What role for state development banks to address regional inequality? SDBs and the spatial diffusion of private sector funding

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Research questions

What role can state development banks play in addressing access to finance challenges in lagging regions?

What do they do in practice?

Agenda

- Background
- Conceptual considerations
- Case studies
- Conclusion

Term clarification: SDB

State-owned development banks (SDBs) are established

"to provide credit and other financial services to individuals, firms and strategic sectors of the economy that private financial institutions were unable or unwilling to serve to the extent desired by policy-maker"

(World Bank, 2012)

Resurgence of academic interest in SDBs

- Older body of literature on SDBs, however largely for the developing countries context and underdeveloped financial markets (e.g. Atkinson & Stiglitz, 1980; Stiglitz, 1994; IADB, 2004)

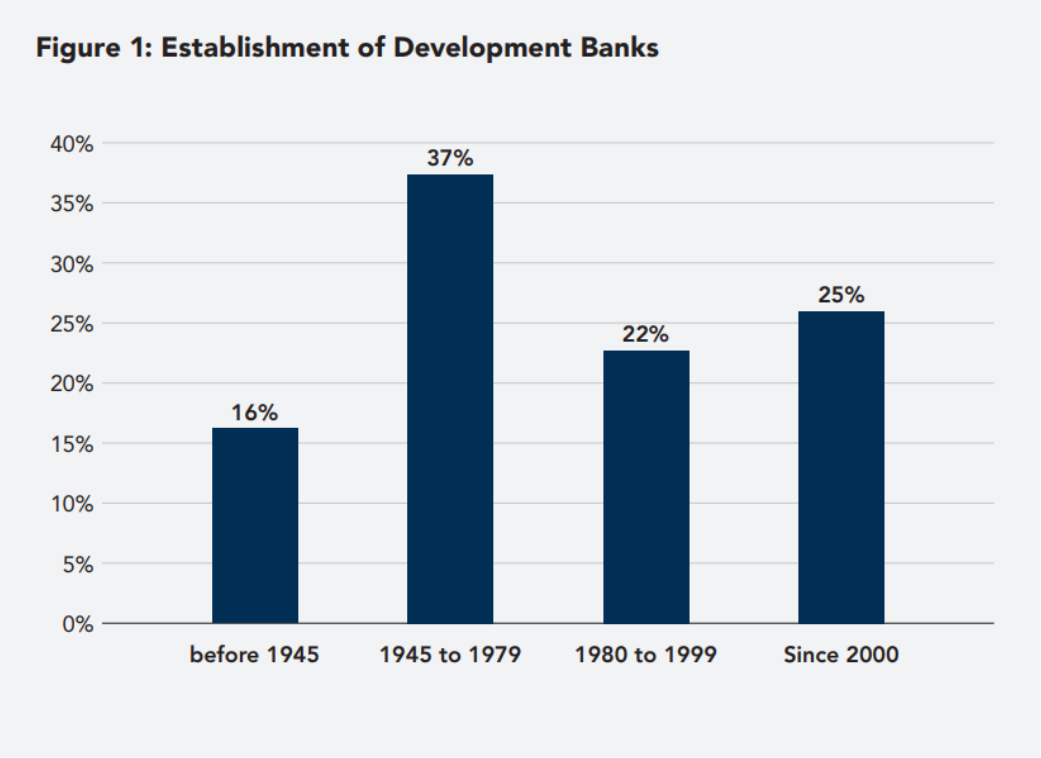
- Recent resurgence of interest in the topic in light of the global financial crisis and industrial policies coming back into fashion (Mazzucato & Penna, 2015; Mazzucato & McFarlane, 2023; Mertens & Thiemann, 2018)

- Emphasis on how state development banks can contribute to address the grand challenges of our time, in particular the green transition

- However, (1) little concern for the question of regional inequalities and polarization; and (2) limited knowledge on how they operate, their policy mandates, target markets and governance structure (World Bank 2012)

Are SDBs a relevant phenomenon to look at?

- Over 500 national, subnational and multilateral development banks in over 155 countries (DFI database, 2017)
- $23 trillion in assets and 10% of worldwide investment activity (DFI database, 2017)
- Many recently established – often in high-income countries with developed financial systems, e.g. National Wealth Fund in the UK (WB survey, 2017)



Source: World Bank, 2017

What's the challenge?

- Growing evidence on significant variations in the availability and pricing of finance across regions (Belucci et al., 2013; Lee & Cowling, 2012; Daams et al., 2025)

- Why? Several mechanisms, including importance of localized tacit knowledge for financing decisions, cumulative causation and networks (see Lee & Luca, 2019 for an overview)

- Why does this matter? Access to finance has important links to economic growth (Ayyagari et al., 2016, Lee & Luca, 2019), hence for regional growth and regional inequalities

- Question in how far state development banks can and do contribute to narrowing the gap

Conceptually, SDBs could have a role in promoting the spatial diffusion of capital (1/4)

"The important thing for government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all' (Keynes, 1927, p. 46).

1. Informational failures/ imperfect information

2. Higher social than financial returns

3. Positive externalities in presence of agglomeration economies

Conceptually, SDBs could have a role in promoting the spatial diffusion of capital (2/4)

1. **Informational failures**
   - Costly and imperfect information for financing projects and capitalizing local banks leads to suboptimal capital allocation and viable projects not being funded or at higher costs in more peripheral places
   - Standard argument in the (limited) economics literature on this (see for example Greenwald, Levison & Stiglitz 1993)
   - Possible solutions:
     - Government directly invests in local firms
     - Support local financial institutions which, based on their access to local information, then lend to firm
     - Support information gathering

Conceptually, SDBs could have a role in promoting the spatial diffusion of capital (3/4)

2. **Higher social than financial returns**
   - Limited incentives for private financial service providers to fund project that exhibit higher social than financial returns, e.g. infrastructure, education and healthcare (Yeyati, Micco & Panizza, 2004)
   - Involvement of SDBS to ensure socially profitable projects are invested in
   - Spatial perspective: investments in lagging regions have social return in the form of reducing disparities and/or increasing cohesion
   - Relevance of political / institutional framework: potential social returns need to be recognized and valued as such

Conceptually, SDBs could have a role in promoting the spatial diffusion of capital (4/4)

3. **Positive externalities in presence of agglomeration economies**
   – Shaping and creating regional markets
   – A lack of a critical mass in peripheral areas and a pull towards core areas can make it hard for investments to happen
   – Smaller markets, more costly management of supply chains, less knowledge spillovers etc reduce the financial viability of projects
   – Facilitating investments and firm establishment/ growth would create positive externalities, which are not internalized by the finance provider, and hence could justify SDB intervention
   – Related to "big push" thinking and growth pole interventions

Conceptual reasons for regional development roles of SDBs - but is this reflected in their organisation?

Background: case studies

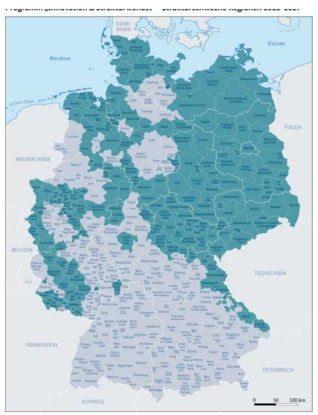
	KFW Bank aus Verantwortung	bpifrance	European Investment Bank
Established	1948	2013	1958
Ownership	80% federal government 20% Laender	Central governments	27 EU member states
Funding volume	EUR 79bn in total, EUR 48bn for private sector financing (2024) ~EUR 600bn in assets	EUR 28bn across different instruments (2023) ~EUR 100bn in assets (2023)	EUR84 billion (in 2024)
Target groups	Public institutions, private firms and individuals Private: Focus on SMEs and start-ups	Only private firms, mainly micro-businesses, SMEs and mid-caps, but in special cases also large caps	Public institutions, including SDBs, and private sector Private: SMEs and midcap as well as large caps

KfW does not explicitly mention spatial aspects in its mandate, but has an important role through its operations

Mandate:
Regional economic development not explicitly considered – no spatial component but focus on financing and promotion of sustainable development more generally

However:

- KfW plays an important role for capitalizing the banking system in all regions
- KfW can finance its operations on the international capital markets at low costs, due to its explicit guarantee from the German government
- Loans offered at advantageous KfW interest rates available to any firm across Germany, independent of location, through local banks and subnation SDBs
- Plus: Regionally differentiated pricing with up to15 bps lower for development regions



→ KfW capitalizes the heavily decentralized German banking system, taking advantage of the close relationship between local banks and customer

BPIFrance has an implicit regional mission through its decentralized structure

Mandate:
Regional economic development <u>implicitly</u> considered – focus on being "one stop shop for entrepreneurs" "by "being entrepreneur centric and <u>heavily decentralized</u>"

- Decentralized approach reflected in 50 branch offices across all regions in France
- BPIFrance has active involvement in the acquisition and management of the loans, with a direct contractual relationship with borrowers
- 95% of decisions taken locally

→ BPIFrance recognizes need for local presence to overcome informational failures in light of a relatively centralized French banking system

EIB has an explicit mandate focused on territorial cohesion

Mandate:
Regional economic development explicitly recognized in mandate - a modern cohesion policy is one of the eight core strategic priorities and was one of the reasons behind EIBs founding:

"the European Investment Bank should continue to devote the majority of its resources to the promotion of economic, social and territorial cohesion […]. (EIB, 2021)

- Commitment to dedicate at least 45% of its total financing in the EU to projects in cohesion from 2025 onwards, At least, 50% of this devoted to Europe's less developed regions

→ Cohesion deemed to have high social value which drives SDB intervention

Conclusion

- Revived interest in SDBs but little engagement to date how they can and do contribute to regional economic development
- Conceptually, several arguments can be put forward in favour of SDB involvement to address spatial inequalities
- In practice, different approaches and rationales: KfW does not have an explicit mandate for regional development but does have a role in practice; BPI France is more explicit about the regional dimension; and EIB has a very clear regional mandate
- Addressing imperfect information important for the interventions, but in very different ways: KfW for local banks and regional SIBs; BPIFrance through direct involvement in acquisition and management of projects. EIB clear political decision.
- Next steps: Many! Refine operational analysis; interplay with other actors and quantitative analysis of effectiveness (and probably many more!)