



# AID-FOR-TRADE: CASE STORY

OVERSEAS DEVELOPMENT INSTITUTE



**Aid for Trade and Blended Finance**



## **Aid for Trade and Blended Finance**

### ***Aid for Trade Case study submission to OECD/WTO***

Mikaela Gavas, Matt Geddes, Isabella Massa and Dirk Willem te Velde  
Overseas Development Institute  
31 January 2011

#### **Summary**

This submission focuses on an underemphasised, yet increasingly important, aspect of Aid for Trade, which is how to blend resources (loan and grants, ODA and OOF; and private finance) for infrastructure. If developing countries want to attract significant financial resources for Aid for Trade, e.g. to cover their infrastructure needs, they and donors need to think outside the traditional Aid for Trade box and consider how grants can leverage in other resources (e.g. loans or private finance) and provide a bundle of blended Aid for Trade finance.

We review three ODI-led studies relevant for blended finance for Aid for Trade and obtain the following broad results.

ODA can be in the form of loans and grants. One concern on blending loans and grants has been that ODA loans are more trade distortionary than ODA grants, e.g. when a loan from a country to a recipient leads the recipient to switch imports to the importing country. However, we find that grants and loans do not differ significantly in their trade distortionary effects, though both affect bilateral trade. Surprisingly, if anything, grants are more trade distorting than loans. A one million change in bilateral aid (whether ODA loans or ODA grants) leads to an increase of bilateral exports of a third of a million in the case of France, but three quarters of a million in Germany and Japan.

We examine EU blending schemes (e.g. the EU-Africa Infrastructure Trust Fund, ITF, or the Neighbourhood Investment Fund, NIF; these together have absorbed more than €1 billion of EC and EU member states pooled grants, of which some € 400 mn to the ITF for regional infrastructure) which add grants to loans. Blending grants to loans is used to finance essential TA studies, improve the quality of the project and achieve the required level of concessionality for funding including for infrastructure. We estimate that one unit of grants leverages in between 5-6 units of loans (for both ITF and NIF) and a further 15 units of other finance (in the case of the ITF aimed at cross border African infrastructure). Thus aid grants (already some €400 mn for the ITF) are likely to leverage in substantial amounts of other finance (official loans as well as private finance) including for regional infrastructure.

Development Finance Institutions (DFIs) are financial institutions backed by the states including by explicit and implicit subsidies (ODA grants) and these can help to mobilise additional capital, including private investment in infrastructure. Some USD 33 billion of DFI investment has been invested in the private sector in 2009. Around a third of this goes to infrastructure and some of DFI finance is directly classified as aid, though much as OOF, or Other Official Flows. Every dollar of CDC investment coincides with \$5 of other investment; every IFC dollar leverages about \$3 from others; every EBRD dollar leverages in another \$1.

Research from the Overseas Development Institute has contributed significantly to the debate on Aid for Trade. Examples of areas covered by ODI research associates and ODI researchers over the period 2003-2010 include:

- Trade preference erosion and the possible establishment of a vertical Aid for Trade fund to compensate for trade preference erosion;
- The financial architecture for Aid for Trade
- Regional Aid for Trade
- Evaluation of the EC's trade related assistance
- Aid for Trade and Africa
- Aid for Trade in the context of WTO proposals on SDT for the LDC group
- Aid for Trade and EPAs
- Aid for Trade and climate change
- Aid for Trade and the private sector
- Overview of trade related capacity building
- The effectiveness (quantitative) of Aid for Trade on trading costs and exporting

Some of the studies in these areas are being discussed in other planned submissions to the OECD/WTO, e.g. by the Commonwealth Secretariat and UNIDO.

This submission focuses on an overlooked aspect on Aid for Trade which is how to blend resources (loan and grants, ODA and OOF; and private finance) for infrastructure. The argument goes as follows. There is an increasing need to finance infrastructure (e.g. US\$ 93 billion is needed to cover African infrastructure needs alone), but donors are increasingly resource constrained and hence have emphasised the use of blending resources (e.g. by the European Commission). How much does blending occur, what are the effects of different types of aid instruments and how can aid grants best leverage in other sources of finance (loans, private finance)?

We have conducted three relevant studies which we review in this submission:

- Massa, I. and D.W te Velde (2009) 'The trade distortion implications of loans and grants: an econometric examination.' Report to KfW Entwicklungsbank. Overseas Development Institute, London, Revised draft, July 2009.
- European Think Tanks Group (2011), 'EU Blending Facilities: Implications for Future Governance Options', report for UK DFID, led by Mikaela Gavas, Matthew Geddes, Isabella Massa and Dirk Willem te Velde from ODI with inputs from researchers at ECDPM, FRIDE and DIE.
- Te Velde, D.W and Warner, M. (2007) 'The Use of Subsidies by Development Finance Institutions in the Infrastructure Sector.' Working Paper 283. London: ODI.

## **1. Issues Addressed**

The key issues addressed in this submission include (i) do loans and grants have differential trade distortionary effects; (ii) what evidence exist on EU blending mechanisms; and (iii) how do Development Finance Institutions (DFIs) use subsidies in conjunction with their other financial instruments to promote investment in infrastructure.

## **2. Objectives Pursued**

The objectives pursued include:

- (i) what is the effect of bilateral loans and grants on bilateral trade, does the type of aid instrument matter?
- (ii) what are possible governance options for EU blending mechanisms in the future; and
- (iii) do DFIs use subsidies efficiently to promote investment in infrastructure?

## **3. For projects and programmes: Design and Implementation**

The design and implementation issues are as follows:

- (i) an econometric study, using a gravity equation explaining bilateral trade by a host of factors, including bilateral ODA loans and ODA grants;
- (ii) a review of the evidence on the economic rationale for blending; a review of activities and governance of existing EU blending mechanisms (based on official literature, data analysis and interviews); it reviews five existing EU blending facilities: The Neighbourhood Investment Facility (NIF); The Western Balkans Investment Framework (WBIF); The EU–Africa Infrastructure Trust Fund (ITF); The Latin America Investment Facility (LAIF); and The Investment Facility for Central Asia (IFCA);
- (iii) a review of the use of subsidies by DFIs generally and with respect to infrastructure specifically (based on DFI publications and interviews); followed by a more recent overview of DFIs.

#### 4. Problems Encountered

The most common constraint is data availability

- (i) the econometric study is challenged by sufficient data points (e.g. the quality of aid data) and depends on the appropriateness of the model specification;
- (ii) the blending study was hampered by the lack of data on EU blending mechanisms (some schemes have only just begun, and even the EU-Africa Infrastructure Trust Fund has only implemented 20 projects which is insufficient for a rigorous quantitative analysis) – and there is no simple counterfactual (what would have happened without blending); Whilst blending has emerged rapidly and is now common practice in development finance, including for Aid for Trade, there is currently a limited evidence base on the effects of blending. Whilst a sizeable literature exists about the theoretical use of loans and grants, there is little on how it works in practice, which methodology or procedure works best and whether a certain governance model is more effective in reaching its objectives.
- (iii) commercial confidentiality considerations hampers a good statistical analysis of the use and effects of subsidies by DFIs.

#### 5. Factors for Success/Failure

- (i) the econometric study provides new evidence for the effects of loans and grants on bilateral trade;
- (ii) the blending study suggested a number of useful principles behind effective blending.
- (iii) the subsidy study described a number of ways in which DFIs use subsidies.

#### 6. Results Achieved

We summarise the results of the three studies.

- (i) *the econometric study on loans vs grants*

This study (Massa and te Velde, 2009) examines whether there is any trade distorting effects of grants or loans at an aggregated level, and whether grants or loans are more trade distorting. ODA can be in the form of loans and grants. One concern on blending loans and grants has been that ODA loans are more trade distortionary than ODA grants, e.g. when a loan from a country to a recipient leads the recipient to switch imports to the importing country. However, we find that grants and loans do not differ significantly in their trade distortionary effects, though both affect bilateral trade. Surprisingly, if anything, grants are more trade distorting than loans. It estimates a gravity model on bilateral exports between 15 OECD donor countries and 74 recipient countries over the period 1980-2006, and test for the effects of loans and grants on trade flows, taking into account other standard explanatory variables. It finds that both loans and grants have effects on export flows from donor countries.

The paper quantifies the impact of additional aid flows (grants or loans) on exports. We first take bilateral exports and aid data, shock aid by 1 million (which is around 0.01% for each donor), multiply the relative increase in aid by 0.025 (which is approximately the coefficient in the pooled and more

reliable regression in the random effects model) and then estimate the relative and absolute change in exports. The results suggest that a one million change in bilateral aid would lead to an increase of bilateral exports of a third of a million in the case of France, and three quarters of a million in Germany and Japan.

(ii) *the study on the governance of EU blending mechanisms*

This study (ETTG, 2011) discusses the complementary use of grants and loans (blending) in the European Union's (EU) external assistance and considers the pros and cons of possible future governance options for EU blending mechanisms. Blending mechanisms, when adding grants to loans, aim to achieve a number of objectives, including the need to increase the volume of development finance in a context of constrained resources.

The facilities specialise in large-scale infrastructure investments alongside SME support, and hence are important in providing Aid for Trade in the trade related infrastructure category. They cover similar, broadly defined, sectors i.e. transport, energy, social, environment and finance for SMEs. Partners in the beneficiary country can be public, private or mixed with public partners dominating the current projects. Most projects are public sector projects. The ITF is restricted to the financing of regional infrastructure and national infrastructure contributing to regional integration. Some €400mn of grants has been allocated under the ITF.

A literature review suggests that compared to pure loans, blending mechanisms allow for:

- Making transfers to heavily indebted countries without exacerbating debt overhang problems; (although in practice in the EU blending mechanisms, the grant share in total loans and grants is often below 5-10%);
- Addressing positive externalities to bring the financial rate of return closer to the economic rate of return for projects with a high socio-economic and/or positive environmental impact;
- Improving the quality of funded projects;

Each EU blending facility covers a specific region. The potential range of instruments includes: technical assistance (TA); feasibility studies; investment co-financing; equity participation; risk-capital; interest rate subsidies; on-lending; guarantees; insurance subsidies; and incentive payments. TA/feasibility studies and interest rate subsidies provide for the largest number of projects.

All the facilities have similar structures:

- A strategic body providing policy direction;
- A decision-making body deciding which projects should receive grants; and
- A group of financiers screening proposals and providing technical analysis before forwarding select proposals to the decision-making body.

In terms of financial additionality, we find that 1 unit of grants leverages in between 5-6 units of loans (for both ITF and NIF) and another 15 units of other finance. Thus aid grants are likely to leverage in substantial amounts of other finance including for regional infrastructure as part of the ITF.

It is not straightforward to evaluate the effects of blended projects (compared to loan or grant finance only). This is because of methodological reasons (lack of counterfactual) and lack of specific data on: 1) the economic and social effects of the blended project; and 2) the exact contribution of the grant component. We do, however, have a large number of project descriptions of grant components of blending mechanisms suggesting they are used to finance essential studies, improve the quality of the project and achieve the required level of concessionality, providing evidence for the importance of blending. There is little quantitative evidence to back this up, though we provide some pointers below.

Some ITF grants are applied as interest rate subsidies. Grants channelled through loans to a HIPC country government for on-lending to the promoters requires that the project includes a minimum concessionality element of 35%. In one case, the ITF interest rate subsidy up to EUR 9.3 million to the loan of EUR 33 million would enable the three countries that are borrowers for the project to meet HIPC2 requirements, while contributing to regional development through the production of sustainable and clean power generation. The three borrowers would on-lend the loan amount. The grant obtained

from the ITF would allow for: (i) a subsidised interest rate of 4.5% instead of a fully commercial rate (which is welcome at a time where the financial situation remains difficult); and (ii) the interest rate differential between 4.5% and 1.9% (which corresponds to the rate paid by the three states) to be used for rural electrification. In another case the ITF Grant was used to subsidise the three loans. Each loan was for EUR 35 million and received a EUR 5 million subsidy.

ITF grants have been used to finance studies and improve the quality of the project. ITF grants have been used to finance Feasibility Studies, Environmental and Social Impact Assessment (ESIA), a Resettlement Action Plan an Environmental and Social Management Plan, a line route study, audits, studies focusing on the institutional and financial framework; consultancy services to enhance the capacity to manage the expansion project through review of documentation, monitoring performance of the contractors and consultants and advising the authority management on smooth project implementation to deliver the project; hiring of the core management team; and the management team's costs during the construction phase of the project.

We were unable to pinpoint any large differences in operational outcomes as a result of a different internal governance arrangement (e.g. ITF vs. NIF). There is however a discussion possible on the principles which may help to inform the best possible governance option for EU blending mechanisms, for example:

- The need for a fair arbiter in order to avoid potential conflicts of interest between eligible Finance Institutions;
- The need to ensure a “policy driven” screening of grant requests based on development policy objectives;
- The need to keep a separation between the policy and technical aspects of the grant award process (donors vs. Development finance institutions);
- The need for transparent and formal checks and balances on the proposals of project financiers at early stages;

(iii) *The study on the use of subsidies by DFIs in infrastructure*

Donor governments “subsidise” a large variety of development finance institutions (DFIs) by providing, in differing degrees, paid-in capital; additional ‘callable’ capital; exemptions on dividends and corporation tax; state guarantees used to obtain cheap borrowing, and grant co-financing.

In 2009 (2005), these (implicit or explicit) subsidies allowed the main DFIs to invest USD 33 billion (21 billion) in developing country private sector projects. Of this amount, in 2005, USD 7.5 bn was for infrastructure, and some USD 200 million worth of technical assistance (TA) activities was provided.

DFIs are asked to use subsidies to address market failures and provide long maturity loans and guarantees and take equity stakes in poorer, higher risk, countries and sectors, to grow markets and improve the investment climate, and to demonstrate positive investment experiences. They are also required to mobilise private capital, price products to generate commercial returns and build companies able to attract private capital in the future. This exposes a conundrum: it might not be possible to concurrently secure commercial rates of return, mobilise additional private investment and move into areas where the private sector prefers not to go (e.g. some infrastructure investments with low financial rates of return). DFIs have not taken on more risks recently despite their high levels of capital in the balance sheet, potentially denying investment in poorer countries and risky sectors with high economic rates of return.

The paper (Velde and Warner, 2007) suggests that the DFI sector would benefit from more transparency in 1) the DFI sector in general; 2) the terms under which they invest; 3) the volumes and terms of TA funds under the control of DFIs and 4) the way grant aid and DFI finance are mixed.

In a further analysis based on CDC’s development review, we estimate that every dollar of CDC investment coincides with \$5 of other investment. CDC has committed more than \$5 billion to 65 fund managers since 2004, and some 20% of this is provided in the form of equity funds which ultimately benefit infrastructure (including power). Alongside this amount, other investors have committed a total of \$24.3 billion. Capital from other DFIs accounts for only \$2.3 billion of this figure. IFC argues that every dollar of its investment leverages about \$3 from others. For EBRD, it is around \$1: it suggests

that, alongside €7.9 billion investment in 2009, it attracted additional co-financing worth €5.1 billion. Of this, €2.3 billion came from private and €2.8 billion from public co-financiers, of which €2.7 billion came from the international financial institutions (IFIs).

DFIs provide significant amounts of technical assistance- some of it directly for the infrastructure sector, Here we provide some examples. IFC's total expenditure on advisory services was \$268 million in 2009 alone. Meanwhile, by 2009, EBRD had administered 184 technical cooperation fund agreements, amounting to an aggregate €1.3 billion. The EIB's Investment Facility (IF) provided €11.5 million worth of technical assistance (in addition to interest rate subsidies) in 2009 alone. In other examples, DEG (German DFI) received €12.2 million to carry out its programme for development partnerships with the private sector (public-private partnership, PPP). FMO (Dutch DFI) invests own resources in and manages the following government funds: financing of Dutch small and medium-sized enterprises (SMEs) that invest in developing countries (FOM); a local currency fund reaching out to SMEs via financial institutions (MASSIF); earmarked funds for infrastructure projects in low-income countries (IDF); a fund financing energy projects (AEF); and Capacity Development (CD), which enables targeted access to know-how, bundled to meet a company's full organisational needs and which is financed by the Dutch government and stimulates technical cooperation between developing country companies and enterprises in industrialised nations.

## **7. Lessons Learned**

One underemphasised aspect of Aid for Trade is how to blend resources (loan and grants, ODA and OOF; and private finance) for infrastructure. If developing countries want to attract significant resources for Aid for Trade, e.g. to cover their infrastructure needs, they need to think outside the traditional Aid for Trade box and consider how grants can leverage in other resources (e.g. loans or private finance) and provide a blended bundle of Aid for Trade finance.

In order to examine ways to provide the resources needed for Aid for Trade, in particular for infrastructure, we need to understand blended finance. We have uncovered a number of important aspects.

One concern on blending loans and grants has been that ODA loans are more trade distortionary than ODA grants, e.g. when a loan from a country to a recipient leads the recipient to switch imports to the importing country. However, we find that grants and loans do not differ significantly in their trade distortionary effects, though both affect bilateral trade. A one million change in bilateral aid leads to an increase of bilateral trade of a third of a million in the case of France, but three quarters of a million in Germany and Japan.

For the EU blending schemes we estimate that one unit of grants leverages in between 5-6 units of loans (for both ITF and NIF) and another 15 units of other finance. Thus aid grants are likely to leverage in substantial amounts of other finance including for regional infrastructure as part of the ITF.

DFIs are backed by implicit and explicit subsidies and these can help to mobilise additional capital, including for infrastructure. Some USD 33 billion of DFI investment is invested in the private sector; around a third of this goes to infrastructure and some is classified as ODA, some as OOF. Every dollar of CDC investment coincides with \$5 of other investment; every IFC dollar leverages about \$3 from others; every EBRD dollar leverages in another \$1.

## **8. Conclusion**

If developing countries want to attract significant resources for Aid for Trade, e.g. to cover their infrastructure needs, they need to think outside the box and consider how grants can leverage in other resources (e.g. loans or private finance) and provide a bundle of blended Aid for Trade finance. Given the scarcity of resources at present, as well as the large infrastructure needs in developing countries, there is a need for further rigorous research into blending mechanisms.