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The European Bank for Reconstruction and Development: a focal partner for change in transition countries

Report

Committee on Economic Affairs and Development

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Summary

Some sixteen years after the start of their transition to democracy and the market oriented economy, the achievements of post-communist countries, where the EBRD operates, vary considerably. The frontrunners that joined the European Union in 2004 are reaping the benefits of reforms and getting ready for a change in their relationship with the EBRD. They will increasingly act as contributors to the EBRD's action in the less advanced transition countries. The latter, especially in central Asia, but also Belarus and the Caucasian states, require a fresh external impetus for reform. This calls for continued ambitious involvement by both the EBRD and the Council of Europe in their respective fields of activity.

Sustaining sound, dynamic and innovative development through EBRD action will be crucial for helping transition countries cope with a double challenge stemming from their legacy of the past and the new need to adjust to globalisation. In this context, the EBRD's role as a catalyst for change through confidence building, policy advice, transfer of know-how and the bridging of mentalities between East and West is paramount. The report encourages the EBRD to persevere with its work to spread high standards of corporate ethics and the concept of corporate social responsibility.

As global financial markets recover from the "credit crunch" crisis and inflation fed by surging energy and food prices hurts growth prospects, the EBRD should be commended for its solid overall performance and determination to reinvest a large share of its profits in the neediest transition countries, thus reassuring investors and stimulating reformist moves.



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A. Draft resolution

1. When the European Bank for Reconstruction and Development (EBRD) was set up and signed an Agreement of Co-operation with the Council of Europe in 1992, Europe faced major political and economic divisions. Through dialogue and concerted efforts in their respective fields, the two institutions built up large networks, platforms and partnerships to work for reform and integration. Although democratic and market-oriented reforms have advanced significantly, improving the life of millions of Europeans, scores of problems subsist and call for continued ambitious involvement. Of the 29 EBRD countries of operation, those situated in the Council of Europe's close neighbourhood (Belarus and the central Asian republics) are confronted with particular difficulties and require a fresh external impetus for reform.
2. The Parliamentary Assembly highly values regular dialogue with the EBRD on the social, political and economic aspects of the Bank's work. This enables parliamentarians from the Council of Europe member states and observer countries – that are among key donor and recipient countries of the EBRD – to draw on valuable information from the Bank in pursuit of their work at national and international levels and to contribute their views and proposals for the Bank's future activity.
3. The EBRD is more than just a bank. It is an institution with a unique mission and experience at the service of people and countries in search of a democratic identity and a greater role on the global scene. Confidence building, integrity values, strategic advice, transfer of knowhow and the bridging of mentalities between East and West are essential aspects of the EBRD's mandate that are difficult to quantify, yet of critical importance. This approach makes the EBRD a focal partner for development and modernisation in the Eurasian region with resources accompanied by scrutiny both from European and non-European stakeholders. Sustaining sound, dynamic and innovative development through EBRD action will be crucial for helping transition countries cope with challenges stemming from their legacy of the past and the new reality of globalisation. The EBRD should also persevere with its most valuable work in spreading high corporate ethics standards and the concept of corporate social responsibility.
4. The year 2007 was once again highly successful for the EBRD despite the turbulence in global financial markets and an increasing share of its operations being carried out in the early and intermediate transition countries with higher risk profiles. However, noting that the share of commitments to the group of early transition countries (Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan and Uzbekistan) was only 9.2% in 2007, the Assembly welcomes the EBRD's determination, as confirmed by the Board of Governors at the annual meeting in Kyiv on 18 and 19 May 2008, to reinvest 80% of its profits targeting in particular the poorest and hence the neediest countries, thus increasing its risk taking but also the added value of its action.
5. The EBRD works in co-operation and complementarity with other development institutions. Joint projects and initiatives with the World Bank, the European Investment Bank (EIB), the Food and Agriculture Organisation of the United Nations (FAO), the International Finance Corporation (IFC) and the Central European Initiative (CEI), as well as the Council of Europe Development Bank, are particularly relevant for stimulating reform progress in the EBRD's region of activity. Technical co-operation to support projects, grant investment and co-financing amplify the impact of multilateral assistance and help avoid both duplication and lacunae.
6. The EBRD's Life in Transition Survey, carried out together with the World Bank, shows generally improved absolute living standards, a growing middle class, a robust private sector and fairly strong support for democracy. The study also reveals persistent concerns about corruption, income disparity and unemployment, as well as overwhelming expectations for better public services, notably in health care and education, which suffer from underinvestment, heavy administration and inefficiencies. Improved public administration and services would broaden people's support for painful restructuring and reforms ahead. Involving the private sector through a partnership approach should be part of the solution and offers the EBRD vast new opportunities for contributing to progress in this area.
7. Support for small enterprises and entrepreneurship lies at the core of the EBRD's mission. Targeted finance, advisory services and skills development are of utmost importance to all of the Bank's countries of operation. This is reflected in a welcome 32% rise in small-scale projects undertaken by the EBRD in 2007. Moreover, the new TAM-BAS (Turn-Around Management and Business Advisory Services) strategy for 2008 foresees more support (including training) for micro, small and mediumsized enterprises, especially in rural areas of the Russian Federation and Ukraine, which should prove particularly useful in tackling the "brain drain" problem or the loss of talented entrepreneurs through emigration.

8. Rising energy prices, high energy intensity and concerns over security of energy supplies are sobering reminders that promoting energy efficiency across the transition region is a vital, urgent and massive task. Many transition countries depend on a single supplier of oil and gas, mainly from Russian companies, and are in a weak bargaining position. With the EBRD's help, they are seeking to reduce this dependence and enhance their competitiveness by diversifying supply and rationalising energy use, starting with the private companies. Generally, a shift towards greater use of renewables is desirable, but the greatest opportunity – and challenge – lies in improving energy efficiency and conservation. The EBRD and its client countries should persevere along this path.

9. The EBRD's role as a neutral broker for intensified regional co-operation in South-Eastern Europe and the Caucasus is particularly valuable. Whilst the economies of both regions have shown continued dynamism stirred by the aspirations of closer ties with the European Union, reform progress is essentially concentrated in South-Eastern Europe, notably in the Western Balkans area. The precarious calm around the zones of simmering conflict is holding back these regions' true development potential and a narrow understanding of a national interest slows down regional integration on the ground. The Assembly hopes that a newly set up Regional Co-operation Council will foster a more grassroots approach to development projects in South-Eastern Europe, with more regional ownership and initiative, simpler co-ordination and closer parliamentary and civil society involvement at national level. Continued assistance of the international community and inspiration from other successful regional cooperation schemes should help the Council mobilise the region's countries in capacity building, shifting from simplistic rivalry to healthy intra-regional competition and convergence.

10. The EBRD's research has revealed the strong reliance of countries in South-Eastern Europe and the Caucasus on workers' remittances and informal finance whereas the institutional set-up, regulatory framework and the range of financial services available to the population are insufficient. Clearly, there are compelling reasons for the EBRD and its partners to continue investing in the services sector. The creation of an EBRD Shareholder Special Fund for supporting technical co-operation to help prepare investment projects, supplementing existing donor assistance, is a welcome step. This pooling of resources will significantly boost aid to "early transition countries" and Western Balkan states, in line with the EBRD's strategic redeployment of activities to the east and south-east of the European Union as decided in 2006.

11. The Russian Federation remains the largest beneficiary of EBRD funds. Its share in the Bank's annual business volume grew from 38% in 2006 to 41% in 2007, with 90% of investment committed to projects in the regions. A wide spread of funds in the corporate sector, municipal and environmental infrastructure, energy efficiency projects, agribusiness, financial institutions, small and medium-sized enterprises and a trade facilitation programme shows a consistent approach to assisting the modernisation and diversification of the country's economic structures. It is hoped that more of the Russian Federation's own income from natural resources will be gradually employed towards a further restructuring of the economy and promoting entrepreneurship, especially at a micro level. The Assembly pays tribute to the EBRD's considerable input in stimulating regulatory improvements via policy dialogue with state authorities and in facilitating the participation of foreign investors in the Russian economy.

12. Despite prolonged political infighting, Ukraine's steady reformist moves are ushering the country into a new era of regional and global economic integration. After fifteen years of multilateral talks, Ukraine has joined the World Trade Organization and has launched negotiations towards a free trade agreement with the European Union which will further improve Ukraine's development prospects as an increasingly strong industrial and agricultural powerhouse. However, continued efforts are required for Ukraine to ease the tax and regulatory burden, overcome infrastructure bottlenecks, restructure the energy sector, improve public administration and strengthen the rule of law with a view to enhancing the country's longterm international competitiveness. The Assembly welcomes the significant breakthrough in the EBRD-led process of decommissioning the Chernobyl nuclear power plant with two key contracts signed in 2007 and a donation by the EBRD of some of its profits (€135 million) to the Chernobyl Shelter project towards accelerating work to complete the confinement structure.

13. Against the backdrop of a difficult political environment in Belarus, the EBRD's work there has been fairly limited for the past decade. A new country strategy for Belarus adopted in December 2006 commits the EBRD to deepening its involvement with the private sector in this country over 2007 and 2008, focusing on microfinance and small enterprises, and the Bank stands ready to expand its operations beyond the private sector if sufficient progress is made with democratisation and market reforms. The Assembly believes that the EBRD should continue using every possible window for policy dialogue with the authorities with a view to encouraging long-overdue reforms and stimulating the development of the private sector. The Bank might consider extending its activity programme in Belarus by encouraging local private enterprises to invest in energy efficiency, not least via its Sustainable Energy Initiative.

14. Central Asia is a region of high geopolitical importance and deserves more attention from, and involvement by, European countries. The five landlocked central Asian states – Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan – face many common threats (terrorism, drug and arms trafficking, corruption) and challenges (poverty, unemployment, desertification, chemical pollution of land and water, governance, the legal status of the Caspian Sea) and are highly interdependent in terms of transport routes, population movements, water resources, and energy supplies. They would gain enormously from more pragmatic and effective cooperation, both economically and politically, going beyond words to deeds.

15. The Assembly believes that the Council of Europe could consider assisting the region's countries via a possible replication of the schools of political studies, on the basis of the Council of Europe's existing programme for member states plus Belarus. At the same time, the Assembly underlines the need for the EBRD to be particularly vigilant and cautious in central Asia, to ensure that in cases where its investments are targeted at private enterprises they do not indirectly support the abuse of human rights, including the use of child labour.

16. In the light of its earlier deliberations and its resolve to strengthen political dialogue with the central Asian states, not least as advocated in Resolution 1599 (2008), the Assembly might consider associating in future the parliaments of the central Asian states with its debates on the EBRD and on the state of human rights and democracy.

17. Following the application of Turkey to become an EBRD's country of operations, the Bank may decide, in October 2008, to extend its activities to this country thereby opening the doors to a more diversified field of activity going beyond the strict interpretation of its core mission in transition countries. The Assembly trusts that the EBRD will make a careful analysis of how Turkey's application could be best accommodated without compromising the bank's level of involvement in the less advanced transition countries. This may well imply the need to increase the Bank's annual volume of operations beyond the current cap.

B. Explanatory memorandum, by Mr Martins

1. Introduction

1. The Council of Europe and the European Bank for Reconstruction and Development (EBRD) signed a cooperation agreement in 1992, one year after the Bank was set up. The Parliamentary Assembly of the Council of Europe (PACE, or “the Assembly”) has since monitored the Bank’s work and has been reporting annually on its activities in support of democracy, market-oriented reforms and entrepreneurship. Its natural focus has been on Council of Europe member states in central and eastern Europe but also their neighbouring countries in central Asia. Over sixteen years of activity the EBRD has accomplished a major part of its mission in central Europe and is now increasingly concentrating on the more needy client countries in eastern and South-Eastern Europe, as well as central Asian republics, while 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.

2. The Assembly’s Committee on Economic Affairs and Development appreciates the regular dialogue with the EBRD on the social, political and economic aspects of the Bank’s work. This enables parliamentarians from the Council of Europe’s 47 member states and observer countries (that are among key donor and recipient countries of the EBRD) to draw on the valuable information from the Bank in pursuit of their work at national and international levels and to contribute their views and proposals for the Bank’s future activity.

3. This report will provide an overview of the EBRD’s key activities to date, in particular since the Assembly’s last report and debate in June 2007, and will examine selected areas of activity. It will look more closely at the macroeconomic development trends in the Bank’s countries of operation, the progress of reforms in the Caucasus and South-Eastern Europe, as well as the Russian Federation, Ukraine and the Council of Europe neighbourhood. The rapporteur’s work relies on various sources, including the media, the EBRD’s publications and discussions in the Committee and 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 planned for June 2008.

2. Background and general overview

4. It is necessary to recall that the EBRD’s work is driven by the mission to facilitate the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the countries of central, SouthEastern and eastern Europe, former Soviet republics in central Asia, and Mongolia. The EBRD is a development bank with a mandate that combines economic tasks with political aims: the Bank would invest only in those countries that are committed to multiparty democracy, pluralism and a market economy.

5. The Bank’s shareholders are all public bodies (61 member countries represented by governments plus the European Union and the EIB); however its prime attention is on the private sector even though some investments also concern the public sector, essentially infrastructure at national, regional or municipal level. The EBRD cofinances projects that are deemed to be financially sound and aimed at advancing reforms, while respecting the environment. It remains the largest institutional investor in most of its client countries, generating added value through investment finance, knowledge transfer, the promotion of strong corporate governance and policy dialogue. Its contribution has been complementary to the efforts of the international community, national authorities and private sector entrepreneurs, and significant in combining sound investment banking with development tasks.

6. The EBRD’s operational priorities seek 1. to assist the creation of healthy financial sectors linked to the needs of local enterprises and households; 2. to shape commercial policies and financial frameworks for infrastructure development; 3. to support business start-ups and small and medium-sized enterprises (SMEs); 4. to underpin the restructuring of ill-performing larger enterprises; 5. to build equity investments; and 6. to promote a sound investment climate and stronger institutions in the countries of operation through policy dialogue.

7. The EBRD currently works in 29 countries of operation¹ although by virtue of an agreement with the Czech authorities it will no longer invest in that country as from 2008 whilst completing the existing projects. The client countries are divided into three geographical groups: central-eastern Europe and the Baltics (CEB),² SouthEastern Europe (SEE)³ and the Commonwealth of Independent States plus Mongolia (CIS +M).⁴ These countries are also ranked and grouped according to their progress with reforms as “early”,

“intermediate” or “advanced” transition countries. Thus, the group of “early transition countries” (Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan and Uzbekistan) can benefit from specific initiatives designed to co-ordinate donor assistance and help alleviate poverty by financing smaller projects in the private sector, to support municipal infrastructure development and to improve the legal environment.

8. In 2007 (see Tables 1 and 2 in the appendix), the EBRD had substantially increased the share of operations in the early and intermediate transition countries (including the Russian Federation) to 90%, while gradually diminishing investment in the group of more advanced countries. However, the share of commitments to the group of early transition countries is only 9.2% for 2007 (or €514 million to 92 investment projects) despite a 39% increase over the 2006 amount. Total EBRD investments in 2007 rose to €5.6 billion from €4.9 billion in 2006. Conversely, in line with the EBRD’s strategy of gradually reducing investments in the new EU member states, the 2007 business volume going to the CEB region decreased by 22% to €546 million.⁵ In relative terms, the advanced transition countries in the CEB represented 10% of total investments in 2007 (14% in 2006), while the early and intermediate transition countries accounted for 49% (versus 48% in 2006) and the Russian Federation for 41% (versus 38% in 2006).

9. The EBRD’s new business strategy, which outlines the course of work until 2010, specifically commits it to support the transition countries in the south and in the east by taking greater risks than private financial institutions commonly do. To meet the requirements of the less advanced economies, the EBRD is prioritising smaller investments. The number of small projects with a value of less than €5 million rose by 32% to 182 in 2007. The strategy also emphasises the commitment to energy efficiency investment and to promoting regional and international co-operation.

10. It is important to note that while the EBRD has a subscribed capital base of €20 billion (consisting of €5 billion paid-in and €15 billion callable), the Bank finances its investments from the funds raised on the international financial markets (currently on very favourable terms as the EBRD enjoys a top AAA credit rating) and does not directly use the shareholders’ capital. Sound risk management, investment policies and a favourable situation in the Bank’s operating environment generated impressive profits soaring to record levels in 2006: net profits reached €2.4 billion (compared with €1.5 billion for 2005) thanks to one large equity divestment. The audited figures put net profit for 2007 at €1.9 billion.

11. We should recall that the allocation of all profits for 2006 into reserves – as decided by the EBRD’s Board of Governors in May 2007 – was met with a protest by the United States (which is the EBRD’s largest shareholder) arguing that at least one part of the record returns should be paid out to shareholders in dividends. This position was supported by several other EBRD shareholders and even provoked some speculation in the media as regards the Bank’s mission and future.⁶ Australia, for instance, announced its intention to sell its shares back to the Bank by 2010. There have also been reports about certain countries working behind the scenes to propose a merger between the EBRD and the EIB. However, considering major differences between the shareholder structure and the mandate of these institutions, such a merger simply does not make sense in the foreseeable future.⁷ What to do with the profits – invest, return to shareholders or add to reserves – is a recurrent question. However, it is clear that, given their low level and pace of development, the early and intermediate transition countries will definitely need EBRD’s assistance, and hence investment, in the next decade. We hope that the Bank’s shareholders will hear these countries which need and seek its support.

1. Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, “the former Yugoslav Republic of Macedonia”, Moldova, Mongolia, Montenegro, Poland, Romania, Russian Federation, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

2. They are: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

3. This group includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, “the former Yugoslav Republic of Macedonia”, Montenegro, Romania and Serbia. Kosovo is also included.

4. This includes 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. EBRD investments to the new EU member states are expected to cease by 2010.

6. For instance, Antonio Maria Costa, a former Secretary General of the Bank, in his article “Privatise the EBRD and put its cash in the Mideast” (published in the *Financial Times* on 30 November 2007), suggested privatising the Bank in order to set up a new bank with a new mission – to assist reconstruction, development, employment and political processes in the Middle East countries.

7. This position has been expressed by Thomas Mirow, the newly elected President of the EBRD, on 19 May 2008.

Assisting small enterprises

12. At the core of the EBRD's mission lies its support for SMEs and entrepreneurship. The EBRD provides finance mainly through existing banks for lending on to small actors. Its efforts to understand the obstacles to SME development include the Business Environment and Enterprise Performance Surveys (BEEPS), carried out jointly with the World Bank every three years. These studies show that despite numerous obstacles faced by small enterprises, they have been a strong force for growth in many transition countries. Recent developments in the Russian Federation have been particularly important with simplifications of regulations, removal of bureaucratic barriers and hence fewer opportunities for corruption.

13. One of the largest lending instruments is the micro and small business programme whose strategic orientations were redefined in 2006. Since its establishment, the EBRD has invested (mainly through credit lines run by local intermediary banks) more than €11.5 billion under its small business programmes (with sub-loans and leases averaging respectively €22 657 and €19 016) providing support across all of the Bank's countries of operation. However, supplying finance is not the only aim: policy dialogue to improve the business environment for small enterprises, business support to develop the skills of entrepreneurs, technical assistance to strengthen the capacity of intermediaries to lend efficiently and support for setting up greenfield microfinance banks⁸ or non-bank institutions are vital additional activities.

14. Essential and complementary business support from the EBRD flows through the TurnAround Management and Business Advisory Services (TAM-BAS) programmes. These donor-funded non-financial schemes seek to improve enterprise management, performance and corporate governance by providing experienced consultants, often former CEO level executives of western businesses, to assist local companies on a wide range of corporate matters, such as business advice and planning, marketing research, cost accounting and cost reduction studies, product development, marketing plans, IT solutions and strategy development (including enterprise restructuring, reorganisation and management). The programmes also help support employment and generate new projects for external financing. Since 1993, the TAM-BAS programmes⁹ have assisted over 6500 enterprises in all countries of operation, except Turkmenistan. The new TAM-BAS strategy for 2008 foresees more support (including training) to micro, small and medium-sized enterprises, especially in rural areas of the Russian Federation and Ukraine. This should prove particularly useful in tackling the "brain drain" problem or the loss of talented entrepreneurs through emigration.

15. For the Bank's eight poorest countries of operation the Early Transition Countries Initiative (ETCI) is particularly useful. It is designed to encourage economic activity by using a streamlined approach to financing more and smaller projects, mobilising more investment, and accepting higher risk in the projects that the EBRD finances. It also seeks to develop and adjust financing instruments dedicated to the funding of local entrepreneurs and enterprises in order to better address these countries' specific needs, as well as to mobilise greater donor support and to activate anti-corruption mechanisms.

Improving energy use

16. Rising energy prices, high energy intensity and concerns over security of energy supplies are sobering reminders that promoting energy efficiency across the transition region is a vital, urgent and massive task. Many transition countries depend on a single supplier of oil and gas, mainly from Russian companies, and are in a weak bargaining position. With the EBRD's help, they are seeking to reduce this dependence by diversifying the supply and addressing the inefficient use of energy, starting with the private companies. Generally, a shift in fuel composition towards more use of renewables is desirable, but the greatest opportunity – and challenge – lies in improving energy efficiency and conservation. Strong measures are necessary to support this effort.

17. Energy efficiency and renewable energy are the backbones of the latest EBRD Energy Operations Policy, approved in July 2006. This policy commits a total of €1.5 billion to energy projects in the 2006-08 period, which means an almost 50% increase over previous levels. To support this effort, the EBRD has

8. There are nearly 6000 microfinance institutions across central and eastern Europe and the Commonwealth of Independent States (CIS) countries, with around a third of all microfinance being undertaken by traditional commercial banks and two thirds being provided by non-bank bodies, such as credit unions, finance companies or NGOs.

9. TAM-BAS projects employed, respectively, €96 million and €67 million in donor funding. Nearly half of the projects (46%) were undertaken in advanced transition countries (now in the EU) and Croatia; 22% benefited early transition countries and 16% went to the Western Balkans. Many assisted enterprises subsequently sought to expand and improve their activities though recourse to commercial funding, not least from the EBRD or its partners. For instance, the EBRD and its intermediaries have invested €722 million in 163 TAM-BAS enterprises, while further co-financing yielded a total project value of €1.7 billion.

employed a specialist team working across sectors and projects. The EBRD's energy efficiency activity, the Sustainable Energy Initiative (SEI), aims to: 1. increase security of supply (by reducing imports of increasingly expensive fossil fuels); 2. improve competitiveness (by saving energy, costs are reduced and cash flows improve); 3. save scarce capital resources (saving energy is cheaper than building a new power plant); and 4. improve the environment (both globally by reducing greenhouse gas emissions and locally by reducing air pollution). With sustainable energy investments of over €900 million in 2007, the EBRD has in fact reached its three-year target in just over eighteen months.

18. In 2007, the SEI included €934 million in financing for a total of 51 projects. Focus is placed on energy efficiency upgrades for large industrial enterprises in energyintensive sectors (34%), cleaner power energy supply, including switching fuels and efficiency improvements with regard to generation, transmission and distribution (30%), small energy users, such as SMEs and residential users (15%), municipal infrastructure, including district heating, public transport, solid waste and water (15%), renewable energy, including hydro, wind and bio-fuels (7%), and carbon finance. By destination, 40% of all financing goes to projects in the Russian Federation, while 26% is committed to Ukraine, the Caucasus and central Asia, 23% to the new EU members states and 1% to the Western Balkans. About one tenth of all the EBRD's energy investment is devoted to regional projects.

19. The three distinctive operational approaches include: defining energy efficiency components in all relevant operations; 2. financing small energy efficiency and renewable energy projects through local banks with dedicated credit lines to SMEs and households; and 3. combining project finance and carbon finance (as emissions trading opportunities are commonly under-utilised). Providing free energy audits funded by donors through technical co-operation has been a particularly successful energy strategy component, as the grant element has helped to enhance motivation and investment (with €1 of grant yielding €5 of commercial finance).

Evaluating projects

20. A small team of 16 staff carries out ex post evaluations of EBRD projects (technical co-operation and investment operations) in order to determine whether the EBRD's mandate has been fulfilled and project outcomes have been in line with expectations. Evaluation includes an assessment of accountability (towards EBRD management and board of directors as well as the general public), transparency (a prerequisite for accountability) and independence (from operational activities). The evaluation team reports directly to the board of directors, where the Audit Committee plays an important role in reviewing the evaluation work and following up on recommendations. The EBRD is also involved in a number of initiatives with a view to harmonising international co-operation and evaluation.¹⁰ The challenges of the coming years include coping with a larger number of operations ready for evaluation, continuing with the harmonisation process and maintaining a good system for the follow-up of evaluation recommendations.

21. The EBRD's evaluation work measures and assesses the transition impact,¹¹ environmental performance and change, the Bank's additionality (financial and nonfinancial), financial performance, fulfilment of objectives, the EBRD's investment performance and bank handling. Between 1996 and 2006, the team evaluated a total of 547 projects, 77% of which had an excellent or satisfactory transition impact rating and 56% a successful or higher overall performance rating. In 2007, the EBRD published 23 evaluation reports on investment operations and six on technical co-operation operations, covering about two thirds of projects ready for evaluation.¹² The evaluation team also carries out special studies on targeted themes or sectors¹³ and gathers and disseminates the lessons learned.¹⁴ The main studies and evaluation reports are available on the EBRD website in a condensed form.

10. For example, by collaborating with the Evaluation Cooperation Group together with other multilateral development banks and international financial institutions (the Council of Europe Development Bank is soon to be included in this group), working on good practice standards to further harmonise evaluation practices and procedures, developing a new framework of peer reviews of evaluation systems, and concentrating on joint evaluation.

11. By looking at the following variables: greater competitive pressures; market expansion (via linkages to suppliers and customers); increased private sector participation; institutions, laws, regulations and policies that promote market functioning and efficiency; transfer and dispersion of skills; demonstration effects from innovation; and higher standards of corporate governance and business conduct.

12. This is in line with the coverage ratios stipulated in the Good Practice Standards for the private sector established by the Evaluation Cooperation Group of the multilateral development banks.

13. Recent studies include sector studies on agribusiness and financial institutions, ETC fund evaluation, study on equity exits and an evaluation on EBRD's environmental policy over 2003 to 2006.

14. By hosting workshops with sector teams and resident offices and through the Lessons Learned database.

Strengthening integrity

22. The transition to a market economy has often taken place in environments characterised by weak institutions and low standards of corporate and public governance. As a result, corruption is endemic in most countries. According to the 2007 Transparency International Corruption Perceptions Index (with corruption being defined as the abuse of public office for private gain), several countries of operation were ranked very high on the corruption scale. Out of 179 countries, Uzbekistan was ranked 175, Turkmenistan 162, Azerbaijan, Belarus, Kazakhstan, the Kyrgyz Republic and Tajikistan 150 and the Russian Federation 143. Other countries were ranked more in the middle, such as Ukraine 118, Moldova 111, Albania 105, and Armenia and Mongolia 99. From the start, the EBRD has been committed to applying sound banking practices in all its financial operations and is bound by the agreement establishing it to prevent its funds from being illegitimately diverted from their intended purposes. In order to ensure the highest level of integrity in its activities, the EBRD has a number of mechanisms in place to combat corrupt, fraudulent, coercive and collusive practices. This is particularly relevant in dealing with politically exposed persons or entities.

23. In its first anti-corruption report of November 2006, the EBRD outlines its strategy based on prevention, detection, investigation and sanction. Preventive measures include guarding the integrity of the EBRD (internal prevention and audit),¹⁵ tackling corruption where it occurs (external assistance),¹⁶ and participating in the global fight against corruption. With regard to the latter, the EBRD actively works with a number of international institutions and initiatives.¹⁷ In 2006, the EBRD and other international financial institutions created the International Financial Institutions' Anti-corruption Task Force (IFITF) to harmonise the methods for combating corruption and fraud within operations and projects. It particularly works towards enhancing information sharing and a greater standardisation of the definitions of corrupt or fraudulent practices. The rapporteur fully supports the EBRD's commitment to address corruption as a global problem which requires solutions based on international co-operation and collaboration.

24. In order to improve the detection of fraud, corruption and misconduct, the EBRD uses an integrity due diligence process for screening clients and sponsors, as well as gathering information through a compliance hotline and by offering protection to witnesses and whistleblowers. Finally, in response to allegations of fraud and corruption, it relies on both internal investigations (of staff members, board members and senior management) and external investigations (of both public and private sector individuals or entities). Moreover, the EBRD's Independent Recourse Mechanism (IRM) assesses complaints with regard to EBRD-financed projects from local groups that may be directly and adversely affected by a project. Finally, according to its mandate, the EBRD engages fully only in countries that are committed to democratic principles and strictly limits its operations to the private sector in countries, such as Belarus and Uzbekistan, with a poor human rights record. Due to a more risky environment and increasing workload on integrity issues with the Bank's move south and east, it is necessary to further strengthen the compliance function.

3. The Bank's 2007 transition report

i. Transition progress and macroeconomic performance

25. The EBRD tracks transition progress by scoring its client countries with regard to nine indicators divided into four categories: 1. enterprises (large-scale privatisation, small-scale privatisation, governance and enterprise restructuring); 2. markets and trade (liberalisation of prices, trade and foreign exchange system, and competition policy); 3. financial institutions (banking reform and interest rate liberalisation, securities' markets and nonbank financial institutions); and 4. infrastructure. The nine indicators relate to different stages

15. The first step in the fight against corruption on the part of an international organisation is clearly to ensure that its own staff members are responsible and held accountable for ensuring the institution's integrity and reputation. All EBRD staff and members of the board of directors have to undergo integrity training to increase their awareness and provide them with guidance if and when they are confronted with a potentially corrupt or fraudulent situation. The EBRD also relies on codes of conduct, institutional controls, assessment of possible reputation and integrity concerns of clients or sponsors (integrity due diligence), efforts to combat money laundering, and observation of "the highest standards of ethics during the procurement and execution" of EBRD-financed contracts.

16. In its support to governments in the countries of operation, the EBRD seeks to raise awareness of corruption (through policy dialogue and technical assistance), strengthen corporate governance within client companies (as summarised in a set of guidelines on sound business standards and corporate practices) and engage in institution and capacity building.

17. Such as the Council of Europe (that is, the Group of States against Corruption, GRECO), the Extractive Industries Transparency Initiative (EITI), Final Action Task Force (FATF), International Group Against Corruption (IGAC), Multilateral Development Banks Investigators Forum (MDBIF), Organisation for Economic Co-operation and Development (OECD), and Transparency International.

of the transition process. First-phase, “market-enabling”, reforms include small-scale privatisation, price liberalisation and trade and foreign exchange liberalisation, while second-phase, “market-deepening”, reforms involve large-scale privatisation and financial institutions reform. The third-phase, “market-sustaining”, reforms entail governance and enterprise restructuring, competition policy and infrastructure reform.

26. First-phase reforms are by and large completed in most countries. Progress last year has mainly been made in second- and third-phase reforms, mostly in the financial sector and on competition policy, although these are not yet completed in the more advanced transition countries and have only begun in the early transition countries. Infrastructure reform remains a major challenge for many countries (especially in the energy sector to enhance energy security, the diversity of supply and energy efficiency). In 2007, transition progress slowed down and only 20 transition score upgrades were awarded in total (which is the lowest since the start of the transition process). Progress was concentrated in SEE (notably the Western Balkans), which received half of the upgrades. In CIS+M countries with strong market support (Georgia and Mongolia), much progress has been made in stimulating the private sector, while financial sector reforms have made headway in western CIS countries. Progress has been slow or limited in the resource-rich CIS countries and CEB states which receive large amounts of EU funds. In some CIS countries, the privatisation process has stalled (or was even reversed). The slowdown in reform pace in many CIS countries is widening the transition gap with CEB and SEE. The newest country of operations, Mongolia, having started at low levels, was the star reformer of the year with a total of three transition score upgrades.

27. The main challenge for the CIS countries is to move beyond first-phase reforms, which requires not only political will and commitment but also institutional and legislative support. SEE should keep the momentum to complete second-phase reforms and advance with third-phase reforms. While further deepening of EU integration is likely to support this process, political risks and uncertainties are causes of concern in parts of the western Balkans, not least following the unilateral declaration of independence by Kosovo. Finally, the CEB countries need to press forward with private sector involvement in infrastructure and more efficient competition authorities.

28. In 2007, the transition region overall recorded the highest average growth rate – 7% – since the establishment of the EBRD. However, the level of estimated GDP in 10 countries – Bosnia and Herzegovina, “the former Yugoslav Republic of Macedonia”, Georgia, Kyrgyz Republic, Moldova, Montenegro, Russian Federation, Serbia, Tajikistan and Ukraine – has not yet reached pre-transition levels of 1989. The high growth has primarily been driven by domestic demand (both consumption and investment are up, especially in the CIS countries and most notably in the Russian Federation), spurred by FDI inflows, migrant remittances and the expansion of lending. With a particularly strong demand for housing, construction is booming, while domestic credit and investment are expanding fast across the region, except for the CEB countries where investment rates have started to decline somewhat in recent years.

29. As trade, especially with Asian countries, is expanding rapidly, there has been strong growth in imports and a corresponding widening of current account and budget deficits in most CEB, SEE and CIS countries whereas resource-rich CIS countries accumulated large trade and budget surpluses thanks to swelling profits from exports. Trade among the CIS countries is still dominated by oil and gas. These trends are likely to persist also this year.

30. Unemployment and poverty rates have continued to fall, boosting the disposable income of the population. However, consumption and investment are likely to slow down, which could moderate growth rates in the near to medium-term future. There are also concerns over overheating economies in many countries with high inflation rates and large external imbalances. The competitiveness of the Baltic states in particular is at risk, despite exports remaining strong. Monetary policies have been tightened, while fiscal policy has not. After Slovenia successfully introduced the euro in 2007, only Slovakia seems fit to follow suit in 2009 while other advanced countries in central Europe will take a few years to rein in inflation and meet the fiscal criteria.

31. Turmoil in the global financial markets has so far had a limited effect in the transition region in general. Nevertheless, there are concerns over how they will affect the region, primarily countries with large external financing needs (such as Kazakhstan), but pressures remain also in Bulgaria, Hungary, Latvia, Romania and Serbia. The primary challenge for the financial sector lies in enforcement of regulation and supervision.

32. Against the background of soaring world food prices (up by nearly 40% in the year to December 2007, according to the UN Food and Agriculture Organisation), there are clear incentives, also for the EBRD, to invest in a significant untapped agricultural production potential in eastern Europe and the CIS region, especially Kazakhstan, the Russian Federation and Ukraine, where millions of hectares of arable land could be reclaimed and returned to agricultural use at no major environmental cost. In reaction to rising prices, some

governments in transition economies have responded by introducing protectionist measures (such as price controls, increased subsidies and restrictions on food exports) to protect domestic consumers. However, these steps could prove counterproductive long term and the EBRD is advocating restraint on interventions that might lead to distortions in domestic markets and in favour of investment facilitation along the entire agricultural value chain, while the most vulnerable population could be better protected through targeted income support. In 2007, the EBRD launched 40 projects in the agribusiness sector worth €517 million (record annual volume).

33. Furthermore, to highlight the importance of these issues, the EBRD organised a conference of private sector investors and public sector officials at its headquarters in London in March 2008 and followed it up two months later with a special Agribusiness Forum on the margins of its annual meeting in Kyiv. Policy dialogue on agricultural investment in its client countries is top priority for the EBRD and will be a central feature of its forthcoming agribusiness sector strategy.

ii. Focus on people in transition

34. In 2006, the EBRD, together with the World Bank, carried out a Life in Transition Survey, through which 29 000 households were surveyed in 28 transition countries¹⁸ plus Turkey. The survey sought to measure how the transition process has affected life satisfaction, absolute and relative living conditions, attitudes to democracy and markets, and future aspirations.

35. Seventeen years of transition have clearly changed life dramatically for most people. While overall more people are satisfied than dissatisfied, general satisfaction is commonly higher in the richer, more advanced transition countries. General satisfaction is hence higher in CEB and lower in SEE and relatively mixed in CIS +M countries. Dissatisfaction (with only 20% to 30% of the surveyed households being satisfied with life today) is strongest in Armenia, Azerbaijan, Bosnia and Herzegovina, Bulgaria, Georgia, Hungary, “the former Yugoslav Republic of Macedonia”, Moldova and Montenegro.

36. While most people believe their living standard to have improved in absolute terms (especially in Albania, Belarus, Estonia, Tajikistan, Mongolia and Uzbekistan), they also perceive a relative decline in household wealth since the start of the transition process (with the exception of Albania where most have seen a relative improvement). Most people strongly support democracy, with Russian respondents relatively less committed. Support for the market (versus planned) economy is weaker than the support for democracy, but is still positive (and especially high in Albania and Mongolia, but also in the new EU member states). The younger, better educated, better off, more connected and more mobile parts of the population have generally benefited more from transition and are hence more satisfied and more supportive of both democracy and the market than other groups.

37. The most striking feature of the transition process in many countries is the emergence of a middle class. As a percentage of the total population, the size of the middle class averaged 19% in CEB, 12% in SEE and 8% in CIS+M. This is closely correlated to democracy (as defined by the Freedom House),¹⁹ that is, the larger the middle class, the more democratic the country (exceptions are Belarus and the Russian Federation, where the middle class is larger than the democracy index would suggest). The transition process has, however, also brought about negative income shocks and destruction of human capital. Large groups have lost out and remain dissatisfied, most commonly poorer, older, less educated and unemployed sections of the population.

38. Overall, people are less happy for the same reasons as in other countries, that is, because of a decrease in income and fewer public goods/services. However, the survey shows that attitudes and values in most transition countries are not yet converging with those in western Europe. Civil society is still emerging, with civic activism²⁰ relatively strong in some CEB and SEE countries and relatively weak in the Caucasus and Central Asia. In terms of civic membership,²¹ figures vary widely. The primary challenge is to adjust policies to reach the dissatisfied groups and include them in the reform process.

39. Most people want governments to invest in health care (39%) and education (23%), while others prioritise pensions (15%), housing (12%), public infrastructure (4%) and environment (3%). Health care and education are also expensive as they account for most of household expenditure for public services (each category amounts to around one third of household expenditure across the transition region). This is also

18. Namely all current countries of operation except Turkmenistan.

19. See www.freedomhouse.org.

20. People who have or might participate in lawful demonstrations, strikes and signing the petitions.

21. People who belong to a political party and/or a voluntary association.

partly due to corruption (“unofficial payments”) in several countries. While health care and education are what people care for most, they are also quite discontent with the quality of these public services (more so with regard to health care than with regard to education). Dissatisfaction is generally higher in the SEE and CIS+M countries than in CEB.

40. Improving public services would broaden support for reforms. The private sector can bring in capital and knowhow and enhance efficiency in the delivery of public services, but its involvement also requires effective regulation, courts and administrative agencies, open tendering, fair competition and transparency. The key challenge is to create a quality public service structure of legal and political frameworks that allows for efficiency gains at the same time as it should provide affordable access for all. Greater transparency and community-based monitoring in particular would engage and provide people with a stake in the reform process.

41. Transition has brought on an upheaval in the labour markets across the region. Many have left the labour force, while others are long-term unemployed. Unemployment levels rose sharply at the start of transition and have only recently begun to subside in a few countries; they remain particularly high in most countries in the western Balkans and in Turkmenistan. In the transition process, there has been a significant reallocation of labour from the state to the private sector and from manufacturing to services. The speed of labour reallocation has varied greatly between the regions. The percentage of working-age population in private employment surpassed that in state employment in CEB in 1997-98 and in SEE in 2003/2004 but has yet to surpass it in CIS+M countries. Self-employment is low, but increasing, especially in CIS+M. The self-employed and the better skilled parts of the labour force are commonly more satisfied and supportive of markets. Increasing employment is clearly a major priority for all transition countries. To this end, they need to invest more in upgrading skills through training and education, improving conditions for entrepreneurial activity, bringing the long-term unemployed back into the labour market, and improving labour mobility (including flexible housing).

4. Reform progress and intra-regional co-operation in the Caucasus

42. Reforms generally stalled in the Caucasus last year (see Tables 3 and 4 in the appendix), as only Georgia advanced more substantially by completing the privatisation process and pushing forward with energy sector reforms, especially as regards services. Armenia earned some praise for involving the private sector in water management and thus improving supply. Both Armenia and Georgia have by and large successfully completed first-phase reforms, but are now having problems with advancing with third-phase (and to some extent also second-phase) reforms. In Azerbaijan, reforms are at a standstill as the beneficial economic situation seems to have reduced the sense of urgency for reform.

43. Real GDP growth rates for 2007 are high at between 8% to 10% in Armenia and Georgia, while Azerbaijan continues to be the fastest growing country in the transition region (primarily thanks to the Baku-Tbilisi-Ceyhan oil pipeline and high oil prices). The absolute levels of real GDP in Armenia and Azerbaijan are around 25% to 35% higher than at the start of transition (and poverty levels have fallen in both countries), while that of Georgia is only half the 1989 level. Armenia’s inflation rate continues to stay low at 3.5%, while Azerbaijan’s rate is projected at 13.5% in 2007 (partly as a result of the central bank restricting an appreciation of the local currency). Azerbaijan’s Government balance is slightly positive, but it has a large non-oil budget deficit as a result of a surge in fiscal spending. Partly due to the Russian Federation’s ban on imports of Georgian agricultural products, Georgia’s current account deficit is expected to be as high as 16% in 2007 whilst the trade sanctions as such are expected to accelerate the reorientation of Georgian entrepreneurs towards western European markets. Azerbaijan, on the other hand, should enjoy a current account surplus of 20%. However, with regard to foreign investment, Azerbaijan, in contrast to the other CIS countries and despite the booming growth rates, has seen a slowdown and net decrease in flows since 2005 (due to a reduced need for investment in energy infrastructure and capital repatriation by foreign oil firms). FDI inflows to both Armenia and Georgia are increasing, projected to account for 4.5% and 14.3% of GDP respectively in 2007.

44. In the short term, strong growth is expected to continue in the Caucasus region, driven by commodity trade (especially for oil and metals), strong domestic consumption (fuelled by massive inflows of migrant remittances), a booming property and construction sector and a growing service sector. In the long term, however, growth could stall as a result of political instability and unresolved regional conflicts, vulnerability to changes in commodity and property prices, the lack of economic diversification, limited export markets, weak financial sectors, continued currency appreciation and barriers to intra-regional trade. The main long-term tasks therefore lie in diversifying the economies (and the sources of energy supply in the case of Armenia and Georgia), managing commodity revenues efficiently and transparently, promoting competition (by ensuring a

level playing field for all firms and by dissolving existing monopolies, both public and private), accelerating post-privatisation restructuring, continued development of the legal and regulatory frameworks, strengthening corporate governance and transparency, developing physical infrastructure and curbing corruption. There is also a need to improve access to capital, enhance the overall business climate in order to attract more investment, streamline the tax and customs administrations, and increase bank mediation.

45. Apart from the regional office for the Caucasus in Tbilisi, opened in September 2006, the EBRD has offices in all three countries. By the end of 2007, cumulative EBRD commitments to the Caucasian states totalled €1.5 billion (Armenia 10%, Azerbaijan 50% and Georgia 40%). In 2007 alone, €392 million were earmarked for 22 operations in Armenia (20% of the total), 27 operations in Azerbaijan (31%) and 27 operations in Georgia (49%), while nearly the double (€665 million) should be invested this year.

46. The EBRD's strategic priorities in the Caucasus region centre on support to micro, small and mediumsized businesses, natural resource development and management, the financial sector (increasing intermediation and upgrading skills), agribusiness (helping efficient processors and retailers), transport infrastructure (with a focus on local and regional networks), municipal services (water supply, heating, urban mobility and energy efficiency projects), and the energy sector (especially renewable energy, power sector improvements, and regional projects).

5. Development prospects for South-Eastern Europe

47. The political turbulences and uncertainties of the 1990s have kept the economic development of the SEE region well below potential. Most economic reforms took off with the prospect of closer integration with the European Union. Not surprisingly, Bulgaria, Croatia and Romania appear, in recent years, as the fastest reformers not only in South-Eastern Europe but also the whole transition region. With their accession to the EU, Bulgaria and Romania saw unemployment fall below 10%, rising wages and a rapid expansion of credit to private enterprises and households accompanied by better banking regulation and new dynamism in domestic investment, insurance and leasing activities. The business environment significantly improved in Croatia with steps for a comprehensive simplification of regulations and strengthened competition policy. The relative prosperity (in terms of GDP per capita) of Bulgaria and Romania is about one third of the EU-25 average, while that of Croatia is about half of the EU-25. The entering into force, in July 2007, of the expanded Central European Free Trade Agreement (CEFTA) and the Interim Trade Agreement with the EU are expected to further intensify regional trade.

48. With 10 out of 20 transition reform upgrades for the EBRD's countries of operation, the SEE region made notable progress in 2007 (see Tables 5 and 6 in the appendix). Most reforms took place in the Western Balkan countries, particularly as regards institutional improvements, but the picture is mixed. Following its independence, Montenegro²² joined the CEFTA in December 2006 and signed a stabilisation and association agreement (SAA) with the EU in October 2007, thus demonstrating strong commitment to an open trade regime and competition. Serbia signed such an agreement with the EU in April 2008, and the last remaining country, Bosnia and Herzegovina, is expected to sign an SAA in June 2008. Bosnia and Herzegovina accelerated the privatisation of large state-owned companies (particularly in Republika Srpska) and strengthened competition policy. The latter aspect of reform was also visible in Serbia and "the former Yugoslav Republic of Macedonia". Romania advanced significantly with regard to reform in the financial sector.

49. Despite relatively strong growth rates (at an average of around 6%), real GDP levels are still below their 1989 levels in all of the western Balkans countries except Albania and Croatia. Unemployment remains stubbornly high in many countries (above 30% in Bosnia and Herzegovina, "the former Yugoslav Republic of Macedonia" and Montenegro, and above 20% in Serbia, although some of those registered as unemployed are in fact working in the informal economy). Wages have, however, increased in most SEE countries. Inflation rates have been fairly stable during the last decade but inflation pressure has been mounting throughout the region since the autumn of 2007 due to higher food and energy prices. As most SEE countries are bound by fixed exchange rate regimes, fiscal policy is the primary instrument to maintain price stability. Although most countries have maintained budget surpluses, government balances are worsening in some countries (particularly large budget deficits are recorded in Albania and Croatia), especially following tax reductions and increasing expenditure for social benefits and public wages.

22. In June 2007, the EBRD opened a resident office in Podgorica.

50. Trade deficits continue widening as growing exports have not been able to match increasing imports as a result of strong domestic demand and insufficient domestic production. The average current account deficit for the entire SEE region is expected to be around 12% of GDP in 2007 (being particularly large in Bulgaria and Montenegro). Such deficits could cause long-term problems with competitiveness, especially for countries with fixed exchange rates. Nevertheless, foreign investment inflows continue to grow following large privatisations in many countries, particularly in Croatia and Serbia. While Bulgaria and Romania are the largest recipients in absolute terms, the largest recipient in relative terms is Montenegro, where FDI inflows accounted for more than one quarter of GDP in 2006.

51. A move towards the third stage of reforms and closer intra-regional economic integration will test the maturity of institutions and the political will of the national elites. The EBRD notes that markets and regulations are still very fragmented along national borders, hampering the build-up of essential infrastructure networks, delaying much needed structural reforms and weakening the region's external competitiveness. Although countries in South-Eastern Europe have seen large inflows of foreign capital, much of this went into real estate and only marginally into productive investment or infrastructure upgrades. The poor condition of the road network and widespread electricity blackouts continue to hurt regional trade, development and competitiveness. Of all the transition countries, those in South-Eastern Europe enjoy the most secure gas supply; however they lag behind the levels of most western European countries in terms diversification of sources for gas imports.

52. While increasing political stability, further regional integration and closer ties with the EU will encourage growth and the reform process in SEE (especially in the Western Balkans), concerns with regard to current account deficits, competitiveness, fiscal relaxation and inflationary pressures (following from increasing prices and rising wages) remain. The Stability Pact for South-Eastern Europe, set up in 1999, has built solid platforms for democracy and structural reforms before evolving, in 2007 and 2008, into a Regional Co-operation Council (RCC, headquartered in Sarajevo) involving a more grassroots approach to development projects, with more regional ownership and initiative, simpler co-ordination and closer parliamentary and civil society involvement at national level. We hope that with the continued assistance of the international community and inspiration from other successful regional co-operation schemes,²³ the RCC will mobilise the region's countries in capacity building, shifting from primitive rivalry to healthy intra-regional competition and co-operation.

6. Working with the Russian Federation and Ukraine

Russian Federation

53. For nearly a decade the Russian Federation has enjoyed strong and sustained growth propelled by comfortable revenue from commodities-dominated exports. The current account, budget surplus, foreign exchange reserves, foreign and domestic investment, GDP per capita and the disposable income of the population have all swollen despite persistent double-digit inflation (some 10% in 2007), currency appreciation, worsening capacity constraints, bureaucracy and the slow pace of institutional and structural change. In the last two years, the Russian Federation's economic growth (of about 7.2% in 2007 and 6.7% in 2006) was outstripped by neighbouring CIS countries far less endowed with resources (Armenia, Belarus, Georgia, Ukraine and the central Asian republics), even though they started from a lower base. While the Russian Federation made much progress in liberalising trade and hence towards membership of the World Trade Organization (WTO), it is still locked in a number of trade disputes with countries such as Georgia, Moldova and Poland. Net foreign investment inflows into the Russian Federation were expected to boom in 2007 (almost tripling in value on 2006) and were increasingly going to non-energy related sectors (such as production facilities to meet the growing demand for consumer goods).

54. In the EBRD's view, reform progress last year in the Russian Federation was minimal, with some noteworthy steps to implement railway reform and the expansion of the banking sector. First-phase reforms are not yet entirely completed (in fact, in some cases, the state's role in the economy has actually grown) and there is much room for progress with regard to second-phase and third-phase reforms. Key challenges, as identified by the EBRD, include structural diversification of the economy (allowing for more private sector participation), more transparent tender procedures for public sector infrastructure contracts (again to stimulate more private investment) and containment of fiscal expansion and price rises (one of the country's main macroeconomic concerns).

23. Such as the Council of the Baltic Sea States (CBSS).

55. The Russian Federation remains the main target country for the EBRD's involvement and investment. The Bank aims to promote further diversification of the Russian economy beyond natural resources, with emphasis on regional development and knowledge-intensive industries. In 2007, it invested about €2.3 billion (or about 41% of the year's business volume) in the Russian Federation, essentially outside Moscow and St Petersburg, spread across the corporate sector (33% of the total), financial institutions (29%), infrastructure and energy projects (28%), and the trade facilitation programme (10%). The EBRD does a very valuable job advising foreign investors, assisting company development (especially by acquiring equity capital and participating in management), initiating energy efficiency audits, stimulating know-how transfer, bridging the gaps in understanding between the Russian and the western European communities, and promoting good governance and policy dialogue with federal and regional authorities. We would hope that the Russian authorities will take advantage of EBRD's expertise for developing major infrastructure projects to ease multiple bottlenecks.

56. We should recall that during the EBRD annual meeting in Kazan on 20 and 21 May 2007, the Russian authorities announced the establishment, within about two years, of a Russian Development Bank. The new entity – a state corporation, the Bank for Development and Foreign Economic Affairs (Vnesheconombank), or VEB for short – was, in fact, set up by reorganising the Bank for Foreign Economic Affairs of the USSR (earlier known as Vnesheconombank of the USSR). Its main task is to promote the competitiveness and diversification of the Russian economy through the “financing of investment projects aimed at development of infrastructure and implementation of innovative projects”. Priority is to be given to projects carried out on the basis of public-private partnerships and all investment projects considered will have to comply with environmental efficiency standards.

57. Although it is not yet quite clear what sort of relationship there could be between the EBRD and the VEB (hopefully – the bond of co-operation and complementarity), the latter seems more involved in particularly large projects, such as a recently announced US\$2 billion loan to the state oil company, Rosneft. This commitment is equivalent to more than a half of the EBRD's total business volume in many operations in the Russian Federation last year. According to the latest information available to the rapporteur, the EBRD and VEB signed, in February 2008, a memorandum of understanding to work together to promote, among other objectives, the diversification of the Russian economy, the renewal of infrastructure and the development of public-private partnerships (PPPs). They will explore the possibility of co-financing projects in areas such as transport infrastructure, energy and municipal services, or in sectors with significant environmental and energy efficiency potential, as well as projects which contribute to the diversification of the Russian economy and the development of regions. The two banks are already co-ordinating their efforts on several important PPP projects that are being developed in the transport sector and will also consider setting up a special unit, together with other interested organisations, in order to assist the process of project preparation for PPPs in infrastructure.

Ukraine

58. The year 2008 started with long-awaited good news for Ukraine: after fifteen years of multilateral talks, on 5 February the WTO General Council formally endorsed Ukraine's WTO membership. Soon thereafter, the EU and Ukraine launched negotiations towards a free trade agreement that would pave the way for the abolition of the EU import quotas for Ukrainian-made products, especially steel. Ukraine's reformers see these keynote developments as an important recognition of the country's regional and global engagement and a gateway to more prosperity as an increasingly strong industrial and agricultural powerhouse. On 16 May 2008, Ukraine became the WTO's 152nd member.

59. Ukraine's economic growth remains strong and relatively stable at around 7% growth in real GDP. It is mostly driven by private domestic consumption, high international prices for metals and increased investment. While inflation fell between 2005 and 2006, it reached nearly 13% in 2007. As a result of underlying pressures (mainly in the food and energy sectors and the national currency peg to the dollar) that have been intensifying, inflation is hitting 30% in the first months of this year and the scope for intervention by the national central bank is limited. Like in the Russian Federation, inflation is one of the main worries from a macroeconomic perspective and the government deficit is worsening. Although foreign investment inflows are expected to remain high, Ukraine recorded its first current account deficit in eight years in 2006 and it was expected to worsen to 3.7% of GDP in 2007 following soaring values of energy and consumer goods imports. Prospects of closer ties with the EU have clearly spurred market reform in Ukraine which has almost completed first-phase (market-enabling) reforms and is moving to second-phase (market-deepening) reforms. In 2007, the EBRD awarded Ukraine a transition score upgrade for progress in securities markets and nonbank financial institutions reform.

60. While the short-term growth outlook is favourable with expectations of high demand for the country's agricultural and commodity exports, Ukraine's competitive advantage underpinned by cheap energy and labour is fading. Rising inflation is causing a real appreciation of the exchange rate. The rapid growth in external borrowing and bank lending in foreign currency makes the economy vulnerable to external financial shocks. A slow reform process and political squabbling would clearly hurt the country's long-term growth potential. Key challenges, as seen by the EBRD, include lowering barriers to market entry, reducing tax and regulatory burdens on enterprises, further development of the domestic capital market (including greater transparency and better enforcement of property rights), stronger banking supervision and greater exchange rate flexibility (to contain external risks and shocks).

61. The EBRD has been active in Ukraine since 1993. It now has two resident offices (in Kyiv and Dnipropetrovsk), with a total of 36 staff. In Ukraine, the EBRD primarily finances investments in fixed assets, working capital and trade facilitation for leading local and foreign companies. By the end of 2007, the EBRD had financed a total of 155 projects in Ukraine, worth over €3 billion (72% of which was allocated to the private sector) while another €3 billion was additionally attracted through co-financing partners, including from other transition countries such as Poland and Serbia. In 2007 alone, the EBRD commitments to Ukraine amounted to €647 million (somewhat down from the record level of €789 million in 2006), making Ukraine the Bank's third largest recipient of funds (after the Russian Federation and Poland). It also successfully launched its lending programme in the local currency, hryvnia.

62. EBRD financing in Ukraine has generally been devoted to agri-business (25%), financial institutions (21%), transport (18%), industry (16%) and the energy sector (6%), while the current projects show greater attention to energy (22%), financial institutions (20%, including credit lines for SME development and energy efficiency, as well as mortgages and guarantees), property (16%), general investment (15%), transport (10%) and natural resources (10%). We should note the significant allocation of resources towards the energy efficiency programme (worth €100 million) to help Ukrainian companies tackle very high energy intensity (which is more than three times higher than in the EU and is thus undermining the country's competitiveness) and activities via the Nuclear Safety Account (for which the EBRD administers donor funds of the international community), namely the start of the construction of the new shelter over the damaged Reactor 4 in Chernobyl and the last stage of work to complete the spent fuel storage facility at the Chernobyl nuclear power plant, which should lead to the transformation of Chernobyl into a safe and environmentally stable area.

63. Following the latest adjustment of the country strategy for Ukraine, in September 2007, the EBRD will further promote energy efficiency and security throughout all sectors of the economy; improve the efficiency and reliability of key infrastructure, power generation, transmission and distribution and of the oil and gas transport systems; support competitiveness and higher corporate governance standards in the local private sector; assist FDI; and further develop the capital markets (including financing in local currency). Pursuant to the programme of co-operation in the public sector, the EBRD intends to scale up its participation in public sector projects to between €200 million and €400 million between 2007 and 2009. This year Ukraine hosted the annual meeting and business forum of the EBRD in May 2008.

7. Developments in the Council of Europe neighbourhood

64. Several EBRD client countries – Belarus, Kazakhstan, Kyrgyz Republic, Mongolia (since 2006), Tajikistan, Turkmenistan, and Uzbekistan – belong to the Council of Europe's neighbourhood. When this Assembly debated, in January 2008, the situation in the republics of central Asia (Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan), multiple shortcomings in the political, economic and social spheres of these countries were highlighted.²⁴ It was noted that the performance of these countries as regards respect for human rights, the rule of law and promotion of the principles of democracy ranged from limited improvement to complete failure, with reforms and transformations stagnant. The Assembly voiced concern, amongst other things, about corruption, lack of accountability and the public authorities' failure to deliver basic services in the social, economic, education and health protection fields. It concluded that the Council of Europe, building on its experience of transition in central and eastern Europe, could contribute to redefining the scope of reforms in central Asia and should promote stability, good governance, institutional modernisation, accountability, the strengthening of national capacities and the establishment of reliable co-operation with these states in addressing common threats.

24. See [Resolution 1599 \(2008\)](#).

65. As regards Kazakhstan, the Assembly has had a closer relationship with this country's parliament since the conclusion of a co-operation agreement in 2004. In November 2006 the Parliament of Kazakhstan applied for observer status with the Assembly. This matter is currently under consideration. Importantly, Kazakhstan already enjoys observer status with the European Commission for Democracy through Law (Venice Commission) and is eager to accede to several Council of Europe open conventions. Moreover, the Assembly and the Parliament of Kazakhstan co-organised, in 2005, a Euro-Asian Forum on Migration, in Almaty; this could give rise to further such initiatives.

66. The rapporteur believes that in the light of the Assembly's earlier deliberations and its resolve to strengthen political dialogue with the central Asian states, not least as advocated for in [Resolution 1599 \(2008\)](#),²⁵ the Assembly might consider associating in future the parliaments of the central Asian states, including Kazakhstan, with its debates on the EBRD and on the state of human rights and democracy.

67. In contrast to most other development banks, the EBRD has a clear political mandate in that it aims to assist only those countries that are committed to and applying the principles of multiparty democracy, pluralism and market economics, with respect for the rule of law and human rights being implicit in the mandate. This commitment clearly affects the EBRD's work in the Council of Europe neighbourhood area where the road to democracy seems long and bumpy. Thus, the Bank's involvement in Belarus and in central Asia needs to strike a delicate balance between lending support to good projects and avoiding support to governments (or enterprises) that do not respect human rights and democratic governance, while using its authority to advance policy dialogue and encourage vital reforms.

68. The EBRD is particularly concerned by Turkmenistan's and Uzbekistan's continued failure to advance towards multi-party democracy, pluralistic society and a market-based economy. This concern has a bearing on its work in these countries. In both countries, for example, the Bank focuses on stimulating private sector development "provided that there is no direct or indirect link to the government or government officials" as well as on policy consultations to assist and monitor political and economic reform efforts. Across the region, it also gives priority to infrastructure projects that enhance cross-border cooperation but in which certain links with governments are unavoidable. Some progress in Turkmenistan has been noted recently (especially as regards the unification of the exchange rate and attempts at political liberalisation) but was not deemed sufficient to change the Bank's country strategy.

69. The five former Soviet republics in central Asia (Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan)²⁶ and Mongolia are among the fastest growing countries in the transition region, with real GDP growth projected at an average of 8.8% in 2007. Nevertheless, in the Kyrgyz Republic and Tajikistan, real GDP levels in 2006 were still 15% to 20% less than the 1989 levels. While growth in the Kyrgyz Republic has remained modest after the political turmoil in 2005, it could increase (projected at 7.5% in 2007) following investments from Kazakhstan and large inflows of migrant remittances (primarily from the Russian Federation). The strong growth in recent years has contributed to falling poverty levels, particularly in the Kyrgyz Republic, Mongolia and Uzbekistan.

70. Although inflation is quite high in most countries (especially in Uzbekistan with 12.2%), budgets are more or less under control (except in Tajikistan where deficit is projected at 14% of GDP in 2007). In terms of external balances, resource-rich Turkmenistan and Uzbekistan are displaying current account surpluses as they continue to benefit from high oil and gas price (with Uzbekistan's surplus hitting 20% of GDP in 2007). However, in Kazakhstan, also resource-rich, a substantial trade surplus is offset by negative balances in services, income and net current transfers. The Kyrgyz Republic and Tajikistan suffer from relatively large current account deficits. Foreign investment inflows into central Asia are mainly concentrated in Kazakhstan and Mongolia, although in relative terms they also benefit neighbouring economies. Recent turmoil in the global financial markets has put particular pressure on Kazakhstan's banking sector (around half of the flows into the Kazakh banking sector come from abroad) and the international rating agency, Standard & Poor's, lowered Kazakhstan's sovereign rating from "stable" to "negative" in April this year.

71. Since joining the EBRD in 2006, Mongolia has made remarkable transition headway and was the star reformer in 2007 with three transition score upgrades for largescale privatisation, competition policy and banking reform. Its economic growth last year was impressive with GDP up by 9.9%. The other central Asian countries made no progress in 2007, although Kazakhstan made some steps to accelerate regulatory

25. Notably paragraph 15.2, which proposes that the Assembly "consider inviting representatives of the Parliaments of central Asian states to follow those plenary sessions, committee meetings and other activities which deal with topics of common interest".

26. See Tables 7 and 8 in the appendix.

adjustment in its banking sector and the road sector reform. On the whole, Kazakhstan, the Kyrgyz Republic and, to some extent, Tajikistan, are close to completing the first phase transition reform. Turkmenistan, the least reformed country in the whole transition region, and Uzbekistan continue to lag behind.

72. Against the backdrop of a difficult political environment in Belarus, the EBRD's work there has been fairly limited for the past decade. A new country strategy adopted in December 2006 commits the EBRD to deepen its involvement with the private sector in Belarus over 2007 and 2008, focusing on microfinance and small enterprises. Despite some improvements in macroeconomic management and performance, state control over the Belarus economy remains very tight, accountability mechanisms are weak and progress in structural and institutional reform has been minor. Whilst in most transition countries the share of the private sector in GDP ranges from 55% to 80%, a corresponding figure in Belarus is only 25% (a similar rate is observed only in Turkmenistan).

73. Thanks to the abolition of the "golden share" rule (whereby the state has the right to interfere with the management of privatised enterprises) in the banking sector in August 2006, Russian investors (including the Vnesheconombank, a state corporation akin to a sovereign fund) rushed in to acquire large stakes in three Belarusian mid-size banks and in August 2007 Belarus obtained its first sovereign ratings²⁷ from major rating agencies. In December 2007, the EBRD with seven international partners²⁸ launched the new Belarusian Bank for Small Business aiming to finance small entrepreneurs with loans ranging from US\$100000 to US\$200000. The same year the EBRD also initiated a micro and SME credit line responding to moves by the Belarus authorities to simplify and reduce taxation for small enterprises; it will also continue providing advisory services to smaller entrepreneurs via the TAM-BAS programmes if donor funding is secured.

74. With the changes in terms of oil trade with the Russian Federation since early 2007, the Belarus economy is under pressure of significant rises in energy prices resulting in a slowdown in GDP growth (down to a still impressive 8.6% for 2007), rising inflation (at about 7.5% in 2007), widening trade and current account deficits (both at least at 6% of projected GDP in 2007) and rising external debt (up by 38% in the first half of 2007). Although prices are largely controlled and wages are centrally controlled by the government, the country's households will soon feel the inevitable increases in energy costs. Absorbing the effects of the energy price rises requires bold adjustments in domestic policies to completely pass on real energy prices to domestic users, cutting subsidies, pursuing enterprise restructuring and rationalising energy use. The EBRD could usefully extend its activity programme in Belarus by encouraging local private enterprises to invest in energy efficiency.

75. The immediate challenges, in economic terms, for the countries in the Council of Europe neighbourhood are to continue with market liberalisation and promote the diversification of production. This is important for both the resource-rich countries, which need to move beyond the energy sector, and the resource-poor countries, which need to be less dependent on remittances from abroad. Regional trade should also be enhanced with a view to fostering competition, freeing the flow of goods and lowering price variations which, according to a 2005 EBRD working paper,²⁹ within one country are just as large as variations across countries due to rent-seeking by enforcement agencies at the numerous internal check points. Also, the borders with Uzbekistan are considerably more difficult to cross in relative terms than those with Kazakhstan or the Kyrgyz Republic. Of the six countries concerned, only the Kyrgyz Republic and Mongolia are members of the World Trade Organization while Kazakhstan and Uzbekistan are observers. There are also a number of free trade agreements between central Asian countries and a series of bilateral co-operation agreements with the EU but they are not effectively used.

76. With the exception of Mongolia, "tight grip" governments and long-term leaders are merely the norm, rather than the exception (especially in Uzbekistan and Turkmenistan). Elections are neither free nor fair and most countries are a long way from being democratic, with no valid opposition, restrictions on public gatherings, excessive use of force (including the Andijan massacre in Uzbekistan in 2005) and tightly controlled media. Although the human rights situation in the Kyrgyz Republic has improved greatly after the ousting of President Akayev in 2005 (the "Tulip" or "Pink" Revolution) and the instalment of a more democratic government, the country still faces political uncertainty in its attempts to sustain democracy. In 2007, Freedom House,³⁰ in its comparative assessment of political rights and civil liberties, classified Belarus, Kazakhstan,

27. B+ from Standard & Poor's and B1 from Moody's for the long-term sovereign foreign currency ratings.

28. These include two German banks, a Dutch financing institution, two American financial institutions, a Swedish Government venture fund and the International Finance Corporation (IFC), the private sector lending arm of the World Bank, pooling altogether €7 million for the start and with a pledge to add a further €5 million after two years.

29. "Beyond borders: Reconsidering regional trade in Central Asia" by Clemens Grafe, Martin Raiser and Toshiaki Sakatsume, December 2005.

30. See www.freedomhouse.org.

Tajikistan, Turkmenistan and Uzbekistan as “not free”, the Kyrgyz Republic as “partly free” and Mongolia as “free”.³¹ With regard to press freedom (evaluated in terms of legal environment, political influences and economic pressures), all five republics in central Asia and Belarus were categorised as “not free” in 2007, while Mongolia was classified as “partly free”.³² Furthermore, as outlined in Chapter II above, the central Asian republics and Belarus (except for Mongolia, ranked more in the middle) are very high on the Transparency International Corruption Perceptions Index.

77. In central Asia, the EBRD needs to be particularly vigilant to ensure that in cases where its investments are targeted at private enterprises they do not indirectly support the abuse of human rights, including the use of child labour. This would be the case if the investments, either directly or through credit lines, went for example to textile companies using cotton harvested by children in their production. Recent media reports³³ have created an intense debate on the use of child labour during the cotton harvest in central Asia. Human rights groups, such as Human Rights Watch,³⁴ estimate that around 450000 children are mobilised each year in cotton harvesting in Uzbekistan which is the world's second largest cotton exporter. There is a similar problem in Turkmenistan, where children are reportedly enrolled for uncompensated participation in the annual cotton harvest. Although supposedly to a lesser extent, children are employed in agricultural areas also in Kazakhstan and the Kyrgyz Republic during the harvest season.

78. Central Asia is a region of high geopolitical importance and deserves more attention from, and involvement by, European countries. The five landlocked central Asian states face many common threats (terrorism, drug and arms trafficking, corruption) and challenges (poverty, unemployment, desertification, chemical pollution of land/water, governance, the legal status of the Caspian Sea) and are highly interdependent in terms of transport routes, population movements, water resources, and energy supplies. They would gain enormously from more pragmatic and effective co-operation, both economically and politically, going beyond words and papers to deeds. One area where the EBRD and the Council of Europe could jointly assist the region's countries is via a possible replication of the schools of political studies, on the basis of the Council of Europe's existing programme for member states and an EBRD-driven donor conference.

8. Joint EBRD activities with other institutions

79. The EBRD co-operates with other institutions with regard to technical co-operation, grant investment co-financing, and lending. The Bank's Technical Co-operation (TC) Funds Programme involves €1.3 billion in contributions from almost 50 donor agencies. The programme supports over €35 billion of investments (which amount to 43% of the entire EBRD portfolio). For every euro in TC funds, the EBRD and its partners invest another €55. Co-operation donors are primarily government aid agencies, including EU entities (60%), but also foreign and finance ministries (30%) and other international financial institutions and initiatives (10%). In a few cases, TC involved co-operation with private entities. In 2007, the EBRD committed some €98 million to 261 assignments, targeting its efforts east and south. The TC funds focus on preparing and implementing investment projects (70% of commitments), but also on improving the investment climate. With regard to the former, funds are allocated to project implementation (46%), advisory services (26%), project preparation (24%), training (3%) and sector studies (1%).

80. There are three different types of TC funds: 1. cooperation funds, through which bilateral donors can support EBRD activities when they conform to aid or foreign policy objectives (such as under the SEI); 2. multi-donor funds (such as the Early Transition Countries Multi-Donor Fund, linked to the ETC Initiative, through which 15 donors provide untied support to the eight poorest countries of operation); and 3. special funds through which contributions are made to the EBRD to support a specific programme (such as the Russia Small Business Fund and the Central Asia Risk Sharing Special Fund).³⁵ Recent trends in donor funding show a greater focus on the poorest countries, a shift from bilateral to multilateral funds, support for

31. The countries are ranked on a scale from one to seven (with one indicating the highest degree of freedom and seven the least amount of freedom). Turkmenistan and Uzbekistan were ranked seven in terms of both political rights and civil liberties, Kazakhstan and Tajikistan scored six with regard to political rights and five with regard to civil liberties. The Kyrgyz Republic was ranked five in terms of political rights and four in terms of civil liberties, and Mongolia scored two with regard to both political rights and civil liberties.

32. On a scale from 0 (best) to 100 (worst), Turkmenistan scored 96, Uzbekistan 91, Belarus 88 (in 2006), Kazakhstan and Tajikistan 76, Kyrgyz Republic 67 and Mongolia 36.

33. Including BBC, 30 October 2007.

34. See www.hrw.org.

35. There are also donor forums, such as the Sustainable Energy Initiative Donor Forum, which are not formal funds, but rather networks of arrangements to support a specific initiative.

climate change and SEI, emphasis on reporting and results, more involvement from recipient countries, engagement in the harmonisation agenda (via the OECD's Development Assistance Committee) and greater demand for grant investment co-financing (although donors are generally still reluctant).

81. Grant investment co-financing involves non-recourse financing for goods and services contracts, incentive payments and other non-TC grants. Between 2004 and 2007 almost €470 million were awarded by the EBRD as co-financing grants, mostly for infrastructure investments, but increasingly also for incentive payments to banks and borrowers.³⁶ A co-financing grant can be in the form of an EBRD-donor co-operation agreement, parallel donor funding, or funding managed by the EBRD but disbursed by donors. As with TC funds, co-financing efforts are also seeking to move to the east and to the south. Significant challenges remain in the Western Balkans, the Russian regions, Ukraine and Kazakhstan.

82. As mentioned in last year's report (Doc. 11300), the EBRD signed a memorandum of understanding with the European Investment Bank (EIB) and the European Commission in December 2006, committing the institutions to work together on jointly financed projects in the Caucasus, central Asia, Moldova, the Russian Federation and Ukraine with regard to energy, transport, telecommunications and environmental infrastructure. So far, the EIB and the EBRD have co-financed almost 80 projects. There is much scope for their enhanced co-operation, especially on cross-border infrastructure projects in the EU neighbourhood area. The EBRD also has a bilateral co-operation agreement with the Council of Europe Development Bank (CEB) but no new project was launched or jointly financed in 2007.

9. Prospects and challenges

83. Despite the turbulence in international financial markets caused by the sub-prime housing loan crisis in the United States, the spill-over effects on the EBRD's countries of operation have been fairly limited. The effects of rising energy and food prices, which constitute a relatively high proportion of the average household income in transition countries, are far more painful to these economies and consumers. Inflation has been rising considerably (often beyond estimates and projections) thus eroding purchasing power, public finances and economic growth. The competitive advantage based on relatively low costs is fading away even more rapidly and is further accentuated by the continued "brain drain". In the more advanced transition countries, restructuring and reforms accomplished so far help to cushion external pressures whilst the less advanced countries will continue to rely substantially on remittances and foreign investment to sustain economic growth.

84. The EBRD expects a moderation of growth rates across the region in 2008 (down to about 6% on average from 7.3% in 2007), especially in South-Eastern Europe and the CIS, with largest downward revisions in respect of Kazakhstan, Romania, Ukraine and Tajikistan, and upward revisions for growth outlook in Mongolia and Turkmenistan. Macroeconomic risks and uncertainties have also led to reduced lending to households and prudential tightening in the Baltic countries whilst Kazakhstan has experienced an abrupt halt in banks' external funding. As inflation is surging, there are clear disincentives for bank deposits (with real returns turning negative) and investment, especially in local currencies. In the light of increased volatility in financial markets, monetary tightening and poorer access to funds of international financial markets is to be expected in all the EBRD's countries of operation.

85. Incentives to invest in energy efficiency and energy savings across the region have never been as high as they are now. Because rising energy costs are directly feeding inflation, by tackling energy waste the EBRD can help its countries of operation address inflationary trends. The EBRD has put in place a new monitoring tool – the Index of Sustainable Energy – that will enable benchmarking of progress with energy efficiency efforts, the development of renewable energy sources and policies for tackling climate change in its client countries. Whereas the index level for central European states shows a high degree of convergence³⁷ with major western European economies (Germany, Spain, the United Kingdom and the Netherlands), most states in eastern and South-Eastern Europe and central Asia are lagging behind considerably. The EBRD will continue stimulating a systemic change in this field, notably as regards profound legal, regulatory, institutional and technological adjustment. At the same time, its new Environmental and Social Policy will ensure that social, health, safety and gender equality aspects are systematically built in through projects supported.

86. The EBRD's determination, as confirmed by the board of governors at the annual meeting in Kyiv on 18 and 19 May 2008, to reinvest 80% of its profits targeting in particular the poorest and hence the neediest countries via a strategic reserve fund, thus increasing its risk taking but also the added value of its action, is

36. Such as the sustainable energy credit lines, totalling €58 million to five countries in co-operation with the European Commission.

37. Slightly less so in terms of energy efficiency efforts.

the right way forward. It is reassuring to know that the Bank has the capacity and resources to employ about €5.6 billion in investment operations every year until at least 2011 when the Bank's new five-year strategy should be agreed. We welcome a donation of some of the profits (€135 million) to the Chernobyl Shelter project (towards accelerating work to complete the confinement structure) and the creation of a Shareholder Special Fund for supporting technical co-operation aimed at project preparation assistance. The latter will be endowed with €115 million of the EBRD's own funds which will supplement the existing donor assistance of some €80 million a year. This pooling of resources will significantly boost aid to "early transition countries" and Western Balkan states, in line with the strategic redeployment of activities to the east and southeast of the European Union as decided in 2006.

87. A gradual withdrawal from more advanced client countries in central Europe, that are now in the European Union, will enable the EBRD to concentrate on countries with huge and largely untapped development potential. Following the application of Turkey to become an EBRD's country of operations, the Bank may decide, in October 2008, to extend its activities to this country thereby opening the doors to a more diversified field of activity going beyond the strict interpretation of its core mission in transition countries despite dissenting voices from the United States, Australia and New Zealand that fear that this way the EBRD focus on the neediest countries may be diluted or that Turkey's bid for EU membership may thus be weakened. We trust that the EBRD will make a careful analysis of how Turkey's application could be best accommodated without compromising the Bank's level of involvement in the less advanced transition countries. This may well imply the need to increase the Bank's annual volume of operations beyond the current cap. Finally, although it is not yet on the agenda, the EBRD should stand ready to assist North Korea,³⁸ when circumstances would permit, in order to facilitate its transition to a market economy and integration into the global community.

88. The comfortable profits that the Bank earned in the last few years show that more risk taking is possible and beneficial (to both the EBRD and its client countries) when underpinned by a sound investment and banking approach, as well as a careful selection of projects. The EBRD has proved to be a creative institution capable of adapting to the varying needs of its clients, constantly diversifying the services and products it offers. In the coming years, it will need to be particularly vigilant about the integrity of its project partners and the management of a wider range of smaller operations whilst stimulating reform attitudes on the part of the authorities it is engaged with through policy dialogue. Moreover, it should persevere with the most valuable work of spreading high corporate ethics standards and the concept of corporate social responsibility.

89. We trust the Bank will remain focused and ambitious under the new cycle of leadership it is entering. In welcoming the election of Thomas Mirow as the new President of the EBRD, the Assembly wishes to pay tribute to the outstanding talent and deep engagement of Jean Lemierre in steering the EBRD for the past eight years. During those years, the EBRD tripled the volume it invests and earned a solid reputation of an innovative partner for progress in transition countries.

38. This idea was put forward by the representative of the Republic of Korea on the board of governors on 18 May 2008.

Appendix

Table 1 – The EBRD's financial and operational highlights, 2001-07

€ million – all figures audited	2007	2006	2005	2004	2003	2002	2001
Operating profit before provisions	1 683	2 442	1 325	468.8*	399.9	294.7	294.7
Provisions for losses	201	(53)	197*	(67.2)*	(21.7)	(186.6)	(137.6)
Net profit	1 884	2 389	1 522*	401.6*	378.2	108.1	157.2
Paid-in capital	5 198	5 197	5 197	5 197	5 197	5 197	5 197
Total assets	33 175	30 691	28 384	22 364	22 045	20 112	20 947
Annual business volume	5 583	4 936	4 277	4 133	3 721	3 899	3 656
Net cumulative business volume	36 938	33 348	30 313	25 425	22 668	21 647	20 219
Total project value	116 919	104 044	95 208	80 040	69 931	70 621	69 867
Portfolio	19 376	17 663	16 810	15 324	14 766	14 576	14 160
Operating assets (minus fair value adjustments)	12 260	10 893	10 118	10 145	9 102	9 102	8 838
Annual gross disbursements	4 076	3 754	2 339*	3 683*	2 344*	2 575*	2 534*

Source: EBRD; * Restated.

Table 2 – EBRD commitments in 2007 (€ million)

Central European and the Baltic states			South-Eastern Europe			CIS and the Caucasus			Central Asia		
Croatia	▼	152.6	Albania	▼	45.1	Armenia	▲	77.8	Kazakhstan	▲	531.6
Czech Republic	▼	39.8	Bosnia and Herzegovina	▲	156.4	Azerbaijan	▼	122.0	Kyrgyz Republic	▼	11.7
Estonia	▲	11.0	Bulgaria	▲	203.0	Belarus	▲	45.8	Mongolia	▲	33.6
Hungary	▲	38.7	Montenegro	▲	17.5	Georgia	▲	192.0	Tajikistan	▲	26.2
Latvia	▲	18.1	Romania	▲	336.4	Moldova	▲	35.6	Turkmenistan	▲	2.6
Lithuania	▲	37.5	Serbia	▼	215.6	Russian Federation	▲	2 300.0	Uzbekistan	▲	14.7
Poland	▼	160.5	"The former Yugoslav Rep. of Macedonia"	▼	26.2	Ukraine	▼	646.8			
Slovakia	▲	74.3									
Slovenia	▲	13.0									

Source: EBRD; ▲ or ▼ shows change up or down since 2006.

Table 3 – Caucasus macroeconomic indicators: 2006 (estimates) and 2007 (projections)

	Real GDP growth (%)		Inflation (%)		Government balance (% of GDP)		Current account balance (% of GDP)		FDI inflows (% of GDP)	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
Armenia	13.4	8.5	2.9	3.5	- 2.8	- 2.6	- 4.5	- 3.0	4.5	n/a
Azerbaijan	34.5	30.0	8.3	16.0	0.1	2.4	15.6	19.8	- 4.7	n/a
Georgia	9.4	10.0	9.2	8.5	- 3.0	- 1.3	- 13.8	- 1.9	14.3	n/a
Average	19.1	16.2	6.8	9.3	- 1.9	- 0.5	- 0.9	0.3	4.7	n/a

Source: EBRD (Transition report 2007).

Note: inflation is measured as the change in annual average retail/consumer price level.

Table 4 – Caucasus transition indicators: 2007

	Enterprises			Markets and trade			Financial institutions		Infrastructure Infrastructure reform
	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities' markets and non-bank FIs	
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+

Source: EBRD (Transition report 2007).

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 5 – SEE macroeconomic indicators: 2006 (estimates) and 2007 (projections)

	Real GDP growth (%)		Inflation (%)		Government balance (% of GDP)		Current account balance (% of GDP)		FDI inflows (% of GDP)	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
Albania	5.0	6.0	2.5	3.0	– 3.2	– 3.9	– 7.3	– 9.9	3.9	n/a
Bosnia and Herzegovina	6.2	6.0	7.0	2.5	2.9	– 1.4	– 11.7	– 12.5	3.7	n/a
Bulgaria	6.1	6.0	7.3	8.0	3.3	2.3	– 15.8	– 20.8	16.9	n/a
Croatia	4.8	5.5	3.2	2.3	– 3.0	– 2.6	– 7.8	– 8.3	7.5	n/a
Montenegro	6.5	7.0	3.0	3.0	3.6	3.0	– 29.1	– 23.0	28.7	n/a
Romania	7.7	6.5	6.6	7	– 1.9	– 2.5	– 11.3	– 8.8	9.4	n/a
Serbia	5.7	6.0	12.5	7.0	2.7	– 2.3	– 12.9	– 12.0	15.3	n/a
"The former Yugoslav Rep. of Macedonia"	3.2	5.5	3.2	2.5	– 0.4	– 1.0	– 0.4	– 1.0	5.6	n/a
Average	5.7	6.1	5.7	4.4	0.5	– 1.1	– 12.0	– 12.0	11.4	n/a

Source: EBRD (Transition report 2007).

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.

Table 6 – SEE transition indicators: 2007

	Enterprises			Markets and trade			Financial institutions		Infrastructure Infrastructure reform
	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities' markets and non-bank FIs	
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+	3–	4	3	3
Montenegro	3+	4–	2	4	4	2–	3–	2–	2
Romania	4–	4–	3–	4+	4+	3–	3+	3–	3+
Serbia	3–	4–	2+	4	3+	2	3–	2	2
"The former Yugoslav Rep. of Macedonia"	3+	4	3–	4+	4+	2+	3–	2+	2+

Source: EBRD (Transition report 2007).

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 7 – Central Asia macroeconomic indicators: 2006 (estimates) and 2007 (projections)

	Real GDP growth (%)		Inflation (%)		Government balance (% of GDP)		Current account balance (% of GDP)		FDI inflows (% of GDP)	
	2006	2007	2006	2007	2006	2007	2006	2007	2006	2007
Kazakhstan	10.6	9.5	8.6	8.5	7.5	4.3	– 2.2	– 3.3	8.2	n/a
Kyrgyz Republic	2.7	7.5	5.6	7.0	– 2.1	– 2.2	– 13.7	– 17.2	6.5	n/a
Mongolia	8.6	8.0	5.1	5.3	8.1	– 2.8	5.6	– 7.7	9.2	n/a
Tajikistan	7.6	8.5	10.0	10.1	1.7	– 14.1	– 2.5	– 15.2	2.3	n/a
Turkmenistan	9.0	10.0	10.5	11.1	0.6	0.5	12.7	7.1	7.2	n/a
Uzbekistan	7.3	9.3	14.2	12.2	5.2	2.3	18.8	20.0	1.1	n/a
Average	7.6	8.8	9.0	9.0	3.5	– 2.0	3.1	– 2.7	5.8	n/a

Source: EBRD (Transition report 2007).

Table 8 – Central Asia transition indicators: 2007

	Enterprises			Markets and trade			Financial institutions		Infrastructure reform
	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities' markets and non-bank FIs	
Kazakhstan	3	4	2	4	4–	2	3	3–	3–
Kyrgyz Republic	4–	4	2	4+	4+	2	2+	2	2–
Mongolia	3+	4	2	4+	4+	2+	3–	2	2
Tajikistan	2+	4	2–	4–	3+	2–	2+	1	1+
Turkmenistan	1	2	1	3–	1	1	1	1	1
Uzbekistan	3–	3+	2–	3–	2	2–	2–	2	2–

Source: EBRD (Transition report 2007).

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.

Reporting committee: Committee on Economic Affairs and Development.

Reference to committee: Standing mandate.

Draft resolution adopted by the committee on 2 June 2008. Members of the committee: Mr Márton **Braun** (Chairperson), Mr Robert Walter (Vice-Chairperson) (alternate: Mrs Claire **Curtis-Thomas**), Mrs Doris **Barnett** (Vice-Chairperson), Mrs Antigoni Papadopoulos (Vice-Chairperson), MM. Ruhi **Açikgöz**, Ulrich Adam, Mrs Veronika Bellmann, Mr Radu Mircea Berceanu, Ms Guðfinna Bjarnadóttir, MM. Vidar **Bjørnstad**, Jaime Blanco Garcia (alternate: Mrs Elvira **Cortajarena**), Luuk Blom, Pedrag Bošković, Patrick **Breen**, Gianpiero Carlo Cantoni (alternate: Mr Dario **Rivolta**), Erol Aslan **Cebeci**, Ivané Chkhartishvili, Valeriu Cosarciuc, Ignacio Cosidó Gutiérrez, Joan Albert Farré Santuró, Relu Fenechiu, Carles Gasóliba i Böhm, Zahari Georgiev, Francis Grignon, Mrs Arlette Grosskost, Mrs Azra Hadžiahmetović, MM. Norbert **Haupt**, Stanislaw Huskowski (alternate: Mrs Danuta **Jazłowiecka**), Ivan Nikolaev Ivanov, Jan Jambon (alternate: Mr Luc **van den Brande**), Miloš Jevtić, Ms Nataša Jovanović, MM. Antti Kaikkonen, Serhiy Klyuev, Albrecht **Konečný**, Bronisław **Korfanty**, Anatoliy Korobeynikov, Ertuğrul **Kumcuoğlu**, Bob Laxton, Harald Leibrecht, Ms Anna **Lilliehöök**, MM. Arthur **Loepfe**, Denis MacShane, Yevhen **Marmazov**, Jean-Pierre Masseret, Ruzhdi Matoshi, Miloš **Melčák**, José **Mendes Bota**, Mircea **Mereută**, Attila Mesterházy, Mrs Olga Nachtmannova, Mrs Hermine Naghdalyan, Mr Gebhard **Negele**, Mrs Mirosława **Nykiel**, Mr Mark Oaten, Mrs Ganira Pashayeva, Mrs Marija **PejčinovićBurić**, MM. Manfred **Pinzger**, Viktor Pleskachevskiy (alternate: Mr Nikolay **Tulaev**), Claudio Podeschi, Jakob **Presečnik**, Jeffrey Pullicino Orlando, Maximilian **Reimann**, Roland Ries, Mrs Maria de Belém Roseira (alternate: Mr Maximiano **Martins**), Mrs Gitte Seeberg, Mr Samad Seyidov, Mrs Sabina Siniscalchi (alternate: Mr Giorgio **Mele**), MM. Giannicola Sinisi, Leonid Slutsky, Serhiy Sobolev, Mrs Aldona Staponkienė, MM. Christophe Steiner, Vjaceslavs Stepanenko, Vyacheslav Timshenko (alternate: Mr Yury **Isaev**), Mrs Arenca Trashani, Ms Ester Tuiksoo, MM. Miltiadis Varvitsiotis, Oldřich **Vojř**, Konstantinos Vrettos, Harm Evert Waalkens, Paul **Wille**, Mrs Gisela **Wurm**, Mrs Maryam Yazdanfar.

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

See 22nd Sitting, 24 June 2008 (adoption of the draft resolution); and [Resolution 1616](#).