The Role of Financial Sector in Sustainable Development (D2398)

Description:

Development institutions across the globe must continually adapt to changing financial and economic development, the emergence of specific development needs, and the adoption of new technologies. This applies naturally to both National and Multilateral Development Banks (NDBs and MDBs, respectively) and other Financial Development Institutions (FDIs) operating in Latin America and the Caribbean (LAC). Much of the efforts are directed by the presence of large financing gaps affecting strategic sectors of the economy, such as traditional infrastructure, communications, and MSMEs. FDIs are going through a period of greater demand which, in part, has renewed questions about the rationale supporting the intervention of the public sector given the budget restrictions; at the same time there is the need to optimize the use of alternative instruments and strategies of intervention, in order to preserve the economic and financial sustainability of these institutions, while trying to attain substantial and meaningful levels of mobilization for an effective intervention. Thus, there is a need to review and update the conceptual and empirical frameworks rationalizing the need for public intervention and the use of specific instruments.

An important part of the rationale for public interventions stems from the fact that the public sector can internalize risks and returns in a way that the private sector can't. The observed outcomes in financial markets are largely driven by the interaction of private agents that cannot fully internalize the complete benefits and costs from their activities. The divergence between private and social returns in financial markets is driven by two sets of factors. On the one hand are the frictions and market failures intrinsic to financial markets, of which those stemming from the asymmetric distribution of information between market participants are the most salient ones. On the other hand, there is a set of conditions originating from market failures and frictions in the markets of goods and services from which the demand for financial services is derived. In this latter group, the failure to align private and social marginal valuations through adequate instruments, results in suboptimal equilibria. This is the case that emerges in the presence of externalities, public goods and, more recently, widely adopted and recognized public objectives. CO_2 emissions are a highly relevant example of externalities that are tackled with interventions in financial markets. Information and knowledge are examples of public goods that, again, can be generated by public interventions in financial markets. Finally, the inclusion of disadvantaged groups is a prime example of public objectives that may not entirely fall within the classifications of public goods or externalities.

Under real world conditions, the public sector may choose to use (sometimes due to political restrictions) interventions in financial markets to move outcomes closer to the social optimum. To adequately calibrate these interventions, it is necessary for public institutions to develop a new set of metrics that align with the recognition of the gap between private and social returns. Currently, public financial institutions, including development banks, are guided to a large extent by metrics (KPIs, Key Performance Indicators) that have been designed for and by the private sector. Recently, the recognition of difference between private and social returns has led to the inclusion of a new set of indicators that are more aligned with the public objectives. However, these new sets of indicators are still fundamentally flawed as they are, almost exclusively, based on quantities without reference to (social) prices. Without properly accounting for (social) prices it is not possible to derive metrics based on social returns (since, by definition, such return cannot be measured without taking in consideration prices).

In short, public financial institutions need to develop a new set of metrics that account for social prices in order to derive Social Performance Indicators (SPIs) that adequately align with social returns (which encompass private returns). To do this, these institutions need to develop the relevant conceptual and empirical frameworks, while at the same time they need to produce a set of information that exceeds what they are currently compiling and producing.

In terms of the rationale for instruments, the ideal is to achieve an alignment between objectives and instruments. Again, in this case, there needs to be a distinction between market failures inherent to financial markets and suboptimal allocations rooted in problems in the markets of final goods and services. However, in real world situations, market failures and frictions affecting financial markets interact with a derived demand from markets of goods and services with market failures and frictions, and the discussion about instrument selection should consider the relative importance given to each of these problems. As an example, the discussion about the use of guarantees against concessional interest rates to foster the uptake of credit for a given use should ponder the informational gains from subsidized credit vs the increased leverage that can be achieved with public partial credit guarantees. The optimal instrument selection (or combination) is likely to be affected by the nature of the market failure in the market of final goods. The optimal selection or combination could be further complicated by public finance considerations and the overall state of the economy.

The Connectivity, Markets, and Finance Division (CMF) has been actively developing such frameworks and tools, while it also has a proven track record in instrument selection conditional on the nature of the intervention under consideration. and other activities in capacity building, to be delivered and shared with development institutions in the Region. Some of these are:

(i) Development of the conceptual framework making the case to derived Social Performance Indicators aligned with the institutional objectives of development institutions (Támola, 2020), which served as the basis of first (still suboptimal) application based on quantities (Támola et al., 2023). Following from these, the development has continued (Támola, Fernández-Díez and Zamarripa 2024, forthcoming) with the formal derivation of SPI metrics and calibration in a pilot case developed in collaboration with FIRA (Mexico). Through these efforts, CMF is developing a novel approach and practical applications to the measurement of social returns in financial institutions, which is an essential element for the justification of public interventions.

ii) Technological solutions to reduce market failures. Imperfect creditor information acts as a barrier, generating adverse selection and risk problems that discourage potential creditors and lead to credit rationing. Financial institutions do not know the true type of risk they would assume when lending, given the characteristics of the applicant or the project to be undertaken. The absence of behavioral histories and internal procedures to generate quality information on the activities and operation of these producers and SMEs generates information asymmetries. This market failure resulting from imperfect information leads to foreclosure and rationing. CMF, through technological solutions, has sought to close these market failures, especially in the agricultural sector.

iii) Methodologies for index construction and generation of relevant information during the pandemic. Sectoral vulnerability indices were constructed based on perceptions of specialists (Fernandez-Díez et al., 2020) and a heat map of expected sectoral vulnerability was generated showing that vulnerability varied significantly and systematically across sectors. This was used for prototype operations in each of the countries. In addition, the analytical framework based on the identification of supply, demand, financial and policy factors was extended to explore the distribution of conditions for recovery after COVID-19 by country (Támola and Fernández-Díez, 2020). This analysis provided robustness to the factors identified above and showed the overall conditions by country. Indices of financial conditions were also generated at the sector level, covering 16 countries in the region for the period 2007-2020 in a sectoral credit recovery index by country.

iv) CMF has also made efforts to compile financial microdata to be used in analytical work and dialogue with counterparts. The main advancement initiated during 2021, through collaboration with Equifax, a leading credit bureau in the region of Latin America, to obtain and map credit conditions (rate, arrears, term, amount and others) at the reference level. This information has already been used to explore gender effects in the cost of financing (Támola, Fernández-Díez, and Franco, 2023 forthcoming), and is currently being worked to explore the financial effects of COVID-19 financial support programs. There are efforts to extend this collaboration to other credit bureaus in the Region (Transunion, Experian).

The main objectives of the technical cooperation would be:

• Support further the development of Social Performance Indicators for development financial institutions in the region, as a key element to provide a rationale for public intervention that would help identify the gaps between private and social returns.

• Support the development and use of new and innovative data collection and generation, such as the use of satellite and digital systems to close gaps due to information asymmetries, among others. This would be another key element in the identification of situations where social returns are different from private ones. Furthermore, it would contribute to reduce informational asymmetries, thus ameliorating a fundamental factor in the emergence of credit rationing.

• Data Management processes to obtain, store, organize and update data from public sources and databases acquired from the bureau, structure and process them.

• Support the development and implementation of Data Science models will be generated to infer from existing data and generate reports by country, sector or type of credit.
• Develop flagship publications in terms of financial sector to address pertinent questions with lesson learns and CMF operations with an interdisciplinary approach and with contribution with external collaboration to address critical questions to promote financial sector development.

Submitted by:
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Submitted

Category:
Research and Dissemination

Tags:

Linked Ideas:

Whiteboard:

Team Leader Name
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Has the proposal been discussed and authorized by the responsible sector or country department/division, as applicable?
Yes

Team Leader Responsible Department
IFD

Are there specific countries that will directly benefit from your proposal?
Yes

Mark the specific countries that will be directly benefited from your proposal?

Argentina

Colombia

Ecuador

El Salvador

Mexico

Paraguay

Where applicable, describe how the proposal aligns with the respective country strategy (for each country selected)

- It aligns with Brazil and Republican Dominic strategy about build a more effective public sector efficiency and reduce social inequality. Strength the role of public sector allows to improve technical capacity to reduce social inequality.

- It aligns with Colombia, Paraguay and Argentina strategy about institution-strengthening, inclusive economic growth based on higher productivity, and poverty reduction and social development. Strength role of public sector improves institutional technical capacity and improves focalization.

- it aligns with el Salvador and Mexico strategy about (i) fiscal sustainability and efficiency; (ii) reducing social vulnerability; and (iii) revitalizing and restructuring production. Strength the technical capacity of public sector allows to invest the resources in a smarter way, knowing where the impact could be stronger. Also, allows to identify which project is better to improves productivity, reduce poverty, among other.

Does the proposal align to one or more sector frameworks?
Yes, the proposal aligns with at least one sector framework

Identify and describe how the proposal aligns to the sector framework(s)
This TC is aligned with the Long-Term Financial Sector Framework Document because it focuses on the development of the financial sector as a mechanism to promote inclusive and sustainable economic growth in the region and on the future of the sector in the face of the risks it faces in order to strengthen its resilience, with special emphasis on small and medium-sized enterprises (SMEs). This TC, through the production of knowledge, aims to institutionally strengthen the NDBs to improve the financial inclusion of SMEs and promote the use of sustainable technologies. This institutional strengthening will be done through the production of documents such as impact evaluations of operations. And using innovative tools that will allow a better understanding of climate risk on public bank operations.
It is aligned with Gender and Diversity Sector Framework Document as one of the objectives is to increase the number of businesses run by women and diverse groups. Women, Afro-descendants and indigenous people face obstacles to the growth and productivity of their businesses related to financing barriers. Some of CMF's operations include a gender and diversity component in their operations. Improving the evaluation and the effectiveness of development would allow the identification of operations that have generated greater inclusion and closing of gaps. And with it, the potential for replicability of the best operations in other countries in the region.

Select the regional challenges and cross-cutting issues to which the proposal aligns to
Social Inclusion and Equality

Productivity and Innovation

Climate Change and Environmental Sustainability

Institutional Capacity and Rule of Law

Justify the alignment to each selection above
This TC is aligned with the institutional capacity challenge, as it will seek to strengthen the NDB in terms of effectiveness development. On the one hand, it will encourage and increase the causal analysis and evaluation of different operations in the LAC region to identify the benefits and gains from them. On the other hand, it allows for smarter investing as we can replicate and scale operations to other countries when we identify a causal outcome.
It also aligns with climate change and environmental sustainability because this TC will strengthen the NDB's capacity with data and innovation tools, such as satellite ones, to improve their capacity on climate risk in their portfolios. This will enable them to invest better and smarter and promote environmental protection. In addition, this data can include vulnerable groups such as women or indigenous SMEs in agriculture and other sectors.

What is the estimated funding that you need in order to implement this proposal?
200000

Select the expected outputs of this proposal
Knowledge Products

Pilot Interventions

Are outputs strictly Knowledge Products?
No, the output is not strictly a Knowledge Product

Describe the motivation and main question(s) this TC intends to answer.
Describe the methodological approach to be used and the type of data (when applicable) which will be used
Please specify the type(s) of Knowledge Product (s) this TC encompasses:
Databases & Datasets

Working Papers

Software

Others

Please provide a brief description of the output(s) selected above (The number of units planned, and the estimated cost). If you selected others, please specify.
• Extension of the conceptual and empirical framework for the development and application of Social Performance Indicators to alternative financing interventions (such as, energy efficiency, financial inclusion, digital infrastructure, and others). (40.000)

• Development of a conceptual and empirical framework to establish the optimality of public sector intervention and use of instruments conditional on the objectives of the public intervention. (50.000)

• Compilation and aggregation of administrative data, primary data collection, and non-structured dataset to be used in econometric analyses of the impacts of public interventions. These would include: (110.000)

o Survey and pilot design

o Satellite platforms to support NDBs depending on their functional nature.

o Open data information platforms

o Micro level datasets of financial information

Outcomes: If the outputs are delivered successfully, what is the change expected (in capacity, knowledge, behavior, etc.)
In capacity, it is expected that knowledge products allow the NDB to used more intelligently and economically the resources. That is, focusing on the operations that have generated the greatest impact and have the greatest potential for replicability and scalability.

(0) **Attachments**

1 Comment

Comment by Daniel Fonseca Silva 01/17/2024
The amount should be adjusted to US$200,000. This TC should be prioritized on the basis of its alignment with the new Institutional Strategy discussions, the generation of knowledge products and innovative pilots that will have a positive impact and demonstration effect in sustainable development.