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Research Report

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The Future of Soft Loans as an Instrument of Development Finance: an Assessment

Livia Fritz and Werner Raza

Within the framework of the Post-2015 Development Agenda, discussions on Financing for Development and the future of ODA have intensified recently. Amongst the many financial instruments that are potentially under review, are soft loans. Combining tied aid with concessional financing, soft loans are of a hybrid nature, involving both export promotion interests and development objectives. A recent ÖFSE research project took a closer look at the institutional evolution and the current status quo of soft loan financing in Europe. Upon that basis, scenarios for the future use of soft loans as an instrument of development finance are presented.

Introduction

With the deadline for the Millennium Development Goals (MDGs) fast approaching, debates at the UN level on a prospective new, post-2015, development agenda have intensified. Inextricably linked to the discussions on a revised goal-set are financial considerations over the types of resources that public and private actors should provide in support of the international development policies, possibly stressing more general global concerns such as climate change, migration and others (UN 2013). These questions are linked to the OECD-wide discussions on the future conceptualization and measurement of Official Development Assistance (ODA) – a central concept that due to *inter alia* the 'embellishment' of reported flows by certain donors has lost some of its appeal over the years. As a result of the global financial and economic crisis, growing public debt has led to austerity programs in many OECD donor countries and, with only a few exceptions, translated into cuts in ODA budgets. Donors have reacted to this situation of constrained resources differently, but some trends are becoming visible. While some countries (e.g. the Netherlands) have effectively abandoned their commitment to the 0.7 % ODA target, others, which are officially sticking to it, are intensifying their efforts to increase their performance by unorthodox measures. Amongst the latter, two related avenues are becoming increasingly popular: firstly, leveraging public aid money (grants) with ever increasing amounts of private money; and secondly, pressing towards a wider definition of what counts as ODA.

In this context, ÖFSE conducted a research project on the relevance of soft loans as an instrument of development finance.[1] Given the lack of public knowledge and academic research, (i) the institutional evolution of soft loans within the Arrangement on Officially Supported Export Credits (Arrangement) was traced, and (ii) the extent to which development policy aspects are integrated into soft loan programs were scrutinized by an in-depth analysis of four European countries. Upon that basis, we draw some lessons and present four scenarios for the future use of soft loans as an instrument of development finance.

An Instrument of Export Promotion at its Origin

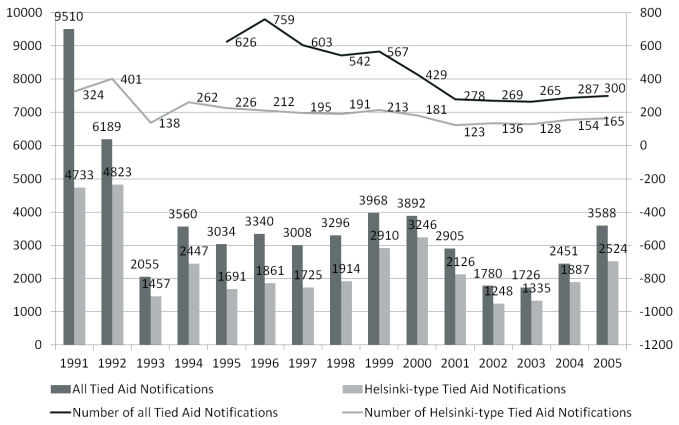
For decades soft loans, concessional long-term credits, have formed part of foreign trade and development finance policies in most DAC donor countries. These have been widely used to finance exports and investment projects in richer developing countries particularly in Eastern Asia and were mainly tied to procurement of goods and services in the donor country. A qualitative analysis of OECD archive footage conducted by ÖFSE showed that in its beginnings this instrument has been inextricably linked with traditional export credits. From 1978 onwards the usage of export credits has been restricted by the Arrangement as part of the OECD's export promotion framework, the latter aiming at the elimination of trade distorting practices. Throughout the 1980ies concerns grew that tied soft loans were used as a backdoor subsidization of national industries. Successively they have thus been brought under regulation through the Arrangement. In particular since the adoption of the Helsinki Package (1991/92) a partial shift towards development policy can be observed. Donors justify the legitimacy of their programs, while being in contradiction with the OECD's liberal trade philosophy, through postulated development goals and their leverage potential. Given the officially stated motivation of contributing to development in recipient countries and conveying a 25 % grant element, the concessional part of a tied soft loan becomes ODA-eligible and contributes to a donor's overall ODA performance. Yet, the developmental dimension of soft loan policies has remained rather vague. This begs the question, whether there is further potential to be exploited for a stronger development orientation of (tied) soft loans.

Mapping the Field of Soft Loan Financing

While prior to the inception of the Helsinki rules, tied aid notifications, expressed as percentage of the volume of bilateral ODA, accounted for roughly one fifth, the relative importance of tied aid experienced a sharp decline ever since. As of 2005 tied aid constitutes only a small fraction (~ 4 %) of bilateral ODA. Figure 1 illustrates the sharp decrease in

the volume of tied aid notifications in the early 1990ies. After a 2-year transition period following the adoption of the Helsinki Package, the volume of Helsinki-type tied aid remained fairly stable. The main donors notifying tied aid from 1996-2005 were Japan, Spain, France, Germany and the Netherlands. Analysis of sectoral notifications suggests that the largest share of tied aid has been fuelled into the sectors transportation and storage (35 %) followed by water supply and sanitation (16 %), and energy generation and supply (15 %). Contrary to these mainly large capital-intensive infrastructure projects, sectors, which typically receive grants, such as health or education, appear to attract comparably small shares. In terms of geographical distribution, the region that received most total tied aid was East Asia and the Pacific (45 %). With roughly 20 % China was by far the largest recipient of tied aid, followed by Indonesia, Vietnam, the Philippines, and Turkey (Fritz et al. 2014: 171).

Figure 1: Overview of the Volume and Number of Tied Aid Notifications 1991-2005 (Million USD)



Source: TD/PG 2006

Note: The figure is based on notifications recorded by the Participants Group between 1991 and 2005. Due to classification policies for OECD documents, data on notifications as from 2006 onwards could not be accessed.

While tied soft loan programs had been in place in most OECD countries up to the early 1990ies, the programs and their successors have evolved into different directions ever since. These new forms are not necessarily covered by the framework of the Arrangement, mostly because they are de jure not conditional upon procurement from the donor country. ÖFSE conducted a comparative analysis of national implementation strategies of Arrangement terms and analogous soft loan programs in *Austria, Denmark, Germany* and *the Netherlands*. Two of the programs scrutinized, the *Austrian Soft Loan Program* and *Denmark's Danida Business Finance* essentially build on the provisions laid down in the Arrangement. They are both largely procurement-tied and soften the terms of a commercial loan, mainly by providing interest rate subsidies. In contrast, *Germany's Financial Cooperation* provides de jure untied loans showing different concessionality levels. The most peculiar case in the sample is the Dutch program ORIO, which associates its formally untied grants with commercial loans (for which typically a guarantee by the Dutch ECA is available). Due to their untied nature and their grant form, respectively, the latter two are covered by neither the rules on project and country eligibility nor the notification obligations of the Arrangement. The comparison of the selected programs with regard to the respective institutional set-up, decision-making processes, project evaluation procedures as well as transparency and accountability provisions revealed a marked heterogeneity in the soft loan landscape. In addition, the extent to which development safeguards are built into the policies and programs as well as the degree of alignment with overall development policy varies. This suggests that development policy aspects are anchored in the programs to different degrees and that there is development potential to be exploited. From the comparison three general conclusions on the characteristics of national soft loan policies can be derived:

1. The Institutional Heterogeneity of Soft Loan Financing

Albeit reunited in the quest for financing large-scale infrastructure projects, the programs show considerable differences in almost all dimensions analyzed. Hence the heterogeneity of both the institutional structures as well as the programmatic design is one of the central traits of the sphere of soft loan financing. Accordingly, the harmonization of donor policies as stipulated in the Paris Declaration on Aid Effectiveness has remained limited. Generally a myriad of actors from both the development policy field and the trade domain assume a role in soft loan policies – mainly the ministry in charge of development cooperation, the aid agency, the Ministry of Finance and the Export Credit Agency. Yet, the distribution of competences among them varies substantially. Remarkably, in all case study countries but Austria political responsibilities for the strategic orientation of the programs lies with the ministry in charge of development cooperation. Whereas in Denmark also program implementation is concentrated in the Ministry of Foreign Affairs (Danida), the German Ministry for Development Cooperation (BMZ) delegates administration to the KfW Development Bank. The Dutch Ministry of Foreign Affairs entrusts NL Agency with the implementation of ORIO, the former being an agency of the Ministry of Economic Affairs. This heterogeneity at the level of institutions appears to be due to specific power balances among relevant actors as well as a function of the respective program objectives. The low degree of harmonization also among Helsinki-type programs can partially be explained by the reluctance of the Arrangement to give guidance with regard to implementation structures. The latter – as such the product of negotiations between sovereign states on a sensitive issue – leaves considerable room for maneuver to national actors and does not spell out any preference for which kind of agency should be in charge of tied soft loans. As a result, the implementing body might or might not have a development mandate to fulfill. Considering that the development of recipient countries is an officially stated goal pursued with soft loans and results in the ODA-eligibility of the concessional element inherent to them, it should be ensured that the implementing agencies have the necessary development competences and tools in order to attain the stated goals.

2. *The Hybridity of the Instruments*

The position of soft loans at the interface of export promotion and development policy evokes a certain ambiguity in their programmatic orientation which is reflected in the multiplicity of goals stated in program descriptions and the resulting attempt to 'kill two birds with one stone'. Yet, the specific hierarchy of goals, the project approval procedures as well as the financing terms might bring programs closer to either the trade or the development cooperation pole. By adopting a long-term perspective on the evolution of soft loan financing, a trend towards strengthening the development orientation of soft loan instruments over the last decades can be noted. Throughout the 1990ies and 2000s, development components increasingly – though to different extents – manifested themselves at least partially in the untying of the programs, in project appraisal and approval procedures, and in financing modalities. The untying of aid has been generally propagated by the DAC as a major step towards greater effectiveness of invested resources. In this vein, both the German Financial Cooperation as well as the Dutch ORET program (the predecessor of ORIO) were untied and Danida complemented its tied program with an untied window. Formal untying, however, does neither per se lead to a proportional increase in the development orientation of programs, nor is it necessarily motivated by aid effectiveness. In the late 1990ies, concern was raised by participants to the Arrangement regarding the circumvention of Helsinki provisions via the de jure untying of soft loan financing. For instance, loans which are formally untied might be provided on significantly harder terms because they do not have to comply with the 35/50 % concessionality requirements of the Arrangement, but only the 25 % grant element threshold of the DAC calculated with a uniform 10 % discount rate. In the case of Germany, the fact that due to prevailing low interest rates also low-concessional loans, presumably without any budgetary effort, are reported as ODA, might exemplify such concerns. These reporting practices have triggered discussions about the – as of now not benchmarked – ODA criterion 'concessional in character' and show the importance of refining decades-old practices (DCD/DAC 2012; also Manning 2013).

3. *Development as Economic Development*

Taking up the additionality argument, which is ingrained in soft loan financing, suggests that in view of internal resource constraints, external financial flows e.g. in the form of soft loans are thought to impact positively on development processes. From this perspective they contribute to economic growth that will eventually trickle down and create wider benefits, mainly via employment creation and income generation. The programs, thus, draw on a conventional notion of development. Furthermore, the examination of program objectives suggests that it is assumed that the provision of public goods, which in the absence of soft loan financing would not have been produced or not in the required amount by the market, is key to development. A focus on the provision of not only physical but also social infrastructure has been observable since the introduction of the commercial non-viability requirement for procurement-tied projects in the early 1990ies. This can be interpreted as a conceptual re-orientation towards the notion of human development, which became the lead discourse on development at that time. In the 2000s, concerns over the sustainability of development in its economic, social and environmental dimensions gained momentum and have also entered the field of soft loan financing. Concomitantly, several programs included the environmental sector as a priority sector. In recent years a priority and rhetorical shift towards Private Sector Development (PSD) can be observed also in the field of soft loan financing. Given the traditional focus on infrastructure development and public projects it remains, however, unclear how any such reorientation could effectively be implemented.

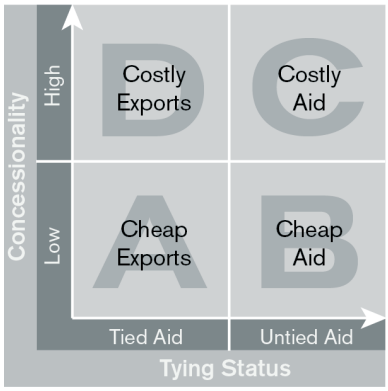
What Future for Soft Loans?

Though national programs have been quite distinct, our analysis has shown that soft loans have been an integral part of external and development finance policies, respectively, in almost all DAC donor countries during the last four decades. Today, the importance and share in volume of the respective concessional finance programs with respect to the overall ODA of a given country varies considerably, with classical tied aid programs lying between 1-6 % of total ODA. By extensively using blending mechanisms, untied concessional finance has increased substantially in the case of Germany. In contrast, tied soft loan financing volumes have decreased and some countries have evidently initialized steps to reform their development finance mechanisms. Triggered by shifts in the geographies of development, the question arises of whether a tied soft loan instrument is still fit for purpose. While the rapid economic development of emerging economies, and in particular China and Indonesia, has for many years provided a geo-economic environment favorable to using soft loan mechanisms, the graduation of many of these countries into upper middle-income status has effectively curtailed this avenue for the foreseeable future. The prospects that a great number of other LDCs will follow the example of the highly dynamic emerging countries remain unclear as of now. Thus, the current situation suggests a shift of focus towards less developed markets, which might be less attractive from an export promotion point of view. The adaptation strategies adopted by the case study countries to overcome the legitimization problems and imminent crisis of soft loan policies differ. With the introduction of the "promotional loans" Germany, for instance, tailored its instruments to specific circumstances in emerging economies. Any such financing, of course, is only conceivable outside the scope of the Arrangement. On the contrary, in the Netherlands a renewed impetus for the export orientation is observable with the introduction of the Dutch Good Growth Fund.

Future developments in the soft loan field will possibly be influenced by the anticipated changes in the international development architecture post-2015, and in particular by the discussions on the future of development finance. The latter is likely to be increasingly affected by non-OECD countries which themselves have become donors, but are not (yet) abiding by the same rules as the DAC members. Due to the considerable volume of annual concessional flows from emerging economies to Low-Income Countries (World Bank 2013: 19), the DAC has increased its efforts to integrate the New Donors into the OECD framework – the latest initiative being the first High Level Meeting of the Global Partnership

for Effective Co-operation in Mexico in April 2014.[2] Considering this dynamically changing international politico-economic landscape, which without doubt will exert a significant influence upon the prospects of development finance, ÖFSE research identified four scenarios for the future of soft loans as an instrument of concessional finance. These can be categorized along the two fundamental dimensions – degree of concessionality (low/high) and tying status (tied/untied).

Figure 2: Four Scenarios for the Future of Soft Loans



Source: Own Elaboration

Scenario A, the combination of tying with low levels of concessionality (< 35 %), is not permissible under current Arrangement terms and would contradict one of the core principles of the DAC development agenda. *Scenario B* combines untying with low concessionality levels. As described, some of our case study countries have recently moved into this direction by leveraging stagnant budgetary aid resources with private monies. Assuming that ODA will remain scarce in the near future, both due to the continuation of austerity policies in many donor countries and the broadening of the post-2015 development agenda, we would posit that this scenario will be attractive to many donors. *Scenario C* merges untied aid with a concessionality level above 50 %. This presupposes large grant elements in loans and would thus be particularly suitable for aid policies targeting LICs. This scenario depends on the political will to allocate substantial amounts of public money to such a program and the acceptance by the respective export interests, since no formal tying is allowed. *Scenario D* is a combination of tied aid with high levels of concessionality and represents the straightforward continuation of the Helsinki provisions for LICs.

A comparative discussion would suggest a juxtaposition of two pairs of scenarios. The first pair consists of Scenario A and C, implying a move from tied to untied, while concomitantly increasing concessionality. This would of course represent an ideal-type movement away from export promotion towards development orientated goals. Unfortunately, from our perspective, this does not seem to be very realistic at the moment. Promoting growth, including via export policies, in order to exit the economic crisis remains the top priority in many OECD countries. Instead, we would posit that the second pair of scenarios consisting of B and D, respectively, presents the more viable avenue under current economic and political conditions. Evidently, this pair involves a trade-off between tying status and concessionality level. Scenario B may become attractive for continuing soft loan programs with emerging economies, both for export promotion, particularly in the case of highly-competitive donor country exporters, as well as for targeted aid programs in those countries. Scenario D is the logical choice, if soft loan programs want to focus on LICs, while to some extent safeguarding donors' export interests. From a development perspective, however, even highly concessional tied aid would contravene the spirit of the OECD development agenda which has declared the untying of aid a top priority. Thus, it would be imperative that such soft loan programs are aligned with donors' development assistance priorities and programmed in a way which adheres to basic development principles, in particular alignment, ownership and policy coherence for development (PCD).

1 The full results of the ÖFSE research project are presented in: L. Fritz/W. Raza/M. Schuler/E. Schweiger: Export Promotion or Development Policy? A Comparative Analysis of Soft Loan Policies in Austria, Denmark, Germany and the Netherlands. ÖFSE Edition 19. Vienna, 2014. http://www.oefse.at/Downloads/publikationen/editionen/Edition19_web.pdf

2 For information on the event see http://effectivecooperation.org/

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