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STREAM 1, POLICY BRIEF 4

REORIENTING DFIS TO PLAY A STRONGER ROLE IN JOB CREATION

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1. PROBLEM STATEMENT

Despite its large size relative to other emerging markets, the South African financial sector does not do a good job of funding productive investment in labour intensive manufacturing sectors, because these sectors are often high risk, and offer relatively low short-term profit opportunities. Since the private financial sector can rarely finance such developmentally important sectors on its own, publicly owned development finance institutions (DFIs) continue to fill these gaps in both industrialised and developing economies including Germany, France, Japan, Korea, China, Brazil and India. They have historically done this in a number of ways, including through providing subsidised long-term loans to priority sectors, or taking equity stakes in companies in order to influence them to make more productive investment decisions. These institutions can play a complementary role to private finance, precisely because they are not constrained by profit motives, and are able to take greater risk than private banks due to their public backing.

While South Africa has a number of DFIs (the largest are IDC and DBSA) these are small in size relative to comparator countries[1], and cannot play a strongly developmental role due to their funding models. Unlike in other developing countries, South African DFIs do not receive a stable source of low-cost government funding, which forces them to adhere to commercial principles in order to raise finance from private investors, and constrains the degree to which they can engage in developmental activities - which by definition are usually not profitable in the short term.

For example, the IDC relies mainly on domestic capital markets and bank loans, which increase in cost if IDC takes on greater risk, or on the international financial institutions, which can attach conditionalities to their loans. As a result, IDC is limited in the extent of subsidy it can offer. In some cases, its loans can be even more expensive than those of private commercial banks[2], which fund themselves through deposits – a relatively cheaper funding source.

South Africa is also the only emerging market country that does not have an export-import (EXIM) bank. EXIM banks are a key tool used to boost the competitiveness of exports through provision of various forms of direct financing to foreign buyers when commercial loans are unavailable, or by guaranteeing and therefore reducing the cost of commercial loans. They are especially important for 'big-ticket' exports (in sectors such as capital equipment, including agricultural and mining equipment, and infrastructure) where the sheer scale of finance required means that private banks have difficulty in taking on the risk by themselves. South African capital equipment exports to other African countries suffer in

particular. When exporting to industrialised economies, South African capital equipment exporters can access trade finance through the importing countries' EXIM bank, but when exporting to less developed African countries, which do not have their own EXIM banks, South African exporters lose deals to China and Brazil because they cannot compete on trade finance provision.

All of this means that although DFIs play a valuable role given their resource constraints, having managed to finance a small number of developmental projects that private banks would not take on through cross-subsidisation from their more profitable investments, and having somewhat increased their lending in the wake of the 2008 crisis, they cannot fulfil their developmental mandate to full potential under the current funding model.

In order for the DFIs to play a role that is sufficiently developmental to meet the massive challenges facing the South African economy, IDC and DBSA need to be scaled up, given a government guarantee, and stable, low-cost source of funding, so that they are no longer beholden to commercial performance criteria. Furthermore, an EXIM bank should be established, either within an existing DFI, or as an independent entity.

2. JOBS IMPACT

The sectors that suffer the most from gaps in private finance provision are also employment creating sectors, since they involve domestic manufacturing production. These include capital equipment exports, automobile subcomponents, mining equipment, metals and engineering, and textiles, and small and medium size businesses, among others. Mitigating financial constraints in these sectors through DFIs should therefore contribute to job creation. It should however be noted that provision of DFI finance by itself will not be sufficient to solve all the problems facing these sectors. Instead, DFI finance has to be part of a coherent overall industrial policy that covers both creating demand, and facilitating investment.

3. PROPOSALS

The proposal includes:

1. Recapitalise IDC and DBSA with public funds so that they can increase their loan volume.
2. Grant IDC and DBSA a stable, low-cost, long-term funding line, either directly as a budgetary allocation to the relevant ministry, or funded from tax sources, so that they can fulfil their developmental mandate free from short-term commercial pressures.
3. Set ambitious developmental targets for IDC and DBSA to complement overall industrial policies made by the DTI.
4. IDC to target labour intensive, high value added sectors which might have high risk, and low profitability, rather than lower-risk sectors that are already commercially viable and receiving private bank finance. Examples include export oriented capital equipment, metals beneficiation, and automotive components, among others.
5. IDC to use its equity portfolio strategically to influence the investment decisions of large firms along the lines of the BNDES model, rather than investing in equities merely to boost its balance sheet.
6. Enforce strict local contents requirements on IDC loans for the purchase of capital goods in order to create domestic demand.
7. Establish an EXIM bank, either within IDC or DBSA, or as an independent entity, reporting to either DTI or EDD.

4. EXISTING INITIATIVES/ EXPERIENCE

In the wake of the 2007/09 global financial crises there has emerged increased support world wide for DFIs (known internationally as national development banks,) as the problems of a purely private financial sector became more evident. International institutions like the World Bank and G24 now recognise the need for DFIs, and even the European Union (EU) has supported the establishment of DFIs in member states as part of the Juncker investment plan. Amongst industrialised economies, the German KfW is the largest development bank in the world, relative to GDP. The most successful developing economies, including China, Brazil, and India all have large DFIs which play an important role in financing industrial policy both domestically and abroad.

EXIM banks in particular have taken on a renewed strategic importance during the 2008 crisis, with every major economy increasing countercyclical public provision to make up for the dramatic contraction in private bank trade finance. China, Brazil, India, and Russia in particular have massively expanded the scale of their EXIM banks

since the early 2000s[3], in order to break out of the 'middle income trap' by using export finance to aid the transition from exporting consumer to capital goods. An appropriate funding model for South African DFIs is that of the Brazilian BNDES. While BNDES received direct treasury loans after the 2008 crisis, to enable its massive countercyclical stimulus, it has historically relied on the FAT fund, a tax on employers, and other sources from the tax base that guaranteed it a stable, low cost, and long-term source of funds.

This funding model enabled BNDES it to carry out its developmental mandate free of short-term commercial pressures. In addition to providing nearly all long-term credit in the economy, its developmental activities include a number of special programs for priority sectors, as well as flagship programs like promotion of the domestic capital goods sector by providing subsidised loans to other sectors for the purchase of capital goods, with a 60% domestic content requirement. This helped create a market for the domestic machinery and engineering sectors to sell their products. Through its subsidiary BNDESPAR, BNDES also takes equity stakes in large Brazilian companies in order to exert influence on firms' investment decisions to steer them in line with industrial policy priorities.

Within South Africa, concerns about DFIs being unable to fulfil their developmental mandate due to commercial pressures have been raised repeatedly at various ANC conferences and previous job summits. Although the ANC has agreed in principle that DFIs are an important tool of industrial policy, and need public funding in order to be effective, these measures have never been implemented due to perceived fiscal constraints.

5. CONSTITUENCY PARTICIPATION IN IMPLEMENTATION

Any increase in DFI capitalisation or budgets would need to be approved by the National Treasury, and administered by EDD or DTI. Business associations (such as Manufacturing Circle, NACAAM, SACEEC) and industrial labour unions (such as NUMSA, SACWTU) in the relevant sectors have an important role to play in identifying specific sectors and areas where private banks fail to provide adequate finance, at reasonable cost.

6. BENEFITS

Labour would benefit through support to job creating sectors including but not limited to export oriented capital equipment, metals beneficiation, and automotive components, and textiles. Manufacturing subsectors with domestic production, and small and medium size businesses that have difficulties in accessing private finance at favourable terms would benefit from a reduced cost of finance, which would enable them to increase investment. Local contents requirements for accessing IDC finance could create demand for domestically produced capital/intermediate goods (if enforced strictly), further benefitting the sector. An EXIM bank would expand available export markets, increasing productivity through enabling economies of scale in export-oriented sectors. This would also help mitigate balance of payments problems. In the longer run, DFIs that facilitate productive investments would also have fiscal benefits.

7. COST AND POTENTIAL SOURCES OF FUNDING

Two potential models of increasing funding are outlined below. One involves recapitalising and funding DFIs through government borrowing, and the other through a direct tax. By themselves, neither may be sufficient, so a combination of both, along the lines of the Brazilian model, is recommended.

Group	Anticipated	Potential sources of funding to implement the project	Time frame for impact
Taxpayers	In order to fund capitalisations/budgetary allocations to the DFIs the government would either have to borrow more in the short term, or tax would have to be increased. If taxation is progressive this is not a problem. It should also be noted that long term fiscal benefits have the potential to outweigh short term fiscal costs	Funds allocated to IDC/DBSA through an increase in the budget (rather than a reallocation of existing funds within the given budget)	On-going
Large corporates	Under this funding model the costs would be more directly borne by the corporate sector	Alternatively DFIs could be funded through a special tax on employers along the lines of the Brazilian model	On-going

8. RISKS

The main risk is a ratings downgrade and loss of domestic and foreign investor confidence as a result of increased short-term fiscal costs. Domestic investors might refuse to lend to the DFIs, but if they are receiving government funding this should not be a problem in any case. The government would carry some fiscal risk from guaranteeing IDC and DBSA lending.

9. RISK MITIGATION

While the proposed changes to DFIs might result in short-term fiscal costs, these need to be weighed against longer-term fiscal benefits. Because DFI loans are channelled to productive investments, they are expected to increase GDP growth and tax revenue in the medium to long term which would improve debt to GDP ratios. DFI lending would also reduce unemployment, which is a drain on the fiscus. Short-termist thinking focusing myopically on fiscal costs traps the economy in a vicious circle where it cannot borrow to make the requisite investments for future growth. This further increases the debt burden down the line.

It has now been recognised in the EU that fiscal austerity, ostensibly to reduce debt burdens has in fact resulted in increased debt to GDP ratios in the longer term because of its negative effect on GDP. For this reason, in many countries such as Germany, DFI lending is not counted towards the gross national debt, nor towards the 3% deficit to GDP ratio Maastricht target according to European statistical conventions.

1. The combined assets of IDC and DBSA amount to just over 5% of GDP. The assets of the Chinese CDB, and Brazilian BNDES alone come up to about 14% and 16% of GDP respectively, while the German KfW is even larger with assets of about 17% of GDP.

2. IDC manages to give some loans at preferential interest rates by cross-subsidising these loans with profits on other parts of their loan book.

3. Since 2000 export credit from BRICS countries has surged from 3% to 40% of the world total. China is now the world's largest provider of export credit, having supplied US$ 58bn in medium and long term export support in 2014 alone.