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European Bank for Reconstruction and Development: focus on eastern and south-eastern Europe

Report
Committee on Economic Affairs and Development
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Summary

In line with the decisions taken at its 2006 Annual Meeting, the European Bank for Reconstruction and Development (EBRD) is redeploying its main activities to the east and south-east of the European Union. It is thus concentrating on countries with huge development potential and rapidly growing economies but also a more complex political profile and riskier business environment. The report explores how the EBRD has so far operated this major strategic shift by focusing on the reform process in the Caucasus, South-Eastern Europe, the Russian Federation, Moldova and Ukraine.

Assisting in the creation of sound financial sectors to underpin economic growth, competition and the needs of entrepreneurs and households in its client countries (the EBRD's 29 "countries of operations") has been a key priority for the Bank. Overall, the financial sectors have undergone extraordinary change, driven by institutional improvements, privatisations and foreign banks entering local markets. Despite this progress, access to finance still represents a major obstacle for business development, especially in the regions and in terms of variety and quality of services offered.

The report notes that the EBRD's pioneering investment and development effort has been sustained while preserving a healthy risk-commitment-result balance, frequently exceeding the Bank's strategic objectives and expectations. Large profits for the past two years will allow the Bank to expand its risk-taking capacity and support for activities where funds are lacking, notably with regard to costly infrastructure projects with lengthy payback periods, wide-ranging technical assistance for project preparation, energy sector restructuring and municipal services.

Contents **Page**

A. Draft resolution 3
B. Explanatory memorandum, by Mr Gasòliba i Böhm 5
1. Introduction 5
2. Background and general overview 5
3. Finance in transition and reforms 8
3.1. Banking sector trends 9
3.2. Private equity 10
3.3. Remittances as a source of finance for small enterprise creation and micro-investment 11
3.4. Corporate responsibility and sustainable development 11
4. The reform process in the South Caucasus 13
5. Prospects for regional integration and development in South-Eastern Europe 14
6. An update on EBRD's work in the Russian Federation, Ukraine and Moldova 15
6.1. Russian Federation 15
6.2. Ukraine 16
6.3. Moldova 17
7. Prospects and challenges 17
Appendix 19

A. Draft resolution

1. The Parliamentary Assembly appreciates the ongoing dialogue with the European Bank for Reconstruction and Development (EBRD) under the 1992 Agreement of Co-operation between the Council of Europe and the EBRD as a valuable means of considering the economic, political and social aspects of the Bank's work and presenting parliamentary views on the challenges for the Bank's action in its 29 countries of operations spread from central Europe to Central Asia. The Assembly recalls that the Council of Europe member and observer states are among the core donor or recipient countries, whereas five countries of Central Asia, where the EBRD is increasingly involved, as well as Belarus, are part of the Council of Europe's close neighbourhood.

2. The Assembly has examined the EBRD's performance over the past several years and views the Bank as a very successful financial institution faithful to its mission as a development bank with a political dimension. A strong commitment to promoting market-oriented economies, good corporate governance and entrepreneurial spirit in central and eastern Europe has earned the EBRD a firm reputation as the leading institutional investor with unique expertise of the region. Although the Bank is now gradually disengaging from central Europe, its steady policy dialogue with partner governments and market operators continues to play the role of catalyst for continued reforms throughout all countries of operations.

3. Following the decisions of its 2006 Annual Meeting, the EBRD will gradually shift the bulk of its operations east and south-east of the European Union thus leaving its new member states by 2010 (except for Bulgaria and Romania) and concentrating on countries with a more complex political profile, riskier business environment and rapidly expanding economies. Despite impressive growth in the region, averaging 6.9% in 2006, the gap between the so-called "early transition countries" and more mature economies is growing as a result of a slowdown in reforms across most of the former group of countries. This represents a structural challenge for the EBRD's work and calls for more detailed short-term planning, enhanced field presence and local reach, more diversified financing offers, closer co-operation with other international financial institutions, project associates and local partners, as well as increased vigilance regarding the integrity of clients.

4. The Russian Federation is and will remain the largest beneficiary of EBRD's funding. Its share in the Bank's annual business volume was 38% in 2006 and is projected to grow further approaching half of all EBRD new lending in 2007. This strengthening participation is a sign of improving investor confidence in the Russian economy and will hopefully pave the way for increased foreign investment across all regions and economic sectors. The Assembly recalls its Resolution 1523 (2006) on Europe's interest in the continued economic development of the Russian Federation and reiterates its support for the action plan set out therein. It trusts that the EBRD will assist the Russian Federation in overcoming its excessive dependence on natural resources, improving corporate governance, modernising infrastructure, promoting financial intermediation, especially in favour of SMEs and regional development, and better exploiting scientific and technological potential.

5. The South Caucasus region (Armenia, Azerbaijan and Georgia) has enjoyed sustained growth in recent years and made steady progress towards completing the first phase of economic reform, despite persisting political tensions, but lags behind other EBRD client countries in terms of overall development. Weaknesses in democratic institutions and the rule of law, corruption allegations, corporate governance problems and deficiencies in infrastructure, competition policy and financial markets are cause for concern throughout the region. The Assembly strongly encourages the EBRD to intensify further its work in these countries and facilitate regional co-operation, notably under the Early Transition Country Initiative, thereby contributing to political and macroeconomic stabilisation of the region.

6. The Assembly welcomes the involvement of the Council of Europe and the EBRD, together with other international organisations, in the Kyiv Initiative Regional Programme designed to promote a democratic and participative society by contributing to sustainable cultural, social and economic development in Armenia, Azerbaijan, Georgia, Moldova and Ukraine. It believes that more such co-operation initiatives will be identified in the future, not least in the light of the recent signature by the EBRD of a memorandum of understanding with the European Investment Bank (EIB) and the European Commission with a view to facilitating joint projects in eastern Europe, the Southern Caucasus, the Russian Federation and Central Asia, under the European Union's European Neighbourhood Policy and other bilateral partnership programmes.

7. The Stability Pact for South Eastern Europe has stimulated the revival and dynamism of the region's economies. It has nurtured stability, regional co-operation and common approaches to many challenges, including organised crime and corruption, as well as assisting in the creation and consolidation of a regional electricity market and free trade area. As the Stability Pact is undergoing transformation into a regional co-

operation council that should foster the implementation of regional projects, the EBRD should remain a major actor in the change and in boosting private entrepreneurship, not least through its Western Balkans Initiative launched in May 2006, as well as the TurnAround Management and Business Advisory Services programmes (TAM/BAS).

8. The EBRD studies and expert estimates show that a third of GDP in most transition countries is generated by the informal economy. This anomaly signals imbalances in taxation systems, social security contribution levels, overly complex regulatory frameworks and a lack of employment opportunities in the formal sector, especially in rural areas. The EBRD should pay special attention to screening the integrity of its clients and partners, strengthen project monitoring and use its authority among policy makers in order to seek the rebalancing of business regulation, taxes, minimum wages, social benefit levels and incentives for the creation of high-skilled jobs with a view to diminishing the informal activities.

9. Healthy financial systems are essential for feeding growth and development in the transition countries. Their extraordinary transformation, driven by wide institutional improvements, privatisations and competition from foreign entrants, has mobilised substantial domestic and foreign resources towards enterprise creation, strengthening private ownership and structural reforms. However, many smaller firms, especially in the CIS countries, still do not have access to the formal financial system; the proportion of nonperforming loans, peaking at 15% in the CIS, remains to be lowered to the average level of mature economies; and the range of financial services and products needs to be broadened. The EBRD should seize large untapped opportunities in this domain while contributing to continued improvements in the regulatory framework and business environment, promoting corporate responsibility and minimising entrepreneurs' reliance on informal financing.

10. One of the most pertinent development challenges in central and eastern Europe is the need to enhance the efficiency of energy use in order to ensure greater competitiveness of local enterprises, reduce greenhouse emissions as economies expand and improve energy security. The EBRD's special role in promoting energy efficiency in the region has been widely recognised by other international financial institutions. The Assembly, in this context, underlines the importance of the EBRD's 2006 Sustainable Energy Initiative, designed to more than double the Bank's investments in energy efficiency and cleaner technologies over the next three years. Accordingly, the Bank will invest about €1.5 billion over the 2006-2008 period while supplementary donor support could reach around €100 million. This is in addition to multiple industrial energy efficiency projects, energy efficiency credit lines and support for renewable energy facilities, district heating projects and urban transport system modernisation programmes that the Bank has financed since 2001, as well as the management of the international community's nuclear safety funds for central and eastern Europe.

11. The Assembly, in conclusion, calls on the EBRD to:

11.1. keep strengthening its field presence in client countries, through the setting-up of new offices or reinforcing staff, as may be appropriate, especially in the regions of the Russian Federation and in other CIS countries;

11.2. diversify and customise its financing offers so as to include more loans in the local currency of its client countries and more micro-credit facilities;

11.3. continue its support for the financial sector of its client countries with a view to promoting high corporate responsibility and enhancing credit availability through the official institutions to both enterprises and households;

11.4. promote cross-border investment projects in the Southern Caucasus;

11.5. seek closer co-operation in the co-financing of projects with other international financial institutions, especially the World Bank, the International Finance Corporation, the European Investment Bank and the Asian Development Bank, as well as project associates such as the Investment Centre of the Food and Agriculture Organization of the United Nations and the Central European Initiative;

11.6. facilitate know-how transfer to the early and intermediate transition countries, especially with regard to environmental risk management, energy efficiency and quality tourism services, notably through its TAM/BAS programmes;

11.7. boost infrastructure investment through enhanced participation in public-private partnerships and lending to municipalities.

B. Explanatory memorandum, by Mr Gasòliba i Böhm

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 (one year after the Bank was set up) the Parliamentary Assembly has kept a close eye on the Bank's work in support of democratic and market-oriented changes, essentially in central and eastern Europe but also in Central Asia. In 15 years of activity the EBRD has accomplished a major part of its mission in central Europe and is now gradually shifting its focus to the east and south-east among its 29 countries of operations. Its major institutional partners and shareholders the European Union and the European Investment Bank – are taking over the EBRD's role in the new EU member states, thus enabling the EBRD to concentrate its resources and experience on the more needy countries.

2. The Assembly's Committee on Economic Affairs and Development highly values the annual exchanges of ideas on the social, political and economic aspects of the EBRD's work, which also gives the opportunity for elected representatives from the Council of Europe's 47 member states and observer countries (that are among key donor and recipient countries of the EBRD) to contribute their views and proposals for the Bank's future guidance.

3. This report seeks to provide a general overview of EBRD's activities to date, in particular since the Assembly's last report and debate in June 2006, and to examine selected areas of activity. It will thus look more closely at the development of financial systems in the Bank's countries of operations, and the progress of reforms in the Caucasus and South-Eastern Europe, as well as in the Russian Federation, Ukraine and Moldova. The rapporteur's work relies on various public and media sources, EBRDs publications and discussions with the Bank's officials. On behalf of the committee, the rapporteur wishes to thank the EBRD for hosting the committee's meeting at their headquarters in London last January and all the assistance kindly provided throughout the preparation of this report in the run-up to a debate in the Assembly in June 2007.

2. Background and general overview

4. We should recall that the EBRD's mission is to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the countries of central and eastern Europe and the Commonwealth of Independent States (CIS). Importantly, the EBRD is a development bank with a mandate that includes political aims: the Bank will in principle invest only in those countries that are committed to multiparty democracy, the rule of law and human rights. Although the Bank's shareholders are all public bodies (61 member countries represented by governments plus the European Union and the EIB), its prime attention is on the private sector even though some investments also concern the public sector, especially infrastructure, whether at national, regional or municipal level. The core business is to assist in the financing of projects that are deemed to be financially sound and to advance reforms, while respecting the environment. The EBRD remains the largest institutional investor in its countries of operations and has on the whole been very successful in reconciling the requirements of sound investment banking on the one hand and development banking on the other.

5. The EBRD has a subscribed capital base of €20 billion (consisting of €5 billion paid-in and €15 billion callable) and foresees no capital increase by 2010. However the Bank does not directly use the shareholders' capital to finance its investments. The mainstream of operations is financed from the funds raised on the international financial markets currently on very favourable terms since the EBRD enjoys a solid banking reputation reflected in its credit rating of AAA from Standard & Poor's and Aaa from Moody's. This also enables the Bank to structure its loan portfolio in a way that best matches the needs of its clients and minimises exchange rate and interest rate risks for its loans. Sound resource management and investment policies combined with a favourable situation in the Bank's operating environment generated particularly good financial results in 2005 and 2006 with profits soaring to record levels. In 2006, the EBRD's net profits for the year reached €2 389 million (compared with €1 525.6 million for 2005 – see Table 1 in the appendix for more details). However, the allocation of all profits for 2006 into reserves – as decided by the EBRD's Board of Governors in May 2007 – sparked a protest by the United States representative who argued that at least one part of the record returns should be paid out to shareholders in dividends.

6. The Bank thus seems well equipped to put into practice a major strategic shift in the focus of its operation towards eastern and south-eastern countries that would inevitably entail increased operational costs due to higher expenditure on project preparation, a larger number of smaller projects and very likely lower returns on investment in the short term. The EBRD nonetheless foresees an underlying base case annual

business volume of €3.9 billion in 2007 with a high transition impact and underlying base case disbursements of €2.8 billion. After 11 years of budgetary austerity (zero real growth budgets), the EBRD's budget is also set to increase by a cumulative 7% over 2006-07 and a total of 13% over five years to 2010.

7. The EBRD's operational priorities, adopted in 1999, include: 1. assisting in the creation of sound financial sectors linked to the needs of local enterprises and households; 2. shaping commercial policies and financial frameworks for infrastructure development; 3. assistance to business start-ups and small and medium-sized enterprises (SMEs); 4. underpinning the restructuring of ailing larger enterprises; 5. building equity investments; and 6. promoting a sound investment climate and stronger institutions in the countries of operations through policy dialogue.

8. The EBRD is now active in 29 countries of operations.[1] The latest newcomer, Mongolia, was accepted as a country of operations by the EBRD in July 2006. With project financing commencing in October 2006, the EBRD, in collaboration with the Mongolian Government and local business community, specifically seeks to assist in the development of private enterprises, SMEs, the financial sector and microfinance, infrastructure and the privatisation process. In the past, the EBRD has been active in Mongolia through the Mongolian Co-operation Fund, which was set up in March 2001 and has secured a total of €10.3 million in donor grants.

9. The countries of operations are divided into three geographical groups: central-eastern Europe and the Baltics (CEEB),[2] South-Eastern Europe (SEE)[3] and the Commonwealth of Independent States plus Mongolia (CIS+M).[4] The countries can also be grouped according to their progress with reforms. The so-called "early transition countries" include Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan and Turkmenistan. In 2004, the EBRD launched the Early Transition Country Initiative, as presented in last year's report on the EBRD (Doc. 10950), in order to increase the impact of its activities in these poorest of its countries of operations. The initiative co-ordinates donor assistance and seeks to alleviate poverty by financing primarily smaller projects in the private sector, supporting municipal infrastructure development and improving the legal environment. By the end of 2006, the EBRD has managed to increase the share of operations in the early and intermediate transition countries plus the Russian Federation to 86% (compared with a projection of about 70%).

10. This, however, does not preclude the EBRD's continued co-operation with EU institutions under the JASPERS, JEREMIE and JESSICA programmes in the advanced countries of operations. These programmes foresee targeted support for, respectively, regional development, SMEs and microfinance, and urban revitalisation in the new EU member states. Further to the opening, in January 2007, of the JASPERS regional office in Warsaw, similar offices will soon be inaugurated in Vienna and Bucharest drawing on the know-how and experience of the EBRD, the European Investment Bank and the European Commission in long-term financing, especially for infrastructure projects. The EBRD's involvement in the eight central and eastern European countries that joined the EU in 2004 will terminate by 2010.

11. The EBRD carries out *ex post* evaluations of its technical co-operation activities and investment operations in order to take stock of results and draw lessons with a view to improving future undertakings. A small team of evaluators, the operationally independent Project Evaluation Department (PED), assesses accountability (towards management, boards and the general public), transparency and the value added of EBRD activities. Together with sound banking practices and additionality (ability to supplement rather than substitute for private sources of financing), transition impact[5] is a key guiding principle. A total of 548 projects have been evaluated to date. Between 1996 and 2006, 78% of the projects were rated as having a positive (excellent or satisfactory) transition impact and 58% of the projects have had a successful or higher rating with regard to overall performance.

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1. Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, the Russian Federation, Serbia, Slovak Republic, Slovenia, "the former Yugoslav Republic of Macedonia", Tajikistan, Turkmenistan, Ukraine and Uzbekistan.
2. Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.
3. Including Bulgaria, Croatia and Romania (SEE-3) and Albania, Bosnia and Herzegovina, "the former Yugoslav Republic of Macedonia", Montenegro and Serbia, including Kosovo (SEE-5 or the Western Balkans).
4. Including the Russian Federation, Belarus, Moldova, Ukraine, the South Caucasus (Armenia, Azerbaijan and Georgia) and Central Asia (Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan).
5. There are seven sources for measuring and assessing the transition impact objectives: 1. greater competitive pressures; 2. market expansion via linkages to suppliers and customers; 3. increased private sector participation; 4. institutions, laws, regulations and policies that promote market functioning and efficiency; 5. transfer and dispersion of skills; 6. demonstration effects from innovation; and 7. higher standard of corporate governance and business conduct.

12. Given the difficult environment in which the EBRD operates, these results are a token of considerable success. As the evaluation team also carries out special studies and disseminates lessons learned, some issues to be addressed in the coming years include coping with more evaluations, peer reviews of evaluation functions, harmonisation of evaluation procedures with other multilateral development banks and maintaining a good system for follow-up on evaluation recommendations.

13. The EBRD tracks the transition progress by ranking the countries of operations with regard to a total of nine indicators divided into four overall categories, namely: 1. enterprises (large-scale privatisation, small-scale privatisation, governance and enterprise restructuring); 2. markets and trade (liberalisation of prices, trade and foreign exchange operations and competition policy; 3. financial institutions (banking reform, interest rate liberalisation, securities' markets and non-bank financial institutions); and 4. infrastructure. The nine indicators relate to different stages of the reform process. While small-scale privatisation, price liberalisation and trade and foreign exchange liberalisation are part of the initial phase of reform, the remaining indicators mark out the second phase.

14. Initial market liberalisation reforms are by and large completed in the CEEB region, Bulgaria, Romania and Croatia, while they still lag behind in many countries of SEE (especially the Western Balkans) and in the CIS+M. The second stage of reform remains incomplete in most countries in the whole transition region. Nevertheless, significant progress has been achieved in the past year, with 16 countries being awarded a total of 24 transition indicator upgrades in 2006.

15. From a geographical point of view, SEE, with 12 upgrades, has moved forward considerably, with most notable reform progress in Bulgaria, Romania and Croatia. Reforms have slowed down after EU accession in CEEB in reaction to weaker public support for painful restructuring measures (although Estonia has made significant advances in a number of areas). The remaining eight upgrades were awarded in the CIS+M countries, where reform change has been primarily concentrated in three of the richest countries (Kazakhstan, the Russian Federation and Ukraine) following positive responses from the markets after institutional strengthening efforts.

16. In terms of indicators for sectors, most upgrades were allocated to second phase reforms as very little progress was made in countries where the initial phase of reform is yet to be completed. The financial sector made the most progress with a total of 11 of the 24 upgrades. The remaining upgrades were allocated to competition policy (four), governance and enterprise restructuring (three), small-scale privatisation (three) and infrastructure (three). Particularly noteworthy is that while there were only three upgrades in the overall category of infrastructure, a total of nine upgrades were given in the telecommunications sub-category.

17. Reform progress, having peaked during the second half of the 1990s (particularly in CEEB and the CIS countries), continues at a slower pace. In general, the transition process in recent years is increasingly driven by markets rather than by governments, especially with regard to telecommunications (namely mobile phones) and the financial sector (see section below). In fact, the entire transition region has made significant progress with regard to reform in these two sectors.

18. With regard to macroeconomic indicators, real GDP growth has remained strong in all these countries, amounting to an average of 5.3% in 2005 and around 6.2% in 2006. This is a steady growth rate, several percentage points higher than the average in the eurozone. Growth rates tend to be higher in the CIS+M region (which has benefited from positive terms of trade developments) than in the SEE and CEEB countries. As the poorer countries are catching up, convergence continues, with most economic reforms undertaken in SEE, especially Bulgaria, Romania, Croatia, "the former Yugoslav Republic of Macedonia" and Serbia, while reform progress has slowed down in central Europe. While high prices and demand for oil, gas, metal and agricultural products lie behind the strong performance of many resource-rich countries (primarily in the CIS +M region),[6] most of the transition region's growth has been consumption-driven as a result of increasing wages and expanding credit. Moreover, in 2006, the whole region benefited from a record high foreign direct investment (FDI) influx of over €50 billion.

19. Interestingly, expert estimates show that about a third of official GDP in most transition countries is generated by the "informal" economy. Such informal activities are thought to persist because of imbalances in taxation systems, social security contribution levels, complex regulatory frameworks and a lack of employment opportunities in the formal sector (especially in rural areas). An EBRD study of the informal sector in Armenia, Bosnia and Herzegovina and Ukraine reveals that agriculture is a key sector behind informal activities which account for 53% of total employment in Armenia, 43% in Bosnia and Herzegovina and 66% in Ukraine. Policy

6. The direct link between high energy prices and growth has, however, been broken.

makers are thus confronted with the delicate task of rebalancing business regulations, taxes, minimum wage and social benefit levels and incentives for the creation of high-skilled jobs. The EBRD, for its part, exercises particular vigilance with regard to screening the integrity of its clients and partners.[7]

20. Strong demand and high energy prices are causing inflationary pressures in most transition countries, and the euro entry dates for the CEEB countries have been pushed back except for Slovenia which joined the Economic and Monetary Union in June 2006 and adopted the euro in January 2007. Furthermore, as domestic savings are not large enough to cover investments, many transition countries suffer from large and continuing current account deficits. Several of the transition region's currencies are also under pressure. Thanks to a favourable global environment, record levels of financing and relatively low investors' risk aversion, the growth outlook is positive. However, there are some uncertainties due to the unclear international (especially the United States) growth outlook, possible disruptions in international financial markets and weakening commodity markets.

3. Finance in transition and reforms

21. The EBRD's 2006 Transition Report provides a special focus on the financial sector, the development of which is essential for growth which is increasingly correlated to the expansion of the financial system and which absorbed 45% of the EBRD's total financing in 2006 (compared with 30% for direct lending to the corporate sector and 17% to infrastructure projects). Overall, the transition countries have seen an extraordinary transformation of their financial sectors, driven by wide institutional improvements, privatisations and foreign banks entering local markets. As a result, the financial sectors have grown in both size and complexity although progress in reform of the financial sector has been uneven. CEEB countries advanced (with regard to both the banking and securities markets) most significantly but even so their untapped financial development potential remains huge given their income levels. Despite progress, the financial sector, therefore, continues to be underdeveloped in many countries, particularly in the CIS+M and SEE (although the latter is more developed than the former).

22. Although banking continues to dominate the financial sector in the transition region, there has been growth in other areas of finance as well. Stock and bond markets have also grown and private equity markets are emerging, providing a complement to banking. In 2005, the stock market capitalisation ranged from just above one-quarter of GDP in CEEB to just below one-fifth in CIS+M. The Russian Federation is currently the transition country with the highest stock market capitalisation. Perhaps the most striking change (both in scale and coverage) with regard to banking is the emergence of foreign banks as major players through the acquisition of existing local bank assets or as new entrants, such as Austrian and Italian banks in CEEB and SEE and Swedish (Nordic) banks in the Baltic states.

23. The credit market in most CEEB and SEE countries has grown considerably in the past five years: it has increased by 70% in CEEB and has almost doubled in SEE. Rapid credit growth is, however, also associated with credit and currency risks and other potential negative spill-overs. An increase in credit has largely contributed to the strong GDP growth rates of many transition countries. In 2005 alone, bank lending in the transition region grew by 20% on average. The highest growth in credit has been recorded in the less advanced transition countries and growth has been fastest for new foreign banks. All the same, although the ratio of domestic credit to the private sector over GDP has gone up, it is still below 50% in CEEB (compared to over 150% in Portugal and Spain and 86% in Greece). Apart from Croatia (with a ratio of 56%), the SEE region's ratio averaged 18% in 2005. In the CIS countries, as bank financing has in fact declined, the ratio averaged only 13% (although it is increasing slowly in Kazakhstan and the Russian Federation).

24. Household loans account for the greater part of the growth in credit, while credit to enterprises has generally not grown so fast. Credit to smaller enterprises remains limited. According to the recent EBRD/ World Bank Business Environment and Enterprise Performance Survey (BEEPS), 60% of the smaller firms surveyed throughout the transition region do not have bank loans (and between one quarter and one third of these declared that they are unable to acquire a loan). Even in the EU-member CEEB countries, access to finance still represents a major obstacle for business development. Again, the financing environment is significantly more difficult for SMEs than for larger enterprises. Internal finance hence accounts for the major part (between 68% in CEEB and 77% in CIS) of enterprise finance.

7. For instance, the EBRD has imposed sanctions on a German engineering contractor that was found guilty of corrupt dealings on a World Bank project.

25. Bank credit can have a positive impact on enterprise performance as, according to a recent EBRD survey, access to bank credit (regardless of size) increases firms' revenues. The survey also shows that credit tends to be used more effectively by larger firms than smaller companies. Institutional factors (most notably creditor rights and credit registries) play an important role in the development of the financial sector. An EBRD analysis shows that institutional reform can reduce the gap between actual and potential levels of financial development (which is particularly large in the SEE and CIS countries). As the progress of reform is slowing down in the financial sector (there were fewer upgrades in 2006 than in the previous years), your rapporteur would like to stress the importance of moving forward. Lack of reforms with regard to creditor protection in particular would hinder further financial development, and hence growth, in many countries. Banking supervision and competition policy are also important. Last, but not least, there is still scope for widening financial access and deepening the financial system in terms of increasing credit and providing more services (such as leasing, equity, pensions and insurance).

3.1. Banking sector trends

26. The banking sector in the transition region has made considerable progress and transition banks are slowly reaching the standards of more mature financial markets. Most significant progress has been recorded in Estonia, Hungary and Latvia. The banking sectors in many SEE and CIS+M countries are still far behind, although upgrades for reform in the banking sector were awarded to the Russian Federation, Tajikistan and Ukraine in 2006. Recent years have seen considerable diversification of services as the banking sector has become more competitive and efficient and better regulated thanks to changes in ownership structures and improvements in the legal and institutional framework (such as better legal protection, more effective enforcement of legislation and improved supervision and regulation). According to the EBRD's Chief Economist, banks in the region are bigger, stronger, better regulated, more profitable and more competitive than ever.

27. The entry of foreign banks has accelerated the integration of the banking sector in the transition region and more mature economies. They have also helped increase the availability of credit, strengthened competition and encouraged the adoption of improved banking technologies and management practices. Foreign banks now dominate the banking sector in most CEEB and SEE countries (all but Latvia, "the former Yugoslav Republic of Macedonia", Serbia and Slovenia), where the share of foreign bank assets exceeded 70% in 2005. In the CIS, on the other hand, domestic banking dominates. However, while the presence of foreign banks has had a positive impact on the banking sector in terms of both efficiency and stability, they should not be seen as a substitute for institutional reform. Furthermore, there is also concern over foreign banks lacking local knowledge and hence being less inclined to lend to smaller businesses.

28. The above-mentioned EBRD BEEPS study reviewed a sample of 220 banks in transition countries. It points to the institutional and legal improvements that have encouraged lending to both households and small businesses. Lending to the former in particular (mostly through mortgage loans) has grown quickly in the whole transition region, although particularly so in CEEB and SEE (where household loans accounted for around 45% and 60% respectively of total credit to the private sector in 2005). Foreign banks in particular have been active in household lending (as it generally requires less information gathering, involves higher margins and is considered less risky),[8] although their focus is slowly moving towards providing credit also to smaller businesses. Mortgage lending has also grown, although its share in total lending is small (especially in the CIS countries).

29. Nevertheless, although SMEs are the most important customers for all kinds of banks, bank credit is primarily extended to larger enterprises. Many smaller firms, even in the more developed transition countries, do not have access to the formal financial system. Smaller firms in the CIS+M countries are particularly constrained. The EBRD's survey also shows that smaller banks tend to lend to smaller businesses to a greater extent than larger banks.

30. The performance of banks in the transition region has improved and returns on assets and equity are now quite high compared to the EU average. In terms of net interest margins, performance has been higher for smaller than for larger banks. Although bank ownership is not correlated to bank performance, reforms with regard to ownership structures (and institutional environment) have reduced costs. For example, foreign ownership is generally associated with greater cost efficiency. Bank profitability (in terms of return on assets) is also strong, especially in CIS countries. However, the ratio of non-performing loans over total loans is, at

8. However, many loans are denominated in foreign currency, which could make it more difficult for households to repay their loans.

15%, very high in the CIS. In CEEB and SEE, the ratios have decreased significantly (though they are still high) to, respectively, 3.4% and 9.5%. Larger banks and foreign banks do generally have better loan portfolio quality than other banks.

31. The banking sector in the transition region is highly concentrated. With the exception of Montenegro, the Russian Federation and Ukraine, the five largest banks in all the other transition countries accounted for over half of total bank assets. While lending and deposits continue to be the most important banking activities in the transition region, many banks are now providing other financial services (such as corporate finance, asset management and securities trading). The range of products and services is, however, still too limited. Improving access to finance is an essential challenge for the transition region. Further improvements in banking regulation and creditor protection need to be made in order for lending activities to increase, especially with regard to SMEs. Greater lending needs, however, to be balanced with greater risk taking. Finally, the banks in the transition region should further develop the range of financial products and services they offer.

3.2. Private equity

32. Private equity markets in the transition region have grown significantly in the past few years. The total volume of financing committed to (new) private equity funds[9] in transition countries peaked at over US$1.6 billion in 2005. In CEEB, the harmonisation and integration measures taken with a view to EU accession have clearly aided the development of these countries' private equity industry. The Russian private equity markets have also been growing as the country's relative stability and strong growth have attracted foreign investors. In general, return performance has increased rapidly in recent years (and returns are now comparable to those in western Europe) thanks to easier exit opportunities[10] and better investment prospects. Yet, most private equity markets in the transition region are still small and often lack liquidity.

33. The EBRD's assessment of data relating to 44 private equity funds (with a total capital volume of US $4.6 billion) that have committed around US$2.7 billion to 450 investments in 399 companies between 1992 and 2005 shows that, in general, larger, older and more diversified funds have tended to perform better and yield higher returns. Funds that have operated longer have normally had more time to exit and return money to their investors. While earlier funds tended to invest in manufacturing and retail, younger ones (established between 1995 and 1999) have concentrated on telecommunications and IT. The most profitable industries have been financial services, telecommunications and high technology. Regardless of the sector, however, funds targeting several sectors have, on average, yielded higher returns than those focusing on only one sector.

34. Transition funds have most commonly been invested in company expansion and start-ups (and less in privatisations and buy-outs). However, returns on start-up investments have generally been lower than returns on privatisation ventures. Although projects with co-investors have tended to have higher returns, most companies have received finance from a single fund (70% of the assessed private equity investments had no co-investors). Furthermore, most private equity funding is coming from abroad as domestic sources for private equity funding are still limited. While it is not clear how (if at all) performance is influenced by the country in which funds are invested, returns have in general been relatively good in the Czech Republic, the Slovak Republic and SEE as a whole.

35. Although private equity provides a complement to bank lending, it is generally a more expensive way of financing an investment than a bank loan. However, the expansion of the private equity industry has had positive and significant effects on the economic development in most transition countries not only as an additional source of finance for enterprises, but also as support for the development of know-how and expertise. Thanks to their active involvement in the companies they finance, private equity funds are playing an increasingly important role in enterprise restructuring and the promotion of entrepreneurial and managerial skills. Further development in this area will rely on improvements to the legal and regulatory framework and on increasing funding from domestic sources. To this end, pension funds and insurance companies could become involved in private equity investments. There is also an increasing interest in investing on the part of rich individuals and companies. Improvements in the general business environment and the development of the banking sector would also assist in the development of the industry.

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9. Commercial funds as donor-supported funds are now virtually non-existent.

10. However, although it has declined, the average exit time (at around 4.6 years) is still higher than in western Europe or the United States.

3.3. Remittances as a source of finance for small enterprise creation and micro-investment

36. Migrants' remittances are attracting growing attention worldwide because of the growth in volume and importance of flows as well as because of their potential to reduce poverty and support development efforts in the destination countries. In 2005, the total value of official remittances worldwide was estimated at US$230 billion.[11] Remittance inflows have become increasingly important to many transition countries' economies, amounting to a substantial part of their GDP. For example, in 2004, official remittances amounted to as much as 27.1% of GDP in Moldova, placing it second among the top remittance-receiving countries in the world in relative terms.[12] The greater part of remittance funds is most commonly used for direct consumption purposes in the destination countries, while smaller amounts are saved or invested in real estate (namely purchase and/or construction of housing). Finally, a small, but very important part often finances small business creation and investment.

37. In January 2006, the EBRD undertook a survey of 639 micro and small enterprises with regard to the use of remittances in the creation, operation and expansion of business in five transition countries with high remittance to GDP ratios (namely Albania, Bosnia and Herzegovina, Georgia, Moldova and Serbia). The results of the survey were presented in the Transition Report Update of May 2006 and show that quite a significant share of remittance transfers are used by business owners to finance investment (especially with regard to start-ups). Overall, 27% of the respondent business owners claimed to receive remittances from abroad and 43% of these in turn used remittance transfers to cover establishment costs, investments and working capital needs. Remittance transfers have been very important for business creation: 93% of the enterprise owners used remittances for starting up their businesses, with around 40% of the start-up costs having been financed by remittance transfers from abroad.[13]

38. Lack of access to finance is one of the main obstacles to the setting-up, operation and expansion of businesses in the transition region. It is generally the smaller businesses (which dominate the enterprise sector in most transition countries) that face the greatest challenge in obtaining financing. Hence many rely on "informal" or non-bank funding. In fact, transition country enterprises finance three quarters of new investments with internal funds or loans from family and friends. Remittance transfers can thus compensate for an underdeveloped financial sector and for the lack of credit availability. They are not a substitute for bank loans, but rather strengthen the possibilities for entrepreneurs of obtaining formal financing.

39. The survey also concludes that banks play an important role in the transfer of remittances. Although the use of banks as a remittance transfer channel varies widely between countries, more than half of all the respondent remittance-receiving enterprises obtained their transfers through the banking system. An important step in seeking to maximise the impact of remittances for the benefit of local development in the destination countries is to attract the remittance flows into formal transfer channels. To this end, concurring with the call for better management of remittance inflows by our colleague, Mr Schreiner, in last year's report on the EBRD (Doc. 10950), your rapporteur particularly argues for a reduction of remittance transfer costs and a greater availability of bank loans (and other financial products). Furthermore, in order to make remittances really work for the local economy, there needs to be a good overall business and investment environment, the creation of which depends on many other factors, including fiscal and monetary policies and structural reform.

3.4. Corporate responsibility and sustainable development

40. Your rapporteur would like to address the concepts of sustainable development and corporate responsibility, two important aspects of good business practices. The latter concept refers to transparency, accountability and sound economic management but also entails environmental and social impacts of business activities, products and services. With regard to the financial sector, there are two major international initiatives seeking to promote social and environmental standards, namely: 1. the Equator Principles – a set of principles agreed upon by a number of leading commercial banks in 2003 laying out a framework of socially

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11. World Bank: "General principles for international remittance services", Consultative report. March 2006. If informal remittances are taken into account, actual remittance flows could have reached around US$350 billion in 2005 – Ratha, Dilip (World Bank) at the UN International Symposium on International Migration and Development, Turin, Italy, from 28 to 30 June 2006.

12. World Bank: "World development indicators" and World Bank: "Global economic prospects: economic implications of remittances and migration", 2006. Furthermore, remittances represent a stable source of income and have outgrown both foreign direct investment (FDI) and overseas development aid (ODA) flows in recent years. In fact, in some countries (such as Albania and Moldova), official remittance flows surpass FDI and ODA combined.

13. The share of remittances in start-up costs was higher for older (more than 10 years) companies than for younger (less than 10 years) ones. This is an indication of other financing sources (such as bank loans) becoming increasingly available to take the place of remittances.

and environmentally responsible lending practices for project finance activities above US$10 million (recently reduced from a US$450 million threshold); and 2. the UNEP Finance Initiative – a more general public-private partnership agreement offering training and advice on best practices on sustainable development to its members. Another initiative, the UN Global Compact, launched in 1999, invites UN agencies, companies (including banks and other financial sector enterprises), NGOs and such to support a set of 10 universal environmental and social principles.[14]

41. The transition region is clearly under-represented with regard to these three initiatives. Transition country signatories to the UN Global Compact represent only around 8% of all participants (with regard to members from the financial sector, this figure is a bit higher at around 10%). Only four banks from transition countries have signed onto the UNEP Finance Initiative. However, although there are no transition country banks among the signatories of the Equator Principles, most project finance transactions in the region are covered as they are commonly implemented by international banks or international financial institutions.

42. With regard to reporting on social and environmental issues, transition country banks (particularly those in the CIS) lag behind. According to a recent EBRD survey of the three largest banks in 20 transition countries, only around one sixth take account of environmental impacts in their lending activities. Even fewer banks consider social implications. Internal social and environmental policies are also uncommon. Only with regard to local community sponsorship and charity programmes can transition country banks be considered at a more or less equal level with banks from the benchmark countries of Greece, Portugal and Spain.

43. Unfortunately, sustainable development does not seem to be high on the agenda for banks and companies in the transition region. However, as the transition process moves forward and as more economic actors recognise that a good reputation is important for business, a higher degree of integration of environmental and social considerations into business practices is to be expected in the not so distant future.

44. With regard to the EBRD, its commitment to corporate responsibility in its investment activities and internal operations is part of its overall dedication to sustainability. Each year, the EBRD addresses matters related to corporate responsibility not only for its own operations but also for all its investment activities in its sustainability report, which, together with the annual report and the transition report, cover many of the reporting aspects of the Global Reporting Initiative (GRI).[15] In addition, the EBRD plays a leading part in the UNEP Finance Initiative and is the current chair of the regional co-ordinating committee. Furthermore, two EBRD initiatives seek to promote sound corporate culture in the transition region: the TurnAround Management (TAM) and Business Advisory Services (BAS) programmes. These donor-funded, non-financial enterprise support programmes aim to assist and further management skills in small, medium and large enterprises with a view to improving their business performance and increasing job opportunities. These two programmes are important elements of the EBRD strategy for micro, small and medium-sized enterprises and primarily target the countries of the Early Transition Country Initiative (as presented in section II above) and the Western Balkans Initiative (see section V below). They also play a significant role in EBRD activities throughout the less-developed regions and rural areas of the Russian Federation and Ukraine.

45. Since its start in 1993, the TAM programme has carried out over 1 350 projects in 27 countries of operations. It assists enterprises with 100 to 2 000 employees working at the senior management level. It maintains a database with over 3 000 business advisors who provide specific industry expertise with a view to restructuring and introducing a new management culture in the target countries. The BAS programme commenced in 1995 and has implemented over 6 000 projects in 17 countries of operations. It uses and develops local consultancy services (with a total of 1 700 accredited consultants) and provides business advice and services to smaller enterprises with 10 to 250 employees. Together, these two programmes have raised about €146 million in donor funding for the support of enterprises with an aggregate annual turnover of €25 billion and a total workforce of 1.1 million employees. While enterprises participating in the TAM programme have maintained employment at 90%, the BAS programme has increased employment by 20%. Activities with both programmes have had high success rates – 82% (TAM) and 92% (BAS). New and upcoming TAM/BAS initiatives will seek to increase the presence of these programmes in the rural areas of all target countries, particularly seeking to support environmental and energy efficiency, women in business, cross-border co-operation, business incubators and tourism. Finally, the programmes also provide a pipeline for EBRD's investment projects, particularly in the Early Transition Countries (ETCs).

14. For further information, see www.equator-principles.com, www.unepfi.org and www.unglobalcompact.org.
15. The GRI is a multi-stakeholder network that seeks to develop and disseminate globally applicable sustainability reporting guidelines for voluntary use (www.globalreporting.org).

46. One of the most pertinent development challenges in central and eastern Europe is the need to enhance the efficiency of energy use[16] so as to ensure greater competitiveness of local enterprises, reduce greenhouse gas emissions as economies expand and improve energy security. The EBRD's special role in promoting energy efficiency in the region has been widely recognised by other international financial institutions. We should point out the importance of the EBRD's Sustainable Energy Initiative, launched in May 2006, whereby the Bank intends to more than double its investments in energy efficiency and cleaner technologies over the next three years. Accordingly, the Bank will invest about €1.5 billion over the 2006-08 period while supplementary donor support could reach around €100 million. This is in addition to 35 industrial energy efficiency projects, as well as a series of energy efficiency credit lines, a renewable energy portfolio, district heating projects and urban transport systems modernisation programmes, worth a total of €673 million, that the Bank has financed since 2001.

4. The reform process in the South Caucasus

47. The South Caucasus region, especially Azerbaijan, has enjoyed very high growth rates in recent years (see Table 2 in the appendix). With the opening of the Baku-Tbilisi-Ceyhan oil pipeline and a rapid increase in oil production, Azerbaijan is now the fastest growing economy in the world. Export revenue is booming and its strategic importance is increasing. Although the Armenian economy has been doing better in recent years, its growth is hindered by the complex political situation in the region and economic non-co-operation imposed by Azerbaijan and Turkey. Although at a slower rate, Georgia's economy has also grown substantially in recent years. An increase in private consumption lies behind much of the growth in Armenia and Georgia following employment and wage increases and as a result of a growth in credit and remittance inflows. Both Armenia and Azerbaijan reached and surpassed their pre-transition levels of real GDP in 2005-06 (and are at around the average level of the transition countries), while Georgia is still only at around half of its "initial" real GDP (and ranks well below the average for the transition countries).

48. Although the inflation rate has been brought down in Armenia in recent years, it is moving up again primarily following the increase in energy prices. In Azerbaijan, inflationary pressures result from an increase in domestic spending boosted by energy incomes. The government deficit is relatively low in the three Caucasian countries (although less so in Armenia), even if it has deteriorated slightly in the past couple of years. The current account deficit has remained more or less the same in Georgia in recent years and has improved somewhat in Armenia, while Azerbaijan has moved from a fairly large deficit (up to a quarter of GDP in 2003 and 2004) to a surplus (0.5% of GDP) in 2006. FDI inflows (both in absolute and relative terms) decreased significantly in Azerbaijan in 2005 and 2006 in comparison to the high levels of recent years. While FDI inflows in Georgia increased in both 2005 and 2006, Armenia's level was relatively low, but stable.

49. With regard to the transition indicators (see Table 3 in the appendix), all three countries are near to completing the first phase of reform (although Azerbaijan is slightly behind the other two). Armenia and Georgia have also made significant progress with regard to large-scale privatisation and some improvements with regard to banking reform and interest rate liberalisation. In terms of the remaining indicators, the South Caucasus is substantially behind, with no transition indicator upgrades awarded in 2006.

50. In terms of future prospects, the 2006 Transition Report (as reflected in Table 4 in the appendix), calls for further improvements in the business environment in all three countries. Azerbaijan and Georgia are faced with a major effort to contain inflation, while a further appreciation of the Armenian currency could threaten the country's competitiveness. Georgia has to address its infrastructural deficiencies and Azerbaijan its overreliance on the energy sector. Finally, all three countries (although perhaps Georgia to a lesser extent) suffer from weaknesses in democratic institutions and the rule of law, and corruption allegations are cause for concern throughout the region.

51. While prospects for EU accession for the South Caucasian countries are slim, they are included in the European Neighbourhood Policy (ENP), which seeks to encourage deeper economic, political, cultural and security co-operation between the enlarged EU and its new neighbours. Individually, the South Caucasian countries' markets are clearly too small to attract significant investments.[17] This fact, coupled with the diversity of their resources and their difficult geo-political situation, makes regional co-operation (with a view to integration in the longer term) essential for the further economic, political and social development of the South

16. EBRD countries of operations currently use up to seven times more energy per unit of GDP produced than western European countries do.

17. The total population of the South Caucasus is about 16.1 million: Armenia 3.2 million, Azerbaijan 8.3 million and Georgia 4.6 million.

Caucasus. While unresolved conflicts (including those over Nagorno-Karabakh, Abkhazia and South Ossetia) clearly hinder regional co-operation in the first place, such co-operation would also help create the conditions necessary for settling those conflicts as well as for avoiding new conflicts arising in the future.

52. Your rapporteur recalls the Assembly's initiative (see Doc. 11082, Resolution 1525 (2006) and Recommendation 1771 (2006)) for the establishment of a stability pact for the South Caucasus. Such a stability pact could draw from the positive experience of the one in South-Eastern Europe, while taking significant differences into account. As a first step, the recommendation suggests the organisation of an international conference for security and co-operation in the South Caucasus with a view to assessing the specific needs and establishing the practical conditions for the potential launch of such a stability pact in agreement with all stakeholders. It invites the authorities of Armenia, Azerbaijan and Georgia to commence a political debate on the possibility of creating such a stability pact and, regardless of its status, encourages them to co-operate regionally. Finally, it also calls for consultation with and support from other member states and international players. The political and financial support of the EU, the EBRD, the Russian Federation, Turkey and the United States are particularly important.

53. Under the Early Transition Country Initiative, launched in 2004 and aimed at stimulating private sector activity in the lowest-income countries, the EBRD is intensifying its work in the three Caucasian countries. In 2006, 11 projects per country were approved in favour of Armenia and Azerbaijan (representing, respectively, €40.4 million and €134.4 million in EBRD financing) and 22 projects were signed with Georgia (worth €114 million in EBRD funds). In September 2006, the EBRD opened a regional office for the Caucasus (as well as for Belarus and Moldova) in Tbilisi (Georgia). The EBRD's work in the region focuses on the reform and strengthening of the financial sector, development of leasing practice, support for microand small enterprises (Armenia and Azerbaijan), infrastructure rehabilitation and development (Azerbaijan and Georgia), restructuring of the energy sector (Armenia), and introducing sound corporate governance measures (Georgia).

54. Together with other international organisations, the Council of Europe and the EBRD are also involved in the Kyiv Initiative Regional Programme. The initiative, launched in December 2006, aims to promote a democratic and participative society by contributing to sustainable cultural, social and economic development in the three Caucasus countries as well as in Moldova and Ukraine. It seeks to do this through multilateral cooperation and trans-sectoral management of culture and cultural heritage. Moreover, at the end of 2006 the EBRD, the EIB (European Investment Bank) and the European Commission signed a memorandum of understanding meant to further facilitate joint projects in eastern Europe, the Southern Caucasus, the Russian Federation and Central Asia, especially with regard to infrastructure development, under the EU's European Neighbourhood Policy.

5. Prospects for regional integration and development in South-Eastern Europe

55. All countries of South-Eastern Europe have made significant progress with reform in recent years. As Table 5 in the appendix shows, in 2006, the SEE region was awarded a total of 12 (out of 24) upgrades on transition indicators for small-scale privatisation, governance and enterprise restructuring, competition policy and financial institutions. On the whole, the region has almost completed the initial phase of reform. Some headway has also been made with regard to large-scale privatisation, banking reform and interest rate liberalisation, although most countries still lag behind in the areas of governance, enterprise restructuring, competition policy, securities markets, non-bank financial institutions and infrastructure. Much reform effort was seen in Bulgaria and Romania in 2006 as they sought to join the EU. Macedonia and Serbia have also made significant progress last year, although the latter still lags behind in many areas of reform. In development terms, the SEE region is now ahead of the CIS+M countries and is slowly catching up with the CEEB area. Prospects for potential EU membership in the future are expected to encourage continued reforms in the Western Balkans.

56. The state of macroeconomic indicators (as presented in Table 6 in the appendix) shows a contradictory picture. Most of the SEE countries have grown strongly in the past two years. 2006 saw a particular boost in real GDP growth for Bulgaria and Romania in anticipation of their EU accession, as well as Montenegro, now for the first year as an independent country.[18] The inflationary pressures are increasing in most SEE countries, especially in Serbia, due to higher energy prices, but also because of rapid growth of credit and wages. As a result, several SEE countries have adopted some form of fixed exchange rate regimes. Current

18. The strong growth rates can be ascribed to a number of factors, including recovery of industrial production (mostly following from increases in FDI inflows) export markets (resulting from intra-regional trade plus duty-free access for many products to the EU), as well as strong domestic demand and a rapid growth in credit.

accounts are in deficit across the whole region.[19] These deficits are large and troubling in the light of the fixed exchange rate regimes. The entire SEE region has seen record inflows of FDI, especially those related to privatisation and acquisitions in the banking sector. Most notable is Montenegro, where FDI inflows accounted for nearly 20% of GDP in 2005 and grew further in 2006, mainly due to privatisations, the expansion of the banking sector and greenfield investment in tourism. Nevertheless, unemployment rates remain high throughout the region, hitting 33% in Serbia, nearly 36% in "the former Yugoslav Republic of Macedonia" and 41% in Bosnia and Herzegovina.

57. The 2006 Investment Reform Index Report prepared by the OECD-led Investment Compact of the Stability Pact found that SEE has made significant improvements in the investment climate and business environment by implementing effective investment policies, liberalising trade regimes and introducing lower corporate tax rates. Prospects for the future are mostly favourable. Growth is expected to continue following export expansion and strong domestic demand. Investment and FDI inflows are also expected to remain strong and the region's image is improving. The countries' primary macroeconomic challenge is to maintain fiscal discipline and vigilance in the financial sector. Unresolved political riddles (especially Kosovo) could threaten the stability of the region.

58. The Stability Pact for South Eastern Europe, adopted in 1999, has been instrumental in the revival of the region's economies in recent years. It has nurtured stability, regional co-operation and common approaches to many challenges (such as organised crime and corruption) as well as assisted in the creation of a regional electricity market and free trade area. The Stability Pact is now transforming itself into a Regional Co-operation Council (RCC) to be in place by 2008. The RCC will concentrate its efforts on areas in which regional co-operation has been deemed by the countries in the region to be most beneficial, namely: economic and social development; infrastructure; justice and home affairs; security co-operation; human capital development; and parliamentary co-operation.

59. The international community will stay engaged, but the ownership of regional co-operation will lie with the countries of the region. A sustainable and successful regional co-operation framework relies on the complete political commitment of the countries in the region as well as the continued involvement of both EU and non-EU donors. A number of decisions are yet to be made with regard to the location of the RCC secretariat, financing scheme and donor contributions, the relationship with the Stability Pact, and a thorough mandate and legal basis for the RCC.[20] The Investment Compact has proposed the creation of a South-East European investment committee to act as the investment arm of the RCC. Expected to be launched in spring 2007, this committee could work towards establishing a high-level regional platform for monitoring progress and for designing, implementing and assessing policies related to foreign and domestic investment in the regional context. It could also monitor and implement the Regional Framework for Investment and the investment clauses of the regional free trade agreement for South-East Europe.

60. The EBRD, for its part, launched the Western Balkans Initiative in May 2006 to boost private business investment, financial institutions and infrastructure development in the five countries of the subregion. This multi-donor fund builds on the Early Transition Country Initiative and seeks to provide an integrated effort for private sector development with an emphasis on job creation. A total of €10 million from 11 donor countries were committed initially.

6. An update on EBRD's work in the Russian Federation, Ukraine and Moldova

6.1. Russian Federation

61. The Russian Federation has continued its integration into the European and global economy, with business climate improving against the background of general political stability and sound macroeconomic management. Investment – domestic and foreign – grew vigorously and will very likely be sustained according to the Foreign Investment Advisory Council in which the EBRD actively participates. This is in spite of restrictions on foreign investment in 39 sectors of the Russian economy seen as strategic. Reform progress in the country's financial sector (which received two transition indicator upgrades in 2006) has been particularly strong last year and notable advances have been recorded in the initial phase reform indicators (with regard to governance and enterprise restructuring, competition policy and infrastructure).

19. Although the SEE is enjoying a robust growth in exports, they are also facing stronger demand for imports (as a result of an increase in domestic consumption and investment needs).
20. Regional co-operation is also deemed a prerequisite for EU integration (and NATO membership).

62. The Russian Federation is enjoying a period of strong growth, primarily as a result of an increase in domestic demand and a strengthening of its terms of trade (the real GDP growth rate stood at 6.7% in 2006). The internal balance for 2006 is estimated at a surplus of 7.5% following measures of fiscal tightening and inflation keeps falling (estimated at 9.7% in 2006 from 12.7% in 2005). An important initiative encouraging price stability is the Oil Stabilisation Fund (OSF), estimated to have reached US$84 billion in 2006. The Russian Federation's current account is also in surplus, projected at a record 10% in 2006, primarily due to the increase in prices of key export commodities even though oil prices lowered in the second half of 2006. In 2006, the EBRD invested €1.9 billion in Russian enterprises, which represents 38% of its total portfolio for the year (up from 26% in 2005). This investment mainly supported agribusiness, manufacturing, property/tourism and telecoms outside the major urban centres, with a growing proportion (about one third of the total) of small range loans (€5 million or less per loan).

63. Although prospects for growth remain strong, the Russian economy appears to be encountering capacity constraints and the population is increasingly worried about corruption and a decline in social services. The EBRD's 2006 Transition Report identifies a series of challenges for the Russian Federation in moving towards self-sustaining, investment and innovation-led economic growth: improving the investment climate by furthering reform of public institutions, combating corruption, reducing administrative and bureaucratic barriers, and clarifying the role of foreign investment in strategic sectors; balancing industry consolidation and the role of state-owned bodies against the need to maintain an open and rules-based regime for trade and foreign investment and to ensure competitive domestic markets; and continued efforts to lower inflation by containing fiscal expansion and allowing for greater exchange rate flexibility.

64. The Russian Federation remains one of the main target countries for the EBRD's investments. In line with its new country strategy for the Russian Federation, approved in July 2006, EBRD activities seek to reduce the country's dependence on natural resources, improve and strengthen corporate governance standards, help the development of SMEs, modernise its infrastructure and promote financial intermediation, especially in the regions. In addition to its existing regional offices in Moscow, St Petersburg, Yekaterinburg and Vladivostok, the EBRD is opening new offices in Rostok, Samara and Krasnoyarsk. During the EBRD Annual Meeting and the Business Forum held in Kazan on 20 and 21 May 2007, the Russian authorities announced a major decision to set up a Russian development bank which would be endowed with about US $2 billion from the Investment Fund (which itself is fed with resources from the Priority Solidarity Fund – OSF) and should in principle become operational within two years. The rapporteur hopes that this new institution will work in complementarity with other institutional investors, such as the EBRD, especially with regard to the financing of costly infrastructure projects with lengthy payback periods through public-private partnerships.

6.2. Ukraine

65. Like the Russian Federation, Ukraine has moved closer towards membership in the World Trade Organization (WTO) and made major reform efforts in the financial sector. It was awarded upgrades in indicators on banking reform and interest rate liberalisation (as well as in infrastructure) in 2006 but many other indicators clearly remain behind. Privatisation targets were missed and many cross-subsidies in the economy still need to be eliminated so as to avoid market distortions and fiscal losses. Unfortunately, Ukraine remains one of the most energy intensive and inefficient countries in the region. The EBRD is currently implementing several energy sector projects in Ukraine, including three projects in co-operation with the EIB.

66. In 2006, real GDP growth attained 7.1% (compared with 2.6% in 2005) as a result of increased prices for export metal, stronger domestic demand and a rise in investments. The country's inflation rate is declining (estimated at 9.1% for 2006), partly owing to budgetary discipline and lower food prices. Ukraine ran a current account deficit in 2006 (1.6% of GDP) for the first time since 1998 due to the boom in imports, escalation of energy prices and less rapid expansion of exports. Nevertheless, FDI inflows remain relatively significant even as the country's political situation, policy priorities and hence decision making suffer from a lack of consensus among key political actors.

67. For Ukraine, the EBRD has recommended prioritising good governance and transparency (including improvements to company law, measures against corruption, a push forward with judicial reform, and ensuring equal competition for private enterprises); promoting investment in energy-saving technologies and increasing private sector participation in the energy sector to offset the impact of rising prices for gas imports; keeping fiscal discipline and allowing for a more flexible exchange rate policy to better withstand adverse external circumstances.

68. The EBRD remains the largest investor in Ukraine where it focuses on policy dialogue to improve the business environment and the competitiveness of the private sector; strengthening the institutional capacity of the financial sector and increasing the level of finance for micro-enterprises and SMEs; as well as supporting

the restructuring and modernisation of the country's infrastructure network (including the energy sector, with particular attention to nuclear safety). The EBRD's investment in Ukraine was a record high in 2006 (€797 million) and totalled, as at 1 January 2007, nearly €2.9 billion in 132 operations, which helped attract an additional €5.6 billion from other investors. We should also note the EBRD's continued efforts to expand its direct lending to municipalities.

6.3. Moldova

69. Although Moldova has nearly completed the initial phase of reforms, the privatisation process and structural reforms have stalled recently. The country has moved forward somewhat with the banking reform and interest rate liberalisation but major improvements in the legal framework and supervision of the banking sector, as well as in corporate governance and transparency, are still pending. Moldova was not awarded any transition indicator upgrades in 2006 (except in the telecommunications sub-category). Its growth rate slowed down (estimated at 4% – down from 7.5% in 2005) and inflation was high (close to 13%) in 2006 following the Russian Federation's ban on Moldovan wine and agricultural products, and a sharp increase in energy prices, mainly for gas imports.[21] Private consumption is growing, essentially as a result of increasing remittance inflows from Moldovan migrants working abroad (estimated to account for at least 11% of the country's labour force). With rising (energy) imports and falling exports, the trade deficit reached nearly 50% of GDP in 2006. Investment levels, however, kept growing, with FDI inflows peaking in 2006 at US$225 million. Government interference with the economy, a weak judiciary, the underdeveloped banking sector, opaque financial system and limited access to finance remain, according to the EBRD, major obstacles to business.

70. Key challenges for the Moldovan economy include: 1. maintaining the reform momentum to improve the business environment, attract investments and enhance competitiveness; 2. enhancing corporate governance and transparency in the banking sector to attract investments and promote competition; and 3. ensuring prudent fiscal and monetary policies (and exchange rate flexibility) to address a growing external account imbalance and inflationary pressures. The EBRD's country strategy for Moldova, approved in July 2005, identifies operational objectives in support of financial institutions, private enterprise and infrastructure. EBRD's activities in Moldova, which is part of the Early Transition Country Initiative, primarily aim to stimulate private enterprises by direct investments (particularly in agribusiness and small enterprises) and intermediary finance through local banks as well as by supporting the development of local business skills. They also include several joint projects with the EIB in favour of the transport sector. By December 2006, the EBRD had approved 48 projects in Moldova representing a total of €205 million (including €13.7 million in 2006), to be added to €125 million mobilised by its partners.

7. Prospects and challenges

71. The assessment of EBRD work over the past five years shows that the Bank is a highly successful international financial institution which performed in line with its mandate as a development bank with a political dimension and made a significant contribution to promoting market-oriented economies, good corporate governance and entrepreneurial spirit in its countries of operations, especially in central and eastern Europe. The Bank's authority among foreign and local investors in the region has grown considerably as has its expertise and involvement. Although the Bank is now gradually disengaging from central Europe, its steady policy dialogue with partner governments and market players continues to play the role of a catalyst for continued reforms throughout all countries of operations.

72. The rapporteur welcomes the EBRD's enhanced attention to the energy sector, especially the challenge of increasing energy efficiency and the security of energy supply in the region. He hopes that the target countries will make the latter issues a lasting policy priority and will accordingly take advantage of the EBRD's financing. The deeper the EBRD gets involved in the east and the south of the region, the more relevant its contribution in this area will be.

73. Further to the decisions of its 2006 annual meeting, the Bank is set to operate increasingly in the needier countries with a more complex and risky business environment. It is important to note that the EBRD's pioneering investment and development effort has so far been sustained while preserving a healthy risk–commitment–result balance and frequently exceeding the Bank's strategic objectives (such as in terms of transition impact, business volume, profitability and stimulatory effects on private sector finance). The Bank maximised its business volume at about €4.9 billion to 301 projects in 2006 [22] (with a 48% share for the early-

21. In November 2006, an agreement to lift the wine export ban was concluded; moreover, a five-year contract for gas deliveries has been signed with the Russian Federation.

to-intermediate transition countries and 38% for the Russian Federation alone) and reaped impressive profits, especially over 2005 and 2006, enabling it to build up general reserves of over 10% of authorised capital in 2006. This financial "cushion" allows the Bank to proceed more swiftly with expanding its risk-taking capacity and support for activities where investments are lacking.

74. According to the EBRD's own estimates, the gap between early transition countries and more mature economies is growing, which is indicative of a slowdown in reforms across most of the former group of countries. This calls for enhanced EBRDs field presence and local reach, more diversified financing offers (including loans in local currency), closer co-operation with other international financial institutions (especially the World Bank, the International Finance Corporation, the EIB and the Asian Development Bank), project associates (including the Investment Centre of the Food and Agriculture Organization of the United Nations, the Central European Initiative, etc.) and local partners, as well as increased vigilance regarding the integrity of clients.

75. The Bank's new business model foresees more specific annual business plans, starting with 2007, in order to better gauge the opportunities, benefits, costs and resource allocation relating to the Bank's development and performance. The core banking activity will be adapted with a view to expanding the product range meant to address large differentiation of country priorities, market conditions, risks and client profiles whilst paying special attention to a proactive policy dialogue conducive to improvements in business environment. The weak capital base of enterprises and financial institutions, underdeveloped infrastructure and energy sector problems are seen as the main constraints in the target countries but they also constitute new challenges for the EBRD's action. Risk control measures, internal audit and project evaluation functions will have to be gradually strengthened.

76. The most recent strategic capital resources review proposes no capital increase in the near future and sets a number of operational priorities, such as the stabilisation of an annual business volume in the range of €3.3 to €3.9 billion, step-by-step increase in the share of financing for the Russian Federation and the volume of operations in the early/intermediate transition countries combined with a steady withdrawal from the advanced countries, and a trend towards smaller average project size to enable the channelling of more resources to SMEs and micro-enterprises. Despite continued productivity gains, it will be necessary to reinforce some of the existing country offices, to open new ones and to close some in the advanced countries already in 2007. It is reassuring to know that the EBRD is estimated to be able to withstand, as from the end of 2008, major shocks equivalent to about 3.5 times the magnitude of the 1998 financial crisis.

22. Compared with €4.3 billion to 276 projects in 2005.

Appendix

Table 1. EBRD's financial and operational highlights

€ million – all figures audited	2006	2005	2004	2003	2002	2001
Operating profit before provisions	2 442.0	1 325.0	468.8**	99.9	294.7	294.7
Provisions for losses	(53.0)	197.0**	(67.2)**	(21.7)	(186.6)	(137.6)
Net profit	2 389.0	1 522.0**	401.6**	378.2	108.1	157.2
Paid-in capital	5 197	5 197	5 197	5 197	5 197	5 197
Total assets	30 691	28 384	22 364	22 045	20 112	20 947
Annual business volume	4 936	4 277	4 133	3 721	3 899	3 656
Net cumulative business volume	33 348	30 326	25 322	22 668	21 647	20 219
Total project value	102 918	94 408	78 542	68 490	69 163	67 765
Portfolio	17 663	16 810	15 324	14 766	14 576	14 160
Operating assets (minus fair value adjustments)	10 893	10 118	10 145	9 102	9 102	8 838
Annual gross disbursements	**3 754**	**2 339****	**3 683****	**2 344****	**2 575****	**2 534****

Source: EBRD: ** Restated.

Table 2. Caucasus macroeconomic indicators: 2005 and 2006 (estimates)

	Real GDP growth (%)		Inflation (%)		Government balance (% of GDP)		Current account balance (% of GDP)		FDI inflows (% of GDP)	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
Armenia	14.0	13.4	0.6	2.9	-2.6	-2.8	-4.2	-4.5	5.2	n/a
Azerbaijan	26.4	34.5	9.6	8.5	-0.7	0.5	1.3	18.8	3.6	n/a
Georgia	9.6	9.4	8.4	9.2	-1.5	-1.7	-5.4	-9.5	6.5	n/a
Average	**16.7**	**19.1**	**6.2**	**6.9**	**-1.6**	**-1.3**	**-2.7**	**1.6**	**5.1**	**n/a**

Table 3. Caucasus transition indicators: 2006

	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	
Armenia	4-	4	2+	4+	4+	2+	3-	2	2+	
Azerbaijan	2	4-	2	4	4	2	2+	2-	2	
Georgia	4-	4	2+	4+	4+	2	3-	2-	2+	

Note 1: Infrastructure includes telecommunications, electric power, railways, roads and water management systems.

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.

Table 4. Key challenges in the Caucasus

Armenia	Azerbaijan	Georgia
Sustained improvements in the business environment, especially with regard to market entry and tax collection, should encourage diversification and foster growth. Improvements in corporate governance, transparency and competition are necessary to promote access to finance and investment. Without faster productivity gains, a further appreciation of the Armenian currency would threaten the country's competitiveness.	A stronger legal and regulatory framework for competition and implementation of effective anti-corruption legislation are necessary to improve the business environment and attract investment in the non-oil sector. Encouragement of private sector participation would advance the development of the financial sector and strengthen the competition in the banking sector. Growing inflationary pressures resulting from considerable oil revenues need to be contained by sensible monetary and fiscal policies while modernising the country's infrastructure and addressing its high incidence of poverty.	Further improvements in the business environment rely on continued implementation of anti-corruption measures, stronger administrative capacity and greater judiciary independence. Addressing the country's infrastructure deficiencies (as they seriously obstruct business) through privatisations in the energy and telecommunications sectors (which should promote more investment and improve performance). Inflationary pressures arising from high energy prices, strong domestic demand and capital inflows should be contained through improved public expenditure management.

Table 5. South-Eastern Europe transition indicators: 2006

	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	3	4	2+	4+	4+	2	3-	2-	2
Bosnia and Herzegovina	3-	3	2	4	4-	2-	3-	2-	2+
Bulgaria	4	4	3-	4+	4+	3-	4-	3-	3
Croatia	3+	4+	3	4	4+	2+	4	3	3
"The former Yugoslav Republic of Macedonia"	3+	4	3-	4+	4+	2	3-	2+	2
Montenegro	3+	3	2	4	3+	1	3-	2-	2-
Romania	4-	4-	3-	4+	4+	3-	3	2	3+
Serbia	3-	4-	2+	4	3+	2-	3-	2	2

Note 1: Infrastructure includes telecommunications, electric power, railways, roads and water management systems.

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 6. South-Eastern Europe macroeconomic indicators: 2005 and 2006 (estimates)

	Real GDP growth (%)		Inflation (%)		Government balance (% of GDP)		Current account balance (% of GDP)		FDI inflows (% of GDP)	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
Albania	5.5	5.0	2.3	2.5	-3.6	-4.1	-6.6	-7.4	3.0	n/a
Bosnia and Herzegovina	5.8	6.0	2.1	7.5	0.8	-0.2	-23.7	-12.8	3.3	n/a
Bulgaria	6.2	6.1	5.0	7.3	1.9	3.3	-11.5	-14.8	8.6	n/a
Croatia	4.3	4.8	3.3	3.2	-4.0	-3.0	-6.6	-8.1	3.9	n/a
"The former Yugoslav Republic of Macedonia"	3.8	4.0	0.5	3.2	0.3	-0.6	-1.4	-0.4	1.7	n/a
Montenegro	4.1	6.3	2.6	3.0	-1.7	-0.3	-8.6	-29.1	20.0	24.4
Romania	4.1	7.7	9.5	6.6	-1.4	-1.9	-10.2	-11.3	6.7	n/a
Serbia	6.3	5.7	17.2	12.5	0.9	2.7	-10.0	-12.9	6.1	n/a
Average	5.0	5.7	5.3	5.7	-0.9	-0.5	-9.8	-12.1	7.0	n/a

Note: Inflation is measured as the change in annual average retail/consumer price level. The Bosnia and Herzegovina inflation figures are averages of the rates in the federation and the Republika Srpska.

Reporting committee: Committee on Economic Affairs and Development.

Reference to committee: standing mandate.

Draft resolution adopted by the Committee on Economic Affairs and Development on 31 May 2007.

Members of the committee: Mr Konstantinos Vrettos (Chairperson), Mrs Antigoni **Papadopoulos** (Vice-Chairperson), Mr Márton **Braun** (Vice-Chairperson), Mrs Doris **Barnett** (Vice-Chairperson), Mr Ruhi Açikgöz, Mr Ulrich Adam, Mr Hans Ager, Mrs Edita Angyalova, Mr Abdülkadir Ateş, Mrs Veronika Bellmann, Mr Radu Mircea **Berceanu**, Mr Akhmed Bilalov (alternate: Mrs Tatiana **Popova**), Mr Vidar **Bjørnstad**, Mr Jaime Blanco, Mr Luuk Blom, Mr Luc Van den Brande, Mr Patrick Breen, Mr Gianpiero Carlo Cantoni, Mrs Cornelia Cazacu, Mr Erol Aslan Cebeci, Mr Ivané Chkhartishvili, Mr Valeriu Cosarciuc, Mr Ignacio **Cosidó**, Mr Ioannis Dragassakis, Mr Joan Albert Farré Santuré, Mr Relu **Fenechiu**, Mrs Urszula Gacek, Mr Carles Gasòliba i Böhm, Mr Zahari Georgiev, Mr Francis Grignon, Mr Kristinn H. Gunnarsson, Mr Alfred Gusenbauer, Mr Nick Harvey, Mr Norbert Haupert, Mr Zěeljko Ivanji, Mr Ivan Ivanov, Mrs Danuta Jazlowiecka, Mr Miloš Jeftić, Ms Dagný Jónsdóttir, Mr Karen Karapetyan, Mr Albrecht Konecny, Mr Anatoliy **Korobeynikov**, Mr Oleksiy Kunchenko, Mr Serhiy Klyuev, Mr Jean-Marie Le Guen, Mr Harald Leibrecht, Ms Anna **Lilliehöök**, Mr Arthur Loepfe, Mr Rune Lund, Mr David Marshall, Mr Jean-Pierre Masseret, Mr Ruzhdi Matoshi, Mr Miloš **Melčák**, Mr José Mendes Bota, Mr Mircea **Mereută**, Mr Attila Mesterházy, Mrs Ljiljana Milićević, Mr Neven Mimica, Mr Gebhard Negele, Mr Bujar Nishani, Mrs Ganira Pashayeva, Mr Manfred Pinzger, Mrs Liudmila **Pirozhnikova**, Mr Claudio Podeschi, Mr Jakob Presečnik, Mr Jeffrey Pullicino Orlando, Mr Maximilian Reimann, Mrs Maria de Belém Roseira, Mr Kimmo Sasi, Mr Bernard Schreiner, Mr Samad Seyidov, Mrs Sabina Siniscalchi, Mr Giannicola Sinisi, Mr Leonid Slutsky, Ms Geraldine Smith, Mr Christophe Spiliotis-Saquet, Mrs Aldona Staponkienė, Mr Stanislav Stashevskyi, Mr Vjaceslavs Stepanenko, Mr Frans Björn von Sydow, Ms Ester Tuiksoo, Mr Han Ten Broeke, Mr Frans Björn von Sydow, Mr Oldřich Vojíř, Mr Robert Walter, Mr Paul **Wille**, Mr Tadeusz **Wita**.

NB: The names of the members present at the meeting are printed in bold.See 22nd Sitting, 26 June 2007 (adoption of the draft resolution); and Resolution 1561.