The European Investment Bank's activities in Central and Eastern Europe

The European Union is on the threshold of ever closer economic integration with the completion of the Single Market and the final stage of Economic and Monetary Union. When it has decided on its own reform to take it into the next millennium it is pledged to open negotiations with the countries of Central and Eastern Europe which have applied to join. These countries have a massive task to prepare themselves for membership. The European Investment Bank, the Union's long-term lending institution, has a major part to play in the process.

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Introduction

The European Investment Bank (EIB) is the European Union's long-term lending institution, set up in 1958 under the Treaty of Rome that established the European Community, now known as the European Union (EU). The principal mission of the Bank is to finance capital investment that furthers the balanced economic development and integration of its member states, in particular projects that help strengthen development in the economically less-favoured regions of the EU. However, the EU has long-standing historical, cultural, political and economic links with neighbouring regions and countries, including those in Central and Eastern Europe, as well as with other parts of the world, and the EIB's operations, which are concentrated in the Union, reflect this.

Over the years, the EU has developed a wide-ranging and active external development cooperation policy, which it calls on the EIB to help support. Accordingly, the Bank now participates in financing projects under the framework of this EU external relations policy in some 130 non-member countries.

In the coming millennium, the economic and political map of Europe will be radically transformed, with profound implications for the whole of continental Europe. The EU member states are now on the threshold of even greater economic integration with the completion of the Single Market, the implementation of Economic and Monetary Union and the introduction of a single currency. At the same time, market reforms and privatisation are proceeding rapidly in most countries of Central and Eastern Europe, as well as in the Mediterranean region.

Once the EU member states have settled the outline for the future evolution of the Union after the conclusion of the Intergovernmental Conference (IGC) this year, they are pledged to begin detailed discussions with neighbouring states in Central and Eastern Europe on their accession to the EU. One of the key issues to be considered by the IGC is reform of the institutional and decision-making procedures to enable the Union to absorb further enlargement.

Historical background

Following the political upheavals in Central and Eastern Europe at the end of 1989, the EU drew up a programme to assist countries in the region that were moving towards market economies and setting up democratic institutions. As in other regions receiving financial aid from the EU, the support strategy was prepared in close cooperation between the European Commission and the EIB.

Within a few months, the European Commission had put together the grant aid programme 'PHARE' , initially for assistance in Poland and Hungary, but soon extended to other countries in the region. PHARE funds are focused on technical assistance for the transformation towards market economies and the introduction of democratic procedures. At the same time the international community established the European Bank for Reconstruction and Development (EBRD), with its headquarters in London. The EBRD is active not just in the Central and Eastern European states but also in Russia and the other members of the Commonwealth of Independent States (CIS). The EIB played an important role in helping the EBRD's initial establishment, providing technical assistance in its start-up phase, and is a 3% shareholder, with a member on its Board of Directors. The EIB's President is also a Governor of the EBRD.

Although the role of the EBRD and the PHARE programme are well known to the informed public, what is not so widely understood is the extensive scope of the EIB's role in Central and Eastern Europe. Since 1989, the EIB has committed substantial resources and know-how to help improve economic development in the region, drawing on its wide experience built up over nearly 40 years in financing projects. This experience has been gained under a wide variety of conditions, both inside the EU and in more difficult environments in non-EU states, where there are similar problems with modernising and improving weak economies and implementing reforms.

In November 1989, the EIB's Board of Governors gave its approval for the Bank to make loans of up to 1 billion ecus for investment projects in Poland and Hungary. The first operations effectively began in 1990. This package was increased in 1991 by 700 million ecus for projects in Bulgaria, the Czech Republic, Romania and Slovakia. In July 1993, the Governors approved the extension of this to the three Baltic states, Estonia, Latvia and Lithuania, plus 150 ecus for Slovenia under a separate Financial Protocol to extend road and rail networks. The EIB does not operate in Russia or in the other CIS countries where the EBRD, the World Bank, the EU through its 'TACIS' (technical assistance) programme and the International Monetary Fund are the key financial institutions contributing to the transition process.

By the end of 1993, the credit package of 1.7 billion ecus had been exhausted. The Governors then approved a new lending mandate for a further 3 billion ecus for the period 1994 to 1996 to cover EIB activity in ten of the countries in the region (excluding Slovenia). This was fully committed by the end of last year, and brings the total amount channelled by the EIB into investment in the region to nearly 5 billion ecus. Since the EIB only finances part of the cost of a project, these loans have gone towards capital investment of some 15 billion ecus. The EIB is now about to implement a new mandate for the period 1997 to end 1999, under which it will lend a further 3.5 billion ecus in the region.

Recent evolutions

The Central and Eastern European countries (CEEC – Albania, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) have committed themselves to particularly close relationships with the EU under 'European Agreements'. The full impact of these agreements is still being worked out. They provide for progressive steps towards the free movement of goods and services, removal of tariff and non-tariff barriers to trade, harmonisation of legislation, financial cooperation, etc. The long-term objective for most is eventually to become themselves members of the Union, and ten have already formally applied for membership (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia). One of the most important issues that now faces the EU will be how to integrate the CEEC into the framework of the Union. Developments in Central and Eastern Europe will therefore have a major impact on the process of European integration.

Economic development in the CEEC

Although progress in individual countries is still varied, the market reform process now under way in the CEEC has been remarkable and opens up huge potential for long-term economic development and business opportunities. The EU member states are already by far the most important trading partners, investors, creditors and donors of aid in the CEEC. Trade with the EU totalled nearly US$100 billion in 1995. Eastern Europe is an important destination for EU manufacturing investment, due to the privatisation process. From 1992 to 1994, EU companies invested 8.2 billion ecus in the region.

The stage appears to be set for a sustained period of investment-led growth. In 1995, there was once again solid general progress across the CEEC, with aggregate economic growth in the CEEC accelerating to 5.4% from 3.8% in 1994, including growth rates of 6–7% in Poland, Romania and Slovakia.

Inflation rates were considerably reduced in all the countries in 1995, except in Hungary where there was an acceleration as a consequence of indirect tax increases and devaluation of the currency. The Czech Republic, Slovakia, Slovenia and Albania were the first countries to reach single-digit rates, and inflation is expected to ease further in most of the CEEC in the course of 1997.

The region's integration into the global economy also continued and Hungary, Poland, the Czech Republic and Estonia in particular proved attractive to foreign investment. Further privatisation in 1996 should result in a continued strong flow of funds into these countries. In most of the larger economies, gross external debt ranges between 30% and 40% of GDP, whereas the smaller economies have low rates of 6% to 15% of GDP. This debt is not expected to pose a financing threat due to private capital inflows.

Most progress in privatisation occurred in Hungary, which is catching up with the Czech Republic in terms of the lowest share of state ownership. Considerable progress was also made in Poland where the privatisation process was broadly completed in 1995. The signs are that the privatisation movement also began to speed up in 1995 in the other CEEC.

The large capital inflows and the increased access to international capital markets reflected an improvement in the perceived creditworthiness of most countries in the region. The Czech Republic, Poland, Slovakia and Slovenia have been classified as investment grade, and Hungary has also received investment grade rating from two of the main rating agencies. The circle of transition countries with access to the international capital markets has therefore widened considerably. Indeed, in 1996 the EIB was able to make its own debut in the Eastern European markets with two Czech Koruna issues.

In general, progress on transition is being maintained, and in the strongest countries of the region prices and trade are being liberalised and currency convertibility for current transactions is being established The tax systems are also moving closer towards the EU format.

The CEEC still, however, have fragile banking sectors with low capital and large stocks of non-performing loans. Improving the banking sector will be a significant issue for ensuring economic and financial stability. Bulgaria has experienced particularly severe problems. The implementation of the European Agreements should have a considerable effect on the performance and structure of the financial sectors in the CEEC, as their legislation begins to be aligned with that of the EU, including the implementation of prudential, non-discriminatory regulations for financial institutions.

Overall, however, economic development in the CEEC still has a long way to go to catch up with present EU members in terms of per capita income and productivity levels.

The role of the EIB

As the bank of the EU, the main focus of the EIB's activity is within the EU. As already mentioned, its prime aim is to support investment in the Union's regional development areas, which accounts for over two-thirds of its lending – mainly Greece, Spain, Ireland, Portugal, as well as southern Italy and eastern Germany.

The EIB also finances major infrastructure investment of European interest, in particular projects improving and developing the Trans-European Networks (TENs) of transport, telecommunications and energy, not only within the Union, but also those outside strengthening links with neighbouring regions, in particular in the CEEC. Projects designed to protect the environment and quality of life, and to ensure secure and efficient energy supplies are also supported; and a significant proportion of the Bank's financing is directed at investment aimed at improving industrial international competitiveness and its integration at a European level, as well as the activities of small and medium-sized enterprises.

The EIB's capital of 62 billion ecus is subscribed by the EU member states and, with a gearing ratio of 2.5 times this capital (compared to the 1:1 ratio of the World Bank and most of the other international development banks), the upper ceiling on outstanding loans is 155 billion ecus. At the end of 1996, the total outstanding came to nearly 130 billion ecus, giving the Bank still plenty of headroom for new operations

In practice the EIB is largely self-financing. The paid in or due to be paid in capital amounts to only 7.5% of the subscribed capital. The Bank thus finances itself through borrowing on capital markets worldwide. Last year, it raised 18.6 billion ecus in 22 currencies. It transformed these resources into loans, mainly for investment within the Union.

Out of a total 23.2 billion ecus advanced in 1996, it lent 20.9 billion ecus inside the Union and 2.3 billion ecus for projects in non-member countries, including 1 billion ecus in the CEEC, an all-time annual high. In terms of its lending and funding operations, the EIB is substantially the largest of the international financing institutions. Nevertheless, with a staff of around 900, the Bank has remained an extremely 'lean' organisation.

The EIB finances sound projects in both public and private sectors. Indeed, well over half of its loan portfolio is in the private sector, without any state guarantee. All projects it considers are rigorously appraised to ensure the investment's technical and economic viability and its environmental and financial justification. These appraisals are carried out by the Bank's own engineers, economists and financial officers.

The EIB cooperates closely with corporate enterprises, major organisations (including the other international financing institutions) and with banks. On capital markets, the EIB's bonds have consistently been given an excellent AAA rating. Working on a non-profit basis, the Bank is thus able to raise funds at the finest rates available, and to pass them on to project sponsors at rates close to the cost of its borrowing. In the CEEC, the EIB finances investment on the same conditions as in the EU member states, transferring the benefits of its AAA credit standing to borrowers in the region.

The Bank specialises as a provider of long-term funds, ranging from 5 to 12 years for industry and up to 20 or more years for infrastructure, depending on the assets being financed. Interest rates are set for each of the currencies borrowed. Loans are normally at fixed rates, though floating and fixed/floating variations are also possible, and may be disbursed in either a combination of different currencies, or in a single currency, depending on borrowers' preferences and the EIB's holdings. The EIB requires that loans are backed by a guarantee or other adequate security, either from the state concerned, or in the private sector from a bank or banking syndicate, a financial institution or large internationally diversified parent company. Exceptionally, the Bank may take as security an assignment of secure long-term project revenues.

In effect the EIB's role is that of a catalyst in helping to mobilise complementary finance required in complex financing packages. Acting as a supplementary source of funds, it can provide up to a maximum 50% of the capital cost of an investment project. On average it tends to lend about a third of the project cost.

EIB activity in the CEEC

EIB lending in Central and Eastern Europe falls within the scope of specific mandates given to the EIB for lending outside the Union, which are approved by the Bank's Board of Governors. The Bank's activities in the region are focused on preparing the countries' economies for membership of the Union, much as the Bank did in the past in Greece, Portugal and Spain. The EIB's emphasis in the region tends, therefore, to be focused on the integration of infrastructure within the CEEC as a region, as well as with that of the EU. When it comes to selecting projects, the Bank is guided by both each country's priorities and those of the EU.

These priorities are increasingly coinciding, particularly in the area of infrastructure and the creation of pan-European transport, telecommunications and energy transfer networks. The needs of the countries vary, and as the transition to market economies proceeds, the priorities will shift – for example from rehabilitation of basic infrastructure, restructuring of state industry and creating an indigenous banking system, to developing domestic capital markets and providing and encouraging equity participation, and thus strengthening under-capitalised companies in the private sector.

Institutional cooperation

The investment needs of the CEEC are still huge. Coordination between the EIB and other sources of finance, such as the World Bank, the EBRD and EU budgetary aid, is therefore essential. The EIB frequently provides finance on a joint basis with these bodies, as well as with other public and private financing institutions.

The EIB works particularly closely with the European Commission. Consultation begins at a very early stage with the Commission to coordinate the Bank's contribution to the 'EU support package', which evolves during country and sector reviews, and extends to specific project discussions. The aim is to maximise possible synergies between EIB lending and the grant aid activities of the PHARE programme. PHARE funds are mainly oriented towards technical assistance, but are also available for financing feasibility studies and other pre-investment expenses.

More recently, the PHARE programme has been able to devote up to 25% of its grant aid towards co-financing infrastructure projects supported by international financial institutions. In several cases, PHARE co-financing with the EIB has been a particularly important factor as a catalyst to secure project implementation. Examples of such EIB–PHARE cooperation include the modernisation of the Berlin–Warsaw–Minsk–Moscow rail line and the upgrading of the Wroclaw–Gliwice section of the A4 motorway in Poland. The PHARE programme has recently been reoriented into a multi-annual rolling programme, with at the moment some 400 million ecus per year to be drawn on from EU budgetary resources.

The EIB also cooperates closely with the EBRD and the World Bank to maximise the effects of their financing in the region. An important distinction between the EIB and the EBRD is that the latter is obliged by its statute to lend at least 60% of its finance to the private sector. The EIB is not covered by such restrictions, though in practice about two-thirds of its lending goes towards public infrastructure projects in the CEEC.

The overall breakdown of EIB lending in Central and Eastern Europe since 1990 is: 1.4 billion ecus in Poland, 992 million ecus in the Czech Republic, 872 million ecus in Hungary, 475 million ecus in Romania, 353 million ecus in Slovakia, 286 million ecus in Bulgaria, 150 ecus in Slovenia, 101 million ecus in Lithuania, 68 million ecus in Estonia, 46 million ecus in Albania and 31 million ecus in Latvia.

Transport and the Trans-European Networks (TENs)

Investment in infrastructure, particularly for transport, will play a crucial role in the future development of the CEEC. Although a basic communications infrastructure exists, it requires widespread modernisation to remove barriers to the flow of trade and to help prepare applicant countries integrate their economies with the EU. Until 1989, the Iron Curtain had not just divided Europe ideologically, but also physically, with east–west links being extremely underdeveloped.

A top EIB priority, therefore, is to support the upgrading and improvement of the region's communications and energy transfer systems, with a particular emphasis on development of pan-European networks. This forms part of the Bank's key objective to develop the Trans-European Networks (TENs) of transport, telecommunications and energy infrastructure within the EU. The European Council meeting in Essen, in December 1994, adopted a list of key TENs transport and energy schemes, some of which will also improve connections with Central and Eastern Europe. These largely coincide with the nine priority transport corridors identified by the Pan-European Conference of Transport Ministers in Crete in March 1994.

To date, the EIB has lent nearly 1.9 billion ecus for transport infrastructure investment in the CEEC, including projects along all these road/rail corridors extending or improving access to the EU's TENs.

Examples include the Dresden–Kiev motorway, the E20 Berlin–Warsaw–Minsk–Moscow railway, the Czech section of the Berlin–Prague–Vienna railway, rehabilitation of the Wroclaw–Opole motorway and construction of a new motorway from Opole to Gliwice in Poland, modernising the most important east–west stretches of the railway network and building of the Ljubljana–Celje motorway in Slovenia, upgrading parts of the Via Baltica in Lithuania and numerous road projects in Hungary, Bulgaria, Romania and the Slovak Republic, many of them of direct importance for transit traffic from and to the EU.

Considerable efforts have also gone towards strengthening air transport facilities, in particular for the modernisation of air traffic control systems in Bulgaria, Estonia, Hungary, Romania and Slovakia. Works to upgrade facilities and extend Vilnius International Airport in Lithuania and Warsaw Airport in Poland have also been financed. Such investment helps maintain safety standards and integrate these countries' systems into the European Air Travel Services system in participation with Eurocontrol.

Major development of sea ports to improve ferry connections and container handling facilities, as well as their modernisation and expansion, have been supported in Albania, Estonia, Lithuania and Romania. Many of these projects form key links in improvement of the TENs.

The EIB has also been a strong supporter of telecommunications development in the region, as a vital support for business development. So far the Bank has advanced 875 million ecus for the modernisation and expansion of the telephone networks in Bulgaria, the Czech Republic, Hungary, Lithuania, Poland, Romania and Slovakia. A particular focus was given to investment for interconnecting networks and to ensuring compatibility with EU and international telecommunications systems.

Private–Public partnerships

Overall, huge resources are required for modernising the region's infrastructure that has suffered from decades of neglect and bad management. It is estimated, for example, that improving the region's nine key Pan-European road/rail corridors will require in the order of 25–30 billion ecus in new investment. As the countries in the region are facing substantial budget deficits, they must not only seek support from multilateral financing bodies such as the EIB and World Bank, but also explore ways of attracting funds from the private sector for infrastructure financing.

It is relatively easy to attract private sector involvement in projects in the telecommunications and energy sectors, which have short pay-off periods and are therefore more easily financed by established capital markets. Attracting private finance is more difficult in the transport sector, where there are the conflicting needs of the state to provide low cost universal services and of private capital to gain an adequate return.

The special characteristics of large-scale transport infrastructure include substantial externalities such as growth advantages, environmental improvements or public service responsibilities, which cannot easily be factored into a cost–benefit analysis because monetary flows either do not arise or cannot be identified. There is also the associated problem of arriving at market prices, due partly to the distortions that exist between different modes of transport and operators, particularly between road and rail, and – given the low per capita income – the difficulty of making users pay for such infrastructure.

Another typical feature is the very long-term commitment of capital and lengthy depreciation periods, as well as protracted and laborious planning and approval procedures, coupled with long construction periods. In the majority of cases, cash flow streams develop only gradually. The consequence is low financial return, although the economic return may be satisfactory. It is not surprising, therefore, that priority transport projects in Central and Eastern Europe have so far only advanced at a sluggish pace.

The state's responsibilities

As in the EU, experience shows that the state cannot expect to be fully replaced by the private sector. A strong public sector commitment is essential to attract and give confidence to private investment. It is important that public funds are deployed so as to maximise their leverage in mobilising private capital. The creation of an appropriate legal and economic framework is essential, including the duty to regulate and supervise the natural monopolies. Cross-border initiatives, which will be crucial for long-term development, must also remain the responsibility of governments, in setting priorities and overcoming administrative and other obstacles.

Fundamental to public/private partnerships is the sharing of risk, particularly in respect of investment in infrastructure. In general, the private sector is best at carrying the financial, design and construction-related, operating and market risks. In turn, the public sector should assume the political, legislative and planning risks.

In reality such demarcation lines are not always clear-cut, particularly in the case of transport projects, where risks such as market trends can be influenced by the state, e.g. through fuel taxes impacting motorway toll revenues. Solutions to public/private partnerships, particularly for large-scale TENs type transport projects, require a case-by-case approach, with a commitment by the state to create a modern infrastructure system. Public/private partnerships are a growing trend in both the EU and the CEEC. The proportion of non-sovereign projects in some CEEC is already around 30% and is set to rise further as the legal and investment framework becomes more conducive to such investment.

Energy and industry

In the energy sector, the EIB has financed investment to help urgently needed restructuring and modernisation to bring about a better balance in the use of energy resources. Funds have been targeted at projects to improve generation capacity utilisation, including the rehabilitation and upgrading of coal-fired power stations, and investment in more rational energy use. Such investment has benefited the environment through the introduction of anti-pollution facilities, the retirement of obsolete and polluting plant, and the more efficient use of remaining capacity. This has been coupled with investment to rehabilitate and expand power transmission networks, improve the gas supply and distribution networks, and modernise district heating schemes.

The Bank has also financed investment for the construction of new international oil and gas pipelines bringing supplies from Russia through the CEEC region into the EU. These pipelines form part of the larger energy transfer TENs. So far the Bank has lent a total of over 1 billion ecus for energy projects in all the CEEC.

Since 1990, some 890 million ecus has also been advanced by the EIB for projects in the industrial sector, particularly for small and medium-sized enterprises (SME). Such projects frequently involve direct investment in joint ventures by EU firms. The largest industrial projects have concerned automobile assembly, glass works, consumer electronics, wood processing, agro-industry and tourism. Most were financed through EIB global loans – in effect EIB lines of credit – arranged with local banks in all the CEEC which are on-lent to small and medium-sized companies, but also for small-scale infrastructure, environmental and energy schemes.

These global loans make it possible for the EIB to combine its financial strengths with the operational contacts and knowledge of local conditions and national priorities of domestic banking and financing institutions. The local bank carries out the selection, assessment and monitoring of the SME investment. Before making such financing arrangements, the EIB ensures that the local institution possesses the necessary technical and practical experience for on-lending EIB funds according to its operational criteria. Many of the EIB's global loan partners in CEEC are institutions in which EU interests hold shares.

Protecting the environment

The EIB attaches special priority to environmental protection projects. Before making a loan decision, the EIB carries out a detailed environmental impact assessment of each project it considers financing directly. The environmental situation in the CEEC is characterised by high levels of pollution resulting from inefficient use of resources, a lack of abatement technologies and an absence of sufficient institutional and legislative support for control. As mentioned, many projects being financed by the Bank in the transport, industrial and especially the energy sector have a direct environmental benefit by reducing pollution.

However, the EIB also finances projects designed directly to benefit the environment in the CEEC. These include funding of a major waste-water treatment plant for Warsaw, and the rehabilitation of water and waste water systems in Riga. At an international level, the EIB is also participating in regional initiatives, laying out a more strategic approach to the CEEC's environmental problems, such as the Baltic Sea Joint Comprehensive Action Programme and the programmes for rehabilitation and protection of the Danube and Elbe river basins.

Conclusion

Lending in the CEEC has become the most important of the EIB's external operations, accounting for 50% of its non-EU lending last year. The size of the EIB's loan portfolio in the CEEC makes the EIB one of the largest single sources of financing in the sectors in which it operates.

EIB lending is highest in those countries that have moved furthest in preparation for accession – accounting for over 70% of its lending in the region. EIB financing inevitably tends to be heaviest in those countries with the highest absorption capacity – those best able to cope with human and financial constraints. In terms of financial commitments these countries also have the better records regarding project implementation and completion.

Political and social developments, as well as economic integration, are moving forward very rapidly in the region. The EU's pre-accession strategy places as much emphasis on building a sound dialogue on political and legal integration as on economic. In the near future, the EU and a number of the CEEC will begin detailed discussions on accession to the Union, to the extent that candidates can satisfy the required economic and political conditions.

At the same time, until the end of 1999, the EIB will implement a new mandate to strengthen support for the integration process. In addition, the EIB has been asked by the European Council to expand its lending in the region further with a new substantial pre-accession facility to help prepare the economies of the successful applicants for integration in the EU. The EIB will bring forward proposals for this later in the year.

The European Investment Bank is a key contributor to the EU's financial and technical cooperation with the CEEC. Expansion of the Bank's activities in the region is a crucial part of the EU's drive to build closer ties with countries in Central and Eastern Europe and to create a wider and more integrated area for European economic cooperation.