safeguard their investment by monitoring the firms concerned on their behalf as well.

Development banks can help monitor corporate governance and performance on behalf of all stakeholders, reducing their dependence of systems of indirect monitoring resulting from the discipline exerted by the threat of takeover in stock markets ostensibly prevalent in developed countries like the US and the UK. The effectiveness of the latter option is limited. Moreover, it is not available in most developing countries where equity markets are poorly developed and most firms are not listed.

Thus, development banks lend and invest. They leverage lending to influence investment decisions and monitor the performance of borrowers. They undertake entrepreneurial functions, such as determining the scale of investment, the choice of technology and the markets to be targeted by industry, and extension functions, such as offering technical support. Stated otherwise, they are a component of the financial structure that can ensure that lending leads to productive investment that accelerates growth and makes such lending sustainable.

In practice, development banks may not always leverage their capital-provision role to intervene effectively in management in all contexts. In some countries such as India, despite a significant role as providers of finance, development banks adopted a passive role with respect to technological or managerial decisions of private borrowers, avoiding a role that such institutions are expected to play. But this is not a characteristic of development banking, but evidence of an opportunity missed, not only to exploit the economies of scale associated with investment in knowledge skills of certain kinds, but also to coordinate investment decisions in systems dominated by private decision-making.

#### *Early examples*

Institutions of this kind are not new to capitalism. When analysing the institutional innovations that late-industrialisers relied on to facilitate their industrial take off, Alexander Gerschenkron pointed to the important role played by these kinds of credit institutions. Gerschenkron believed that late industrialisers in Europe such as Germany in the late nineteenth century could find institutional substitutes for crucial “prerequisites” such as prior accumulation of capital or the availability of adequate entrepreneurial skills or technological expertise. It was in the elaboration of these institutional instruments that we find some of the most useful insights in Gerschenkron’s contributions. Principal among these was his discussion of the role that certain institutional adjustments in the financial sector played in the success of late-industrialisers like France and Germany. Basing his arguments on the roles played by *Crédit Mobilier* of the brothers Pereire in France and the ‘universal banks’ in Germany, Gerschenkron argued that the creation of “financial organisations designed to build thousands of miles of railroads, drill mines, erect factories, pierce canals, construct ports and modernise cities” was hugely transformative. Financial firms based on the old wealth were typically in the nature of rentier capitalists and limited themselves to floatations of government loans and foreign exchange transactions. The new firms, were “devoted to railroadisation and industrialisation of the country” and in the process influenced the behaviour of old wealth as well.

As Gerschenkron argued: “The difference between banks of the credit-mobilier type and commercial banks of the time (England) was absolute. Between the English bank essentially designed to serve as a source of short-term capital and a bank designed to finance the long-run investment needs of the economy there was a complete gulf. The German banks, which may be taken as a paragon of the type of the universal bank, successfully combined the basic idea of the credit mobilier with the short-term activities of commercial banks.” (Gerschenkron 1982: 13).

The banks according to Gerschenkron substituted for the absence of a number of elements crucial to industrialisation: “In Germany, the various incompetencies of the individual entrepreneurs were offset by the device of splitting the entrepreneurial function: the German investment banks—a powerful invention, comparable in economic effect to that of the steam engine—were in their capital-supplying functions a substitute for the insufficiency of the previously created wealth willingly placed at the disposal of entrepreneurs. But they were also a substitute for entrepreneurial deficiencies. From their central vantage points of control, the banks participated actively in shaping the major—and sometimes even not so major—decisions of the individual enterprises. It was they who often mapped out a firm’s paths of growth, conceived far-sighted plans, decided on major technological and locational innovations, and arranged for mergers and capital increases.” (Gerschenkron 1968: 137).

Thus the lack of an adequate period of prior accumulation and of an adequately evolved entrepreneurial class did not constitute constraints in these instances, because of the institutional substitution in the realm of finance which made up for those inadequacies. These institutional substitutes need not, however, evolve automatically. In fact, their emergence in the private sector itself maybe completely fortuitous, and countries seeking to accelerate industrialisation from a low base may find the need to create institutions that can play such a role. This might require these institutions to be established by the government, even owned by it and supported with significant resources from the budget or the central bank. It is this requirement that explains the creation of development banks in many less developed countries, such as Brazil and India.

Thus, the overall objective of establishing development banks is to ensure that the processes of financial expansion occur in the context of a policy regime that can ensure the delivery of credit to targeted clients, in adequate amounts and at an appropriate interest rate. This because, though availability of credit in itself cannot be expected to spur investment in a supply-leading manner, wherever the inducement to invest and, therefore, demand for credit, exists, lack of access can prevent the full realization of the potential for investment and growth. This requires specialised development banks.

Since development banks play a role normally bypassed by commercial banks and as they are funded by the state (with deep pockets), there is always the possibility that lending to projects that are neither commercially viable nor socially profitable may occur for reasons other than errors of judgment. Governance mechanisms to ensure transparent procedures, adequate disclosure and participative monitoring involving oversight by democratically elected bodies are crucial. Such mechanisms should not be diluted or passed up on the grounds that they undermine managerial autonomy.

According to an OECD estimate quoted by Eshag (2000), there were about 340 such banks in some 80 developing countries in the mid-1960s. Over half of these banks were state-owned and funded by the exchequer; the remainder had mixed ownership or were private.

In short, handicapped by colonial legacies, international inequalities and various systemic biases, these kinds of institutions are a ‘must’ for developing countries. Any national strategy of modernisation in a mixed-economy framework must provide for the establishment of institutions of this kind.

#### *Development banks and innovation*

Given the role played by development banks, it is to be expected that they can serve as vehicles to promote innovation by encouraging small and innovative companies. Special funds created to finance such investments have a long history. Originally, their role was in

the nature of the development banks of today. Examples of such funds in Europe are Charterhouse Development Capital established in 1934 and 3i in 1945. 3i, which was first established as the Industrial and Commercial Finance Corporation, was created by the UK clearing banks and the Bank of England to meet the long-term capital requirements of smaller companies with limited access to financial markets. These kinds of entities were also established in the US, in this case with the declared aim of commercialising many of the new technologies that had been developed during the war years. Examples are the American Research and Development Corporation (ARD) established in 1946 and the Small Business Investment Companies in the 1950s, all of which were aimed at encouraging technology-based entrepreneurial businesses. ARD sought to finance its investments by raising institutional capital using a publicly traded, closed-end investment company while the SBICs were supported by or were offshoots of the banks.

While there are some examples of development banks serving this role in individual developing countries, in instances like India where the state focused on creating specialised Research and Development institutions, often in the state sector, this kind of activity of the development banks is less prominent.

### *Two experiences*

Two developing countries that relied heavily on development banks in their post-War industrialisation effort were Brazil and India. In Brazil the principal development bank is the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) established in 1952. Over time the government has used various measures such as special taxes and cesses, levies on insurance and investment companies and direction of pension fund capital to mobilise resources for the industrial financing activities of the BNDES. (Baer & Villela, 1980) The size of BNDE support for investment increased significantly, with a transition in 1965 when BNDES support rose from below 3 per cent of capital formation to 6.6 per cent. There was also a shift in the focus of BNDES activities. While initially sectors like transport and power overwhelmingly dominated its lending, subsequently there was considerable diversification in support, to sectors such as nonferrous metals, chemicals, petrochemicals, paper, machinery, and other industries. Further, while in its early years BNDES investments were focused on the public sector, there was a significant shift in favour of the private sector in later years. In the period 1952-66, 80-90% of financing was directed to the public sector. That figure fell to 44 per cent during 1967-71, and then to between 20 and 30 percent.

India adopted a more elaborate structure. Apart from setting up an Industrial Finance Department (IFD) in 1957 within the Reserve Bank of India (RBI) and administering a credit guarantee scheme for small-scale industries from July 1960, a series of industrial credit institutions were promoted, which in fact had begun earlier with the setting up of the Industrial Finance Corporation (IFC) in July 1948 for rendering term-financing for traditional industries. In addition, State Financial Corporations (SFCs) were created under an Act that came into effect from August 1952 to encourage state-level medium-size industries with industrial credit. In January 1955, the Industrial Credit and Investment Corporation of India (ICICI), the first development finance institution in the private sector, came to be established, with encouragement and support of the World Bank in the form of a long-term foreign exchange loan and backed by a similar loan from the government of India financed out of PL 480 counterpart funds. In June 1958, the Refinance Corporation for Industry was set up.

Two other major steps in institution building were the setting up of the Industrial Development Bank of India (IDBI) as an apex term-lending institution and the Unit Trust of India (UTI) as an investment institution, both commencing operations in July 1964 as

subsidiaries of the Reserve Bank of India. With a view to supporting various term-financing institutions, the RBI set up the National Industrial Credit (Long-Term Operations) Fund from the year 1964-65.

The importance of these institutions is clear from the fact that their investments (disbursals) in Net Fixed Capital Formation in India rose from less than 10 per cent before the 1970s to around 35 per cent in 1988-89. Over 70 per cent of sanctions went to the private sector, and took the form of loans as well of underwriting and direct subscription of shares and debentures.

The real difference between Brazil and India with respect to development banking has occurred in the period since the early 1990s when the government in these two countries opted for internal and external economic liberalisation. In Brazil, reform notwithstanding, the BNDES has grown in strength. Its assets total Reals 277.3 billion or close to \$120 billion at the end of 2008. This has served Brazil well. The bank's role increased significantly, when private activity slackened in the aftermath of the financial crisis. This countercyclical role helped Brazil face the crisis much better than many other developing countries.

According to reports, the BNDES has stepped in to keep business credit going, when private sector loans dried up in 2008. It lent a record 168.4 billion reais (\$100.8 billion) in 2010, which was 23 percent higher than the previous record in 2009. As a result, the country's credit to gross domestic product ratio continued to grow after the onset of the financial crisis. (Bevins, 2010)

On the other hand, liberalisation has damaged the structure of development banking in India. On March 30 2002, the Industrial Credit and Investment Corporation of India (ICICI) was, through a reverse merger, integrated with ICICI Bank. That was the beginning of a process that is leading to the demise of development finance in the country. The reverse merger was the result of a decision (announced on October 25, 2001) by ICICI to transform itself into a universal bank that would engage itself not only in traditional banking but investment banking and other financial activities. The proposal also involved merging ICICI Personal Financial Services Ltd and ICICI Capital Services Ltd with the bank, resulting in the creation of a financial behemoth with assets of more than Rs 95,000 crore. The new company was to become the first entity in India to serve as a financial supermarket and offer almost every financial product under one roof.

Since the announcement of that decision, not only has the merger been put through, but similar moves undertaken to transform the other two principal development finance institutions in the country, the Industrial Finance Corporation of India (IFCI), established in 1948, and the Industrial Development Bank of India (IDBI), created in 1964. In early February 2004, the government decided to merge the IFCI with a big public sector bank, like the Punjab National Bank. Following that decision, the IFCI board approved the proposal, rendering itself defunct.

Finally, the Parliament approved the corporatisation of the IDBI, paving the way for its merger with a bank as well. IDBI had earlier set up IDBI Bank as a subsidiary. However, the process of restructuring IDBI has involved converting the IDBI Bank into a standalone bank, through the sale of IDBI's stake in the institution. Now IDBI has been merged with IDBI bank. With this creation of a universal bank as a new entity, that has multiple interests and a strong emphasis on commercial profits, it is unclear how the development banking commitment can be met. These decisions are bound to aggravate the shortage of long term capital for the manufacturing sector, especially for medium sized units seeking to grow.

These two experiences point to the two very different directions that development banking is likely to take in the years to come.

### **Development Finance in Vietnam**

In Vietnam, the government has continued with targeted lending for specific purposes even after the adoption of financial liberalization policies. This involved the creation of a special Development Assistance Fund (DAF) in 200, separate from the commercial banking system, which had as its objectives: (i) the provision of subsidized state loans for medium to long-term investments in priority sectors such as infrastructure, heavy industry and public services, (ii) provision of interest-rate support and investment guarantees for chosen projects, and (iii) provision of short-term export promotion credit. Support in these forms can go to both private and state-owned enterprises, taking account of both commercial and policy criteria, such as encouraging investment in underdeveloped areas, preferential sectors, and projects related to health, education, culture and sport. The DAF has branches in all sixty-one provinces, with a registered capital of five billion dong (US\$326.8 million). Before 2002, the Office of the Prime Minister determined allocation of funds. Funds came from the Social Insurance Fund, the Sinking Fund, the Vietnam Postal Service Savings Company (VPSC),<sup>1</sup> the government budget, loan repayments, and official development assistance (ODA). Since 2002, the DAF has been expected to mobilize its own resources. It continues to draw funds from the sources mentioned above, through negotiation. If funds come from the government budget, this usually involves issuance of investment bonds.

Outstanding credit from the DAF in 2001 to 2002, and loan disbursements in 2002 and 2003 grew much faster than total domestic credit to the economy. As a result disbursements through the DAF amounted to an increasing share of domestic credit, reaching 24 percent in 2002, equal to 3.3 per cent of GDP. Over time, the DAF has emerged as the largest financial intermediary in Vietnam for channelling domestic and foreign funds to investment activities (Weeks et al., 2003).

### *Policy banks*

Developing countries soon realised that development banking of the kind described above was not in itself adequate to deal with their needs. This is because the financial structure must not only contribute to growth by directing investment to crucial investment projects, but it must render development broad-based by delivering credit to sectors that may otherwise be ignored by the financial sector. A typical example of this, for example, is small peasant farming. Credit to support agricultural operations that are seasonal in delivery of produce and subject to much volatility is crucial. But providing credit in small volumes to dispersed and often remotely located borrowers increases transaction costs substantially. Further, the volatility of production, especially in rain-fed agriculture, often results in costly restructuring or large scale defaults. This implies that the risk premia associate with such lending would also be high.

If these transaction costs and risk premia are to be reflected in interest rates charged on loans, rates could be so high that the loans concerned cannot be used for productive purposes. This

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<sup>1</sup> VPSC was established in 1999. In 2002, it already had 539 to 600 branches all over the country, and has been a good and fast-growing venue to mobilize rural savings. There are around half a million deposit accounts with outstanding deposits at D3.8 billion (around US\$250 million).

implies that returns on lending to sectors such as these would be significantly lower than normal. This would require the state to intervene in one of many ways. It could insist on “social banking” on the part of ordinary banks, set low ceilings on interest rates chargeable to priority sectors and provide the banks a subsidy in the form of a subvention. Or it could require public banks to lend at low interest rates and cross-subsidise such lending with returns on normal commercial operations. This would imply that the returns expected of such banks would be lower than a normal purely “commercial” benchmark. Or it could create specialised development banks, provided state funds a extremely low interest rates to carry out these operations.

Most countries have found that it is best to create separate development banks to provide long-term capital at near-commercial rates and “policy banks” to provide credit to special areas such as agriculture or the small scale sector where interest rates have to be subsidized and grace periods have to be longer. This allows different criteria to be applied to the evaluation of the performance of these banks, with profitability a more important consideration in the case of the former.

Thus, in India in the sphere of agricultural credit, apart from setting up two funds in 1955, namely, the National Agricultural Credit (Long-Term Operations) Fund and National Agriculture Credit (Stabilisation) Fund from out of the profits of the RBI to support the cooperative credit structure, the Agriculture Refinance and Development Corporation (ARDC) was set up in 1975. Subsequently the government established the National Bank for Agriculture and Rural Development (NABARD) in 1981 to provide refinance for institutions engaged in lending in rural areas and coordinating their activities.

### *Conclusion*

Thus, over a significantly long period of time, countries embarking on a process of development within the framework of mixed, capitalist economies have sought to use the developing banking function, embedded in available or specially created institutions, to further their development goals. The role of these institutions in the development trajectories of late industrialising, developing countries cannot be overemphasised. However, as noted above, with financial liberalisation of the neoliberal variety transforming financial structures, some countries are doing away with specialised development banking institutions on the grounds that equity and bond markets would do the job. This is bound to lead to a shortfall in finance for long-term investments, especially for medium and small enterprises. Fortunately, there are some countries such as Brazil that have thus far not opted for this trajectory.

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