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## Soft loans as an instrument of development finance: A comparative assessment and options for the future

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# Soft Loans as an Instrument of Development Finance: A Comparative Assessment and Options for the Future

Vienna, September 2014

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## List of Abbreviations

BRICS	Brazil, Russia, India, China and South Africa
DAC	Development Assistance Committee
DBF	Danida Business Finance
DDR	Differentiated Discount Rate
DEG	Deutsche Investitions- und Entwicklungsgesellschaft
DfID	Department for International Development
DGGF	Dutch Good Growth Fund
ECA	Export Credit Agency
FC	Financial Cooperation
FMO	Netherlands Development Finance Company
GNI	Gross National Income
ICB	International Competitive Bidding
KfW	Kreditanstalt für Wiederaufbau
LDCs	Least Developed Countries
LICs	Low Income Countries
LMICs	Lower Middle Income Countries
MDGs	Millennium Development Goals
MfA	Ministry of Foreign Affairs
MILIEV	Program for Environment and Economic Self-sufficiency
NCB	National Competitive Bidding
NGO	Non-Governmental Organization
OCL	Overall Concessionality Level
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
ÖFSE	Austrian Foundation for Development Research
ORET	Development Relevant Export Transaction Program
ORIO	Facility for Infrastructure Development
PCD	Policy Coherence for Development
PSD	Private Sector Development
SDGs	Sustainable Development Goals
SDR	Special Drawing Right
UMICs	Upper Middle Income Countries
UN	United Nations

## Abstract

Within the framework of the Post-2015 Development Agenda, discussions on Financing for Development and the future of Official Development Assistance (ODA) have intensified. Amongst the instruments under review are soft loans. Though originally conceived as export promotion tools, development objectives have recently become more prominent in soft loan policies. Albeit regulated through the Arrangement on Officially Supported Export Credits, soft loans claim a place amongst the instruments of development policy. By means of comparative case study analysis, this paper examines the relevance of soft loans as an instrument of development policy.

We discuss three characteristics of soft loan financing: (i) the institutional heterogeneity of programmes between countries, (ii) the hybrid nature of the instruments between export promotion and development objectives, and (iii) the underlying notions of development. Upon that basis, scenarios for the future use of soft loans as an instrument of development finance are presented.

**Keywords:** soft loans, post-2015 development agenda, development finance, (un)tying, export promotion

# 1. Introduction

The first decade of this century saw the international community declare the Millennium Development Goals (MDGs), which have guided international aid efforts ever since. Along with this declaration of intent came pledges to not only increase the volumes of aid, but even more importantly to improve its effectiveness through better management and delivery. The Working Party on Aid Effectiveness, hosted by the Organisation for Economic Co-operation and Development (OECD), organised a series of High Level Forums in Rome (2003), Paris (2005), Accra (2008) and Busan (2011) and put aid effectiveness at the top of the agenda. With the deadline for the MDGs fast approaching, debates at the level of the United Nations (UN) on a post-2015 development agenda have intensified. This prospective new framework is likely to be considerably broader, as suggested by the outcomes of the Rio+20 Summit (2012). The latter resulted in agreement among the participating states to set-up Sustainable Development Goals (SDGs) which shall feed into the post-2015 process, possibly stressing more general global concerns such as climate change, migration or security and moving to a 'beyond aid' approach (UN 2013). Linked to the discussions on an altered and more holistic framework are financial considerations over the types of resources that public and private actors should provide in support of the international development policies. These questions are reflected also in the OECD-wide discussions on the future conceptualisation and measurement of ODA – a central concept of the Development Assistance Committee (DAC) that due to *inter alia* the 'embellishment' of reported flows by certain donors has lost some of its appeal over the years (Manning 2013). As a result of the global financial and economic crisis, growing public debt has led to austerity programmes in many OECD countries and, with only a few exceptions, translated into stagnating or reduced ODA-budgets. Donors have reacted to this situation of constrained resources differently, but some trends are becoming visible. While some countries such as the Netherlands, have effectively abandoned their commitment to dedicate 0.7 % of gross national income (GNI) to ODA (Dutch MfA 2013a), 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 with private sources (Romero 2013); and secondly, pressing towards a wider definition of ODA. In these circumstances, a real danger exists that the 0.7 % target, which was meant to serve as an incentive to donors, creates the perverse effect of watering down the prevailing ODA concept by including a variety of other financial flows and instruments. Today's development finance reaches far beyond the Cold War image of aid, which could be described as one of northern states from both East and West transferring aid to southern developing countries, and has come to encompass a myriad of private and public actors. While ODA still holds a prominent position, increasingly claims have been made that other and more innovative forms of financing for development are needed if profound changes are to occur in the international system (OECD 2005: 30).

In the context of a dynamically changing international politico-economic landscape, this paper assesses the relevance of soft loans as an instrument of development finance and policy. Originally conceived as a tool of export finance (Ray 1995), tied soft loans have successively been brought under regulation through the Arrangement on Officially Supported Export Credits (the Arrangement) as part of the OECD's export promotion framework. In spite of these institutional roots in the export promotion field, tied soft loans claim a place amongst the instruments of ODA. A partial shift towards development policy can be observed since the adoption of the Helsinki Package (1991/92) of the Arrangement. Given the objective of contributing to development in recipient countries and complying with the 25 % grant element required by the DAC, 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.

In view of a substantive lack of both public knowledge and academic research, this paper (i) seeks to scrutinise the extent to which development policy aspects have been integrated into soft loan programmes of four European donors, and (ii) upon that basis, explores possible scenarios for the future use of soft loans as an instrument of development finance. By means of an in-depth analysis and a systematic comparison of four European systems, the ways of articulating development policy aspects in the institutional set-up, decision-making processes, monitoring and evaluation procedures as well as transparency and accountability provisions are explored. Overall, a mix of qualitative and quantitative methods was chosen to collect and interpret data. This paper relies on expert interviews (50 interviews in five countries), OECD archive footage (Participants Group and the DAC Working Party on Financial Aspects of Development Assistance), official and policy documents, statistical databases (Participants Group, DAC statistics, national databases) and four case studies conducted by an ÖFSE research team.

When doing some first research in libraries and relevant journals in order to get an overview of the state of research on (tied) soft loans, we were puzzled to find only very little academic literature: some OECD publications on the occasion of the Arrangement's anniversaries (OECD 1998, 2008, 2011), a few academic papers dealing with export credits thereby briefly touching upon tied aid credits (e.g. Evans 2003; Hall 2011; Rosefsky 1993) and some books and articles, the majority of which were written by (former) OECD representatives. By far the most comprehensive account of the genealogy of tied soft loans is provided by Ray (1995). In contrast to the literature gap on tied aid credits, the academic literature dealing with the incentives for and consequences of tying aid in general is rather extensive, but one-sided. Most authors dealing with tied aid in general and not tied soft loans in particular are economists who use macro-economic modelling to show the welfare-effects when moving from a tied to an untied scenario (for an overview see Clay et al. 2008). Explanations for ODA allocation patterns from a microeconomic perspective are given by Michaelowa (1998). With the exception of some publications in the wake of the 2001 DAC Untying Recommendation (e.g. La Chimia 2004; Petermann 2013), tied soft loans have been surrounded by peaceful silence since around 2000. While large projects supported by traditional export credits have repeatedly been caught in the crossfire of Non-Governmental Organization (NGO) criticism for their negative environmental and social impacts, tied soft loans have not attracted considerable attention by civil society.

Thus, the relevance of this paper lies in systematically analysing a subject, which has been widely marginalised in academic research. The remainder of this paper is structured as follows. The first section defines key terminology and presents a statistical overview of soft loan financing, showing the aggregate evolution of soft loan volumes over time as well as the sectoral and geographical distribution of tied aid credit notifications. The second section compares soft loan programmes in four European countries, including the respective institutional set-up, the programme goals and the degree of alignment with overall development policy. Finally, the fourth section inquires possible future avenues in the field of soft loan financing, while taking into account current challenges and the dynamically changing international policy arena



## 2. Mapping the Field of Soft Loan Financing: A Statistical Overview

Weak definitions and inconsistent terminology characterise the soft loan field. Thus, at the beginning a few words shall be spent on terminology. The main definition of tied aid credits can be derived from the minimum conditions laid down in the Arrangement. Throughout this paper the terms tied aid credits and tied soft loans are used synonymously, the former being the *terminus technicus* which is predominant in official documents at the OECD level. Following the Arrangement's eligibility criteria for tied aid (Helsinki disciplines) tied soft loans can broadly be defined as follows:

They are officially, state, supported credits that are procurement-tied, contain a concessionality level<sup>1</sup> of at least 35 % or 50 %, which in principle is ODA eligible, and can be used to finance commercially non-viable projects in a limited pool of recipient countries (GNI threshold).

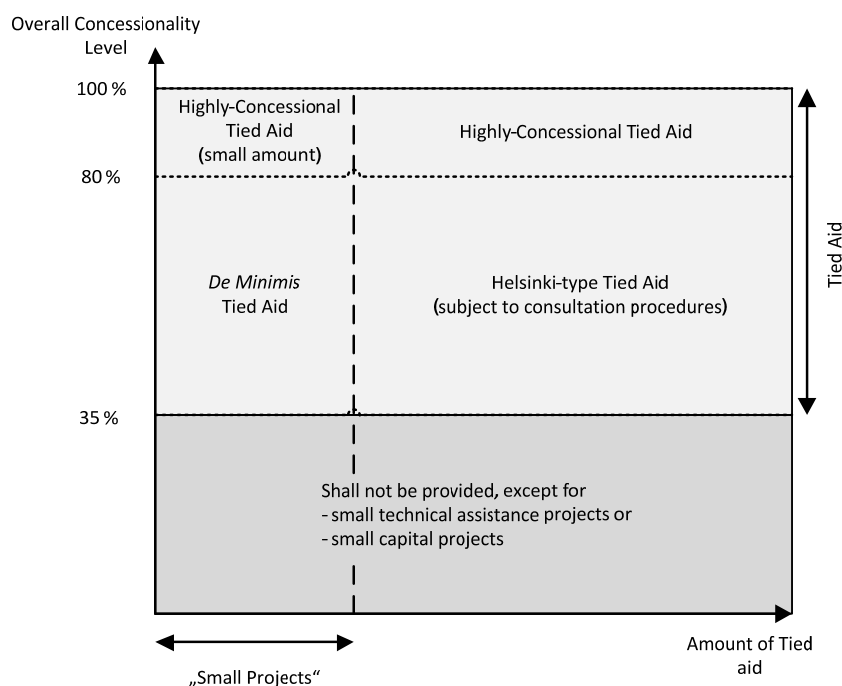
Notably, this working definition only applies to procurement-tied concessional loans, while the term 'soft loan' comprises a broader spectrum of credit-based financing without *prima facie* indicating the tying status. For the definition of tied as opposed to untied aid, the Arrangement relies on the *DAC Guiding Principles for Associated Financing and Tied and Partially Untied Official Development Assistance* (OECD/DAC 1987). While the definitions provided therein seem straightforward, in reality, the borderline between them is often difficult to draw (Jepma 1991: 20).

Figure 1 summarises different forms of tied aid which are defined by the Arrangement according to the overall concessionality level (OCL) and amount and recorded by the Participants Group – the informal group monitoring the Arrangement. With the exception of small technical assistance and small capital projects, financing arrangements with an OCL of less than 35 % and less than 50 % for Least Developed Countries (LDCs) are not in conformity with Arrangement terms. De minimis tied aid complies with the minimum OCLs but it is not subject to consultation procedures. Helsinki-type tied aid, on the other hand, is subject to consultation procedures and corresponds to an OCL between 35 % and 79 %. Tied aid with a concessionality level of 80 % and more is called highly-concessional (OECD/TAD 2014).

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<sup>1</sup> Just as the grant element, the concessionality level assesses the softness of a credit and reflects its financial terms i.e. the interest rate, maturity, and grace period of a commitment. While the method of computation is the same as in the case of the DAC's grant element, the discount rate differs. For the latter, a market-based discount rate, a so-called differentiated discount rate (DDR) is used (DCD/DAC 2012b: 2).

**Figure 1: Classification of Tied Aid Based on the Overall Concessional Level and Amount**



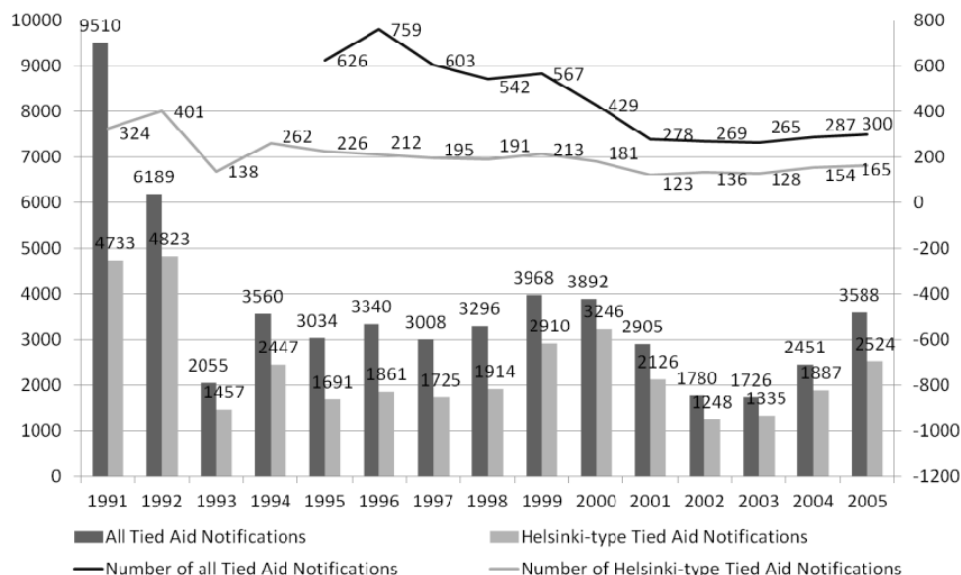
Source: OECD/TD 2006

Note: The classification does not apply to tied aid for LDCs except for the minimum OCL (50 %).

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, their relative importance experienced a sharp decline ever since. As of 2005 tied aid (notifications) constituted only a small fraction (~4 %) of bilateral ODA. Figure 2 illustrates the sharp decrease in the volume of tied aid notifications in the early 1990s.<sup>2</sup> 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, Denmark ranking 7th and Austria 8th (OECD/TD 1997, 2006). The relative importance of soft loans as an instrument of development finance varies amongst the four countries of particular interest in this paper. Due to multiple data sources, comparisons have to be drawn with caution. In Austria, the volume of associated financing grants varied between 2.2-6.8 % of bilateral ODA in the period 2009-11 (Fritz et al. 2014: 401). With an annual budget of roughly EUR 40 million, Denmark’s mixed credits programme is in comparison relatively small and accounts for 1-2 % of ODA (Fritz 2014). In the Netherlands, the share of ORET/MILIEV – the programme preceding the ORIO programme – including the disbursements of the LDC Infrastructure Fund (2002-05) of total ODA varies between 0.4-3.8 % in the period 1992-2005. With a share of more than 30 % of ODA in 2010-12, the by far biggest share of concessional financing on overall ODA is observable in Germany (Schuler 2014a: 100, 57).

<sup>2</sup> Due to classification policies for OECD documents, data on tied aid notifications from 2006 onwards was not accessible at the OECD-archives.

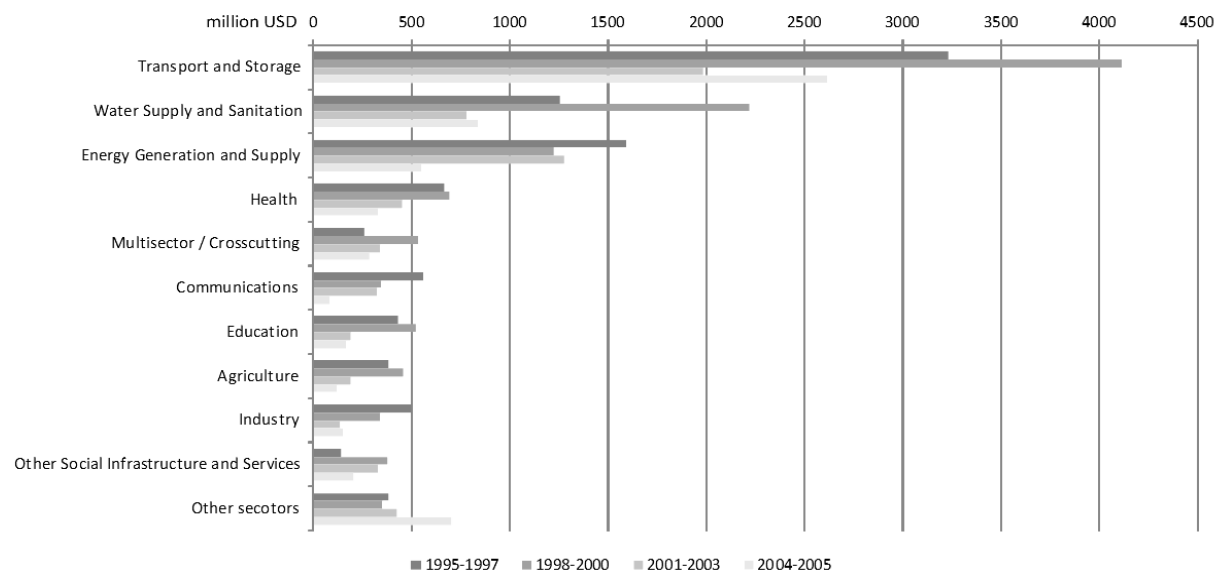
**Figure 2: Overview of the Volume (Million USD) and Number of Tied Aid Notifications 1991-2005**



Source: Own Elaboration, based on OECD/TD 2006

Figure 3 suggests that the largest share of tied aid has been channelled into the sectors transportation and storage (35 %) followed by water supply and sanitation (16 %), and energy generation and supply (15 %). Contrary to the mainly large capital-intensive infrastructure projects in these sectors, sectors which typically receive grants, e.g. health or education, attract comparably small volumes.

**Figure 3: Total Tied Aid by Sector 1995-2005**

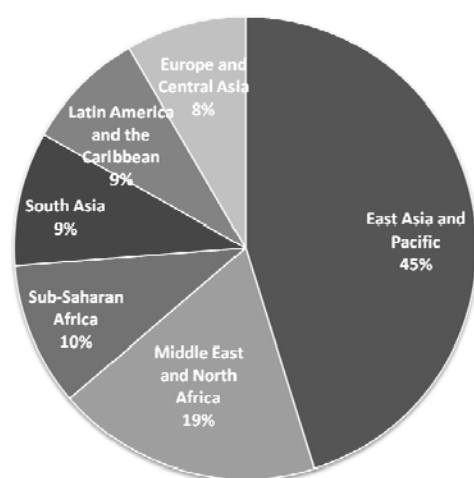


Source: Own Elaboration, based on OECD/TD 2006

Note: The data represents the cumulative volume of tied (notifications) from 1995 to 2005.

In terms of regional distribution (Figure 4), East Asia and the Pacific are the main destinations of total tied aid notifications. In the period 1995-2006, 45 % of tied aid and 53 % of Helsinki-type tied aid went to this region. Thus, most Helsinki-type tied aid was concentrated on emerging economies in Asia, while the poorer developing countries of Sub-Saharan Africa and South Asia received disproportionately higher shares of non Helsinki-type tied aid. With roughly 20 % China was by far the largest recipient of tied aid, followed by Indonesia, Vietnam, the Philippines, and Turkey. Examining the absolute changes in the geographic distribution of total tied aid over time demonstrates that notifications fell sharply in the East Asia and Pacific region having an exceptionally high peak in 2000 of USD 2675 million. Downward trends can also be observed in all other regions, with only Latin America and the Caribbean experiencing a modest rise (Schweiger 2013: 64-67).

**Figure 4: Recipient Regions of Total Tied Aid Notifications 1995-June 2006**

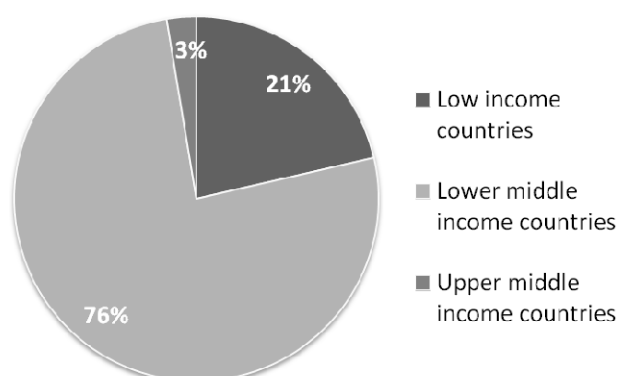


Source: Own Elaboration, based on OECD/TD 2006

Note: SDR-based calculation.

In order to arrive at a more comprehensive picture of the distribution of tied soft loan notifications, in Figure 5 recipient countries are clustered according to the World Bank classification into groups of Upper Middle Income Countries (UMICs), Lower Middle Income Countries (LMICs) and Low Income Countries (LICs). While 71 % of total tied aid notified in the period analysed goes to LMICs and 26 % to LICs, the snapshot in Figure 5 shows that 76 % of total Helsinki-type tied aid flow to LMICs and 21% to LICs (ibid.: 69). Tied soft loans cannot be used in countries with a GNI above the LMIC threshold, thus explaining the small proportion of flows to UMICs. Mainly due to changes in the classification during the observed period (e.g. Turkey had received UMIC status by 2005), the figure displays tied aid also for UMICs. In more recent data stemming from national sources as well as from DAC aid statistics, the share of UMICs can be explained by the graduation of China (Fritz et al. 2014: 221, 263). Following Arrangement rules a country graduates only after its World Bank category has remained unchanged for two consecutive years (OECD/TAD 2014: 20). For instance, in 2010 and 2011 China was in the transitory phase (World Bank 2013a), as of 2012 it is no longer tied aid-eligible.

**Figure 5: Helsinki-Type Tied Aid According to World Bank Analytical Classification 1995-June 2006**



Source: Own Elaboration, based on (OECD/TD 2006)

Note: The data represents the cumulative volume of Helsinki-type tied aid (notifications). Recipient countries were classified according to World Bank estimates of 2005 (World Bank 2013a).

### 3. European Soft Loan Policies: Between Institutional Heterogeneity, Hybridity and Development

#### 3.1. Choice and Presentation of the Sample

While tied soft loan programmes had been in place in most OECD countries up to the early 1990s, they have evolved into different directions ever since. Recent debates on aid and development effectiveness are closely intertwined with the call for Policy Coherence for Development (PCD) as well as with a formal consensus on the untying of aid. As a result, tied soft loans have increasingly come under pressure to justify their very existence, which has pushed several OECD countries to end their schemes, untie these or at least evaluate them (Clay et al. 2009). The succeeding forms of soft loan financing are not necessarily covered by the Arrangement, mostly because they are *de jure* not conditional upon procurement from the donor country. In the attempt to contribute to filling the current knowledge gap, we provide a comparative analysis of national implementation strategies of Arrangement terms and respective soft loan programmes in Austria, Denmark, Germany and the Netherlands. The countries were selected on grounds of their importance as European soft loan donors, their common status as open, export-oriented economies, and/or their strong commitment to development assistance.

As part of its export promotion policies, Austria, a small and open economy, offers tied soft loan financing in accordance with the Arrangement. Prevailing low interest rates and the graduation of major recipient countries have triggered discussions on the future of the instrument (Schweiger 2014). The latter are taken as a point of departure for an inquiry into the functioning of the soft loan system in place. Denmark is amongst the countries with a proven commitment to development co-operation, shares basic characteristics with Austria (small, export-oriented economy) and the Danida Business Finance (DBF) programme provides Arrangement-type mixed credits (Fritz 2014). The comparability of macroeconomic indicators and the country's export orientation notwithstanding, the Dutch programmes differ in two essential characteristics: they provide grants and they are in their majority officially

untied. Furthermore, the Dutch development finance system currently is under reconstruction, possibly serving as a trendsetter for future developments in the field. Due to the country's economic and political weight in Europe, Germany figures as an important point of reference for economic and development policy discourse. Thus, its chosen path of providing formally untied concessional financing is of particular interest. Furthermore, recent criticisms voiced by DAC peers with regard to Germany's reporting of low-concessional loans as ODA and the associated debate about 'concessional character' give further relevance to an assessment of German Financial Cooperation (FC) (Schuler 2014b: 49-51).

Due to their *de jure* untied character not all of the programmes fall within the scope of the Arrangement. In this respect, the choice of case studies encompasses a variety of institutional arrangements and goes beyond traditional tied aid credits. The comparison of Austrian Soft Loans, Denmark's DBF, German FC and the Dutch ORIO programme reveals a marked heterogeneity in the soft loan landscape. Additionally, the extent to which development safeguards are built into the policies and the degree of alignment with overall development policy varies. This suggests that development policy aspects are anchored in the programmes to different degrees and that there remains development potential to be exploited. Our comparison allows to draw three general conclusions on the characteristics of national soft loan policies, which are discussed in the following.

## **3.2. The Institutional Heterogeneity of Soft Loan Financing is High**

The idea that harmonised policies enhance aid effectiveness led to the adoption of the Rome Declaration on Harmonization and later was upgraded to one of the five pillars for effective development co-operation (OECD 2005-2008: 6). Albeit comparable in the quest for financing large-scale infrastructure projects, the programmes show considerable differences in almost all dimensions analysed. Despite a certain degree of convergence of policies through the Arrangement, the heterogeneity of both the institutional structures and the programmatic design characterises the soft loan field. Accordingly, the harmonisation of donor policies has remained limited.

### **3.2.1. Financing Modalities and Tying Status**

Heterogeneity can firstly be traced in the financing modalities which encompass tied and untied (pre)mixed credits as well as grants in *de facto* association with loans. The most peculiar case is the Dutch ORIO programme, which *de jure* only provides untied grants. These, however, are *de facto* associated with commercial loan financing for which typically a guarantee by the Dutch ECA is available. Described as a programmatic shift from loan-based forms of development finance to grant financing, this specific arrangement follows from the political dynamics in the Netherlands in the late 1980s/early 1990s, which have been motivated by the deep debt crises, many LDCs had experienced (Schuler 2014a: 84).

The official tying status is the most obvious difference between the four programmes. The Austrian and Danish programmes are largely tied (pre-)mixed credits, German FC and the Dutch ORIO programme, on the contrary, claim to be untied. From the perspective of international regulation – in particular the Arrangement – the respective tying status has important repercussions on the design of the instruments, e.g. the concessional requirements, country/project eligibility and transparency obligations (Fritz et al. 2014: 397). Also within the categories of tied/untied significant variations can be detected. While the Austrian programme sets a domestic content rule of 50 %, the Danish counterpart does not provide for any such threshold. Furthermore, presumably as a reaction to the untying debate that gained momentum in the early 2000s, an untied window was introduced in 2002. Notably, this option only materialises if National Competitive Bidding (NCB) under the tied regime is not sufficiently competitive (Folketinget 2013). In contrast, the Dutch and the German counterparts are *de jure* not procurement-tied. Yet, with regard to both programmes

suspicion has repeatedly been voiced regarding *de facto* tying. Current DAC definitions of tying leave grey-zones for subtle forms of tying, for instance through hidden contract clauses or by opaque calls for International Competitive Bidding (ICB). In the Netherlands, there is reason to assume that although the grant facility ORIO has officially been an untied programme since 2009, grants are *de facto* procurement-tied (Interview). However, until the time of our research (September 2013) tenders had evidently been held only for the Development Phase, not the Implementation Phase. The fact that in the new Dutch Good Growth Fund (DGGF), which is scheduled to start operating in 2014, a tied pillar will be included illustrates this ambiguity towards the untying consensus. In Germany, the untied nature of FC notwithstanding, roughly 60 % of all project deliverables are eventually awarded to German companies (Seebens 2012). Whether this high ratio can be attributed solely to the competitive strength of German exporting companies has repeatedly been questioned. Informal practices providing domestic companies with informational advantages or tailor-made calls for tenders might distort competition. In this respect, project development activities, often conducted by German technical advisors, are likely to assume a pivotal role (Schuler 2014b: 50).

### **3.2.2. Split of Competences in the Donor Countries**

The design of the instruments is linked to the specific distribution of responsibilities within the donor/exporting country. Generally various 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 co-operation, the aid agency, the Ministry of Finance and the export credit agency. Remarkably, in all case study countries except for Austria the political responsibility for the strategic orientation resides with the ministry in charge of development co-operation. Whereas in Denmark also implementation is concentrated in the Ministry of Foreign Affairs, the German Ministry for Development Co-operation delegates administration to the KfW Development Bank. The Dutch Ministry of Foreign Affairs entrusts NL Agency (recently changed to Netherlands Enterprise 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 attributable to specific power balances among relevant actors as well as a function of the respective programme objectives. In line with the institutional set-up, project approval procedures show substantial heterogeneity. Whereas in all programmes (*de facto*) approval is given by a committee, the composition of the latter is country-specific. In some countries (Austria, the Netherlands), specialised committees are in charge of project screening and approval, in others (Denmark, Germany) decisions are made by committees in charge of overall development co-operation projects/programmes. The composition of approval bodies can be categorised along the dimensions ‘expert-driven’ vs. ‘political representation’. Strikingly, overall transparency and public availability of project information appear to be inversely proportional to the degree of stakeholder involvement in the approval process. It seems that in Denmark and Germany, where funding decisions are largely made by development ‘experts’ (internal and external), increased transparency of the programmes is strived for by making extensive information available to the wider public (Fritz 2014; Schuler 2014a). On the contrary, in Austria and to a lesser extent in the Netherlands various political stakeholders outside of development co-operation are involved in the project approval process, but the responsible committee and its members are subject to limited transparency provisions (Schweiger 2014; Schuler 2014a).

The low degree of harmonisation also among Helsinki-type programmes can partially be explained by the reluctance of the international framework to give guidance regarding implementation structures. The latter – as such the product of negotiations between sovereign states on a sensitive issue – leaves significant room for manoeuvre to national actors and does not spell out any preference for which kind of implementing structure should be in charge of tied soft loans. As a result, the implementing body might or might not act

upon a development mandate. Depending on the institutional embedding of the programmes, the project selection criteria used and the weight attributed to development components and expected impacts differ widely. Furthermore, unlike in Development Finance Institutions such as the Dutch FMO or the German DEG, systematic quantitative assessment tools are not common practice in the field of soft loan financing (Gössinger et al. 2011).

Considering that the development of recipient countries is an official goal pursued with soft loans, it should be expected that the implementing agencies have the necessary development competences in order to attain the stated goal of promoting development. Our analysis of the institutional set-up and the role of key agents of development co-operation revealed, however, that this 'minimum condition' is met to varying degrees in our sample.

### **3.3. Hybrid Instruments at the Interface of Export Promotion and Development Policy**

With soft loan policies OECD states ambitiously claim to promote domestic exports, while simultaneously contributing to economic development and welfare in the recipient country. This position at the interface of export promotion and development policy evokes a certain ambiguity in the programmatic orientation which is reflected in the multiplicity of programme goals and the resulting attempt to 'kill two birds with one stone'. Yet, the specific hierarchy of goals, the project approval procedures, the country policies and geographical focus as well as the financing terms might bring programmes closer to either the trade or the development co-operation pole. A look into the history of soft loans provides a partial explanation for this hybridity. Their genealogy reaches back to the mercantilist foreign trade policies of the 1970s/80s and shows that they were closely linked to outright export promotion tools. Since then, policies have evolved and the instruments have been adapted. Yet, up to today this status in-between two policy fields makes them subject to tensions stemming from the diverging interests of the actors involved. To varying degrees these tensions are perceptible for instance in the discussions on the untying of programmes. By adopting a long-term perspective on the evolution of soft loan financing, a trend towards strengthening the development orientation of the instrument over the last decades is observable. Throughout the 1990s/2000s, development components increasingly manifested themselves partially in the untying of the programmes, in project appraisal and approval procedures, and in financing modalities.

While hybridity can be detected in all four programmes, it articulates itself differently in the respective national contexts. Although one could *a priori* assume otherwise, the institutional set-up *per se* has only to a limited extent proven useful as an indicator of the dominance of either of the two poles. Seemingly more important is the degree of alignment with the priorities and procedures of overall development co-operation. For instance, the geographical orientation of the programmes and their consistency with country strategies of development co-operation serve as an indicator for the relative importance of the respective goals. In the Austrian case, the assessment of programme objectives, the distribution of competences and implementation procedures shows that the instrument is primarily designed to promote exports. In this case study, the link between the institutional setting and the dominance of the export promotion pole is found to be the most direct. Austrian soft loans were originally conceived as a tool for export promotion. Only through slowly negotiated steps development components have been integrated into the procedures, mainly via the introduction of a questionnaire that aims at assessing the developmental relevance of prospective projects. These changes were accompanied by the inclusion of development into the programme goals and can be interpreted as a modest increase in the development orientation of the programme. Yet, alignment with overall development policy remains limited, as for instance the lack of alignment of programme beneficiaries with priority



countries of the Austrian Development Co-operation exemplifies (Schweiger 2014). Just as the Austrian programme, its Danish counterpart claims to 'kill two birds with one stone'. Export promotion interests are reflected in the instrument in so far as the majority of Danish mixed credits is procurement-tied. Assessing the institutional embedding of the programme, the distribution of political responsibilities and the parameters of implementation, however, suggests that considerable attention is directed to the development policy goals. Thus, DBF projects can be expected to demonstrate a high level of development orientation. The recent geographical focus on Danida's priority countries will presumably further strengthen the development policy components of the programme (Fritz 2014). The Dutch programme ORIO simultaneously aims at fostering human development and Private Sector Development (PSD). In this endeavour it complements the efforts of the Dutch development co-operation and its focus on private sector activities as stipulated in the latest policy document (Dutch MfA 2013b). With the establishment of the DGGF, export promotion goals might (re-)gain prominence among the objectives of Dutch instruments (Schuler 2014a: 96). The German FC is formally based on overall development policy and aligned with the country and sector strategies of the recipient country. The programme objectives and the institutional set-up suggest that development policy objectives are pronounced. This institutional set-up notwithstanding, the development orientation and motivation of the resulting flows cannot be taken for granted and export interests might be accommodated in more subtle ways (Schuler 2014b).

As a reaction to the untying initiative, both the German FC as well as the Dutch ORET programme (the predecessor of ORIO) were untied and Danida complemented its programme with an untied window. Notably, however, the development orientation of soft loans is not an exclusive function of their tying status. Formal untying does neither *per se* lead to a proportional increase in the development orientation of programmes, nor is it necessarily motivated by aid effectiveness. In the late 1990s, concern was raised regarding the circumvention of Helsinki provisions via the *de jure* untying of soft loan financing (Stafford 1998: 49). Firstly, conceptual ambiguities in the determination of the tying status of aid flows might lead via informal practices to a situation in which untied programmes have similar effects in terms of the delivery of goods/services from the donor country as tied ones. Secondly, untied loans 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. These and other ODA-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 2012a; Lømo 2013; Manning 2013). The fact that due to prevailing low interest rates, Germany reports low-concessional loans, presumably without any budgetary effort, as ODA, exemplifies such concerns (Martens 2012: 6). Analysis of the composition of overall funds of German FC reveals that the volume of standard loans has decreased in favour of development loans and promotional loans within the past decade. Federal budget funds, which go into development loans, have remained at a rather low level in the past five years. In comparison, the high volume of total KfW funds raised at the capital markets has dramatically increased the leverage of development loans. While the leverage ratio (total KfW funds to total budget funds) was 7:1 in 2009, the leverage nearly doubled to 13:1 in 2012. Besides, promotional loans, exhibiting low concessionality levels, have increased from EUR 41 million in 2002 to EUR 1603 million in 2012 (Schuler 2014a: 55).

### **3.4. Investments in Infrastructure as Key to Development**

Soft loans have traditionally served to finance infrastructure projects. This focus has been persistent over time, with slight variations across the four countries in accordance with the strengths of the respective national export industries. The examination of programme objectives shows 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, is assumed to be central to development. The sectoral recommendations suggested in the *Ex Ante Guidance for Tied Aid* (OECD/TD 2005), which are followed at least in the Austrian, the Danish and the Dutch programmes, support this assumption.

Despite this steady focus on infrastructure projects, the soft loan field has followed certain programmatic trends in international development policy. Since the introduction of the commercial non-viability requirement in the early 1990s, a focus on the provision of not only physical but also social infrastructure has been observable. This can be interpreted as a conceptual reorientation towards the notion of human development, which became the leading development discourse at the time. In the 2000s, concerns over the sustainability of development in its economic, social and environmental dimensions gained momentum and also entered the soft loan field. Concomitantly, several programmes included the environmental sector as a priority sector. In this vein, also the ability of projects to sustain themselves economically gained importance. Training components as well as skills and know-how transfer were built into the project designs and partially became a criterion for receiving soft loan financing. Recently, a priority and rhetorical shift towards PSD can be observed. Given the traditional focus on infrastructure development and public projects it remains, however, unclear how any such reorientation could effectively be implemented. Nonetheless, taking up the Busan call for partnership with the private sector, across the case study countries, the business community has recently been described as an indispensable partner, although partly as a result of the global financial crisis, private funding for development has stagnated during the last years. One of the main aspects, subtly inscribed in the programmes and used for legitimising the injection of grant money into a loan, is the leverage component of the resulting financing packages achieved by tapping private sources as well as the additionality of the invested resources. Thereby, similarly to the case of 'blending mechanisms' the strengths of instruments of mixed financing are interpreted in the context of constrained (public) resources for financing development (Greenhill/Prizzon 2012: 1). However, under prevailing capital market conditions with very low interest rates, the tied soft loan programmes in place in Austria and Denmark encounter genuine difficulties in meeting the concessionality thresholds required by the Arrangement. As a result, the instrument loses one of its most appealing characteristics: its leverage potential (Fritz 2014; Schweiger 2014).

## **4. The Road Ahead: What Future for Soft Loans?**

Although national programmes have been distinct, soft loans have been an integral part of external and development finance policies, respectively, in almost all DAC donor countries during the past four decades. Today, the importance and share in volume of the respective concessional finance programmes with respect to the overall ODA of a given country varies considerably, with classical tied aid programmes lying between 1-6 % of total ODA. By extensively relying on 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 initialised 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 favourable to using soft loan mechanisms, the graduation of many of these countries into UMIC 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 reorientation towards less developed markets, which might, however, be less attractive from an export promotion point of view. The adaptation strategies adopted by the case study countries to overcome the legitimisation 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 Arrangement. On the contrary, in the Netherlands a renewed impetus for export orientation is observable with the launch of the DGGF.

A proper assessment of the future of soft loans as an instrument of development finance will have to consider a number of recent developments, which will certainly exert significant influence upon the future of development co-operation and development finance. Amongst the former, three major drivers of change need to be highlighted:

- (1) the global financial and economic crisis and its repercussions on development policy;
- (2) the discussions on a post-2015 development agenda at UN level and the associated discussion on the future of ODA;
- (3) the emergence of new donors, in particular amongst the BRICS countries, and their influence upon development co-operation.

*Ad (1):* The most obvious consequence of the global economic and financial crisis on most OECD donors has been its effects upon public finances. Although it currently appears as if the economic situation in the OECD world has somewhat stabilised, consolidation policies will be continued in the medium term, particularly in the EU. Budgetary resources for development co-operation will thus remain circumscribed for years to come. Clearly grants as the central instruments of development assistance in particular to LDCs become decidedly less attractive, while loans or mixed/blended instruments with low concessionality levels become the instruments of choice.

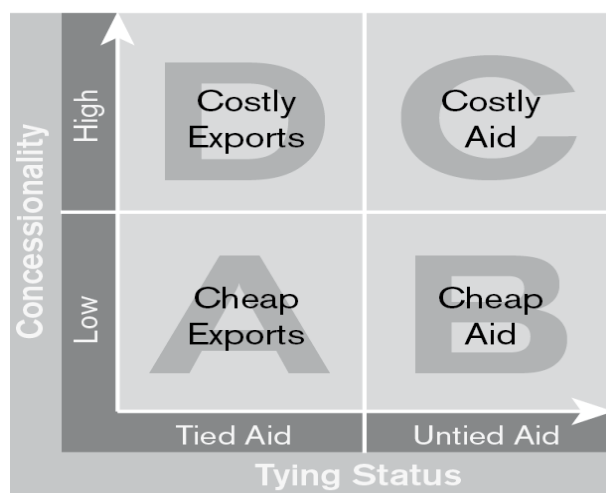
*Ad (2):* The discussions on a post-2015 development agenda are still on-going at the UN level. It remains to be seen if agreement on a new framework with binding commitments will be achieved. This indeterminacy notwithstanding, the thrust of the discussion so far suggests that the revised agenda will probably be substantially widened (UN 2013). This expansion bears two dangers: firstly, that the focus on poverty alleviation in development assistance will become diluted, and secondly, that the additional financing needs resulting from the new agenda will not be met by a proportionate increase in disposable financial resources. Thus, unless hopes for raising substantial amounts of private financing for the post-2015 agenda eventually materialise, competition for – as a consequence of the financial crisis – scarce public resources amongst the many development challenges will foreseeably increase. In addition, pressure to include the new items on the development agenda into the ODA-definition should be expected to mount.

*Ad (3):* The emergence of New Donors has raised significant attention recently. By 2011, annual concessional flows from emerging economies to LICs were estimated at USD 12-15 billion. Technical assistance grants from China stood at USD 67 billion annually (World Bank 2013b: 19). Though unsurprisingly the new donors also serve their own interests with their aid policies, their emergence in the field of international development was welcomed by most developing countries, be it for political reasons, e.g. the appeal to a new south-south co-operation agenda, or be it for the pragmatic reason of attracting new and alternative sources

of development finance. Besides, it has been well received that the New Donors do not attach political conditionalities and social and environmental standards of the kind DAC donors usually require. Consequently, it has become more difficult and/or costly to pursue foreign (economic) policy goals for DAC donors via their development assistance activities, including concessional financing. Additionally, development programmes and projects are implemented not only with funding from New Donors, but also to some extent with procurement-tied goods/services from the former. This has led to two kinds of reactions: (i) business interests in DAC countries lobby for relaxing demanding conditionalities and standards attached to aid and external finance (in particular finance under Arrangement terms), since the former are perceived as disadvantageous to their business interests. The export-led growth strategies promoted by many OECD countries as a response to the financial and economic crisis have given additional weight to these calls; (ii) DAC members have increased their efforts to integrate the New Donors into the OECD/DAC framework, the latest initiative being the first High Level Meeting of the *Global Partnership for Effective Co-operation* in Mexico. Progress on these initiatives has, however, remained limited so far.

Against this general framework, four scenarios are conceivable for the future development of soft loans as an instrument of concessional finance. As illustrated in Figure 6, these can be categorised along two fundamental dimensions: degree of concessionality and tying status.

**Figure 6: Four Scenarios for the Future of Soft Loans**



Source: Own Elaboration

*Scenario A* combines tying with low concessionality levels (<35 %). It is a scenario that under current Arrangement terms is not permissible with the exception of very small projects (<SDR 1 million) (OECD/TAD 2013: 22). It would contradict both the spirit of the Arrangement and one of the core principles of the development agenda, in particular the formal donor consensus on untying aid. Thus, scenario A does not seem feasible in the near future, since it would depend on a complete overhaul of the current institutional architecture.

*Scenario B* combines untying with low concessionality levels (<35 %). Some of our case study countries have recently moved into the direction of leveraging stagnant budgetary aid resources with private monies. Germany with its development loans and the Dutch ORIO programme are cases in point. Assuming that budgetary resources will remain scarce, both due to the continuation of austerity policies in many donor countries and the broadening of the post-2015 agenda, we would posit that Scenario B will be attractive to many donors. This is particularly true for donors, who want to target graduating emerging economies, be it in

the interest of their export sectors or for development reasons. The recent parliamentary report of the UK House of Commons on British development assistance has explicitly called upon the Department for International Development (DfID) to search for financial instruments in order to be able to continue support for poverty alleviation programmes in emerging economies (UK House of Commons 2014). Evidently, aid contributions for UMICs will have to involve lower concessionality levels, which under current Arrangement terms, is allowed only in untied form. Overall, we therefore think that concessional financing under Scenario B will be of relevance.

*Scenario C* combines untied aid with high concessionality levels (>50 %). This presupposes large grant elements and would thus be particularly suitable for aid policies targeting LICs. In this sense, Scenario C would present the straightforward option for re-programming soft loans towards a strong development orientation. The realisation of this scenario depends on (i), the political will to allocate substantial amounts of public money to such a programme, and (ii) acceptance by the respective export interests, since no formal tying is allowed. The latter would seem most likely in countries with highly-competitive export sectors, e.g. Germany, where national exporters win a high share of contracts also under ICB. However, the viability of this scenario depends on the confluence of two conditions, the probability of which must be judged rather small.

*Scenario D* is a combination of tied aid with high concessionality levels (>50 %). It represents the straightforward continuation of the Helsinki disciplines for tied aid to LDCs and LICs, respectively. In contrast to Scenario C, its viability depends on only one condition, i.e. the political will to allocate sufficient budgetary resources in order to finance the concessional element, while simultaneously satisfying prevailing export interests. The potential of this scenario therefore consists of combining a higher development orientation of such a programme, e.g. by targeting focus countries of national development assistance and/or priority sectors with procurement from donors, thus making a, albeit limited, contribution to export promotion.

The comparative discussion suggests a juxtaposition of two pairs of scenarios. The first pair comprises Scenario A and C, implying a move from tied to untied, while concomitantly increasing concessionality. This reorientation towards highly-concessional untied instruments would represent an ideal-type movement away from export promotion towards development orientation goals. Unfortunately, from our perspective, this does not seem to be very realistic and politically feasible 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 presents the more viable avenue under current circumstances. Evidently, this pair involves a trade-off between tying status and concessionality level. Scenario B may become attractive for continuing soft loan programmes with emerging economies, both for export promotion, particularly in the case of highly-competitive donor country exporters, as well as for targeted aid programmes in those countries. Scenario D is the logical choice, if soft loan programmes 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. It would be imperative that such soft loan programmes are aligned with donors' development assistance priorities and programmed in a way which adheres to basic development principles, in particular alignment, ownership and PCD.

## 5. Conclusion

Tied aid credits will represent a test case in the context of the debate on Finance for Development within the post-2015 development agenda. As our discussion has highlighted, what we have seen over the last two decades has been as steady decline in volumes and thus importance of this instrument. Somewhat paradoxically, the global financial and economic crisis has led to a partial reversal of policies: while before tendencies both to untie soft loans and increase their financial leverage with private funds were noticeable, since the crisis some countries have undertaken – so far limited – efforts to reintroduce tying practices. As OECD projections show that the number of countries graduating from ODA will continue to rise for the next 15 years (Sedemund 2014), tied aid policies are clearly at a crossroads. Either donors will focus their soft loan funding on the remaining LICs and thus strengthen the developmental mandate (our scenarios C and D), or sharply depart from the Arrangement by supporting the export interests of national industries *vis-a-vis* emerging economies (our scenario B). In the first case, the Arrangement may retain some of its relevance for regulating tied aid policies, though from a development point of view substantial reforms would seem vindicated. In the latter case tied aid as a hybrid form of development finance would eventually disappear, giving way to some straightforward form of export finance.

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