Parliamentary Assembly
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COUNCIL OF EUROPE
CONSEIL DE L'EUROPE

Doc. 10571
3 June 2005

Contribution of the European Bank for Reconstruction and Development (EBRD) to economic development in central and eastern Europe

Report
Committee on Economic Affairs and Development
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Summary

The present report – prepared by the Parliamentary Assembly in its role as a parliamentary forum for the European Bank for Reconstruction and Development (EBRD) – reviews the Bank's performance and key activities in 2004 in its twenty-seven countries of operations, stretching from central Europe to central Asia. It welcomes the Bank's contribution to what is at present a record number of investment projects in these regions and salutes its increasing focus on the "early" and "intermediate" transition countries where its financing, often complementary to and combined with those of others, can make a true difference.

This year's report gives particular attention to the EBRD's involvement in several specific areas, such as the Kaliningrad region of the Russian Federation or the countries covered by the Stability Pact for South-Eastern Europe. It also examines the Bank's strong emphasis on good governance and on infrastructure investment capable of benefiting general economic development. Other aspects highlighted are the Bank's efforts to involve in particular non-European Union countries in a closer regional co-operation. The report also discusses the EBRD's findings indicating a strong relationship between reform and economic growth. Economic growth in the transition countries covered by the Bank is strikingly higher than the world average, albeit with important regional differences. As the Bank increasingly focuses on the less advanced countries, its work is far from over and increasingly promising.

I. Draft resolution

1. The Parliamentary Assembly, in line with its 1992 Agreement of co-operation signed between the Council of Europe and the European Bank for Reconstruction and Development (EBRD), has reviewed the Bank's performance and key activities in 2004 in its twenty-seven countries of operations. It welcomes the Bank's record commitments, totalling €4.13 billion, towards the financing of investment projects and its increasing focus on less economically advanced countries of operation in eastern and south-eastern Europe and in the Caucasus region.

2. The Assembly notes that the Bank's good management of its capital has enabled it to continue the announced shift in its lending towards its poorer "early" and "intermediate" countries of operations, while still observing sound banking principles and indeed exceeding both the operational and the financial targets established in its Medium Term Strategy for the years 2004-2007.

3. The Russian Federation remains the largest EBRD country of operations, benefiting as it does from about a third of total commitments for 2004. The New Country Strategy for the Russian Federation approved in 2004 points to the need for accelerated institutional and structural reform as well as efforts towards economic diversification and modernisation, fiscal discipline and the full protection of property rights.

4. The EBRD's participation in the Stability Pact for South-Eastern Europe is to be commended, especially in furthering private sector development via micro-financing, trade facilitation and infrastructure improvement in energy, transport and municipal services. Continued Bank involvement in the Pact is vital to ensure further economic and other reform as well as greater economic integration in the region.

5. The Assembly welcomes the EBRD's increasing emphasis on clarifying the complex relationship between reform and economic growth in its countries of operations, and its finding that - despite initial hardships and heightened pressure on national social safety systems - the opening of markets combined with steady structural reform yield positive macroeconomic results over time. This helps to explain why EBRD countries of operations have consistently over the past few years grown faster than the world average, exceeding 6% in 2004. Although considerable regional disparities remain, most transition countries are thereby in a good position to enjoy continued political stability and economic progress, provided that work to further consolidate institutions, democratic principles and the rule of law continues.

6. Reliable and efficient infrastructure networks are crucial for economic development. They represent a major investment challenge for countries of operations and the EBRD alike. The Assembly highly values the Bank's input in developing regulatory institutions and rules that encourage cost-efficient, competitive, environmentally sustainable and affordable infrastructure networks and services as well as paving the way for more extensive private sector participation.

7. The Assembly draws attention to the significant "multiplier effect" inherent in EBRD activities, in that its own lending attracts additional commercial, institutional and governmental co-financing. It notes that the Bank's partners invested €5.4 billion in 2004 – doubling from the previous year – in projects supported by the EBRD.

8. In conclusion, the Assembly:

i. encourages the EBRD to further strengthen its involvement – under strict observance of its requirements for improvement as regards human rights, democracy and the rule of law – in central Asia, especially within the framework of its new Early Transition Country Initiative in favour of Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan, as well as in regard to Kazakhstan and Turkmenistan;

ii. welcomes the EBRD's New Country Strategy for the Russian Federation and in this context supports the Bank's strong and increasing emphasis on small business development across all regions. It in particular commends the Bank's involvement alongside other investors in the Kaliningrad region, thereby contributing to enhanced co-operation between Russia and the European Union;

iii. supports – not least against the background of the opening for signature at the Third Council of Europe Summit of Heads of State and Government in Warsaw in May 2005 of a Convention on laundering, search, seizure and confiscation of the proceeds from crime and on the financing of terrorism and a Convention on action against trafficking in human beings - the EBRD's policy of "zero tolerance" of any occurrence of fraud, corruption and misconduct, such as via its Compliance Function promoting good governance and its new Independent Recourse Mechanism to assess the integrity of projects. It also commends the EBRD's improved Public Information Policy which renders the Bank's operations, investment strategies and evaluation activities more accessible to scrutiny by the public;

iv. asks the Bank to pay special attention, through its new policy on energy projects, to enhancing energy efficiency and savings;

v. notes the EBRD's co-operation with the Council of Europe Development Bank in supporting several projects in Hungary and Poland and strongly hopes that such joint activity can be further pursued in EBRD countries of operations which are in their early and intermediate transition stages.

II. Explanatory Memorandum by Ms Pirozhnikova, Rapporteur

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1. INTRODUCTION

1. Since 1992, when the Council of Europe and the European Bank for Reconstruction and Development (EBRD) signed an agreement of co-operation, the Parliamentary Assembly of the Council of Europe has prepared annual reports and held debates on the activities of the EBRD. It has thus been reviewing the Bank's efforts in support of democratic development and market-oriented reforms in the Bank's countries of operation. The parliamentary input from the Council of Europe's forty-six member states is meant to assess the Bank's activities against the framework requirements set forth in the EBRD mandate, to take stock of country experiences and to provide further guidance to the Bank's work.

2. This report will accordingly give a general overview of the EBRD's activities to date (particularly since the Assembly's last report in June 2004), will examine a few selected areas more closely and will seek to identify upcoming challenges. It is primarily based on various EBRD publications[1], as well as on presentations by and discussions with EBRD senior officials during the meeting of the Assembly's Committee of Economic Affairs and Development at EBRD headquarters in London in January 2005. On behalf of the Committee, the Rapporteur wishes to thank the EBRD for their warm welcome in London and for the generous assistance provided throughout the preparation of this report.

2. BACKGROUND AND GENERAL OVERVIEW OF THE BANK'S WORK TO DATE

3. The EBRD was established in May 1991 to foster the transition towards open market-oriented economies and to promote private sector initiative in the countries of central and eastern Europe (CEE) and the Commonwealth of Independent States (CIS). The EBRD's mandate, however, is unique among development banks in the sense that it also includes political aims. The Bank assists only those countries that are committed to multi-party democracy, the rule of law and human rights. Moreover, the projects financed have to be financially sound and advance the transition process, while respecting environmental protection needs. The EBRD has successfully managed the difficult task of reconciling the requirements of sound investment banking with those of development banking.

[1] Including Annual Report 2004; Annual Report 2003; Transition Report 2004 – Infrastructure; as well as policy documents, country strategies, and working papers.

4. Although the Bank devotes most attention to the private sector, some of its financing relates to investment projects in the public sector, especially as regards infrastructure (at national, regional or municipal level), privatisation and restructuring of state-owned companies. The **EBRD's operational priorities**, embraced in 1999, include: 1) assistance to the creation of **sound financial sectors** linked to the needs of local enterprises and households; 2) pursuit of commercial approaches and financial frameworks for **infrastructure** development; 3) help in developing **business start-ups and small and medium-sized enterprises** (SMEs); 4) **restructuring** of malfunctioning large enterprises; 5) promoting **equity investments, a sound investment climate and stronger institutions** in the countries of operation.

5. The EBRD counts 60 countries and two intergovernmental institutions (the European Union and the European Investment Bank) in its membership. It is the largest single investor in the region spanning from central and eastern Europe to central Asia, with 27 countries of operation[2]. The Bank's capital base totals € 20 billion, of which a quarter is paid-up capital and the remaining € 15 billion are callable funds. In addition, € 7 billion are set aside in the form of reserves, which grew by an impressive 82% in 2004. The strong capital base and sound operational, as well as financial, policies have earned the EBRD top ratings from Standard & Poor's (AAA) and Moody's (Aaa).

6. According to the Bank's Medium Term Strategy 2004-2007, special emphasis in 2004 was placed on sustaining high activity in the early and intermediate transition countries, wider regional coverage in Russia and continued expansion of SME and micro-lending in all the countries of operations. Key financial objectives for 2004 were: growth of the net portfolio volume of € 1.7 billion, € 3.9 billion in business operations and a net income of € 155 million.

7. The audited results, published in March 2005, show that by the end of 2004 the EBRD had committed € 25.3 billion in cumulative business volume over the 14 years of its existence, while the total value of the 1,140 projects co-financed with other institutional investors amounted to € 78.5 billion. In 2004 alone (see Table 1 below and the appendix), the EBRD committed a total of € 4.13 billion towards the financing of a record number of projects (129), covering all countries of operation and with the private sector share of investments rising to 86% from 79% a year before. Such results significantly exceed the projections of the Medium Term Strategy. The Bank's net profit in 2004 was € 297 million, down from the record high of € 378.2 million in 2003 but still considerably more than the average (€ 139 million) for the 2000-2002 period.

Table 1. EBRD's financial and operational highlights*

€ million - all figures audited	2004	2003	2002	2001	2000
Operating profit before provisions	382.6	399.9	294.7	294.7	327.1
Provisions for losses	(84.9)	(21.7)	(186.6)	(137.6)	(174.3)
Net profit	297.7	378.2	108.1	157.2	152.8
Paid-in capital	5,197	5,197	5,197	5,197	5,186
Total assets	22,364	22,045	20,112	20,947	21,290
Annual business volume	4,133	3,721	3,899	3,656	2,673
Net cumulative business volume	25,323	22,668	21,647	20,219	16,553
Total project value	78,542	68,490	69,163	67,765	58,502
Portfolio	15,324	14,766	14,576	14,160	12,218
Operating assets (minus fair value adjustments)	10,145	9,102	9,102	8,838	7,563
Annual gross disbursements	3,398	2,105	2,419	2,442	1,464

* Table drawn up under the responsibility of the EBRD.

[2] Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, "the former Yugoslav Republic of Macedonia", Moldova, Poland, Romania, Russian Federation, Serbia and Montenegro, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

8. The scope of EBRD co-financing with partner institutions was particularly important in 2004 as commercial lenders, export credit agencies and other international financial bodies invested € 5.4 billion jointly with the Bank. This is nearly the double the previous year. Almost two-thirds of these funds came from commercial institutions and the remainder from official institutions.

9. In terms of financing by sector, the spread of EBRD commitments is rather stable. One-third of investment traditionally goes to financial institutions (including bank equity, bank lending, equity funds, non-bank financial institutions, and small business finance); the infrastructure and specialised industries (such as agribusiness, property, tourism and shipping, and telecommunications, information technology and media) sectors each receive one-fifth of total EBRD financing, while smaller portions are allocated to the energy sector (including energy efficiency, natural resources and power generation) and general industry (respectively, about 16% and 14%).

10. To date, the EBRD has drafted sector policies for its operations in agribusiness; energy; municipal and environmental infrastructure; natural resources; property; shipping; telecommunications, informatics and media; and transport. A new energy policy is currently under preparation and is expected to come into play in 2005. The EBRD has also started revising its transport policy. In line with its new Public Information Policy adopted in 2003, the Bank is actively seeking comments from interested stakeholders in the revision of both policies (thus the EBRD is currently holding public consultation workshops on its prospective energy policy in various regions).

11. With regard to EBRD countries of operation, as presented in Table 2 below, nearly two-fifths of total commitments between 1991 and 2004 went to central Europe and the Baltics[3]. The Russian Federation, the largest country of operation, and south-eastern Europe[4] each received another fifth of EBRD financing, while smaller proportions went to Central Asia[5], Eastern Europe and the Caucasus[6]. However more recently these proportions have gradually changed in favour of more needy countries.

Table 2. EBRD Financing by Region (as % of total for each period)*

	Cumulative 1991-2004	2003	2004
Central Europe & the Baltics	38.8%	31.3%	23.4%
South-eastern Europe	20.4%	25.8%	24.5%
Russian Federation	23.2%	29.6%	30.0%
Eastern Europe & the Caucasus	10.3%	5.3%	14.5%
Central Asia	7.3%	8.0%	7.6%

* Table drawn up under the responsibility of the EBRD.

12. In recent years the EBRD has shifted more of its resources towards assisting the so-called early and intermediate transition countries: those in central Asia, eastern Europe, the Caucasus and south-eastern Europe. Nevertheless, it will continue to support also the advanced transition countries in central Europe and the Baltics, focusing on middle-sized businesses and developing the banking sector, but also helping municipalities to provide better and more sustainable public services.

13. EBRD commitments in 2004 were more or less equally distributed between the Russian Federation (€ 1.24 billion or 30%, - slightly up on the previous year from € 1.1 billion, 30% share), the advanced transition countries (€ 960 million or 23% – down from 1.17 billion or 31% in 2003), and the early and intermediate transition countries (€ 1.93 billion or 47% – up from € 1.45 billion or 39% in 2003). It is worth noting that the New Early Transition Country Initiative in favour of Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan in 2004 yielded € 378 million in investment (€ 93 million if oil and gas projects are excluded) as compared to € 84 million in 2003. These figures demonstrate the Bank's

[3] Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia.

[4] Albania, Bosnia and Herzegovina, Bulgaria, "the former Yugoslav Republic of Macedonia", Romania, and Serbia and Montenegro.

[5] Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

[6] Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine.

welcome increasing investment in the less advanced transition countries. The Rapporteur hopes that this upward trend can be upheld also in the coming years, even if it implies greater risks and potentially reduced profits. Indeed, provisions for losses in 2004 quadrupled when compared to the previous year, although they were still considerably lower than in the 2000-2002 period.

14. Since 1993 the operationally independent EBRD Project Evaluation Department (PED) has assessed project performance. Evaluations are carried out *ex post* (generally one or two years after the final disbursement for a given project). They seek firstly to measure the positive results of projects and secondly to draw lessons for the future. Projects are rated on the basis of: transition impact[7]; financial performance[8]; environmental performance; 'additionality', by which is meant the EBRD's ability to supplement rather than substitute for private sources of financing; fulfilment of objectives; and investment performance.

15. The Department has so far evaluated 436 projects or 76% of projects ripe for evaluation. Between 2000 and 2004, 77% of the projects evaluated were rated as having a positive (excellent, good or satisfactory) transition impact. In terms of overall performance, 53% of the evaluated projects between 1996 and 2004 were rated as "successful" or "highly successful". The primary reason for projects ranking lower on overall performance than on transition impact is that the former also takes into account financial performance, which may suffer from the relatively higher risks encountered in some countries of operations. All evaluation reports are available on the Bank's website (www.ebrd.com) either in full or shortened form, including special studies on themes and sectors. The PED is also currently developing a database for external use over 'lessons learned'.

16. With regard to the overall transition process, much of the reform progress in 2004 was found in South Eastern Europe (see also Section 3.b. below). Following their rapid improvement in this regard leading up to the EU accession in May 2004, many countries in Central Europe and the Baltics are registering a slowdown in the pace of reforms, with the latter often primarily limited to improving the business environment. Reform in the CIS countries has, with a few exceptions, been sporadic not least due to hesitations in advance of elections in many countries, but can be expected to speed up once these elections have been held. The reform pace also slowed down somewhat in the Russian Federation, even though recent government initiatives have been launched to accelerate it anew. Most transition progress in 2003 and 2004 in EBRD countries of operations was in banking reform and interest rate liberalisation, as well as in overall infrastructure reform (see further Section 3.d. below) and large-scale privatisation in South Eastern Europe and the CIS countries.

17. Fifteen years after the beginning of transition, most countries of operations are enjoying strong economic growth and relative macroeconomic stability. The region's growth - supported by rapid credit expansion, booming consumption and new investment – stood at around 6.2% in 2004. This is significantly higher that the expansion rates of most western European economies and higher than the world average. Growth has been particularly pronounced in many of the new EU countries and candidates, while several CIS countries have benefited from high world commodity prices. Some in the latter group are seen as being still excessively dependent on exports of natural resources, a circumstance which tends to erode the competitiveness of non-resource sectors and discourage reform.

18. Inflation remains generally under control, despite intermittent prices increases in central European and the Baltic countries. However, inflationary (and fiscal) pressures are building up in Ukraine and need to be addressed promptly by the new Ukrainian government. Although net FDI inflows to the transition countries contracted sharply in 2003 (from $ 30.3 billion in 2002 to $ 19 billion in 2003), they seem to have recovered in 2004 and are expected to grow further in 2005. This decline has been explained by the gradual drying up of privatisation as a destination for FDI, notably in central Europe and the Baltics. Repayments of loans to foreign parent companies and the transformation of some transition countries into FDI source countries are also believed to have contributed to the reduction.

[7] Key indicators are: Promotion of privatisation; Development of skills; Encouragement of competition; and Support for market expansion. Other relevant aspects include: Institution-building to improve the functioning of markets; Contribution to government policy formation and commitment; Contribution to laws; Positive demonstration effects (i.e., potential to provide a model); and Setting new standards in business conduct and governance.

[8] Both with regard to the general performance of the project and the performance of the company responsible for executing the project.

19. The new country strategy for the Russian Federation, approved in November 2004, applauds that country's robust, although regionally uneven, economic performance and continuing political consolidation. Yet much of the economic growth is attributable to a combination of favourable external factors (such as high world commodity prices, abundant liquidity, low interest rates and strong investor interest in emerging markets). In order to keep growth strong and further encourage domestic and foreign investors, the government will need to speed up institutional and structural reforms and their implementation. Further efforts towards economic diversification and modernisation, fiscal discipline and enhanced protection of property rights are seen as crucial to improving the economic environment and reducing vulnerability to swings in commodity prices and capital flows. The EBRD informed the Economic Committee that it will continue to support small business financing across all regions. This also holds for the modernisation of large standalone companies, not least via its enhanced participation in the new phase of the Russian privatisation process between 2005 and 2007.

20. The 2004 Transition Report also looks at the relationship between growth and reform and other variables. There is some evidence that a strong reform commitment goes hand in hand with improved macroeconomic performance. High growth can also encourage further reform in a "virtuous circle". However, transition is normally associated with high short-term costs and pains and the relationship between reform and growth is not easy. Other factors also need to be taken into account. To this end, the 2004 Transition Report also addresses: 1) initial conditions (including initial level of development and the extent of inherited structural and macroeconomic distortions), 2) implementation of appropriate monetary and fiscal stabilisation policies (creating a macroeconomic environment of lower inflation and sustainable fiscal deficits), 3) and progress in market-oriented reforms.

21. There appears to be an overall relationship, although weak, between a better starting point and higher growth. The positive effect of good initial conditions does, however, decline over time as other factors begin to play a more important role. Evidence also suggests that countries that stabilised their economy early on had shorter and less deep recessions and grew more quickly than was the case with late stabilisers. Since 1999, however, growth rates among late stabilising countries have been higher than for early stabilisers, suggesting a catching-up pattern. Moreover, early reformers (which correspond almost exactly with early stabilisers) have recorded positive growth rates earlier compared to late reformers, although late reformers (and stabilisers) grow more rapidly now.

22. In conclusion, the 2004 Transition Report says, "there are clear [positive] links over the whole transition period between real GDP growth, good initial conditions, sound macroeconomic policies and progress in structural reforms". Studies do not yet show consensus over the causes of growth in transition countries, although there is broad agreement on the importance of stabilisation polices, and that early adoption of such policies is good for sustainable growth. There is also fairly wide agreement on the role of initial conditions (although the interpretation of what constitutes such conditions may differ). Much of the recent debate circles around the effects of reform on growth. While earlier studies pointed to reform being uniformly good for growth, some recent studies have been less categorical, perhaps because it is often more difficult to identify the best direction of further reforms once the basic ones have been undertaken and a certain level of development has been reached. Nevertheless, on the whole and when other additional variables[9] are taken into account, most evidence shows "that a sustained commitment to reform and sound fiscal policies will bring substantial benefits over the longer term".

23. On the whole, the EBRD can be considered to have been highly successful in operating according to its mandate of fostering transition towards open market-oriented economies and promoting private and entrepreneurial initiative in the countries of CEE and the CIS, especially considering the difficult environment in which it operates. The Bank has conscientiously observed the political aspects of its mandate in reserving its assistance to countries "*committed to and applying the principles of multi-party democracy [and] pluralism*".

[9] Such as the potential for countries that suffered worse declines to recover more quickly afterwards (catching-up), changes in the terms of trade (especially with regard to energy prices), and the impact of external growth (i.e., the growth of main trading partners).

24. Following Uzbekistan's meagre progress in meeting the EBRD's political (and economic) benchmarks established following its 2003 annual meeting in Tashkent, the Bank's activities in the country are very limited. Reform paralysis seems to have set in Turkmenistan. The EBRD's involvement in Belarus and Turkmenistan is essentially limited to monitoring existing projects.

25. In line with its political mandate, the EBRD is also closely following developments in Ukraine, especially after the presidential elections in the autumn of 2004. It has recently announced a package of new investments to support the country's transformation toward greater democracy under its new President Viktor Yushchenko and its role as a catalyst for broader democratic change in the region. The Bank intends to focus on the foreseen privatisation of the Ukrainian telecommunications monopoly (Ukrtelecom) and parts of the banking sector, but loans will also be provided to local government agencies for infrastructure projects, for instance to improve drinking water and transport facilities, as well as the sectors for power generation, oil and gas. At the same time the EBRD and other institutional investors have asked for some caution in reviewing earlier privatisations. In a new strategy for Ukraine adopted in May 2005 the EBRD places special emphasis on the provision of credit lines for micro and SME finance, mortgage, leasing, energy efficiency and warehouse receipts. It is also planning to start work with insurance companies and other non-bank financial institutions.

26. Further to the 1999 co-operation agreement between the EBRD and the Council of Europe Development Bank, the two institutions in 2004 pursued co-financing activities in favour of small and medium-sized enterprises, micro-businesses and municipal infrastructure in Hungary and Poland (€30 million and €38.9 million, respectively). The Economic Committee in adopting the present report strongly felt that this kind of cooperation should be extended also to countries of operations which are less advanced and find themselves in their early and intermediate stages of transition.

3. THE BANK'S PARTICIPATION IN SOME SPECIFIC AREAS

27. Following the general overview, the Rapporteur wishes to focus on a number of specific areas, necessarily restricted in number for the sake of brevity.

3.a. The Kaliningrad region

28. The Kaliningrad region is a region in the Russian Federation (15 100 km^2). With the accession of Lithuania and Poland to the EU in May 2004, it is now a *de facto* Russian exclave within the EU. Although small in terms of both geography and population (950 000 inhabitants, with around 420 000 in the city of Kaliningrad itself), the importance of the Kaliningrad region has grown following the EU enlargement process.

29. Around 30% of the region's working population are employed in industry and construction, 21% in social services, 11% in agriculture and forestry, and 8% transport and communication. The region possesses unique amber deposits (with more than 90% of the world reserves), as well as oil resources (both proven and estimated) and coal reserves.[10] Kaliningrad also harbours the Russian Federation's only deep sea port on the Baltic Sea.

30. The economic crisis that followed the collapse of the Soviet Union had particularly severe consequences for Kaliningrad, as traditional patterns of production and trade were disrupted. In an effort to combat this decline, Russia in 1996 declared Kaliningrad a Special Economic Zone (SEZ), offering a privileged investment and business regime for investors.

31. Kaliningrad's special status (offering the possibility of tax-free imports) has for instance spurred furniture makers and many foreign companies to set up assembly plants, such as for car production) in the region. More than 50% of all TV-sets made in the Russian Federation in 2004 were produced in Kaliningrad. Other important sectors are food processing (mainly meat and fish), oil extraction and power generation,

[10] gov.kaliningrad.ru

ship-building and machine-tool manufacturing, wood processing and pulp and paper production. The Kaliningrad region, as elsewhere in the North-West Federal District, is dominated by large enterprises, although the share of SMEs in the region's economy is significant.

32. Primarily as a result of its special economic status, Kaliningrad's economy has grown with impressive speed in recent years: average annual economic growth was nearly 15% between 1999 and 2002[11]. However, although the SEZ regime has had a positive effect on economic growth, it has also made it more vulnerable[12]. Furthermore, the region's GDP per capita is still over one-third below the Russian average, and even further below those of its closest neighbours in the Baltics and Poland. Furthermore, recent annual FDI in Kaliningrad amounts to only around 0.5% of regional GDP, compared to around 1% for the Russian Federation as a whole and about 4% in neighbouring Lithuania[13]. Kaliningrad also suffers from high unemployment, low wages, a high HIV infection rate[14], organised crime and smuggling[15].

33. An important factor limiting the growth of industries in Kaliningrad today is the energy (electricity) shortage, which is expected to worsen further as the Lithuanian nuclear power plant that has supplied Kaliningrad with electricity is set to close in 2009 in line with Lithuania's commitments upon joining the EU. Kaliningrad's unique position makes it particularly vulnerable to external factors, both Russian and international. The region faces two primary development challenges: the effects of the recent EU enlargement[16] and the forthcoming accession of the Russian Federation to the WTO. A recent survey[17] indicates that over half of the stakeholders in the region see changes to external trade resulting from these two processes as the most urgent challenges for the region.

34. The development of the Kaliningrad region is very important for the relationship between the enlarged EU and the Russian Federation. Kaliningrad is one of the most important Russian regions when it comes to co-operation between the EBRD and the EU. The region can reinforce cross-border co-operation and partnership. Many argue that Kaliningrad can be used as a pilot/model region for furthering and deepening the strategic relationship between the Russian Federation on the one hand and the EU on the other towards boosting the regional economy[18]. An important aspect of Russia-EU co-operation is the transit and visa policies for Kaliningraders. Currently a Facilitated Transit Document (FTD) scheme applies to the transit of citizens between Kaliningrad and other parts of Russia by land. It seems to work relatively well. Numerous unresolved problems remain regarding the transit of freight and military equipment.

35. An important focus of the Russian Government's Economic and Social Development Programme for the Kaliningrad Region until 2010 is infrastructure investments (primarily in energy, public utilities, roads, and water treatment facilities) in order to wean Kaliningrad off its special economic status and make it an attractive place to invest. Furthermore, the federal government of the North West Federal District will continue to consider Kaliningrad a priority region, especially in the light of its geographic uniqueness. For the future, Kaliningrad's main opportunities include its proximity to European markets, being a transportation juncture along trans-European routes, and tourism.

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[11] Yegorov, Igor. "Overview of Kaliningrad Region", www.bisnis.doc.gov, August 2003.

[12] Vinokurov, Evgeny. "Economic Prospects for Kaliningrad: Between EU Enlargement and Russia's Integration into the World Economy", Centre for European Policy Studies (CEPS) Working Document # 201, June 2004.

[13] The Economist, "Cut off", 19 December 2002.

[14] In 2003, the average wage in the Kaliningrad region was around $ 150 per month, roughly half the level in Lithuania and a third of that in Poland. The rate of HIV/AIDS infections, at more than 350 cases per 100 000 people, is among the highest in Europe. The Economist, "Deplore it, then ignore it"; 20 November 2003.

[15] For instance, until visa-free travel was interrupted following Lithuania's EU accession, shuttle trading was the main source of income for one-tenth of the Kaliningrad population. The Economist, "Behind the crystal curtain", 23 October 2003.

[16] Since Kaliningrad's main trading partners are Poland, Germany and Lithuania, the region has already to some extent had to face up to and meet EU standards. However, now that both Lithuania and Poland have joined the EU, it risks further isolation. Yegorov, Igor. "Overview of Kaliningrad Region", www.bisnis.doc.gov, August 2003.

[17] "Kaliningrad Region External Trade: Present and Future", Bulletin # 1, EUROPEAID/114287/CSV/RU Support to regional development of Kaliningrad, 2003.

[18] Vinokurov, Evgeny. "Kaliningrad in the Framework of EU-Russian Relations: Moving Towards Common Spaces", www.kaliningradexpert.org.

36. The Government of the Russian Federation is currently preparing a draft Federal Law in order to make the economic development of Kaliningrad region more liberal. According to the provisions of the draft law, the entire territory of the region will become a Special Economic Zone. The status of Special Economic Zone will be granted for the region for the next 25 years. The enterprises currently enjoying preferential status will keep it for another 10 years, but lose it thereafter. The sole exception concerns products related to investment. For a company to qualify as "part of the special zone" it must produce at least 70% of products and services there. Investors who during a three year period invest at least 150 million roubles in the region's economy will have the right to import tax-free equipment and parts. During first six years a SEZ member will be exonerated from revenue and property taxes and will, during an additional six years, pay only 50% of revenue taxes. This new draft law is expected to attract foreign investors and promote social development for local population to the level of neighbouring countries. The regional GDP is expected to grow by 10-15% during 2005-2010.

37. As part of its effort to reach further out into the regions of the Russian Federation, the EBRD adopted a Kaliningrad Action Plan already in 2001. It focuses on major projects around which subsidiary activities can cluster. The model has served as a blueprint for EBRD operations in other regions of the Russian Federation.

38. The largest on-going EBRD-financed project in Kaliningrad is the 1999 Water and Environmental Services Rehabilitation project worth € 48.2 million (of which € 14.3 million are in the form of a loan. It aims to improve water supply services, waste-water treatment and upgrade infrastructure). Another project, the Kaliningrad District Heating Rehabilitation project (in the energy efficiency sector), is awaiting final board approval. The total cost is estimated at € 20.8 million, of which € 11.2 million come as a loan.

39. While the EBRD most often promotes private entrepreneurship in the Russian Federation through the Russia Small Business Fund (RSBF) it also participates in the furthering of regional entrepreneurship via technical assistance initiatives. For example, the EBRD has supported a Kaliningrad study by the Foreign Investment Advisory Service (FIAS) on identifying impediments to small businesses and advising on ways to reduce such obstacles.

40. In July 2003, the EBRD, with € 500 000 of funding from Finland, Luxembourg and Sweden, opened a new Business Advisory Service (BAS) in Kaliningrad as part of an effort to develop the economy by stimulating the growth of local SMEs. The BAS programme aims to tutor and accompany around 75 Kaliningrad entrepreneurs on self-improvement projects. Using local consultants and working directly with individual SMEs, the BAS programme seeks to provide practical business advice on how to remove barriers to growth and development, as well as on how to make firms more efficient and competitive. BAS assistance generally focuses on short-term interventions, such as upgrading IT systems to improve financial controls, carrying out market research, and introducing systems for quality management and enterprise reorganisation[19]. Expanding the EBRD's Turn Around Management programme activities into Kaliningrad might also be worthwhile.

41. In the current strategy period, continued attention will be paid in the North West Federal District (of which Kaliningrad forms part) to new opportunities in environmental and transport projects, (in the context of the Northern Dimension framework), as well as ports and forestry. Future EBRD plans in Kaliningrad (according to the latest country strategy for the Russian Federation) include the establishment of a branch of a specialised SME-lending bank. A delegation of the EBRD Board of Directors visited Kaliningrad in May 2004.

42. The overall expansion of EBRD financing to Russian regions has been particularly encouraging over the past few years. The Bank now has about 250 projects and sub-projects covering 41 Russian regions, with the proportion of business volume beyond the conurbations of Moscow and St. Petersburg constantly growing. The share of such regional projects currently represents about 85% of total Bank commitments across Russia. To further strengthen this trend, the EBRD is planning to reinforce its regional presence in the coming years.

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[19] The Kaliningrad BAS office is the 17th in the EBRD's BAS programme. BAS was launched by the EBRD and the Nordic Council of Ministers in 1995 in the Baltic states and has since been successfully expanded to 15 countries of operation. A wide range of donors have provided € 34.5 million to more than 2 500 projects so far.

3.b. The Stability Pact for South-Eastern Europe

43. The Stability Pact for South-Eastern Europe[20], adopted in 1999, is a political declaration of commitment and a framework agreement on international co-operation towards developing a comprehensive and long-term strategy for growth and stability. It in particular seeks to encourage and reinforce co-operation among donors and between countries, as well as to streamline activities and efforts at financial, political and technical assistance.[21]

44. The Stability Pact targets a total of eight countries in the region: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, "the former Yugoslav Republic of Macedonia", Moldova, Romania, and Serbia and Montenegro. Other partners include the EU member states, the European Commission and seven other non-EU member countries[22] as well as the EBRD and other international financial institutions[23], international organisations[24] and regional initiatives.[25]

45. The Stability Pact is not a fundraising mechanism in itself or an institution with its own project implementation, but rather serves as an instrument to co-ordinate and facilitate implementation via its members. The work of the Stability Pact is structured around three main areas (or Working Tables): I) Democratisation and human rights[26]; II) Economic reconstruction, co-operation and development; and III) Security issues[27]. The EBRD is particularly active under Working Table II, where it leads the Stability Pact's private sector development initiatives. Since March 2000, the EBRD has launched ten private sector initiatives, to which it has pledged a total of € 356 million. Donors have committed € 140 million, to be matched by another € 450 million from international finance institutions. The main EBRD priorities under private sector development include trade facilitation; micro and SME financing; as well as SME support and development.

46. With regard to trade facilitation, EBRD aims at developing both intra- and inter-regional trade, institutional development (by assisting local banks in structuring trade transactions); creating track records with foreign banks; and avoiding cash collateral requirements (i.e., cheaper financing terms for exporters or importers). EBRD guarantees cover payment risks by the issuing bank to the confirming bank.

47. In micro-finance, a total of eight banks with 106 branches/outlets in all Stability Pact target countries except Croatia participate. By the end of 2004, a total of 120 000 loans had been made representing $ 750 million, with an average loan size of $ 6 700. As far as SME credit lines are concerned, financing goes through the EBRD-EU SME Facility for accession countries (Bulgaria and Romania). This model is expected to be replicated in the Western Balkans. Overall EBRD support to the banking sector in the Stability Pact target countries by the middle of 2004 reached 148 commitments representing € 1.4 billion in credit lines and equity participations. Relationships with 64 banks in the region had been established.

48. SME support and development initiatives include Business Advisory Services (BAS) as well as Turn Around Management (TAM) programmes. BAS support is given through local consultants. By October 2004 a total of 700 BAS initiatives (75 currently in progress) with a donor support of € 9 million had been launched

[20] www.stabilitypact.org

[21] The core of the Stability Pact lies in the conviction that self-sustaining conflict prevention and peace building can be achieved only if there is successful and parallel progress in the following three areas: creation of a secure environment; promotion of sustainable democratic systems; and promotion of economic and social well-being.

[22] Canada, Japan, Norway, Russia, Switzerland, Turkey and the USA.

[23] Council of Europe Development Bank (CEB), European Investment Bank (EIB), International Monetary Fund (IMF), and World Bank.

[24] Council of Europe, North Atlantic Treaty Organisation (NATO), Organisation for Economic Co-operation and Development (OECD), Organization for Security and Co-operation in Europe (OSCE), United Nations (UN), and United Nations High Commissioner for Refugees (UNHCR).

[25] Black Sea Economic Co-operation Initiative (BSEC), Central European Initiative (CEI), South East European Co-operation Initiative (SECI), and South East Europe Co-operation Process (SEECP).

[26] Covering the areas of media, education and youth, local democracy and cross-border co-operation, parliamentary co-operation, and gender issues.

[27] Working Table III is in turn divided into the two sub-tables of Defence and security issues, and Justice and home affairs. Furthermore, all three Working Tables operate under and are organisationally dependent upon the Regional Table, which is chaired by the Special Co-ordinator. The primary tasks of the Special Co-ordinator are to streamline the Stability Pact partners' political strategies and efforts and to co-ordinate existing and new initiatives in the region in order to avoid unnecessary duplication of work carried out.

in Bosnia and Herzegovina, Bulgaria, Croatia, "the former Yugoslav Republic of Macedonia", and Serbia and Montenegro. TAM programmes are undertaken by specialised industrial advisors in all Stability Pact target countries. As of 31 October 2004, total donor support of € 13 million has been channelled into 240 programmes (68 still on-going).

49. Apart from private sector development activities, the EBRD has been very active in the field of infrastructure (namely energy, transport and municipal services) - a key focus of the Stability Pact. Cumulative EBRD financing by October 2004 amounted to € 2.2 billion in 80 projects. € 800 million of these commitments were earmarked for 21 Stability Pact regional infrastructure projects. 37 other projects with an additional € 0.5 million of EBRD funding are in the pipeline.

50. Another important Stability Pact initiative under Working Table II is the South-East Europe Compact for Reform, Investment, Integrity and Growth (Investment Compact)[28], led by the OECD. The Investment Compact sets out a number of commitments, which are in turn translated by the individual countries into concrete measures to create a sustainable market economy and encourage private sector investment. The activities seek to attract and encourage investment; improve the investment climate; drive and monitor the implementation of policy reform; and ensure private sector involvement in policy reform. To these ends the Investment Compact supports and promotes policy reform in three broad, inter-related policy areas: 1) FDI policies and promotion strategies; 2) SME support; and 3) governance, competition and regulatory regimes.

51. Following an assessment (of investment conditions) phase and an identification (of policy priorities for action) phase, the SEE countries are currently involved in the implementation phase. Seeking to create "ownership" of policy reform with the countries themselves, the Investment Compact offers a number of "instruments" for support.[29]

52. A recent independent evaluation of the Investment Compact[30] concluded that it "has clearly contributed to improving the investment environment and increasing private investment and employment" in the SEE region, even though the impact has on the whole been stronger in some countries, such as Albania and Romania, compared to others. In particular, the Investment Compact has helped to increase FDI and employment (especially in Moldova, Romania, and Serbia and Montenegro); promote regional co-operation; boost private sector involvement, credibility and effectiveness; establish the ground for greater regional "ownership"; and institutionalise a monitoring process. The most effective areas have been those where the private sector has been actively involved and co-leadership encouraged. While key stakeholders support the Investment Compact as a whole, they also call for a greater focus, more concrete actions and more effective communication. In conclusion, for the future, the assessment suggests that resources should be concentrated in those areas where they achieve maximum impact, notably the monitoring process[31], implementation support[32], private sector involvement[33] and political support[34].

53. All in all, by the end of 2003, the EBRD had committed € 6.6 billion (or 26% of total EBRD financing) to various projects in the eight Stability Pact target countries. In 2004 alone, projects (74% of which are in the private sector) in these eight countries received € 1.13 billion (or 27%) of EBRD financing.

54. After a turbulent first decade of transition, the majority of the south-eastern European countries have, overall, made significant economic progress more recently. As illustrated in Table 3 below, growth rates have picked up in all countries at the same time as inflation has been brought down. (It still, however, remains relatively high in Bulgaria, Moldova, Romania and Serbia and Montenegro). Budget deficits have also been reduced in most countries (although worsening more recently in Albania, Bosnia and Herzegovina, Moldova and Serbia and Montenegro). Current account deficits remain high throughout the region, particularly in

[28] www.investmentcompact.org

[29] These instruments include country fact sheets (providing "snapshots" of the status of policy reform and key policy priorities to serve as a benchmark for monitoring future progress); "regional flagship" initiatives (i.e., concrete examples of agreed action taken on a regional basis) and monitoring instruments (prepared for each country in a common format to monitor progress).

[30] Evaluation of the Investment Compact Program, AT Kearney, July 2004.

[31] Maximum of 12 government-set concrete and measurable targets agreed with the private sector and monitored quarterly.

[32] Focus on the two areas of FDI policies and promotion strategies and of SME support with practical steps on how to proceed.

[33] Further strengthen existing structures and integrate these into the monitoring process.

[34] Move beyond Ministers to parliamentarians and local government officials.

Bosnia and Herzegovina. Finally, FDI inflows have recently increased to record levels in most countries, while remaining more or less stable in Moldova and decreasing somewhat in Croatia and Serbia and Montenegro.

Table 3. Stability Pact for South Eastern Europe Macroeconomic Indicators: 2004 (projections)*

	Real GDP growth (%)	Inflation (%)	Government balance (% of GDP)	Current account balance (% of GDP)	FDI inflows in 2003 (% of GDP)
Albania	6.2	3.4	-6.5	-7.3	3.0
Bosnia & Herzegovina	4.0	0.7*	-0.9	-14.8	5.0
Bulgaria	5.5	6.0	-0.4	-8.0	7.0
Croatia	3.7	2.5	-4.5	-5.8	6.0
"the former Yugoslav Republic of Macedonia"	2.5	2.8	-1.5	-6.9	2.0
Moldova	7.0	10.0	-0.7	-6.4	2.5
Romania	5.8	11.9	-1.6	-5.6	3.0
Serbia & Montenegro	5.0	8.5	-3.4	-11.3	7.0
Average	*4.96*	*5.7*	*-2.6*	*-8.3*	*4.4*

Note: Inflation is measured as the change in annual average retail/consumer price level. * The Bosnia and Herzegovina inflation figure is an average of the inflation rate in the Federation (-0.5%) and the Republika Srpska (1.9%) in 2003.
* Table drawn up under the responsibility of the EBRD.

55. On the whole, south-eastern Europe is catching up with the more advanced transition countries in Central Europe and the Baltics. EU accession remains high on the agenda for most countries in the region, most notably Bulgaria, Croatia and Romania. The importance of the private sector is growing, particularly thanks to SMEs. Foreign capital inflows (on the increase in most countries) play a crucial role in providing a source of financing for enterprises (which commonly identify the lack thereof as their key constraint)[35].

56. Over the past year, all eight Stability Pact target countries have received transition "upgrades", as presented in Table 4 below. Reform has accelerated particularly in the EU candidate countries (Bulgaria, Croatia and Romania). Most countries have made particular progress with regard to banking reform and interest rate liberalisation over the recent year (though less so in terms of securities markets and non-bank financial institutions). While most countries have completed the liberalisation of prices as well as trade and foreign exchange system, competition policy progress is still weak in most countries. Finally, with regard to enterprises, South Eastern Europe has made relatively good progress in terms of small-scale privatisation (and to a lesser extent also large-scale privatisations), while reform progress is still needed on governance and enterprise restructuring. Finally, there is still much room for improvements in infrastructure across the region.

Table 4. Stability Pact for South Eastern Europe Transition Indicators: 2004*

	Enterprises			Markets & Trade			Financial Institutions (FIs)		Infrastructure
	Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank FIs	Infrastructure reform
Albania	2+	4	2	4+	4+	2	3-	2-	2
Bosnia & Herzegovina	2+	3	2	4	4-	1	3-	2-	2+
Bulgaria	4	4-	3-	4+	4+	2+	4-	2+	3
Croatia	3+	4+	3	4	4+	2+	4	3-	3
(FYR of) Macedonia	3+	4	2+	4	4+	2	3-	2	2
Moldova	3	3+	2-	4-	4+	2	3-	2	2
Romania	4-	4-	2	4+	4+	2+	3	2	3+
Serbia & Montenegro	2+	3+	2	4	3+	1	2+	2	2

Note 1: Infrastructure includes telecommunications, electric power, railways, roads, and water and waste water.
Note 2: The rating/classification scale ranges from 1 to 4+, where 1 represents little or no change from a rigid centrally planned economy and 4+ represents the standards of an industrialised market economy.
Note 3: Shaded numbers indicate upgrades (improvements) from previous year.
* Table drawn up under the responsibility of the EBRD.

[35] Falcetti, Elisabetta, Sanfey, Peter, and Taci, Anita. "Bridging the gaps? Private sector development, capital flows and the investment climate in south-eastern Europe", EBRD Working Paper No. 80, June 2003.

57. At the last Regional Table meeting in Skopje ("the former Yugoslav Republic of Macedonia") in November 2004, Working Table II reaffirmed its intention to focus on the implementation of the regional strategies agreed in various sectors, such as transport infrastructure, energy, trade, investment generation and employment policies. The importance of monitoring and publicising the implementation of agreed reforms in each country was stressed in light of the pressing need to increase investment flows (particularly "greenfield" investment, that is, the creation of enterprises). Furthermore, Working Table II encouraged the discussions underway to establish a regional multilateral free trade agreement, commended the agreement on the regional energy community and recommended further emphasis on investment promotion and enterprise (particularly SME) development.

58. For the future, the highest priorities for the EBRD with regard to the Stability Pact are to speed up the implementation of existing projects and support both financially and institutionally the target countries in their transition process. It will in particular continue to promote private sector development and investment flows.

3.c. Good Governance

59. A recent EBRD paper[36] examined anti-corruption activities in 24 transition countries[37] between 1999 and 2002. It concluded that those with relatively low levels of administrative corruption were more likely to adopt intensive anti-corruption programmes than those with relatively high levels of administrative corruption, regardless of the level of so-called state capture[38]. The analysis also showed that while omnibus anti-corruption programmes and international anti-corruption convention memberships did not reduce the level of administrative corruption (at least not in the short term), new or amended specific anti-corruption laws as opposed to more general anti-corruption programmes often did. Finally, it appeared that enterprises' perceptions of corruption in the countries surveyed were positively linked to the strength of anti-corruption initiatives.

60. The EBRD naturally has a "zero tolerance" policy with regard to any occurrence of fraud, corruption and misconduct. In 2000, it established the so called Compliance Function towards promoting good governance and ensuring that the EBRD and its operations observe the highest standards of integrity in accordance with international best practice. The Compliance Function particularly addresses issues of conflicts of interest, corruption, confidentiality and money laundering. Activities include examining hotline reports, performing integrity checks, and conducting investigations under the new Procedures for Reporting and Investigating Suspected Misconduct (PRISM).

61. As part of its accountability and transparency policy, the EBRD in 2004 established the Independent Recourse Mechanism (IRM), which is designed to assess and review complaints about the Bank's projects. The IRM is activated whenever a complaint is received. It verifies whether banking operations are in line with the Bank's policies, especially in the field of its Environmental Policy and its Public Information Policy, with the aim to restore trust between the parties involved and redress the situation.

62. Moreover, in December 2004, a year after the signing the United Nations Convention against Corruption, a meeting among EBRD and other development banks reaffirmed the commitment to fighting corruption in operations and projects. The EBRD has also assisted Transparency International and Social Accountability International (two leading NGOs in the fight against corruption) in drawing up a set of principles and tools for businesses to counter bribery. It provides a framework against bribery based on international best practices.

[36] Steves, Franklin and Rousso, Alan. "Anti-corruption programmes in post-communist transition countries and changes in the business environment, 1999-2002", EBRD Working Paper No. 85, October 2003.

[37] All EBRD countries of operations except Serbia and Montenegro, Tajikistan and Turkmenistan.

[38] Meaning private firms or individuals "capturing" the state in the sense that private entities establish conditions of undue influence over state institutions in order to serve their own private interests.

3.d. Infrastructure

63. Special attention in the EBRD's 2004 Transition Report is given to infrastructure, in particular energy, telecommunications, transport, water supply and municipal services. Reliable infrastructure networks and services are crucial for the efficient functioning of any market economy and the promotion of growth, as well as in encouraging regional and international trade. Although most transition countries invested heavily in infrastructure networks during the communist era (and hence have relatively good structures in place compared with other emerging markets), most infrastructure services are suffering from decades of neglect, under-funding or poor management. Infrastructure reform has been an essential part of the transition process in all countries, although their individual experiences differ. The 2004 Transition Report looks in particular at the role of regulatory frameworks and private sector participation in the infrastructure reform process.

64. With regard to regulatory frameworks, the experience of transition countries in establishing modern regimes for network utilities varies. While most advanced transition countries have made considerable progress towards establishing independent and accountable regulatory authorities to promote competition, some countries, notably in South Eastern Europe and the CIS, are still seeking to put credible regimes in place. Difficulties result partly from weak institutional environments, but also from the risk of vested interests creeping into the reform agenda.

65. Recent infrastructure reform progress partly results from a growing recognition that better regulation and commercialisation are essential for the effective provision of infrastructure services as well as for the improvement of networks. While comprehensive data is lacking, surveys indicate that effective regulation assists in improving the delivery of infrastructure services. In particular, service delivery has generally improved and suffered from less interruptions where regulators have stimulated more commercial discipline (through for example tariff reform, improved collection rates and private sector investment) in the provision of services. Furthermore, although each country's infrastructure environment differ (and regulatory models hence need to adapt to local conditions), overall experience points to the importance of establishing a sound regulatory framework before commercialising or privatising utilities. Better regulation has promoted private investment overall and private investments have encouraged higher collection rates, prevented arrears and ensured adequate revenue flows. The impact of private ownership on service performance depends largely on the degree of competition. Experience suggests that is important to address the overall market structure already from the outset.

66. Greater incentive for infrastructure reform has recently been created by the renewed attention of the international development community to this area. The most important incentives are clearly those following from EU accession criteria, covering energy, telecommunications, transport, water and waste water. The eight new EU members are consequently the most advanced in this regard, followed by the three EU candidate countries (Bulgaria, Croatia and Romania) as well as the Russian Federation and the Kyrgyz Republic. Reforms in railways, telecommunications and water sectors are advancing in south- eastern Europe and the CIS, but do not yet match reform achievements in Central Europe and the Baltics [39].

67. Many transition countries have turned to private sector participation (PSP) to ensure adequate funds in order to cover the great investment needs for the rehabilitation, upgrading and extension of infrastructure networks. Countries have promoted PSP for other reasons as well, including revenue raising and improvement of operating performance. While the consequences of PSP are not very well known (due to limited data), the programme does assist in commercialising services, increasing productivity and, in some cases (particularly telecommunications), improving access to finance. (Investors' expectations are not always, however, met as returns at times are modest when seen in relation to the initial capital). It has also assisted in the introduction of new management, seeking to balance financial management with attention to customer service. The current trend is for PSP to move away from pure asset sales to more concessions and management contracts.

[39] The regulatory and competitive situation varies by sector. In telecommunications, technological development has encouraged competition, although there is still a clear need for regulation in all transition countries. With regard to the power sector, low tariff levels and high payment arrears remain a serious problem in most countries. In the water sector, performance varies and regulatory functions are commonly undertaken at municipal levels. Finally, with regard to railways, most countries have followed a model of separating actual infrastructure from operations and regulatory bodies are much needed in order to assure fair access.

68. The degree of PSP varies greatly between sectors. Telecommunications in particular have attracted most PSP interest (mostly foreign)[40], followed by urban transport and, to a smaller degree (mostly in the new EU members), the power sector (mainly electricity and gas). With regard to municipal utilities (including water), the primary role of the private sector has been to promote commercialisation through management and operational improvements.

69. PSP has been most intense in the EU accession and candidate countries. Most investment has come from western European utilities, although transition region investors and small local investors are becoming increasingly important. In fact, small, locally owned companies already dominate PSP in municipal services (water supply, heating, urban transport and waste collection). Such investors are likely to grow (in both size and expertise) and are expected to remain important PSP infrastructure players.

70. Issues of importance for the future of infrastructure networks and services in the transition countries include market size (for smaller countries regional coordination can offer considerable possibilities)[41], tariff levels, administrative and technical capacity, as well as the power of vested interest and broader political considerations, as the EBRD puts it.

4. EBRD ANNUAL MEETING

71. In May 2005 the EBRD held its 14th Annual Meeting in Belgrade, the capital of Serbia and Montenegro. The event signified a milestone in the history of the Bank, in the sense that eight of its countries operations are now among the ten new members which joined the European Union in 2004. No doubt the work of the EBRD has contributed to the establishment of strong democratic institutions in these countries and the kind of market economy that form the necessary criteria for EU membership. The Annual meeting welcomed not only the strong performance of the Bank in 2004 but also its flexibility and openness to change. EBRD President Jean Lemierre argued that, because the times and needs are changing, "the EBRD, too, must change, and this even faster than ... [its] countries of operations".

72. Given the EU enlargement, it is only natural that the EBRD should now be shifting its focus to the less developed countries in south-eastern Europe, and eastwards to countries of the former Soviet Union. Indeed, the American representative, Mr Randal Quarles, demanded that the EBRD withdraw completely from the new EU member states in two to three years, in order to concentrate entirely on these regions. This proposal was, for understandable reasons, not received with the greatest enthusiasm by either the new EU member states concerned or the EU (which is a member of the EBRD in its own right), but the general trend eastwards and southeastwards is nevertheless clearly visible.

73. The need for good urban planning – essential also for providing a quality investment environment, including in infrastructure – was highlighted at the roundtable of mayors during the Annual Meeting. The EBRD's contribution so far to regional infrastructure projects and policy dialogue has encouraged countries, especially in south-eastern Europe, to work closer together thus enabling to speed up regional exchanges and to enhance competitiveness. Whilst much of the post-war reconstruction in the Balkans is now over and the economic growth is reassuring, investors often still have to wrestle with unnecessary bureaucracy, petty corruption, legal voids, a plethora of bilateral free trade agreements (28 at present) and pronounced agricultural protectionism. As the former Italian Prime Minister Giuliano Amato, who currently chairs the International Commission on the Balkans, said "the key to economic growth for the region is the prospect of joining the EU" and "EU membership is the main hope for stability in the Balkans". He at the same time cautioned that the otherwise welcome and necessary presence of the international community in Bosnia and Herzegovina and Kosovo should not be allowed to take on any patronising character which could easily be interpreted as a 'colonising' presence.

74. Mr Lemierre, in his presentation to the Annual Meeting, rightly raised a number of hope-inspiring recent developments. These include the strengthened reform will under new governments in Georgia and Ukraine. Mr Lemierre saw further hopeful signs in Kazakhstan and Moldova, where the heritage of central

[40] The telecommunications sector can however be considered a special case since there seems to be a great willingness on part of consumers to pay for services as well as a high rate of technological innovation that reduces costs.

[41] For example, energy sector reform in South Eastern Europe is very much motivated by the objective of a regional energy market.

planning is now giving way to more open economic systems. By contrast, the EBRD is still very much limiting its activities in Belarus, Turkmenistan and Uzbekistan due to the prevailing political situation in those countries. Thus, activities in Belarus are restricted to the private sector, while only small enterprises are assisted in Turkmenistan. In Uzbekistan activities are already very modest. On the other hand, the EBRD would become more involved in Mongolia against the background of new reform mindedness in that country.

75. Tendencies already noted in the present report were confirmed at the Belgrade Meeting. Thus, the projects being financed are increasingly small scale, something which implies greater care in preparation and follow-up. Mid-sized companies will still be assisted to permit them break out of their local environment and develop internationally tradable goods and services. The EBRD will also increasingly try to further accompanying investments from abroad, by building regional capital markets, competitive banking sectors and the development of new financial instruments. Innovations in the energy sector will also be stimulated.

76. Mr Karl-Heinz Grasser, the Austrian Minister of Finance and current Chairman of the Governing Council of the EBRD drew a cautionary note in pointing out, however, that such new undertakings will also involve higher risks and project costs, which could have a negative influence on the Bank's present, impressive profit level. Mr Grasser therefore called on the Bank to engage in very careful risk-management in the years to come. At the same time he asked member countries to supply the EBRD with more resources and greater co-financing opportunities.

77. In a way, the challenges for the EBRD are no less daunting than those at the time of the Bank's creation some fifteen years ago. It is for our Parliamentary Assembly closely to follow how the Bank meets them and adjusts its *modus operandi* - such as in laying greater emphasis on equity investment and smaller projects, including in local currencies, or in shifting its geographical emphasis south and east (without therefore walking away from obligations further to the west).

5. CHALLENGES AND PROSPECTS

78. The EBRD's gradually shifting focus on its eastern and southern countries of operations is very welcome, for it is there that the need for support to continued reforms and new investment is the greatest. This shift towards more assistance to the early and intermediate transition countries - in central Asia, eastern Europe, the Caucasus and south-eastern Europe - implies increased risk-taking and as a result reduced profits. However, the Bank's solid financial standing and performance beyond the beginning-of-the-year targets provide sufficient margin in this regard.

79. The success of advanced transition countries in joining the EU in 2004 sets a remarkable example for other transition countries to proceed along the path of European integration. The ever closer ties that link EU and non-EU countries in partnerships for political and macro-economic stability and legal co-operation provide the EBRD with additional opportunities to expand its operations in countries where its involvement can make the greatest impact. In order to bridge the gap in living standards and capital availability among European countries and regions, country-specific measures are essential to increase access to capital, reduce the size of the informal sector, improve the investment climate and facilitate trade. It is this way that the EBRD's country profiles and strategies come to the best use.

80. A 2004 EBRD study highlights the role of infrastructure for enterprise development, economic growth and social welfare, and points to the still substantial investment needs in that domain in the transition countries. Although experiences with the participation of the private sector in infrastructure development have varied across Europe, in many countries private investors are increasingly important contributors for the pooling of resources to permit infrastructure improvements, for stimulating competition and boosting the efficiency of infrastructure services. The EBRD's work in helping transition countries put in place independent and accountable regulatory systems in order to balance the interests of different stakeholders has been particularly useful.

81. Fifteen years of reform have produced impressive, though admittedly uneven, results across the 27 transition countries. Those that demonstrated the strongest commitment to reforms from the start have on the whole also been helped most by foreign partners – prominent among them the EBRD – to enter a virtuous circle of growth and increased resources which in turn have permitted more reform. It is now time for

countries which for one reason or another have moved slower along this path to try harder, and for the EBRD and its partner institutions to give them all the support they need. The central, eastern and south-eastern Europe in which the EBRD operates today is a very different, and immeasurably better-off, place than the one that was there when the Bank started its work in the early 1990s – and this also very much holds for the Rapporteur's own country Russia. The EBRD can be proud of its major contribution to this state of affairs. However, it speaks very much to the Bank's advantage that what it feels – and this came out loud and clear during the Rapporteur's and the Economic Committee's talks with it in January – is not so much pride as a determination to now see the job through, in tackling ever more persistently the problems in the less well-to-do among its countries of operations.

Appendix *:

EBRD commitments by country

Country	2004 Number of signed projects	2004 Commitments € million	2004 % of total EBRD investments	Cumulative Number of signed projects	Cumulative Commitments € million	Cumulative % of total EBRD investments
Albania	2	62.0	1.5	17	223.3	0.9
Armenia	1	5.3	0.1	7	88.1	0.3
Azerbaijan	6	213.6	5.2	22	458.6	1.8
Belarus	0	23.6	0.6	7	161.2	0.6
Bosnia and Herzegovina	3	97.6	2.4	17	348.6	1.4
Bulgaria	6	232.3	5.6	52	1,001.4	4.0
Croatia	3	98.5	2.4	54	1,310.0	5.2
Czech Republic	3	80.8	2.0	45	996.5	3.9
Estonia	1	22.6	0.5	44	467.6	1.8
FYR Macedonia	4	80.3	1.9	24	376.1	1.5
Georgia	2	77.5	1.9	21	242.6	1.0
Hungary	3	259.1	6.3	68	1,739.8	6.9
Kazakhstan	8	245.9	5.9	37	1,027.8	4.1
Kyrgyz Republic	2	29.6	0.7	16	144.7	0.6
Latvia	0	3.2	0.1	24	284.8	1.1
Lithuania	2	52.4	1.3	29	434.3	1.7
Moldova	2	11.8	0.3	22	157.4	0.6
Poland	8	292.9	7.1	136	3,063.6	12.1
Romania	13	401.1	9.7	87	2,531.4	10.0
Russia	37	1,238.5	30.0	210	5,874.7	23.2
Serbia and Montenegro	10	142.2	3.4	33	662.6	2.6
Slovak Republic	2	103.1	2.5	41	999.8	3.9
Slovenia	1	51.0	1.2	26	552.3	2.2
Tajikistan	2	6.7	0.2	7	29.2	0.1
Turkmenistan	0	0.1	0.0	5	117.0	0.5
Ukraine	7	267.4	6.5	64	1,519.2	6.0
Uzbekistan	3	34.0	0.8	24	509.5	2.0
	129	**4,133.1**	**100.0**	**1,140**	**25,322.3**	**100.0**

Note: Financing for regional projects has been allocated to the relevant countries. Table refers to projects signed, but not yet necessarily disbursed, by the EBRD. Project numbers do not add properly because of rounding; sub-projects signed under framework agreements are counted as fractional numbers.

* Table drawn up under the responsibility of the EBRD.

Reporting committee: Committee on Economic Affairs and Development.

Reference to committee: Standing mandate

Draft Resolution adopted by the Committee on 23 May 2005

Members of the committee: Mr Evgeni **Kirilov** (Chairperson), Mrs Antigoni Pericleous Papadopoulos (Vice-Chairperson), Mr Márton **Braun** (Vice-Chairperson), Mr Konstantinos **Vrettos** (Vice-Chairperson), MM. Ruhi **Açikgöz**, Ulrich Adam, Hans Ager, Miguel Anacoreta Correia, Abdülkadir **Ateş**, Radu-Mircea Berceanu, Akhmed Bilalov (alternate: Mr Nikolay **Tulaev**), Jaime Blanco, Patrick **Breen,** Milos Budin, Erol Aslan **Cebeci**, Mrs Ingrīda Circene, MM. Valeriu Cosarciuc, Ignacio Cosidó, Giovanni Crema, Øystein Djupedal, Ioannis Dragassakis, Iván Farkas (alternate: Mrs Edita **Angyalová**), Relu Fenechiu, Mrs Siv **Friđleifsdóttir**, Mr Carles Gasóliba, Ms Jane Griffiths, MM. Francis Grignon, Alfred Gusenbauer, Norbert **Haupert**, Anders G. Högmark (alternate: Mr Göran **Lindblad**), Klaus Werner **Jonas**, Ms Verica Kalanović, MM. Karen Karapetyan, Orest **Klympush**, Anatoliy **Korobeynikov**, Rudolf Kraus, Zoran Krstevski, Jean-Marie **Le Guen**, Harald Leibrecht, Rune Lund (alternate: Mr Jens Hald **Madsen**), Gadzhy Makhachev (alternate: Mrs Liudmila **Pirozhnikova**), Jean-Pierre Masseret (alternate: Mr Jean-François **Le Grand**), Miloš **Melčák**, Mrs Ljiljana Milićević, MM. Neven **Mimica**, Conny **Öhman**, Mart Opmann, Mrs Clara Pintat Rossell, MM. Bogdan **Podgórski**, Jakob **Presečnik**, Jeffrey Pullicino Orlando, Luigi Ramponi, Maurizio Rattini, Maximilian **Reimann**, Dario **Rivolta**, Lord Russell-Johnston (alternate: Baroness Gloria **Hooper**), MM. Volodymyr Rybak, Kimmo **Sasi**, Bernard Schreiner (alternate: Mr Michel **Hunault**), Samad Seyidov (alternate: Mr Aydin **Mirzazada**), Leonid Slutsky, Ms Geraldine Smith, Mrs Aynur Sofiyeva, MM. Christophe Spiliotis-Saquet, Dimitar **Stefanov**, Qazim Tepshi, Frans Timmermans, Dragan Todorović, Mrs Ágnes Vadai, Mr Luc **Van den Brande**, Mrs Jelleke **Veenendaal**, Mrs Birutė **Vėsaitė**, MM. Oldřich Vojíř, Varujan Vosganian (alternate: Mr Gheorghe **Mereută**), Robert **Walter**, Andrzej **Wielowieyski**, Marek Wikiński, Paul **Wille**, Mrs Rosmarie Zapfl-Helbling (alternate: Mr Johannes **Randegger**), Mr Kostyantyn Zhevago

NB: The names of the members who took part in the meeting are printed in **bold**

Head of Secretariat: Mr Torbiörn

Secretaries to the committee: Ms Ramanauskaite, Mr de Buyer