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The Development Loan Fund

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The Development Loan Fund

The Congressional hearings on the Mutual Security Act of 1957 were preceded by the most widespread study of foreign economic assistance since the inception of the Marshall Plan. The study was occasioned principally by growing dissatisfaction with the existing basis for providing economic aid; the Senate Special Committee to Study the Foreign Aid Program noted that "there is serious cause for concern when foreign policy programs of the size and impact of the annual mutual security acts do not command the support of more than two-thirds of the Senate," ^{1/} and observed that a number of Senators had voted for the Mutual Security Act of 1956 only on the assurance that the program would be studied carefully in the following year.

The report of the Senate Special Committee, recommending that development assistance be placed on a repayable basis through the mechanism of a development fund, represented in principle an endorsement of the Administration's proposal for the establishment of the Development Loan Fund, made about a month earlier. A number of earlier studies had also urged the establishment of a fund, or at least the incorporation of some of the advantages of the fund principle into the development aid program, and the Administration's proposal reflected the consensus of the various reports with respect both to the necessary changes in the form of the development assistance program and to the recognition that some increase in the level of assistance was called for.

The Administration's request for an appropriation of \$500 million for the Development Loan Fund in fiscal 1958 and for authorizations of \$750 million for each of the two succeeding fiscal years was initially approved by the Senate; however, Congress appropriated only \$300 million for fiscal 1958 and limited the authorization to \$625 million for fiscal 1959. While the details of operations of the Fund have not yet been determined, the broad outline is sufficiently well defined to warrant an examination of the nature of the changes envisioned for development aid and to permit some estimate of the role which the Fund might be expected to play.

Aspects of Fund Operation

The fund principle was proposed as a means of eliminating the main defects in the existing method of administering the development aid program. The advantages claimed for the fund were:

(1) The separation of development assistance from military aid and defense support, thus making it possible to establish specific criteria for the provision of development aid. Previously it was argued that what was

^{1/} Foreign Aid. Report of the Special Committee to Study the Foreign Aid Program, 85th Congress, First Session, page 2.

designated as development aid was "provided for a variety of political, economic and other purposes with inadequate regard either to the economic capacity or to the needs of recipient countries." 1/

(2) Somewhat greater assurance of the continuing availability of funds for development assistance. Under the system of annual authorizations and appropriations which prevailed previously, it was required that 80 per cent of the appropriations be obligated before April 30 and the entire appropriation within the fiscal year. Mr. Dillon testified that this practice led to hasty commitment of funds by U. S. authorities, and prevented them from providing the less developed countries with "assurances which will encourage them to undertake . . . long-term programs." 2/

(3) The programming of assistance on a project basis, facilitating the use of specific criteria for the allocation of development assistance; the technique of basing requests for appropriations on illustrative country programs tended to freeze the distribution of aid before an analysis of individual projects could be undertaken.

The extent to which the Fund will be able to distribute development assistance on the basis of long-run economic criteria, and the relative role of the Fund in contributing to development, depend largely on the terms of reference of Fund operation. We shall consider below some of the principal issues involved in defining these terms of reference.

Loans versus grants -- Virtually all the various reports on the foreign aid program recommended an increased emphasis on loans, and the Mutual Security Act of 1957 specifically prohibits the Fund from providing aid in the form of grants. Two major lines of argument were used in support of loans. First, aid-receiving countries find it politically more palatable to accept assistance in this form; and second, the use of loans places foreign economic aid on a more "businesslike basis." The implications of this second point warrant further examination.

Insofar as the provision of assistance on a grant basis required payment into a counterpart account by either a private firm or a separately operated government corporation, the difference between loans and grants for that recipient agency would be one of repayment schedules, and in either case the agency could be subject to a market-type calculation if it were operated on this basis. However, the terms under which investment funds would be made available to the firm or government corporation will not be the same in the two cases. Most or all loans by the Development Loan Fund are apparently to include a provision to the effect that loan payments (both principal and interest) should be made at exchange rates that will maintain the dollar value of the repayments; hence a borrower would have to increase his local currency repayments in proportion to any devaluation of the local

1/ Ibid., page 15.

2/ Mutual Security Act of 1957. Hearings before the Committee on Foreign Relations United States Senate, 85th Congress, First Session, page 593.

currency. On the other hand, loans to provide funds for counterpart deposits would presumably be made by domestic banks at rates of interest which took into account the possibility of inflation. While the actual cost of these two sources of funds to the borrowing firm (or the prospective cost at the time of the loan, the relevant factor in the firm's calculation) would be the same only by accident, there would appear to be no inherent cost bias in either direction, and no necessary distortion of market calculations.

So far as the government of the recipient country and the U. S. Government are concerned, the economic difference between loan and grant aid is likely to be substantial only in the case of dollar repayment. Where repayment is in local currency, the main difference is in ownership of the local currency funds: counterpart receipts are owned by the aid-receiving country, while loan repayments are owned by the U. S. This difference, however, may be significant in some countries.

Dollar versus local currency repayment -- Congressional concern was frequently expressed during the hearings on the Mutual Security Act lest the Fund compete with existing agencies engaged in international lending, specifically the Export-Import Bank and the International Bank, and the Administration spokesmen were unanimously agreed that there should not be such competition. The potential area of competition is defined by the functions assigned to these two agencies. If, together, they were conceived as providing capital for all projects for which the mechanism of the capital market does not provide an appropriate assessment of costs and returns, and hence of economic feasibility, there would be no room for the Development Fund to operate. Alternatively, if the two agencies are viewed as providing all the investment (in addition to that supplied through private capital) which could be justified on the basis of the country's prospective dollar earnings (or other foreign exchange earnings, if no distinction among foreign exchange is necessary) within the time period envisioned in the repayment schedule, then the Fund should limit its assistance to loans repayable in local currencies. If Fund loan operations were not restricted to loans repayable in local currencies, there would necessarily be competition with the Export-Import Bank and the International Bank with respect to that part of the country's future foreign exchange earnings which could appropriately be committed in the form of fixed obligations.

In Mr. Dillon's testimony on the bill, the necessity of restricting all or nearly all Fund assistance to loans repayable in local currencies was explicitly recognized, ^{1/} although previous testimony by both Secretary Dulles and Mr. Hollister had clearly been more sanguine concerning prospects for dollar repayment. Presumably the Fund would guard against competing with the Export-Import Bank or International Bank by essentially the same sort of procedure employed by the Export-Import Bank to insure that it does not

1/ Mutual Security Act of 1957, Hearings before the Committee on Foreign Affairs House of Representatives, 85th Congress, First Session, page 1,320.

compete with private lending activities; some provision of this sort would be necessary in any case because the provision for repayment in local currency would make loans from the Fund more attractive to foreign governments.

The revolving character of the Fund -- Once the operation of the Fund is circumscribed by the exclusion of loans repayable in dollars or in other foreign exchange, the Fund can revolve only in the limited sense in which the continued internal relending of the various local currencies might be so considered. (Counterpart funds generated from grant assistance could equally well "revolve" in this fashion.) If the local currency repayments by one country could be loaned to a second country, the Fund could become revolving in a wider sense; however, in order for this result to materialize it would be necessary to find projects for which the capital imports into the second country would not represent a diversion of resources of the first country which would result in increased import payments or reduced export receipts.

In the hearings on the Mutual Security Act of 1957, Mr. Dillon held out hope that the Fund might become revolving over "the very long term":

I think there is a very good chance that you will get a very substantial part of this back eventually. When I say "eventually," it may be as long as 25, 30, 50 years. It may be and will very likely be in due time. You lend the money to the country first. They repay in local currency. You then relend to the country the second time and we would expect that by then their economic progress would be so much higher that they would be able to begin to repay that second loan at least partly in dollars. ^{1/}

This suggestion appears to imply abandonment of the injunction against competition with the Export-Import Bank and International Bank, and to exhibit an exceptional degree of optimism concerning the possibilities for negotiating local currency loans repayable in dollars.

The fact that the terms of reference of the Fund's operation prevent it from being revolving in more than a limited sense is a restriction, though not the only one, on the extent to which assistance can be allocated on a project rather than a country basis. Since development assistance has political objectives, it seems rather unlikely that over the first few years of operation, for example, assistance could be allocated without regard for the political repercussions of any particular pattern of distribution; and at a later date distribution of aid solely according to economic criteria becomes rather more unlikely if the revolving local currency amounts must be relent within the country of the original loan, and if the prospects for additional dollar appropriations are inversely related to some extent to the local-currency holdings of the Fund.

1/ Ibid., page 1,321.

However, while the Fund thus can hardly be expected to allocate development assistance purely on the basis of criteria of economic feasibility, it does represent a step in this direction. As compared with grant assistance, the fund principle (in the context in which the Development Fund must operate) may possibly provide somewhat greater assurance of continuity of assistance, though Congressional enthusiasm in this direction is restrained, and it does provide a greater measure of flexibility in the selection of projects. While the ownership of the local currency funds generated under the two types of assistance programs differs, the fact that disposition of the funds in either case can only be made by mutual agreement probably tends to minimize the economic importance of the distinction. There might, however, be adverse political effects from U. S. ownership of large amounts of foreign currencies, and these effects might offset, at least in part, the presumed gain to be derived from placing assistance on a loan rather than a grant basis.

In each case, the local currency funds will prove useful principally in minimizing the fiscal problems which would be encountered by the government of the aid-receiving country in establishing a development loan agency with the same resources, and (of lesser quantitative importance) in meeting the local currency costs encountered by U. S. government agencies operating in that country. The adoption of maintenance-of-value clauses for Fund loans will insure that these advantages are not lost because of exchange rate devaluations, and in this respect Fund operations will be more effective than previous grant assistance.

New types of financing -- The Development Loan Fund has been given authority to engage in certain new types of financing as a means of encouraging private investment. Loans may be made directly to private firms (including U. S. firms), whereas previously assistance was provided primarily through public institutions. (Under the Cooley Amendment, up to 25 per cent of the local currency receipts of P.L. 480 loans may be used for loans to U. S.-owned enterprises or their branches, subsidiaries or affiliates, or to foreign-owned enterprises if such loans will increase the markets for U. S. agricultural products, at local rates of interest and without maintenance of value. Development Fund loans, on the other hand, may be made to any private firm so long as there is reasonable prospect of repayment and the loan promises to contribute to economic development. The terms will resemble those of Mutual Security loans and P.L. 480 loans prior to the Cooley Amendment; interest rates will be comparable to U. S. rather than foreign rates and, as noted above, a maintenance-of-value clause will be required.)

The additional flexibility granted the Fund will enable it to channel loan funds through public development corporations in those countries where such corporations appear to have employed criteria appropriate to Development Fund loans in their operations (thus simplifying administration), and to make loans directly in those countries where domestic institutions seem unlikely to make loans on such bases.

The significance of the Fund's ability to engage in certain sorts of investment-type financing cannot be assessed on an a priori basis. The Fund is able to acquire convertible debentures and "other evidence of ownership"; it is not able to purchase equity securities, though it may acquire them "by exercise of conversion rights or . . . to satisfy previously incurred indebtedness" ^{1/}. While activities in this area might involve the Fund in potential competition with the International Finance Corporation, the limitations imposed by that organization on its own investments would appear to leave considerable room for operation by the Fund. The IFC, for example, as a matter of policy does not make investments in agricultural or commercial enterprises; it generally limits its investment to \$2 million; and to date it has adopted a rather conservative policy in the selection of investments. Published information on the experience of the IFC, which has made investments totaling \$6 million to date, does not indicate whether a significant amount of investment could be expected to result from Fund activities of this type. If substantial opportunities for Fund investments exist, the pioneering role which IFC officials envision for that agency and its limited capital (\$92 million) would in all likelihood prevent competition from the Development Loan Fund from becoming a matter of concern.

Conclusion

The most important change in U. S. foreign assistance brought about by the Development Loan Fund may well lie in the increased amount of assistance, rather than in the differences between the provision of assistance in the form of grants and of loans -- particularly so, if Fund appropriations approach the amounts initially requested by the Administration. In addition, the greater flexibility of Development Loan Fund operation (as compared with previous methods of distributing aid) will presumably make it possible to increase efficiency in the allocation of assistance. In no important respect does the fund principle appear to be at a distinct disadvantage as compared with grant assistance, especially so long as technical assistance continues to be provided on a grant basis, as remains the case under the Mutual Security Act of 1957.

The scope of Fund operations is circumscribed by the rule that it should not compete with the activities of the Export-Import Bank or the International Bank -- that is, it should not make bankable loans repayable in foreign exchange. There will, however, be a substantial number of investment projects which can make a significant contribution to economic development, although not eligible for dollar loans under the criteria set up by these two agencies. In fact, it is within the area of projects appropriate for Fund assistance (and aid provided under P.L. 480) that there exists the possibility for achieving the rate of investment (and growth in output) in individual countries necessary to the foreign policy objectives of U. S. development assistance. If, as maintained in recent studies of U.S.

^{1/} Mutual Security Act of 1957, Section 205.

development aid, ^{1/} U. S. objectives require the attainment of minimum rates of growth in per capita income (significantly in excess of current rates), in the less-developed countries of Asia and Africa, Development Loan Fund assistance may be substantially more important than would be suggested by a mere comparison of magnitudes.

1/ See, in particular, The Objectives of United States Economic Assistance, Cambridge, Center for International Studies, Massachusetts Institute of Technology, 1957, and The Role of Foreign Aid in the Development of Other Countries, Chicago, Research Center in Economic Development and Cultural Change, University of Chicago, 1957.