Holthus, Manfred; Kebschull, Dietrich

Article

The effects of tied and untied development loans

Intereconomics

Suggested Citation: Holthus, Manfred; Kebschull, Dietrich (1985) : The effects of tied and untied development loans, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 20, Iss. 3, pp. 130-135, http://dx.doi.org/10.1007/BF02928467

The Effects of Tied and Untied Development Loans

by Manfred Holthus and Dietrich Kebschull, Hamburg*

A decisive change now seems to be occurring in the development practices of the major OECD donor countries. Their own economic objectives are being moved distinctly closer to centre stage. Changes in the instruments of development policy are reputed to generate direct benefits for their own economies. The following article shows that such behaviour is questionable.

A country debating the introduction or strengthening of measures that will enable it to pursue its own economic objectives directly through the medium of development aid policy should first examine more closely

☐ the relationship between national and development policy objectives in various donor countries,

☐ the foreign trade effects stemming from this, and

☐ the probable repercussions on a country such as the Federal Republic of Germany.

The frame of reference for development aid policy is fundamentally different from that for other areas of policy. Its original objective was to overcome underdevelopment, so that it relates unmistakeably to other countries and thus to population groups residing outside the national borders of donor countries. On the other hand, development policy is also generally defined as being an integral part of the donor country's overall policy, and as such must be subject to the binding set of overriding objectives within an economy. This means that it must take account of the needs of the economy as a whole and contribute towards achieving price stability, a high level of employment, external equilibrium and adequate growth. Its effects are therefore important to donor countries as well as developing countries.

When considering the conflict or identity of objectives that is possible against this background, it is important to remember that in principle the instruments employed in the context of economic co-operation for the granting of credit, the transfer of know-how and for facilitating the indirect transfer of resources are the instruments of foreign trade. This alone could cause difficulties for development policy, as the instruments of foreign trade serve to optimise output and the supply of goods and were therefore created to attain domestic objectives.[1]

Such problems do not appear to be inevitable, however. Providing it is assumed that

☐ aid will lead to faster and more durable growth in the developing countries,

☐ the acceleration in growth will generate higher demand for imports,

☐ this demand will be weighted in favour of goods and services in which the particular donor country has a comparative advantage, and

☐ international competition is not distorted,

development aid will encounter no difficulties. Efforts to narrow the economic gap between industrial and developing countries will then also help the donor country attain its own overriding economic objectives. There is merely a time-lag between the granting of aid and the additional export and employment effects it induces. If these conditions are met, development policy fits comfortably into the broader framework of economic policy.

The situation is different, however, if the political decision-makers attempt to use development policy to achieve national goals over the short term, and preferably with no time-lag at all. This attitude is particularly prevalent in times of recession, when much higher priority is accorded to objectives such as export growth and the safeguarding of employment. As the simultaneous achievement of development policy objectives and national aims is impeded by the fact that

☐ inflows of funds are not used to effect a real transfer

---

* HWWA-Institut für Wirtschaftsforschung-Hamburg. This article summarises one section of a comprehensive study that the authors carried out in conjunction with R. Kuhlmann, A. Naini, S. Schattner and C. Wilhelms for the German Federal Ministry for Economic Affairs under the title "The Development Policies of Major OECD Countries and their Foreign Trade Implications".

[1] See also A. Borrmann et al.: Zum Verhältnis von Außenwirtschafts- und Entwicklungspolitik, Hamburg 1975.

of resources and therefore generate no increase in demand,

□ demand is directed towards other countries, because industries producing the required goods in the donor country are not sufficiently competitive, and

□ competition is distorted, mainly as a result of measures taken by international competitors,

the instruments of development policy must be modified in an attempt to make development aid generate direct demand for the goods and services of the donor country, regardless of other competitors.

The classical example of this is the "tying" of official development loans, whereby goods purchased with the funds must originate in the donor country. As far as the accompanying commercial transactions are concerned, official loans then have the same effect as export credit granted by a firm, for such credit is by definition "tied".

The "tying" effect can also be achieved by means of mixed financing. Here, official development loans are combined with export credit and other market loans for specific projects. The interest cost is lower than with export credit and the maturity is longer. Combinations of this kind still offer better terms than commercial loans. The tying effect derives from the fact that the companies granting the export credit are usually those contracting to supply the goods and services.

By orienting the aid mechanism towards the donor country's objectives, development policy is enlisted to serve the interests of national economic policy, thereby pushing development policy objectives increasingly into the background. An international credit terms war tends to develop among donor countries, as export contracts for the private sector – and the consequent employment effects – depend mainly on the interest rates and redemption terms granted under tied loans, mixed finance and similar arrangements. It is primarily the credit terms that will sway the developing country's choice between otherwise identical offers; this is all the more true, the larger the number of countries attempting to use development policy to serve national interests directly.

Such action fundamentally alters the traditional frame of reference for the policy of economic co-operation and its orientation. It also restricts international competition in the projects and programmes financed in this way and may mean that because of higher prices the potential real transfer of resources to the developing country will be lower and the growth effects smaller.

An examination of the development policies of the major donor countries shows clearly that there is a universal attempt to use aid to develop and secure markets in the Third World. The prime motive is unmistakeably the promotion of the country's own products. The deciding factor for such behaviour is chiefly these countries' high degree of integration in world markets and their reliance on foreign trade. Even in the United States and Japan, which have lower export ratios, the reliance on foreign trade is so strong in the economically crucial growth industries that governments repeatedly perceive a need for both export promotion and protection measures.

The actions of other states provide an excuse for such behaviour. The distortions caused by their measures are blamed for the fact that companies cannot make headway against international competition despite being competitive and that they by no means always win the development contracts for which they tender.

Quite apart from this line of argument, development aid policy has a different status in many donor countries than in the Federal Republic of Germany. In Germany the question whether development policy objectives should be subordinate to foreign trade goals or vice versa has been and still is the subject of endless debate, whereas this issue seems to be of little or no significance in other countries.

Back to Bilateralism

In the United Kingdom and France there is broad agreement that development policy is not a purpose in itself but should as far as possible serve national objectives directly. These aims are also openly pursued in Italy. It is worth noting that this stance arouses little political opposition. That it enjoys the support of broad sections of the population can be seen particularly clearly in the United States, where official aid itself has long had the task of promoting exports to the Third World. The belief that humanitarian and charitable objectives are sufficiently well served by the large-scale activities of private organisations and foundations may partly explain this attitude.

A movement against the general tendency to make development aid subordinate to foreign trade policy has been clearly visible in Japan since at least the mid-seventies. After a period when the country's own economic interests were very heavily stressed, foreign policy considerations have now come to the fore, leading to more generous grants of aid and greater sensitivity towards the interests of the developing countries.

The greater weight attached to a country's own interests is reflected in the increasing concentration on bilateral aid, which the donor country can influence. This tendency is very pronounced in the United Kingdom and even more so in Italy, which entered the development aid scene relatively late. Reservations about multilateralism are unmistakeable in other countries too; growing doubts about the efficiency of multilateral mechanisms and dislike for the increasing politicisation of the United Nations appear to be reinforcing the trend towards bilateral aid.

The high priority that donor countries accord to their foreign trade objectives is also clearly reflected in their institutional arrangements. The United Kingdom ensures that the country's own interests are served by linking together official, semi-official and private organisations. In recent years the United States showed that the benefits its own economy derived from economic co-operation were to be given greater prominence by establishing a new institution in the form of the Trade and Development Program and setting up the Bureau of Private Enterprise.

Alongside these initiatives, all of the countries in question except Germany and Japan have consistently continued to tie loans and in many cases have even extended the practice considerably. In addition, mixed financing has been widely adopted. The United States resisted for a long time, but at present it is unclear whether it will also follow that path or improve export credit terms under other official facilities by subsidising interest rates.

The increasing efforts to influence the real transfer of resources linked with aid naturally have consequences for all the donor countries, as they can force them to take action in the economic field; this is particularly true of those countries that have hitherto resisted these practices. However, the deciding factor is not so much the existence of tying arrangements and trade promotion measures as their quantitative impact. In particular, the effect of the ties on the donor countries is still very poorly understood.

Credit Ties, Credit Volume, Exchange Costs

The extent to which aid is tied varies considerably among the countries under examination (see Table 1). Whereas OECD data show that Germany tied only 15.8 % of its ODA loans to sales of German goods between 1978 and 1982, the corresponding figure for the United States was just under 80 %. With the exception of Japan, whose ODA loans were only 40 % tied in the same period, the other countries all recorded percentages in excess of 60 %.

The purpose of tying aid is to secure exports of the donor country's products, on which hangs the

Table 1

Net Bilateral Development Assistance Loans of Selected DAC Countries, by Degree of Tying 1978-82

(cumulative figures)

	Net ODA loans		
	Total in US$ million	Percentage untied	Percentage partly or wholly tied
Federal Republic of Germany	3,530.7	84.2	15.8
France	2,497.8	26.0	74.0
United Kingdom	−60.1	31.9	68.1
Japan	6,829.0	59.3	40.7
USA	6,649.0	20.7	79.3

Sources: OECD: Geographical Distribution of Financial Flows to Developing Countries, Paris, various issues; OECD: Development Co-operation, Paris, various issues.

expectation that jobs at home can be protected. A further consideration is to reduce the foreign exchange costs incurred by the donor country as a result of the loans. These are not equal to the net amount of credit, for the recipient country uses the foreign exchange from the loan to import goods and services, some of which will usually be bought in the donor country. The higher the donor country's exports of goods and services as a result of lending, the lower the foreign exchange costs of the exercise. If the full amount flows back to the donor country in the form of additional export contracts, the foreign exchange costs are nil, provided no materials had to be imported to produce the exports.

The scope for reducing the foreign exchange costs by tying loans and by other means is subject to a number of conditions, however. Even if a loan is wholly tied, it does not mean that the recipient's demand for exports from the donor will increase by the full amount of the loan. In extreme cases the recipient may use the entire sum to buy goods that it would have ordered in the donor country even if the loan had not been granted. In that event the tied credit releases an equivalent amount of foreign exchange reserves, which can be used without any strings attached (switching effect). Undoubtedly only part of this sum will be spent in the donor country, so that the tie becomes completely ineffectual. The other extreme is represented by the case in which the loan is tied to special goods from the donor country that the borrower had not previously imported. Foreign exchange cannot then be freed and the tie is one hundred per cent effective. Indeed, in certain circumstances the effect may even exceed 100 %. If the highly specialised goods had previously been imported from another country, substitution occurs at the latter's expense. Part of the foreign exchange freed will probably also be spent in the donor country, on top of the full value of the tied loans.[2]

In practice, the recipient country will not succeed in fully substituting tied foreign exchange for freely usable reserves that have already been allocated, nor will the lender be able to impose a fully effective tie. The more the donor succeeds in tying loans to projects that require large quantities of foreign exchange and in financing projects that would not have been undertaken without the loan, the more effective will the tie be.

It is quite feasible to achieve the first of these requirements. Most donor countries avoid financing local project costs. However, it is doubtful that these are mainly projects that would not have been undertaken in the absence of the loan. Most projects could be financed out of foreign exchange earnings or credit from other donors or multilateral institutions. Moreover, very few projects indeed will hinge on the purchase of specific goods from the donor country. It is therefore likely that countries receiving tied development loans will be able to substitute tied currency from a donor country for freely usable reserves at least equal to the value of tied goods that it would have purchased from the donor in any case.

Furthermore, a donor country will probably be able to attract part of the foreign exchange released through switching, although the extent of this effect will depend on the type of project, the goods required and the competitiveness of the industries supplying these goods in the donor country.

Similarly, untied development loans do not lead to exchange costs equal to the net value of the loans, for here too the costs are offset by additional exports on a scale determined by the competitiveness of the donor country's products. However, these direct return flows are augmented by indirect flows generated both by untied loans and by foreign exchange released by switching in connection with tied credit. The relationship between direct and indirect return flows can best be explained by means of an example.

It is probably realistic to assume that the regional breakdown of the additional foreign exchange expenditure more or less matches the average shares of the various regions in the total imports of the country receiving the loan. A loan of, say, US $ 100 from Germany to "Africa" in 1977 would have led to direct demand for US $ 11 worth of German goods, corresponding to Germany's share of Africa's total imports in 1977 (direct return flow). African countries would have spent a further $ 4 in the Middle East, which would in turn have bought goods in Germany in proportion to the country's share in the region's total imports (indirect return flow). These indirect return flows from the second and subsequent "expenditure round" therefore have to be added to the direct flows of the first "expenditure rounds" stemming from a development loan.

On the assumption that freely usable foreign exchange and untied development loans will be used in proportion to the individual regions' shares in the recipient country's total imports, the direct and indirect return flows in successive rounds of spending from untied aid can be calculated by raising a world trade matrix reflecting import shares to successive powers.[3] This method has been used to estimate foreign exchange costs actually incurred by donor countries as a result of granting aid.

The estimation of return flow ratios was based on a world trade matrix for 1977. In calculating the indirect ratios by raising the matrix to successive powers it was assumed initially that the industrial countries, apart from those consolidated into the group "other industrial

[2] Cf. B. Hopkin et al.: Aid and the Balance of Payments, in: The Economic Journal, Vol. LXXX, 1970, No. 317, pp. 3 f.

[3] Cf. W. W. Hicks: Estimating the Foreign Exchange Cost of Untied Aid, in: The Southern Economic Journal, Vol. XXX, 1963, No. 2, pp. 168 ff.

Table 2

Cumulative Net Bilateral Development Loans from Selected DAC Countries, by Regions[a], 1978-82

(in percentages)

Donor countries / Recipient regions	Developing countries in					Centrally managed economies in Asia	Total US$ million
	Africa	America	Middle East	Asia	Oceania		
Fed. Rep. of Germany	28.3	10.5	33.1	20.0	0.3	1.7	3,530.7
France	54.9	13.2	4.4	17.3	0.1	2.5	2,497.8
United Kingdom	−247.9	−114.0	−145.4	590.0	−18.5	0.2	−60.1
Japan	16.1	5.3	4.4	68.4	0.1	5.7	6,829.0
USA	54.1	9.7	5.5	16.7	–	–	6,649.0

[a] The lines do not always add to 100 %, as the overall total also includes loans whose regional distribution is unknown.
Sources: OECD: Geographical Distribution of Financial Flows to Developing Countries, Paris 1980 and 1984; OECD: Development Co-operation, Paris 1978, 1979, 1980, 1981, 1982 and 1983.

countries", add to their foreign exchange reserves the full amount of export receipts generated by development loans granted by themselves or other donor countries (assumption a in Table 3). As an alternative, it was assumed that only 50 % of such export earnings were added to the reserves (assumption b).

The regional distribution of net bilateral development loans is reproduced in Table 2. The regional emphasis set by each donor country is clearly discernible. The United Kingdom's extremely low lending to Asian countries stands out. Repayments from that region are so high that they outweigh the positive net lending to developing countries in Africa, America and the Middle East. The priority that Japan accords to the Asian region is also plain to see, as is the preference of the other donors for African countries.

Using the regional return flow ratios, it was possible to estimate the gross foreign exchange costs of development loans granted by individual donor countries for the period from 1978 to 1982. The results are shown in Table 3 according to recipient regions. These were calculated by totalling the return flow from untied loans, the return flow from the switching of tied loans and the value of effectively tied credit and then deducting this sum from total lending to a region. It will be seen that the Federal Republic of Germany bore the highest foreign exchange costs. In none of the other countries examined is such a small proportion of net lending offset by additional exports. The foreign exchange costs naturally diminish if it is assumed that the industrial countries add only 50 % of their export earnings to their foreign exchange reserves. In the case of German loans to Asian countries between 1978 and 1982, for example, this would mean that not 76.47 % but 70.43 % of the amount are genuine foreign exchange costs with an impact on the German balance of payments. However, even then Germany still has a clear lead over all the other countries.

After Germany, Japan shows the highest gross foreign exchange costs. As a proportion of net lending they come to between 41.57 and 53.49 %, depending on the recipient region and the assumption about the industrial countries' behaviour with regard to foreign exchange reserves. In the other countries a substantially larger part of their net lending is offset by exports. In almost all cases their gross foreign exchange costs are well below 30 %. Only in the case of French loans to African countries do they rise to just under or just over 30 %, depending on the foreign exchange behaviour assumed.

This enables regional return flows to be compared with trade balances. It emerges that as a rule the export effect of development loans has only a small influence on regional trade balances. Only in a few exceptional

Table 3

Estimated Cumulative Gross Foreign Exchange Costs of Development Loans of Selected DAC Countries 1978-82

Donor countries / Recipient countries		Developing countries in: Africa	America	Middle East	Asia	Oceania	Centrally managed economies in Asia
Fed. Rep. of Germany	a	737.0	278.9	837.5	540.1	7.5	43.5
	b	73.8	75.0	71.6	76.5	78.7	74.2
	c	661.4	254.7	754.8	497.5	6.9	40.7
	d	66.2	68.5	64.6	70.4	71.4	69.4
France	a	427.2	85.2	28.5	114.6	0.5	17.2
	b	31.2	25.8	25.9	26.4	27.9	27.1
	c	401.8	81.1	26.9	110.9	0.4	16.6
	d	29.3	24.5	24.4	25.6	26.8	26.1
United Kingdom	a	34.0	15.0	21.8	–	2.6	0.0
	b	22.8	22.0	25.0	–	23.0	0.0
	c	32.9	14.4	20.8	–	2.4	0.0
	d	21.7	21.0	23.8	–	21.9	0.0
Japan	a	588.3	188.1	147.2	2,082.4	2.9	197.8
	b	53.5	52.2	49.0	44.5	49.3	51.0
	c	554.6	174.0	137.7	1,943.1	2.8	190.7
	d	50.4	48.3	45.9	41.6	46.6	49.2
USA	a	830.9	170.9	104.1	257.3	0.0	0.0
	b	23.1	26.4	28.4	23.1	0.0	0.0
	c	751.2	155.6	93.7	228.5	0.0	0.0
	d	20.9	24.0	25.5	20.5	0.0	0.0

a Gross foreign exchange costs in millions of US dollars on assumption a, as explained in the text.
b a as a percentage of net development loans.
c Gross foreign exchange costs in millions of US dollars on assumption b, as explained in the text.
d c as a percentage of net development loans.
Source: Calculations by the authors.

cases does the effect reach appreciable proportions. For example, Germany's deficit of US $ 873 million with the countries of Asia in the period under review is between 19 and just under 24 % lower than it would have been in the absence of development loans. In the cases of France and Japan this effect is still higher in trade with Asian countries, with values of more than 30 %.

Impact of Untied Loans from Other Donors

Of course, it is not just a question of the real transfer of resources resulting from aid granted by a single donor country. For recipient countries the potential scale of the additional real transfer derives from the sum of all development loans received. Provided the recipient's freedom to use the funds is not restricted by tying conditions and similar constraints, all countries engaging in world trade can attempt to supply part of this potential real transfer. For example, Japan's granting of untied loans to Asian countries can lead to an increase in Germany's exports to the region.

The positive impact of other DAC countries' development loans on German exports does not stem from the sum total of such lending, however. Germany can tender only for the portion that does not revert to the relevant donor country through tying arrangements or other return flows. Hence only the actual foreign exchange costs of the other DAC countries have an impact on Germany's exports.

Table 4 shows the extent to which Germany probably derived additional exports from the development loans granted by other countries in the sample during the period from 1978 to 1982. It has been assumed that in the successive expenditure rounds Germany was able to maintain the market share it had attained in 1977. The resulting additional exports were then compared with German development lending. It can be seen that the results for the various recipient regions vary widely. Between 6 and 65 % of Germany's own lending was offset by exports stimulated by loans from other DAC countries. A comparison with Table 3 clearly shows that in none of the regions were these effects sufficient to balance the gross foreign exchange costs of German loans.

Abolition of Tying

The aforegoing examination has shown that with the present structure of trade German development loans can induce exports equal to between 29.6 and 35.4 % of the volume lent, depending on the region. However, more than half of the outflow of foreign exchange in the form of loans is offset by real transfers of resources, because Germany also benefits from the untied loans granted by other countries. In examining arguments in favour of increasing the ties and introducing other measures with similar effects, it should be borne in mind that 15.8 % of German loans were already tied in the period under review.

It cannot be concluded from this that Germany should join the ranks of those currently violating free trade and competition in the development loan field. Nor should Germany merely seek a compromise where agreement on the highest common denominator is hailed as success. What is needed is to sever the ties between aid to the Third World and exports by the donor country, whatever form those ties may take. For Germany to promote such a cause is not a question of imposing its own ideological views but of safeguarding its long-term interests. It must be made clear that these interests are identical with the objectives of other major donor countries. The change in Japan's development aid policy is an indication that Germany would not always be alone in pursuing this cause.

Table 4

Estimated Cumulative Impact of the Development Loans of Selected DAC Countries on the Exports of the Federal Republic of Germany, 1978-82

Estimation procedures / Recipient countries	Developing countries in					Centrally managed economies in Asia
	Africa	America	Middle East	Asia	Oceania	
(1) Loans from the Federal Republic of Germany (US$ million)	999.4	371.7	1,168.9	706.3	9.6	58.6
(2) Foreign exchange costs of loans by other DAC countries (US$ million)	1,739.9	425.1	279.1	2,282.5	5.6	207.3
(3) Induced German exports as a result of (2) (US$ million)	414.8	83.0	70.2	388.7	0.9	38.1
(4) (3) as percentage of (1)	41.5	22.3	6.0	55.0	9.4	65.0

(1) Net ODA loans granted by the Federal Republic of Germany.
(2) Gross foreign exchange costs of net ODA lending by France, the United Kingdom, Japan and the USA, in each case only on assumption b.
(3) (2) multiplied by the cumulative return flow ratios for the Federal Republic of Germany under assumption b after four expenditure rounds.
Source: Calculations by the authors.