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# ODA LOANS – INVESTMENTS TO END POVERTY DISCUSSION PAPER

Rob Tew, April 2013

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# Contents

# Executive Summary

Concessional loans form a significant proportion of global aid flows and have been on a rising trend, compared to overall ODA, since 2007.

There are, however, a number of issues with the valuation of loans within ODA and also some controversies regarding whether, and in what circumstances, loans should be used instead of grants.

The value to the recipient of each dollar of lending, as measured by the grant element of each loan, varies widely from donor to donor. Also the basis on which the grant element is estimated is itself highly questionable. This is due to the OECD's use of an across-the-board 10% reference rate in its calculation of grant element.

This leads to significant potential for distortion of the ODA figures. Specifically it means that Gross ODA, as a measure, will overstate the true value of ODA loans when viewed from the perspective of the recipient.

The Net ODA measure also gives an incorrect picture of the true value of ODA loans to the recipient. This measure subtracts capital repayments from gross loans to arrive at a net figure, but fails to take interest repayments into account. The result is that the net value of ODA loans to recipient countries is overstated by approximately $5 billion per annum.

A new measure of 'gross grant equivalent', defined as grants plus the grant element of gross lending, may be more appropriate for the measurement of aid, in place of Gross ODA. Also the definition of Net ODA should subtract interest as well as capital repayments from gross lending.

The paper then turns to the question of whether aid should be given in the form of loans at all. An examination of the arguments for and against loans leads us to conclude that there is no *a priori* justification for excluding loans from ODA altogether. However it seems highly likely that, in some cases, loans are being used as an aid instrument in situations where there is a strong case for believing grants would serve the recipient better. The reverse is also true, some ODA is delivered in the form of grants in cases where a loan may well be an appropriate instrument. Furthermore, it appears that switching from grants to loans may not deplete the resources of loan-giving agencies as much as some observers suggest.

This begs the question: should donors only give loans in circumstances where grants would not be preferable?

Some initial criteria are suggested that may guide this choice:

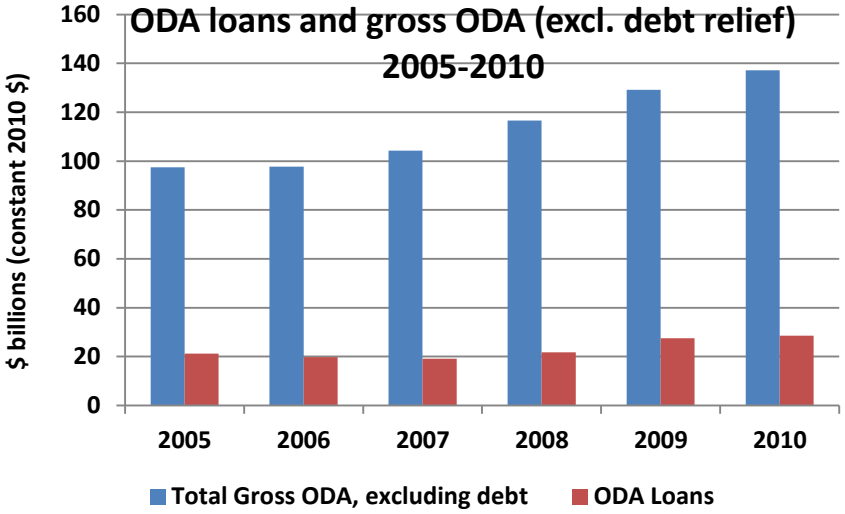
- The income level of the recipient
- Whether the aid is going to productive sectors or social sectors
- The level of indebtedness and the risk of debt distress faced by the recipient

The lending targets operated by loan-giving development agencies should perhaps also be reviewed to minimise the risk of inappropriate 'loan pushing' in order to meet such targets.

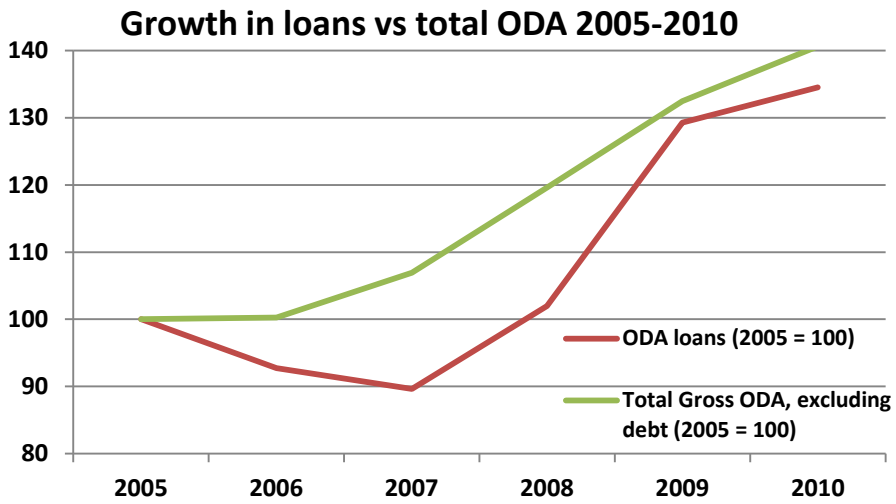
# Section 1: ODA Loans – A Significant & Growing Resource

## Overview

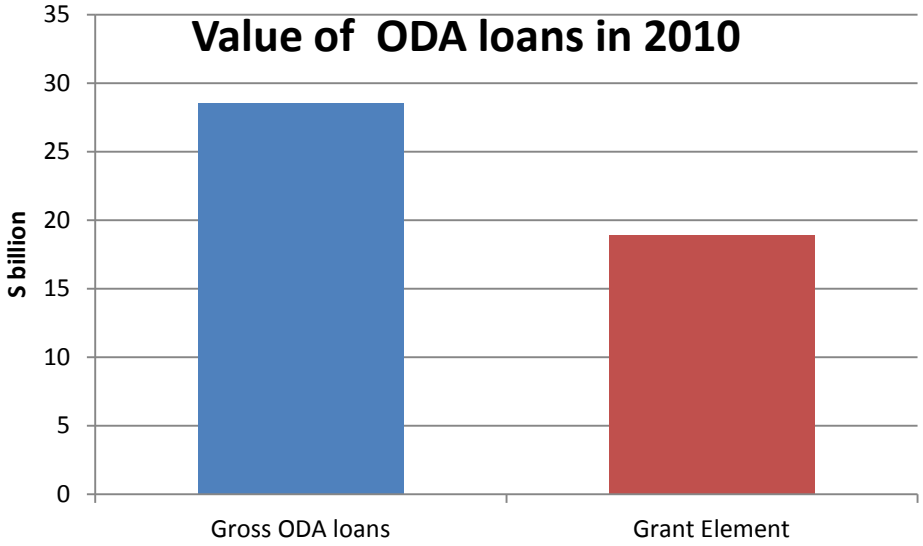
Loans make up a minority share of total ODA, accounting for approximately one-fifth of gross ODA (excluding debt relief) over 2005-2010. It is, however, still an important flow with over $28.5 billion of ODA loans reported by donors in 2010.




Indeed, as can be seen in the figure below, since 2007 the growth in ODA loans has outstripped the growth in overall ODA.



An important consideration when analysing ODA loans is the 'grant element' of the loans concerned (see section 2 for a fuller discussion of grant element). The grant element of loans in 2010 was slightly less than two-thirds of the total value of new lending counted by donors in the ODA figures (see figure below). Thus it could be argued that the value of ODA loans to recipients, when compared to how cash grants are valued, is approximately one-third less than the amount claimed by the donors.



# Section 2: Valuation of ODA Loans May Not Reflect Their True Value

The way in which loans are valued for the purposes of ODA can potentially give a misleading indication of what a donor's aid is worth and what the cashflow implications of ODA loans are. This section discusses the way grant element is calculated and used to determine a loan's eligibility for ODA. It also looks at the implications of excluding any consideration of interest repayments from the measurement of Net ODA.

## How Loans are valued in ODA

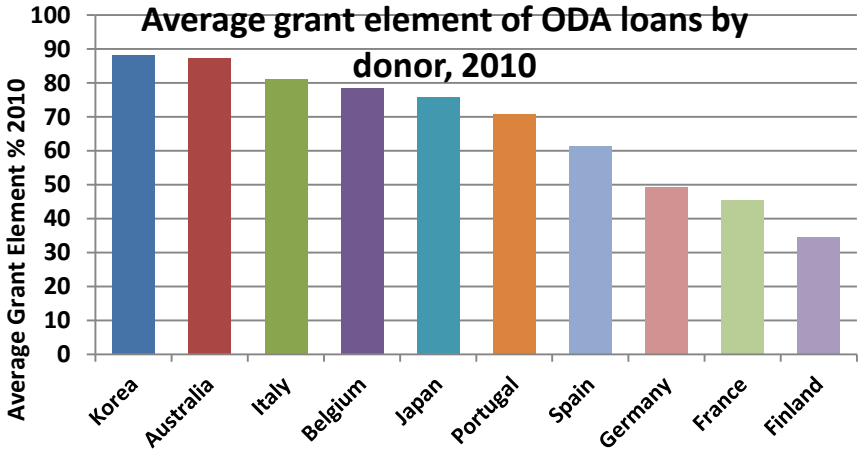
Loans are allowed to be included in a donor's reported ODA if they are 'concessional in character'. In practice the level of concessionality associated with a loan is measured by calculating its grant element. Grant element is a widely-used measure of the level of concessionality associated with a loan and is calculated as the difference between the face value of a loan and the discounted present value of the service payments the borrower will make over the lifetime of the loan, expressed as a percentage of the face value. A loan from the official sector (i.e. from a donor government agency, or multilateral body) is allowed to count as ODA if the grant element is at least 25 per cent. Loans with a grant element of less than 25 per cent are counted as Other Official Flows (OOF).

## Issues with the valuation of ODA loans

In the ODA figures any loans with a grant element of over 25 per cent are included in the ODA figures in their entirety. This means that loans with a relatively low level of concessionality (just over 25%) are valued the same in the ODA statistics as highly concessional loans.

From statistics published by the OECD DAC we can see that there appear to be wide differences between the average grant element of loans given by different donors.

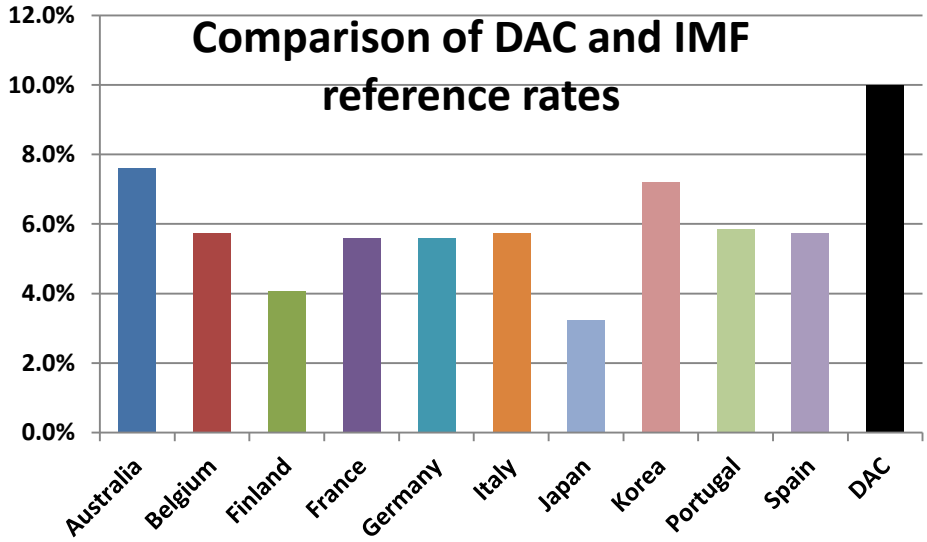
Different donors also give loans with very different grant elements. For example in 2010 Korea, Australia and Italy reported that their ODA loans had an average grant element of over 80% whereas ODA loans from Germany, France and Finland had average grant elements of less than 50%.



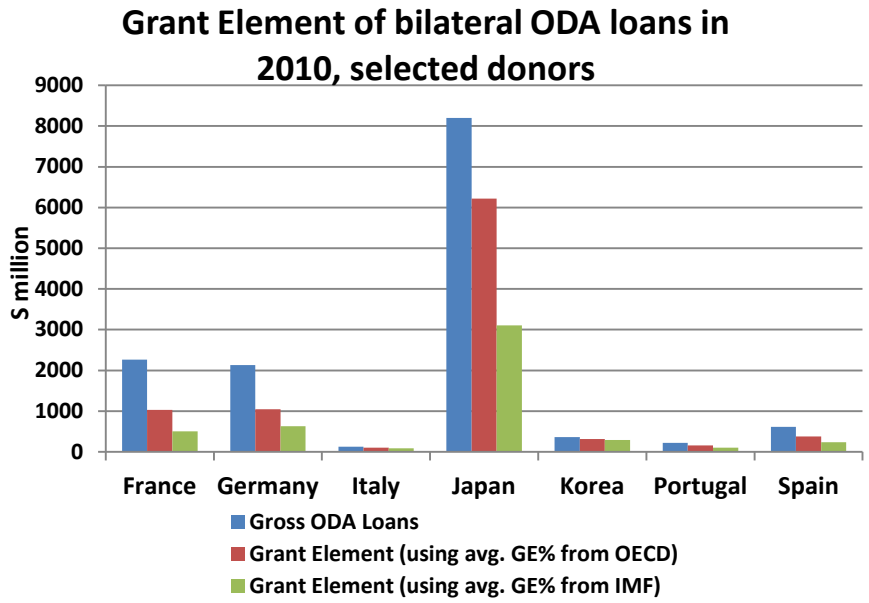

The great majority of bilateral ODA loans in 2010 were given by just three donors: Japan, Germany and France. However the average grant element of Japanese loans was over 75%, implying that their loans were worth three-quarters of the value of an equivalent level of cash grants. On the other hand France and Germany reported loans with average grant elements of 45% and 49% respectively, meaning that loans from them are arguably worth less than half the value claimed for them in the ODA figures (when compared to similar-sized cash grants).

The analysis of the value of loans is further complicated by the fact that the OECD use a reference rate set at an arbitrary level of 10% when calculating the grant element of loans. This 10% rate was set years ago when global interest rates were substantially higher than today. In contrast, when the International Monetary Fund is assessing how concessional a loan is, the IMF uses a range of reference rates specific to each donor and currency.

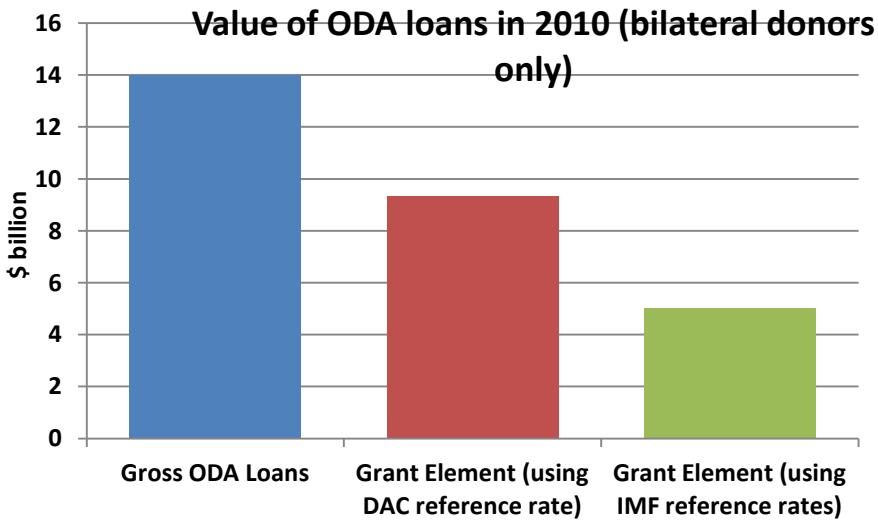
The chart below shows that the reference rates used by the IMF are in every case lower, and sometimes substantially lower, than the 10% rate used by the OECD-DAC in its calculation of grant element.



The fact that the reference rates used by the OECD are considerably lower than that used by the OECD means that, according to the IMF, the OECD calculations substantially over-value the grant element of ODA loans – making more loans eligible to be recorded as aid. The chart below shows the reported level of ODA loans from each of the major loan-giving donors alongside the grant element of those loans calculated using the OECD's 10% reference rate and the grant element calculated using the IMF's reference rates.




The effect of the IMF's reference rates on the value of ODA loans is striking. As shown in below, the grant element of loans from bilateral donors is 67% of the total reported for those loans if one uses the OECD's reference, but this falls to only 36% if one uses the IMF's reference rates.

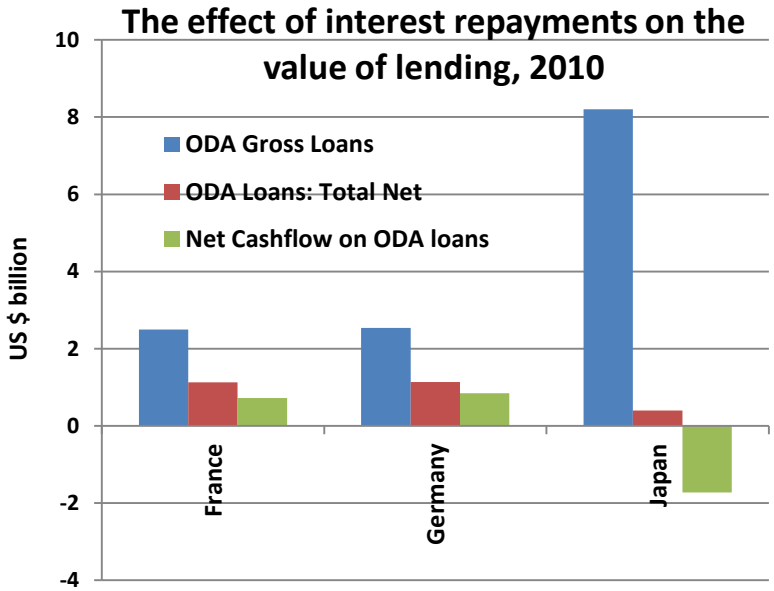


Indeed, if the grant element of ODA loans is calculated using the IMF's reference rates but one still applies the yardstick that a loan must have a grant element of over 25% to qualify as ODA, then a significant proportion of the ODA loans from some donors *could cease to qualify as ODA*[1].

## The cashflow implications of lending – net, gross and interest repayments

The value of ODA loans may be expressed in the DAC statistics either in gross or net terms. The use of net lending reduces the value of the ODA from loan-giving donors by subtracting the repayments made by the recipients. However, according to the OECD DAC reporting directives, only *principal repayments* are taken into account when calculating the net figure. *Interest repayments* are not subtracted from gross lending, but are instead recorded as a memo item in the statistics. This means that, in practice, a significant reverse flow (i.e. money paid from the developing countries to the donors in the form of interest payments on ODA loans) is ignored in the ODA statistics. Thus even the net lending figure overstates the true net transfer of resources between ODA donors and recipients.

This is illustrated in the chart below which shows the gross and net ODA lending from the three largest providers of ODA loans and compares these amounts to the actual cashflow implications of lending when interest repayments are taken into account. As can be seen, the actual transfer of resources associated with ODA loans is significantly smaller than the net lending figure suggests and, in the case of Japan, there is actually a net transfer of resources *from* developing countries *to* the donor.




The data published by the OECD DAC shows that, if interest repayments are taken into account, the net resource flows associated with global ODA are approximately $5 billion per annum lower than the reported total net ODA figure suggests.

[1] The data published by the OECD only gives *average* grant element percentages for the ODA loans advanced by each donor. This makes it impossible to say with certainty exactly what proportion of loans may cease to qualify as ODA if a reference rate of less than 10% was used in the grant element calculation.

# Section 3: Grants versus Loans

There has been controversy around whether any aid should be given in the form of loans for some years. In 2000 the Meltzer Commission[2] recommended that all poor-country debt should be cancelled and that development assistance should only be given in the form of grants.

This recommendation has been criticised by a number of observers who, in their turn, point to a number of advantages that, it is claimed, loans have over grants:

- Aid money goes further
- Profits from loans are recycled, contributing to the sustainability of aid programmes
- Loans improve the fiscal discipline of the recipient

On the other hand many writers have offered arguments that grants are preferable to loans, either in general, or in specific circumstances:

- Concessional loans may lead to over-borrowing
- Loan-pushing by agencies in order to meet lending targets may lead to excessive lending
- Grants may be better than loans for funding the social sectors
- Grants are preferable to loans for the poorest countries

These arguments are summarised below.

## Arguments in Favour of loans

### Loans make aid money go further

Cohen, Jacquet & Reisen (2007)[3] summarise this argument as follows:

*"Suppose a donor earmarks $1 billion of taxpayers' money for Official Development Assistance (ODA). The donor may use two instruments, an outright grant or in combination with a market-rate loan to produce a concessional loan of $2 billion with a percentage grant element of 50 per cent."*

This, of course, only holds when one considers *Gross* ODA flows as, when measuring *Net* ODA, over the long run the repayment of the loan principal and any added interest will offset the apparent extra $1 billion of ODA generated by the use of the loan instrument.

However, depending on the length of any grace period and the interest rate vis-a-vis the inflation rate faced by the borrower, the real (i.e. inflation-adjusted) value of the repayments may be lower than the original loan amount.

[2] Report of the International Financial Institution Advisory Commission, 2000
[3] Cohen, D., Jacquet, P., and Reisen, H. Loans or Grants. *Centre for Economic Policy Research, 2007*

### Recycling loan profits makes aid programmes more sustainable

Sanford (2002)[4] points out that reflows of principal repayments on IDA loans grew from $274 million in 1991 to $920 million in 2000. This, according to Sanford, enabled IDA to shift a greater part of the cost of funding its future loans onto , reducing the amounts required from donor countries.

This view was echoed in a 2002 DFID briefing paper[5] which stated that: *"40% of IDA's resources come from reflows on previous IDA loans. If IDA provided grants, this gap would have to be filled by a substantial increase in donors' contributions.... In this climate, it is unrealistic to assume that it will be possible to sustain a substantial grant window within IDA."*

However, writing a few years later, Nunnenkamp, Thiele & Wilfer[6] observed that the ratio of debt service to loans extended was bound to rise in the latter years of the 1990s as IDA loans only gained momentum in the 1980s. They noted that IDA loans extended since 1994 did not follow this increasing trend. Nunnenkamp, Thiele & Wilfer also pointed out that a proportion of the debt is not repaid by IDA clients, but is either forgiven or recycled through defensive lending (i.e. new loans extended for the service of maturing loans in order to avoid outright default). Taking these issues into account, Nunnenkamp, Thiele & Wilfer conclude that : *"The fear of resource depletion thus fails to be a compelling argument in favour of retaining a major role for loans as a means of development financing".*

In a similar vein, Bulow & Rogoff (2005)[7] argue that the failure to adjust returns for risk means that the development banks' profits (which are said to be used to finance further ending) are "an accounting illusion".

Odedokun (2004) also observed that empirical results do not show that resource transfers are influenced at present by reflows generated from past loans.

### Loans lead to better fiscal discipline

A number of writers have argued that delivering aid in the form of loans leads to greater fiscal discipline and improved domestic resource mobilisation among recipient countries. Cohen, Jacquet & Reisen (2007)[8] typify this position, writing: *"Since grants need not be repaid, they entail a potential disincentive on the mobilisation of public revenues and on the quality of public spending...In principle, loan repayments should help build financial discipline and promote the efficient use of funds."*

Some empirical support for this position comes from Gupta et al. (2004)[9] who took data on 107 countries that received ODA between 1970 and 2000 and assessed the impact of grants and loans on domestic fiscal effort. They concluded that grants resulted in lower fiscal effort than loans, with as much as 28 cents out of every $1 of ODA grants being offset by a reduction in the fiscal effort of the recipient.

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[4] Sanford, J., World Bank: IDA Loans or IDA Grants. *Congressional Research Service*, 2002

[5] Department for International Development (DFID), "Loans or Grants: IDA's Concessional Lending Role" http://webarchive.nationalarchives.gov.uk/+/http://www.dfid.gov.uk/news/News/files/bg_ida_grants.htm

[6] Nunnenkamp, P., Thiele, R. & Wilfer, T.: Grants versus loans : much ado about (almost) nothing, Kiel economic Policy Papers, 2005

[7] Bulow, j. & Rogoff, K.: Grants versus Loans for Development Banks, *Paper presented to the American Economic Association,* 2005

[8] Cohen, D.,Jacquet, P. & Reisen, H.: Loans or Grants, *Centre for Economic Policy Research*, 2007

[9] Gupta, S., Clements, B., Baldacci, E. & Mulas-Granados, C.: The persistence of Fiscal Adjustments in Developing Countries, *Applied Economics Letters*, 2004

## Arguments Against Loans

### Concessional loans may lead to over-borrowing

Economic theory suggests that any good that is subsidised may be over-consumed. Odedokun (2004)[10] finds empirical evidence that this applied to concessional ODA loans. Arguing that soft loans may give borrowers an adverse incentive to borrow too much and that *"the past debt overhang of many poor countries could partly be explained by earlier inducements to borrow through high concessionality".*

### Loan-pushing by agencies in order to meet lending targets may lead to excessive lending

The flip-side of the above argument is that the lending targets operated by development banks may lead lenders to 'push' loans inappropriately onto borrowers thus increasing the future repayment liabilities and consequent risk of default.

The Meltzer commission report stated that:

*"The World Bank had developed a lending culture. Rewards were closely related to the volume of lending, not to a project's value or program accomplishments...an Asian Development Bank portfolio review found that dedication to client interest was undermined by an 'approval culture' aimed at achieving yearly lending targets. Incentives to lend for lending's sake are built into the structure of the Banks."*

As a means of determining whether excessive or potentially excessive debt accumulation by some borrowers is still a feature of ODA lending we reviewed lending to countries covered by the World Bank-IMF Debt Sustainability Framework. This framework assesses the levels of indebtedness of low income countries and gives each country a ranking indicating the risk of external public debt distress faced by that country.

Debt burden indicators for each country are compared to indicative thresholds over a 20-year projection period with countries given one of four rankings as follows:

- **Low risk**, when all debt burden indicators are well below debt-stress thresholds
- **Moderate risk**, when debt burden indicators are currently below the thresholds, but stress tests indicate that the thresholds could be breached in the event of economic shocks or changes in economic policy
- **High risk**, when there is a protracted breach of the debt-stress thresholds, but the country is not yet facing repayment difficulties
- **In debt distress**, when a country is already experiencing repayment difficulties.

An analysis of the most recent ODA data reveals that a total of over $900 million was lent in 2011 to countries rated by the IMF as either at a high risk of debt distress or already suffering from debt distress and a further $3.6 billion was lent to countries at moderate risk of debt distress. A total of nine countries which were either in debt distress or at high risk of debt distress received more than one-tenth of their ODA in the form of loans in 2011 (see table below).

[10] Odedokun, M.: Bilateral and Multilateral Loans versus Grants: Issues and Evidence. *The World Economy, Vol 27,* 2004

| | ODA Loans, 2011 ($ million) | ODA Loans, 2011 (% of gross ODA) |
|---|---|---|
| **Djibouti** | 37 | 24% |
| **Gambia** | 14 | 11% |
| **Grenada** | 2 | 12% |
| **Laos** | 47 | 11% |
| **Maldives** | 22 | 45% |
| **Sao Tome & Principe** | 20 | 28% |
| **Sudan** | 199 | 17% |
| **Tajikistan** | 55 | 16% |
| **Yemen** | 75 | 13% |

Thus it appears that there is still significant lending activities to many countries who could be said to be over-indebted, or at least in danger of becoming so.

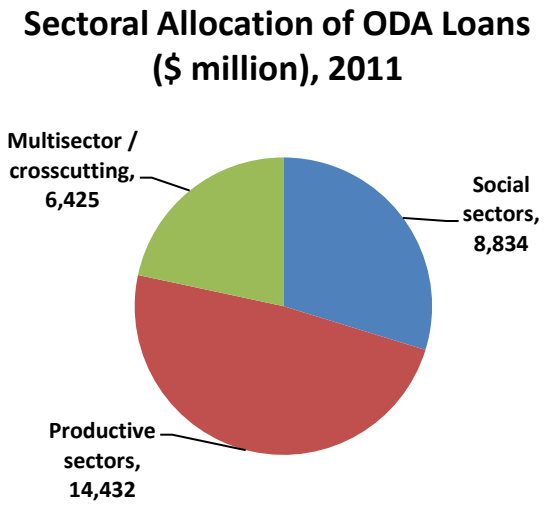
### Grants may be better than loans for funding the social sectors

Loans may not be appropriate for aid activities in the social sectors which do not directly generate additional revenue which recipient governments may use toward the cost of servicing a loan.

Odedokun (2004) suggests that *"If a recipient government is seeking aid transfers to assist the poorer segments of the population (e.g. safety nets, scholarships to the poor, etc...grants would be more appropriate."*

This is echoed in a recent paper by Das & Khan (2012)[11] who conclude that *"From the recipients' point of view, loans should be channelled to those sectors which are productive."*

An analysis of the most recent ODA data shows less than half of ODA loans are specifically allocated to productive sectors, with 30% allocated to social sectors and the remainder earmarked for projects described as multisector.




[11] Das, A. And Khan, S.: Is Grant Aid More Effective than Concessional Loans? Evidence from a Dynamic Panel of Sub-Saharan African Countries, *International Journal of Economics and Finance*, 2012

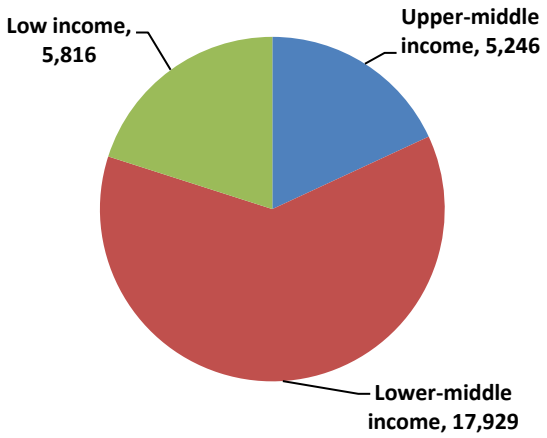
## Grants are preferable to loans for the poorest countries

It has been suggested that lending to the poorest countries will be counter-productive, due to lower absorptive capacity and risk of unsustainable debt burden. Cordella & Ulku (2007)[12] carried tested panel data from 62 developing countries in an attempt to determine under what conditions should grants be preferred to loans. They concluded that giving aid to the poorest countries in the form of loans *"could negatively affect both their current and future growth performance through the accumulation of a stock of eventually unsustainable debt"* and that giving grant aid to such countries would *"prevent repeating the mistakes of the past, when large loans left countries poor and indebted."*

In a similar vein, Odedokun points out that, in cases where aid recipients, are facing long-term resource constraints (as opposed to temporary liquidity problems) loans may well worsen the country's situation.

Despite this, the most recent ODA data show that significant amounts of ODA is still provided to low-income countries in the form of loans.

**ODA Loans by Recipient Income group ($ million), 2011**




[12] Cordella, T. And Ulku, H.: Grants vs. Loans, *International Monetary Fund Staff Papers Vol 54, No 1*, 2007

# Section 4: Concluding Points for Discussion

In our conclusions we look at the issues surrounding ODA loans from two perspectives:

- How should loans be measured and accounted for in the ODA statistics reported by donors?
- What are the factors affecting the appropriate use of loans and grants?

## The measurement of loans in ODA

The current methods of measuring the value of loans in ODA may distort and overvalue the worth of these loans both from the perspective of the donor and the recipient.

### Reference rates

The current practice of using a fixed 10% reference rate when calculating the grant element of ODA loans overstates the economic effort of donors when providing such loans.

**In future, should the level of concessionality of ODA loans should be calculated with reference to more realistic interest rates, for example the currency-specific "commercial interest reference rates" (CIRRs) used by the IMF?**

If a lower reference rate were adopted this would mean that the level of grant element associated with ODA loans would fall substantially. Additionally, if the current grant element threshold of 25% were retained as a criterion for counting a loan as ODA, many loans that currently count as ODA could be reclassified as Other Official Flows (OOF). Thus, although the total amount of finance would stay the same, the amount of reported ODA would fall unless donors increased the level of concessionality of their lending.

**If lower reference rates were used, should the current 25% grant element criterion still apply?**

### Grant element and the measurement of Gross ODA

Some writers, for example Easterly and Williamson (2011)[13] have employed the fallacious method of adding up all Gross ODA over a period of time in order to arrive at a total for the aid resources transferred to developing countries. This obviously fails to take into consideration the reverse flows associated with ODA loans and thus overstates the value of resources transferred to aid recipients by donors.

Others have called for only the grant element of loans to be included in the valuation of ODA with Burnside & Dollar (2000)[14] stating that this would: *"yield a truer estimate of foreign aid"* ad Chang et al (1998)[15] calling it a *"conceptually superior aid measure"*.

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[13] Easterly, W. & Williamson, C: Rhetoric versus Reality: The Best and Worst of Aid Agency Practices, *Development Research Institute*, 2011

[14] Burnside, C. & Dollar, D.: Aid, Policies and Growth, *The American Economic Review*, 2000

[15] Chang, C., Fernandez-Arias, E. & Serven, L., Measuring Aid Flows: A New Approach, *Inter-American Development Bank*, 1998

**Should donors and the OECD therefore supplement the existing measures of ODA with a measure of the 'Gross Grant Equivalent' of aid activities?**

This measure would be the sum of grants and the grant element of gross ODA loans. This measure could then be used in place of the current Gross ODA total, especially in cases where gross flows are being added together over a period of time.

### Interest repayments and the measurement of Net ODA

As noted previously, the Net ODA measure used by the OECD subtracts capital repayments of loans made by recipient countries to donors, but fails to take account of the interest repayments made by borrowers. This means that the true value of net resource flows between donors and developing nations is in the region of $5 billion per annum lower than the figure suggested by the OECD's Net ODA measure.

**Would Net ODA be a truer measure of the value of aid if it took all repayments (interest as well as capital) into account?**

## Policy implications of the loans v. grants debate

From the arguments presented in section 3 of this paper, it seems clear that there are logical arguments in favour of continuing to use loans as a means of delivering some aid. Also many of the criticisms of aid loans are not actually arguments against loans *per se*, but rather arguments against the use of loans for some recipients in some circumstances.

Specifically, it seems plausible to suggest that grants are likely to be preferable to loans in the following cases:

- Where the recipient is at risk of debt distress
- Where the recipient is a low-income country
- Where the aid is intended to fund the social sectors

If these criteria were applied to the ODA loans disbursed in 2011, this could have meant the replacement of $5.8 billion of ODA loans to low-income countries and $7.2 billion of ODA loans to middle-income countries with grants. If one assumes an average grant element of 67%, this could imply a release of an additional $4.3 billion of value to the poorest communities in one year.

As discussed in section 3, the replacement of some loans with grants would not necessarily imply a smaller overall amount of ODA. Also donors who wished to give loans could also give less grants and more loans to the productive sectors of middle-income countries who were not at risk of debt distress. In 2011, for example, $5.4 billion of aid to the productive sectors of middle-income countries was given in the form of grants.

**Do donors pay sufficient attention to the comparative advantage of loans and grants when choosing the most appropriate funding instrument for a given aid activity?**

**What factors may affect the relative suitability of loans and grants?**

**What other advantages and disadvantages of loans relative to grants are there? (Do loans help to build the credit-worthiness of borrowers in the eyes of international markets? Do concessional loans offer an alternative to market-rate borrowing for some recipients?)**

Finally, it appears that the lending targets of development banks and bilateral donors who give aid loans may have the effect of causing over-lending as employees in these agencies may be incentivised to meet their targets.

**Should the system of lending targets operated by loan-giving development agencies be reviewed to minimise the risk of inappropriate 'loan pushing' in order to meet such targets?**

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