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AID AND THE BRITISH BALANCE OF PAYMENTS

by

ANDRZEJ KRASSOWSKI

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ERRATUM

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Section (a) *The aid programme*

In the first line for £175m. read £157m.

# *Aid and the British Balance of Payments*

by Andrzej Krassowski

Research officer, Overseas Development Institute

## INTRODUCTION

**D**ECISIONS on the direction and scale of government expenditure, both domestic and overseas, emerge from a complex interplay of political pressures and conflicting priorities, set against a background of long-standing commitments and the general economic situation. The state of the balance of payments is yet another consideration of importance, though by no means the dominant one: within the broad limits set by an overall balance of payments constraint, decisions to spend £x millions in one way, or £y million in another, are usually taken on other grounds. With some categories of expenditure which attract wide support the balance of payments gets no more than a polite nod, while general economic policy is shaped in such a way as to release or generate any requisite foreign exchange.

There is no reason to suppose that the size of the overseas aid programme is not determined by the same interplay of internal and external pressures and competing demands for alternative expenditure as are other programmes. And yet, the official attitude of successive governments has been to regard the *balance of payments* as the primary constraint to the volume of aid that Britain can afford. No other category of government expenditure has so consistently been accompanied by sombre pronouncements on Britain's balance of payments

plight; certainly not military expenditure—nor any others, which, though primarily domestic, nevertheless require a—sometimes high—foreign exchange outlay.

It seems that, at least in the sphere of aid, propaganda has had some effect, for, though aid accounts for only a very small proportion of total British overseas payments, its effect on the balance of payments causes a great deal of concern. In some circles aid is even thought to lie at the very heart of Britain's recurring payments problems. But since there have as yet been no official published estimates showing the nature and extent of the balance of payments burden of aid, public debate has assumed an air of unreality, with claims and counter-claims about the balance of payments cost of aid usually being advanced without reference to statistics. When statistics are produced, they are all too often not the relevant ones.

Comparisons of the aid total and the balance of payments surplus on current account, for example, are used to show how aid undermines what is claimed to be a fundamentally healthy trade and invisible earnings balance, with the inference that substantial cuts in aid would restore a sound payments position. It is not always appreciated, however, that there is a functional relationship between aid and the credit side of the trading and invisibles account. A cut in aid involves also a reduction in some apparently unconnected credit elsewhere, and the *actual* balance of payments saving is almost always much less than the *apparent* saving.

The present article attempts to trace—and quantify where possible—the direct and indirect links between aid on the one hand and British exports on the other. Using the 1963 aid programme—the latest year for which enough data is available—as an illustration, it is hoped to show the probable magni-

tude of the balance of payments cost of aid. But since aid can be provided under many different forms and conditions—each involving a different balance of payments cost—the balance of payments cost per £1m. of aid need not be the same for any increased aid as it was for total aid extended in 1963. In the immediate future the issue will not be whether the aid programme should be abandoned or continued, but rather by how much, if at all, aid should be increased. So, the calculations of the balance of payments cost of the aid programme as a whole are supplemented by a discussion of the balance of payments effects of *changing* the value of aid in each of a variety of ways.

## *The Balance of Payments Cost of the 1963 Aid Programme*

### *(a) The aid programme*

In 1963, Britain provided £175m. of official economic aid to the developing world. But only part of this was directly relevant to the balance of payments, a fact which is not self-evident from a glance at the published aid statistics. This is not to say that official figures inflate the aid total, but rather that the conventional presentation does not distinguish between those items that can be thought of as a charge to the balance of payments from those that cannot. A preliminary step to a proper assessment of the balance of payments cost of aid, therefore, is to identify those items which are not a direct charge to the balance of payments.

In 1963, there were two obvious candidates: aid spent in *Britain* for the benefit of developing countries, and transfers where the *intended* beneficiaries were British residents or companies. The former involved no external transactions, the latter was self-cancelling, payments being repatriated to Britain. Together, these forms of aid amounted to about £18m., or 12% of the gross total.\*

The figure—£139m.—obtained by subtracting £18m. from the aid total will be referred to as “the flow of foreign exchange (or its equivalent) overseas” to distinguish it from the official figure which includes all items classified as aid, irrespective of their effect on the balance of payments.

In estimating the cost of aid to the balance of payments, the treatment of interest and amortization presents a problem. One must credit these receipts against the cost of aid, but aid in which year? A similar problem arises with the treatment of future interest and amortization expected on current loans. The procedure adopted here is to credit current receipts against

\* The figure is based largely on information available in the Civil Estimates, and consists of the following items (totalling £17.7m.):

- 1 Expenditure on scholarships and training facilities in Britain for overseas students; research and other services performed in Britain on behalf of developing countries (£1.5m.).
- 2a Payments made in Britain to technical assistance personnel (e.g. travel and education allowances), and repatriated salaries (£2.7m. approx.).
- 2b Grants and loans for the compensation and commutation of pensions of former British overseas civil officers under OSAS and other schemes (80% of the total to allow for some officers not returning to Britain—£8.0m. approx.).
- 2c Loans to foreign governments for meeting commitments to British firms (£5.5m.).

The transactions under 2b and 2c were made following agreements whereby a number of developing countries formally undertook certain commitments on the understanding that Britain would provide a considerable portion of the costs. These payments place no extra resources at the disposal of developing countries, since without the aid there would also have been no payments on their part (or, in the case of 2c, default on old commitments). Whether these items should be called “aid” at all is a wider issue and will not be commented on here; what is important to note is that they are not a charge to the balance of payments.

the cost of current aid, and to ignore altogether future interest and amortization of current new loans. In principle, of course, current receipts are independent of current aid (since they are the result of past aid disbursements, and a contractual obligation to Britain irrespective of current British aid policy) but in practice, the two are not independent. Of the countries which paid interest and amortization in 1963, most were also recipients of new aid. Many faced serious debt-servicing problems; for some the problem was acute, despite the inflow of new aid. It is unlikely that they could have honoured their interest and amortization commitments without new aid; a proportion of new aid was, in fact, made available with the implicit recognition that it will be (indirectly) used to meet existing obligations. It seems rational, therefore, to credit receipts in 1963 to the balance of payments cost of aid extended in that same year, and to ignore (uncertain) future interest and amortization of loans made in 1963.\*

Adjusting for items which were in no way a direct charge to the balance of payments (£18m.), and for interest and amortization (£26m.), gives a net flow of foreign exchange (or its equivalent) in 1963 of £113m. (see Table 1).

This represents the maximum total value of imports of goods and services into poorer countries (from all sources) made possible by British aid, or the other side of the coin, the

\* Current new loans have the same impact on the reserves, in the short-run, as grants. However, the loans represent an acquisition of external assets (interest or non-interest bearing, as the case may be).

Repayment of the loans results in the liquidation of the asset, but also in a corresponding improvement in the reserves, plus a gain to the reserves from interest receipts. Since concern about the balance of payments is confined to what happens in the short-run (and since assets acquired as a result of aid are hardly "gilt-edged"), no allowance has been made for future interest and amortization of *current* loans. This procedure was not adopted in respect of *past* loans; interest and amortization payments have been credited against the balance of payments cost of aid in the year that they were received, for the reasons given in the text.

**DISTRIBUTION OF BRITISH AID AND  
"NET FLOW OF FOREIGN EXCHANGE" IN 1963**

Area	Total Aid (gross) £m	Amortization Interest and Other Receipts* £m	Net Flow of foreign exchange* £m
Sterling Africa	62.3	16.9	45.4
Sterling Caribbean	7.4	0.8	6.6
Sterling Asia	36.3	11.1	25.2
Sterling Middle East**	13.0	0.4	12.6
Other U.K. Colonies	9.1	0.1	9.0
All other countries	13.6	12.4	1.2
Home based†	1.5	—	—
<b>Total (bilateral)</b>	<b>143.2</b>	<b>41.7</b>	<b>100.0</b>
Multilateral‡	13.4	—	13.4
<b>TOTAL</b>	<b>156.6</b>	<b>41.7</b>	<b>113.4</b>

Notes: \* See text (a small margin of error must be allowed for in respect of "other receipts", as also in the distribution of interest receipts amongst the six regions).

\*\* Includes Cyprus.

† See text.

‡ Grants to the Indus Basin Development Fund included under "Sterling Asia".

Sources: Financial Statistics, March 1964, Table 70  
Civil Estimates, Class II, 1962/63, 1963/64.

maximum balance of payments cost to Britain of the 1963 aid programme.\* Having established the maximum cost, the way is now open for a consideration of the actual cost\*\*, this being determined by the extent to which aid was spent on additional British goods and services.

\* Throughout the paper, "cost" refers to the balance of payments—i.e. the effect of aid on the gold and foreign exchange reserves. An estimate of the "real" cost of aid to the British economy (or "real" benefit to the recipient—the two need not be the same) is a separate matter, and beyond the scope of the present discussion.

\*\* In this and the next two sections, the discussion is limited to the balance of payments effects in the short-run. The indirect effects of current aid on the balance of payments in the long-run are considered in the final section of Part II.

(b) *Aid and British Exports*

In the case of untied aid, it is not possible to determine with great accuracy how large a proportion of British aid is spent on British exports of goods and services. Even if a complete list of orders directly financed by aid were available, the picture would still be blurred by the practice of "switching" (see below), and uncertainty as to the source of imports resulting from aid for local costs, which is initially spent in the recipient country but creates an indirect demand for imports. Even in the case of aid contractually tied to expenditure in Britain, it is by no means certain that it is spent entirely on additional exports of British goods, again because of the possibility of "switching". The term "switching" applies to the practice of using aid funds to buy goods which, if no aid had been provided would still have been bought from the same source with the recipient's own foreign exchange earnings. If tied aid can be "switched", it therefore frees the recipient's own foreign exchange earnings for other import requirements, from any source. In other words, when "switching" is possible, it makes tying ineffective; it also makes the stated source of direct import purchases with untied aid an unreliable guide to the actual ultimate source.

In the absence of a direct method of calculating the value of British exports financed by aid, it is possible to fall back on indirect estimates, based on world trading patterns, and two simple (and one hopes plausible) assumptions.

The first assumption is that recipients of aid are generally too poor to accumulate reserves; they spend their aid in one or other of the industrial countries, either directly or indirectly. (Indirect expenditure on imports from industrial countries occurs when one recipient imports from another, who in turn spends the exchange earned in an industrial country.) It is true that some aid recipients accumulate small reserves; all keep some reserves, of course, as working balances, and in the nature of things these fluctuate. Still, it is a rare exception

(if indeed there is one) to find a developing country with reserve accumulation as a policy objective.\* That the developing countries ultimately spend their aid in industrial western countries, as a group, is clear. The latter are the only countries with a surplus of output to export. (Trade with the eastern "Bloc"—small in any case—is on a bilateral basis. Where developing countries do run up a trade deficit with the "Bloc", this is financed from "Bloc" aid, or, if it is settled in cash, the "Bloc" itself eventually spends this in the western industrial countries.)

All British aid eventually finds its way back to one or other of the western industrial countries, and a proportion to Britain. But how large a proportion? This can be answered with the help of the second assumption. It is that the proportion of untied aid returning to Britain is approximately equal to Britain's current share of industrial countries' exports to the developing countries. There is, of course, the possibility that the marginal and average proportions imported from Britain are not the same. The average proportion gives an estimate which is probably a little too high (allowance for this will be made later), but in the absence of a more precise measure one has to take the best approximation readily available.\*\*

Tied aid, in principle, is spent on the donor's exports. This does not mean, however, that exports purchased with tied aid increase the donor's exports to the recipient by an equivalent amount. Recipients do spend some part of tied aid on products they would have bought from Britain with their own foreign exchange earnings, and are then free to use the exchange released in this way on imports from any source. This process—which has been referred to as "switching"—loosens the tying constraint, thereby allowing some aid, though *formally* tied to British goods and services, to be spent on

\* The problem of time-lags in expenditure is taken up later.

\*\* The trading patterns are themselves "distorted" by tied aid. But since tied aid accounts for a small proportion of *total imports* into developing countries, such "distortions" are ignored.

TABLE 2  
THE NET FLOW OF FOREIGN EXCHANGE AND BRITISH EXPORTS IN 1963

Region	Net Flow of Foreign Exchanges <sup>a</sup>							Total Aid— financed British exports	
	Total Flow	In untied form <sup>b</sup>		Tied to British purchases <sup>b</sup>					
		Returning to Britain (c)	%	Returning to Britain	Direct (d)	Indirect (e)			
£m	£m	%	£m	£m	£m	£m			
<b>Sterling Area:</b>									
— Africa	45.4	39.9	45	17.95	5.5	70	3.85	0.74	22.54
— Caribbean	6.6	6.6	40	2.64					2.64
— Asia	25.2	-1.1f	25	-0.29	26.3	70	18.42	1.97	20.10
— Middle East	12.6	12.6	30	3.78					3.78
— Other Colonies	9.0	9.0	30	2.70					2.70
All other countries	1.2	-4.5f	10	-0.45	5.7	90	5.13	0.06	4.74
<b>Total (bilateral)</b>	<b>100.0</b>	<b>62.5</b>		<b>26.33</b>	<b>37.5</b>		<b>27.40</b>	<b>2.77</b>	<b>56.50</b>
<b>Multilateral</b>	<b>13.4</b>	<b>13.4</b>	<b>14*</b>	<b>2.00</b>					<b>2.00</b>
<b>Total</b>	<b>113.4</b>	<b>75.9</b>		<b>28.33</b>	<b>37.5</b>		<b>27.40</b>	<b>2.77</b>	<b>58.50</b>

Notes: (a) See Table 1.

- (b) Tied aid consists solely of loans under Section 3 of the Export Guarantees Act, 1949 (ECGD loans). Other tied aid had to be included under "untied" as no figures were available. Tied aid is therefore understated, resulting in a probable underestimate of the total figure for aid-financed exports. This, and the generous allowance for "switching" of tied aid, probably suffices to offset the over-estimate of exports financed with untied aid, based, as this figure is, on the (higher) average, rather than marginal proportion imported from Britain.
- (c) The proportions given here are the same as Britain's share of industrial countries' exports to each region.
- (d) 100% minus an allowance for "switching".
- (e) Tied aid, which is "switched" is equivalent to untied aid; the same proportion of "switched" aid is assumed to return to Britain as in the case of contractually untied aid.
- (f) The minus sign indicates that new untied aid from Britain was less than interest and amortization received by Britain. This net transfer to Britain meant that less currency was available for general imports, some of which would have come from Britain.
- (g) 14% is the British share of industrial countries' exports to all developing countries.

imports from third countries. As a general rule there is scope for switching when the recipient of tied aid is already a fairly large importer of the donor's products, and when tied aid is available for a wide range of imports. More specifically, it is most likely to occur (a) when the value of tied aid is very small in relation to a recipient's own foreign exchange earnings spent in the donor country, and (b) when tied aid is available for imports of goods which the recipient traditionally purchases from the donor.

All tied aid, does not "return" to Britain. But, since information on the extent of "switching" is available in only a number of isolated cases, one can do no more than give a rough estimate of its overall impact which seems not unreasonable. In the calculations below it is assumed that 30% of tied aid to Sterling Area, and 10% to non-Sterling Area countries, is "switched", and is therefore equivalent to untied aid (with the proportion spent on British goods determined by the British share of industrial countries' exports to the recipients in question).

Table 2 shows the net flow of foreign exchange in 1963 to each of six groups of countries, together with the British

share of industrial countries' exports to the same groups of countries, and estimates of the value of British exports which can be attributed to the aid programme. Taking tied and untied aid together, such exports came to just under £60m.

One possible conclusion that could be drawn from this table is that an easy way to save on the balance of payments cost of aid is to resort to more tying. Although tying may save some foreign exchange, it also reduces—often considerably—the real value of aid to the recipient. And, since after all, the primary objective of aid is the encouragement of growth in developing countries, there is a conflict between more tying on balance of payments grounds, and less tying on grounds of the general efficiency of aid. Moreover, tied aid may be an equivocal balance of payments “saver”. For one thing, tied aid amounts to subsidising uncompetitive export production, which in the long run may reduce rather than boost exports. Also, if one takes into account the repercussions on other donors' policies (as one must) the net effect of more tying all round may well be damaging to Britain's balance of payments.

It now remains to be considered whether these aid-financed exports were *additional* exports (rather than “diverted” from other export markets) and whether their import content led to *additional* imports. The conclusions partly depend on what is assumed about the state of the British economy and on whether one takes it that if aid expenditure had not been made, there would have been some alternative domestic expenditure.

It must, in general, be assumed that output can be expanded in the short-run. If this were not the case, the balance of payments cost of aid would be 100% (displacements of ordinary exports, or increase in imports, to the value of the aid spent on British goods, with the balance accounted for by a direct loss of reserves). However, with capacity absolutely “full”, all additional expenditure imposes a 100% balance of payments cost; it does not matter whether the expenditure is

domestic or external. Now, if Britain is worried about its balance of payments (or inflation), such a situation is not likely to be allowed to occur. It must be assumed that the Government in fact aims to achieve some ideal state of demand in relation to domestic output possibilities, having taken into account the need for some slack to permit greater exports, especially if the demand is known to be there. If this is so, then it follows that if £10m. of bilateral aid is not made available, then alternative domestic expenditure is made equal to that part of the £10m. which would have been spent on British exports.

No allowance should, in principle, be made for export "diversion". Of course, the occasion will arise, but as a rule it must be treated as negligible. If this were not so, then the correct policy, given a degree of substitutability between products for domestic and aid-financed foreign markets, is not to reduce *aid*, but to reduce demand in general. Furthermore, no allowance should be made for the import content of aid-financed exports, since in the absence of aid some equivalent demand would have been placed on domestic production, with a similar effect on imports (unless it can be shown that the import content is higher for aid-financed exports than for other output).

Given all the above qualifications, the balance of payments cost of the 1963 aid programme is estimated to have been not more than about 35% of total gross aid. (A word of caution must be added on this figure. It is, very probably, on the high side; the calculations behind it are no more than reasonable estimates based on the limited data that could be obtained. It is to be hoped that the new Overseas Development Ministry will, in time, publish better estimates based on more complete information).

So far, British aid and exports have been considered in isolation. Although Britain is one of the "Big Four" western

donors, the combined efforts of other DAC\* members are many times larger than the British contribution. Other donors' aid also adds to the importing capacity of developing countries, and some of these imports come from Britain. In recent years, there has been a degree of interdependence in the aid policies of the various DAC members, each exerting influence on the others by its action and contributions. The significance of this interdependence to the British balance of payments is so important that it merits some detailed consideration.

(c) *Donor Interdependence and the British Balance of Payments*

Over the past few years, Britain has contributed about 8% of total official aid made available by all members of DAC. This compares with the British share of industrial countries' exports to developing countries of over 14%. Were all DAC aid genuinely untied, Britain would very clearly gain from the combined aid effort. Britain's share in DAC aid would more or less have to double (or Britain's competitive position suffer a very serious setback) for this potential advantage to be "lost".

At present, however, a large proportion of other donors' aid is tied to donor procurement. Even so, some aid is not tied, and some more is ineffectively tied (because of "switching"—see above). Of this untied or ineffectively tied portion, some 14%, on average, is probably spent on British exports. It is difficult to assess with certainty how much aid is not subject to effective tying, but a rough estimate can be made. A good estimate is available for U.S. aid. A recent study by the Brookings Institution\*\* shows that at present (with fairly extensive tying) some 30% of U.S. bilateral aid (excluding

\* Development Assistance Committee of OECD. DAC members' aid accounts for almost all western aid.

\*\* W. S. Salant, and others, *"The U.S. Balance of Payments in 1968"*, Chapter VI, Brookings Institution, Washington, 1963. The U.S. Government's own estimate is 20%, but this does not allow for "switching".

PL 480\*) is spent on the exports of industrial countries other than the U.S. Contributions to multilateral agencies can be considered as untied\*\*, while for other DAC members the following proportions of aid not returning to the donor seem reasonable: Germany 20%, France 10%, other DAC members 10% †.

Table 3 shows total DAC aid in 1963 (excluding aid from Britain), the value of aid not returning to the various donors, and an estimate of the extent to which other donors' aid financed exports from Britain. This came to \$269m. (£96m.).

Even these very rough calculations suggest that the balance of payments cost of British aid was more than offset by Britain's gain from other donors' aid contributions, despite the high proportion of others' aid that was effectively tied.

Is one justified, however, in offsetting in this way the cost of British aid by Britain's export gain from the aid of other donors? Clearly not if the aid decisions of other donors are totally uninfluenced by British aid policy, or the volume of British aid.

This, however, has certainly not been the case in recent years, especially since DAC was set up. Since 1961 DAC has been collecting statistics on aid and scrutinising the various donors' efforts and policies. At the annual "confrontation", donors are subjected to a considerable

\* The usual short name given to U.S. transfers of surplus commodities against local currencies.

\*\* Except the contributions to the European Development Fund. Aid from the Fund is tied to purchases from the EEC. Where aid finances local costs, the bulk of indirect imports also comes from the EEC, especially France.

† A large proportion of German aid is not formally tied. Despite this, the Federal Government estimates that 80% of its aid is spent in the Federal Republic. Allowance for "switching" would lower this figure, but since no alternative estimates are available which do take account of "switching", the official figure is used. French aid is concentrated in the Franc Area. The informal financial and trading arrangements of the Area assure France a large "flowback" of aid. Tied aid in the form of export credits accounts for a large proportion of other bilateral programmes (e.g. Japan's or Italy's).

**DAC AID IN 1963—TOTAL AND UNTIED**

	Total	Aid not returning to donor		Probable resulting expenditure on British exports	
		Prop. Assumed	Value		
	\$m (1)	% (2)	\$m (3)	% <sup>a</sup> (4)	\$m (5)
<i>Bilateral:</i>					
U.S.	2,640 <sup>b</sup>	30	792	22	174
Germany	396	20	79	16	12
France	831	10	83	16	13
Other DAC	455	10	45	16	7
DAC contributions to multilateral programmes	381 <sup>c</sup>	100	381	14	53
<b>Total</b>	<b>4,703<sup>bc</sup></b>		<b>1,380</b>		<b>269</b>

Notes: (a) Since the figures in Col. (3) show aid which is spent on industrial countries *other than the donor*, the particular donor is excluded for purposes of calculating the percentages in Col. (4).

(b) Excludes PL 480.

(c) Excludes contributions to the European Development Fund.

amount of pressure from both the Secretariat and other donors to move in concert in certain areas (e.g. volume of aid, terms, tying policy, etc.). Although DAC has, as yet, not adopted a formal "burden-sharing" formula, there is considerable behind-the-scenes activity to get the various donors to pay attention to some notion of fair distribution of aid contributions. On the commonly used criterion of performances (net aid as a percentage of GNP), the French stand out high above the other major donors. The U.S., Germany and Britain have more or less "harmonised" their "aid burden" on this criterion (making no allowance for rates of interest, tying, etc.). The U.S. has been, for several years now, explicit in its insistence that its own efforts depend on others doing more. Judged by the recent expansion of British and German aid, this insistence may well have been successful, though of course it is not

possible to say how much less aid the U.S. would contribute now had it not been for this expansion. It is known that Germany regularly compares its "performance" with that of Britain. Of the Big Four, only France is likely to be uninfluenced by increases in other donors' aid, since France is already doing so much. Of minor donors' attitudes in this, very little is known, except that Japan is always anxious to maintain its relative position in the aid league table. Multilateral aid is a special case. Here interdependence is at its strongest, since substantial increases in multilateral aid inevitably depend on the co-operation of at least two of the Big Four donors.

In spite of Britain's small share in total aid, its potential influence on other equivalent and lesser donors, and the willingness of the U.S. to increase its aid in line with that of others, means that the total flow of aid from other countries is partly dependent on British aid policy.

But this influence brings with it some disadvantages. For one, any attempt to economise on aid because of balance of payments difficulties can boomerang. Apparent balance of payments savings achieved by cutting aid may be illusory, if there is an unfavourable response from other donors. A lead by Britain in a downward direction may cause bigger balance of payments losses to Britain on the roundabouts than can be saved on the swings. This is a consideration that cannot be ignored when there is a strong temptation to cut back on aid on other grounds.

(d) *Future Balance of Payments Effects of Current Aid*

Finally a few comments may be included on the long-term balance of payments effects of aid. Through the operation of two related factors, current aid may affect the British balance

of payments in the future\*. These two factors are the "foreign aid multiplier" (which is analagous to the "trade multiplier") and the "advertising effect" of aid-financed exports.

Given enough data, the aid-multiplier can show how aid recipients' income and imports are related. An inflow of aid raises the national income of the recipient (usually through the additional investment it makes possible, or the bottlenecks it may help to remove); this leads to increased imports (which are someone else's exports), which in turn increase the exporter's income and raise his imports, etc. For the multiplier to work itself out fully, exports from the developing countries as a group to the industrial countries must increase in step with imports. Otherwise extra imports generated by rising income will have to be financed by new aid, or will not be possible. If exports do increase at the right pace, and the multiplier works smoothly, there is no balance of payments gain for the industrial countries *as a group*. The net result is an increase in world trade and income. But the balance of payments of any *single* industrial country can benefit from this process. In Britain's case, a large proportion of its exports are sold to developing countries, and it has world-wide interests in shipping, banking and insurance, so that the balance of payments is likely to benefit in the long run from aid which stimulates growth in the developing countries.

These potential benefits will not be realised unless Britain can correct the deterioration in its competitive position which has resulted in a gradual decline of Britain's share of industrial countries' exports to the developing countries. Of some importance in this context is the "advertising effect" of British aid: aid-financed exports of machinery and plant advertise British products, and may lead to orders for spare parts, extensions and, eventually replacements not financed by aid.

\* Future amortization, and interest due on current aid loans are ignored here.

In the same way, training in Britain, or by British personnel, or use of British consultants under technical assistance schemes, should contribute to greater familiarity with British goods and methods, and indirectly, help to promote British exports.

### III

#### CAN AID CUTS HELP THE BALANCE OF PAYMENTS?

##### (a) *Aid in a Sterling Crisis*

In a crisis, one often hears the cry: "cut aid". Would such action serve any useful purpose? The very nature of a crisis requires that action to control it must take immediate effect, and in the very short run there is little scope for manipulating the flow of aid. A few examples can illustrate the limited scope there is for even marginal savings.

First, disbursements of ECGD loans (and some other forms of tied aid) are made as payments to British exporters fall due. There is no scope for short-term balance of payments economies. Second, when aid is made available in support of a colony's budget (or on other current expenditure items), once the recipients' Estimates are approved, disbursements are made automatically on a certain date. If delayed, this would usually disorganise important services in the recipient countries. Third, a postponement of aid which had been committed to a recipient may force him to postpone his own interest and amortization payments to Britain.

Furthermore, when aid is given to a member of the Sterling Area, there is no immediate drain on the reserves. Instead sterling liabilities rise. Not until the aid is spent outside the Sterling Area, which may involve a considerable time-lag (or not occur at all, if the aid is spent on British exports), will the reserves be affected.

Finally, it must be borne in mind that at the height of a crisis the drain on reserves may be in the order of anything up to £30-40m. *a day*; total aid disbursed in any one *quarter* has averaged about £40m. since 1960, and has never exceeded £60m.

(b) *Aid and a Persistent Balance of Payments Problem*

Is it possible to gain a lasting improvement in the British balance of payments by a permanent cut in aid? This "solution" to Britain's difficulties is sometimes put forward by those who feel that Britain's basic trading balance is sound, and that balance of payments difficulties are caused by the volume of government overseas expenditure. In 1963, government overseas expenditure on both current and capital account came to about £500m. (The largest single category was military expenditure £250m.).

£500m. is, of course, a considerable sum, but in balance of payments terms it is misleading. As has been shown already, the net balance of payments loss resulting from the 1963 aid programme was, at the very most, in the region of only £55m., and it may well be that similar calculations on the military side would also show that the balance of payments cost of such activities was less than the gross figure of £250m.

It is true that a cut in untied aid of, say, £10m. would save, in the first instance, an almost equivalent amount. The saving over a period of about eighteen months to two years, however, would be much lower, since a proportion of this aid would have been spent in Britain within that time. The exact balance of payments saving depends on the geographical distribution of aid reductions. Thus a £10m. net cut in untied aid to African countries of the Sterling Area would result on the assumptions made earlier, in a balance of payments saving of about £5m. In general, a cut in aid to a country which ordinarily buys a large proportion of its imports from Britain leads to a smaller balance of payments saving than cuts in aid to other countries.

A cut in tied aid, in the first instance, does not affect the balance of payments. (In practice, such a cut is not possible at short notice, since disbursements usually coincide with deliveries of goods which have been ordered some time before, and there may be a lag of years between commitments and disbursements.) Over a period of eighteen months to two years, cuts give a balance of payments saving of somewhat less than the amount of the cut, the exact "deficiency" depending on the degree of "switching" that would otherwise have taken place.

A general across-the-board cut in net bilateral aid of £10m., which left unaltered the 1963 regional distribution, and the proportion of tied to untied aid, would save the balance of payments less than £5m. If the cuts were concentrated in untied aid to countries which import relatively little from Britain, the saving would be greater.\*

If the extreme policy measures were taken to phase out aid over a number of years (by not entering into new commitments and only honouring existing ones, for example), the balance of payments would improve by about *one-third* of the value of present aid disbursements. (This figure might be higher if the loss of export orders forced some manufacturers to find new export markets that would not have been explored if aid-financed exports had continued.)\*

Alternatively, if instead of phasing out aid, Britain tied a far higher proportion of its aid, the present balance of payments cost of aid would be reduced. But even 100% tying does not reduce the balance of payments cost to zero, since there will always be some "switching". Moreover, tied aid is often an unsuitable form of aid. It reduces the value of aid, makes its use more difficult, and in many cases encourages

\* The analysis of this and the preceding paragraph also applies to the opposite case—the additional balance of payments cost of increasing aid.

\* There would, of course, be no balance of payments saving if expenditure were cut on those items of aid which do not, in any case, affect the balance of payments (see footnote to p. 3).

the wrong type of development expenditure. Because of this, an inflexible insistence on tying substantially reduces the real value of aid to recipients and can be considered to amount to a "cut in aid". Moreover, since tied aid is of limited use to many recipients, insistence on tying a very high proportion of aid would increase the time-lag between commitments and disbursements, and so itself reduce the volume of disbursements, even if the level of new commitments were maintained.

Finally, the reaction of other donors to a British policy decision to cut aid on a permanent basis would have to be considered. With the comments of an earlier section in mind, one cannot avoid concluding that there would be unfavourable reactions among other donors, though exactly what form these would take and how important they would be cannot be forecast. However, one can say that the reactions of other donors would not need to be very drastic for the balance of payments saving of a cut in British aid of some 10% to be completely offset.

#### IV

#### CONCLUSIONS

From the standpoint of the balance of payments it is in Britain's interest to see the present world aid effort maintained or expanded. Certainly, if one looks at the British aid programme in isolation, there is a balance of payments loss to be taken into account—though this is much smaller than is generally supposed. This loss, however, is more than offset by the expenditure on British exports of a part of other donors' large aid programmes. If, therefore, Britain through its own aid policy can help to maintain an expansion in the volume of global aid, the balance of payments should present no obstacle. And, even if Britain's aid increases were to outpace those of other donors, the additional balance of payments cost to Britain would be very small indeed.

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