



Doc. 12349

21 July 2010

The activities of the European Bank for Reconstruction and Development (EBRD) in 2009: facilitating economic integration in Europe

Report¹

Committee on Economic Affairs and Development

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Summary

After nearly twenty years of steady growth in economic prosperity and improvements to democratic processes across central and eastern Europe, the year 2009 put to test progress in development achieved so far and solidarity among European states. With the global financial crisis in full swing, many countries have experienced a sharp economic downturn leading to soaring unemployment, shrinking state revenue and household income, an erosion of budget discipline and questions about the solidity of macroeconomic fundamentals. It is reassuring that the response of the population has so far been moderate and that domestic political stability and structural reform efforts have not been adversely affected.

The year 2009 represented a serious challenge to European development institutions – including the European Bank for Reconstruction and Development (EBRD) – as they responded to the crisis. If, in earlier years, some of the EBRD's shareholders believed that the Bank's mission of supporting transition to open and democratic market economies had been largely accomplished, the turn of events thereafter proved the contrary. The EBRD acted swiftly and effectively despite major uncertainties over the state of affairs in central and eastern Europe. The Bank's investments in 2009 were unprecedented in scale and were targeted at the countries suffering most from the crisis, thus helping to stabilise the macroeconomic situation and reassure both domestic and international investors.

This report examines the causes and effects of the crisis in the eastern parts of the continent, the lessons learnt and the implications for future action at European level, in particular through institutions such as the EBRD. It urges Council of Europe member states to embrace the broad policy conclusions drawn from the crisis with a view to tackling inherent economic vulnerabilities and imbalances to achieve balanced and sustainable growth.

1. Reference to committee: standing mandate of the committee.



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A. Draft resolution²

1. In 2009, the global financial and economic crisis was in full swing across Europe, leading to an exceptionally deep downturn for most Council of Europe member states in central, eastern and south-eastern parts of the continent, which put to test the solidity of economic fundamentals, social peace, governance and institutions, as well as the direction of structural reforms. Timely and concerted action at national and international levels was crucial in mobilising resources to stabilise the macroeconomic situation and preserve confidence of all stakeholders in development prospects.

2. Parliamentary scrutiny over the prioritisation of expenditure by states and international institutions, such as the European Bank for Reconstruction and Development (EBRD), is particularly relevant with a view to ensuring fair allocation and good use of resources. Building on the Agreement of Co-operation between the Council of Europe and the EBRD, the Parliamentary Assembly appreciates the opportunity to contribute its views on the action of the EBRD in the light of the ongoing economic crisis.

3. In keeping with its mandate, the EBRD actively responded to the region's needs for financial resources in order to mitigate the impact of the crisis. The Bank's investments over 2009 were unprecedented in scale and were targeted at countries that suffered most from the crisis: two thirds of the operations concerned the category of "anti-crisis measures" and were implemented in collaboration with other international financial institutions and governments of the region. The collective approach to tackling financial problems enabled the region's countries to preserve macroeconomic stability and economic growth potential. However, the major problems revealed by the crisis still require appropriate solutions. The task and the challenge for the international community is to rehabilitate the current economic model, to enhance the sustainability of the financial system and to stimulate employment.

4. The Assembly welcomes a substantial increase in the EBRD's volume of operations over 2009 – with commitments up from €5.1 billion in 2008 to €7.9 billion in 2009 and disbursements amounting to a record €5.5 billion – even as the Bank's own accounts incurred a net loss of €746 million in 2009 after a loss of €602 million in 2008. It notes that these losses, the first since the effects of the Russian crisis in 1998, were largely unavoidable due to the shrinking value of the Bank's equity operations and higher provisions for the potential underperformance of loans. The Assembly is aware of the likely prolonged demand for the EBRD's financing at similarly high levels for the period 2010-2015 and fully supports the decision to approve a corresponding temporary 50% increase in the Bank's capital from €20 billion to €30 billion.

5. In this context, the Assembly underscores a major catalytic role of EBRD lending for the realisation of investment projects through co-financing arrangements. The Bank has thus mobilised funds several times larger than its own and has, together with its partners, achieved a significant multiplier effect in its operations. This effect is all the more relevant for spreading high standards of corporate ethics and the concept of corporate social responsibility.

6. The Assembly appreciates the EBRD's contribution to the establishment of the Vienna Initiative (more formally known as the European Bank Co-ordination Initiative), which not only bolstered investor confidence in the banking sector of central, eastern and south-eastern Europe at a critical moment, but also helped avert a systemic banking crisis in some parts of the region. Early in 2009, the EBRD, together with the International Monetary Fund and the European Union, rallied a gathering of foreign banks, their subsidiaries, governments and regulators with the aim of reaffirming multilateral commitment to the region and devising an action plan underpinned by solid funding support.

7. Eastern European economies experienced an overall contraction of 6.1% of GDP in 2009 (ranging from 18% in Latvia, 8.7% in Russia to modest growth in Poland and Albania, at, respectively, 1.6% and 2.2%), the largest of any emerging market region. The spread of the crisis into the EBRD client countries can be linked to persisting global imbalances, deficient international regulatory frameworks for financial markets and institutional failures to correctly assess complex financial products. However, the countries in the region that were most seriously affected generally had inherent structural weaknesses, including heavy dependence on foreign capital, a rapid growth of the private sector and household debt spurring property and construction bubbles and a consumption boom, budget deficits, regulatory flaws and in some cases excessive reliance on remittances and external demand.

8. The Assembly is concerned that the deteriorating macroeconomic situation and the implementation of anti-crisis or stabilisation measures have resulted in a slowdown or a reversal of improvements in living conditions throughout the EBRD's countries of operations. Household incomes decreased and poverty levels

2. Draft resolution adopted unanimously by the committee on 21 June 2010.

increased as wages were cut, unemployment soared and social benefits were curtailed. It is reassuring that the response of the population has so far been moderate and that domestic political stability has not been seriously affected throughout the region. Furthermore, recent turbulences in the euro zone have not hurt the EBRD client countries which remain on a steady, though fragile, recovery path with average growth forecast at 3.7% in 2010.

9. Moreover, even though progress with structural reforms inevitably slowed down in 2009 when governments focused on the immediate problems caused by the crisis, in no country did the leadership adopt an anti-reform policy stance. This is a sign of growing political consensus over the ultimate goal and the necessity of socio-economic reforms with a view to building lasting prosperity and securing long-term benefits in the context of globalisation. Policy dialogue and co-operation with international development institutions, such as the EBRD, remain a highly valuable tool for these countries to identify appropriate national reform-oriented options and solutions.

10. The Assembly notes that despite a large increase in the volume of EBRD financing, the number of projects supported in 2009 increased only slightly compared to the year before (respectively 311 and 302 projects). This corresponded to a massive support to major banking groups and enterprises and a welcome sharper focus on lending to the real economy, in particular through enhanced participation in trade facilitation, energy and infrastructure projects (including participation in important public sector undertakings) and stronger commitment to micro, small and medium-sized enterprises with a strong job-creation potential. The Assembly is concerned that the latter commitment is not sufficiently covered and should further be expanded.

11. The Assembly welcomes the start of EBRD projects in the newest country of operations – Turkey – and the resumption of commitments to the countries of central Europe and the Baltic states against the background of their evolving needs and changing circumstances. It believes that the EBRD is well placed to promote further economic integration in Europe, not least through support to projects in the priority areas (including energy security and efficiency, good environmental governance and development of small and medium-sized enterprises) under the European Union's Eastern Partnership in favour of Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine, and more generally under the European Union Neighbourhood Investment Facility.

12. The Assembly calls on the EBRD to:

12.1. use its network of partner institutions in order to stimulate a debate on macroeconomic policy prescriptions and the longer-term implications of the financial-economic crisis in terms of good governance, including more effective regulation and oversight of cross-border lending and further institutional development, in both private and public sectors;

12.2. assist its countries of operations in respect of pension system reform, notably as regards the setting up and governance of private pension schemes and funds, and to take part in the process of institutional reform;

12.3. expand its contacts with the Council of Europe Development Bank with a view to identifying possible joint activities;

12.4. maintain its increased volume of lending to support economic recovery in its countries of operations and to co-operate more closely with regional development institutions;

12.5. foster, together with other international financial institutions, investment in companies with good management but facing temporary financial difficulties and to help such companies restructure their debt obligations and carry out structural adjustments through technical assistance programmes;

12.6. tighten its control over the indirect loans, in particular the financing conditions applied and the risk premiums charged by the intermediaries to the final borrowers;

12.7. contribute to the harmonisation of lending standards, in particular with a view to cutting the administrative hurdles in the lending process;

12.8. extend the investment programme under its Sustainable Energy Initiative into new sectors, such as buildings, transport and renewable energy, and to increase the range of instruments to channel such investment;

12.9. increase lending to the Early Transition Countries and the European Union candidate countries in south-eastern Europe, based on the analysis of their medium-term needs, taking into account the impact of the crisis, and to reduce consultancy while increasing more tangible enterprise support services;

12.10. continue to give priority to the financing of projects in the fields of energy security and efficiency, good environmental governance and development of small and medium-sized enterprises;

12.11. enhance its assistance to the development of local capital markets and lending in the local currencies of client states in order to decrease these countries' dependence on lending in foreign currency and on external financing;

12.12. assist the elaboration of mechanisms of risk control in relation to domestic currency lending in order to diminish reliance on highly leveraged credits through hedge funds;

12.13. continue facilitating the access of women entrepreneurs to finance and business advisory services, notably through microfinance institutions.

13. The Assembly also draws the attention of the Council of Europe member states to the broad policy conclusions drawn from the crisis. It is convinced that financial institutions are an essential part of a market economy and that they ought to serve – first and foremost – the needs of the productive sector. This calls for the strengthening of regulatory frameworks and oversight mechanisms to ensure responsible lending and investment practices, adequate capitalisation and deposit insurance, and a timely and effective regulatory base.

14. The Assembly encourages the executive and parliamentary authorities of the Council of Europe member states to pursue sound macroeconomic policies that take better into account the cyclical nature of economic development, reinforce tax compliance, fiscal discipline and activities for combating corruption, stimulate improvements in the business climate, foster productivity gains, and give due consideration to future health and pension obligations for ageing populations. The Assembly therefore asks these authorities to give due support to the EBRD's New Growth Agenda that seeks to help countries tackle economic vulnerabilities and imbalances, boost competitiveness and achieve sustainable green growth.

B. Explanatory memorandum by Ms Naghdalyan, rapporteur

1. Introduction

1. For most transition countries, 2009 was the year when the full impact of the global financial and economic crisis took hold. Although the impact differed between countries, many experienced sharp and sudden falls in output and incomes which only began to stabilise around mid-year. The year was also the 20th anniversary of the fall of the Berlin Wall, culminating a period of steady growth in economic prosperity throughout most of the region. It was marked by the growth of the private sector from very low levels to over 70% of the economies of the region over this period.

2. Much progress in development was supported by globalisation and the prospects of European integration, especially membership of the European Union (EU) for several countries. The implementation of democratic principles has also steadily improved, although arguably the record is more mixed than on the economic side, particularly in some of the former countries of the Commonwealth of Independent States (CIS). However, the fact that by early 2010 the economic crisis had not led to any major political upheavals or any significant reversals of reform in the region is testament to the progress that has been made over the years.

3. The year 2009 represented also a major challenge for the EBRD as it responded to the crisis. If in earlier years some of the EBRD's shareholders thought that the Bank's mission of supporting transition to open and democratic market economies was largely accomplished, the turn of circumstances thereafter proved the contrary. The EBRD's decision, at the start of 2009, to boost planned commitments to €7 billion seemed ambitious, given the major uncertainties over the state of banking sectors, the steep decline in capital inflows and the more general loss of investor confidence. The EBRD thus mobilised almost €8 billion, a 50% increase over the amount recorded in 2008, with particular focus on providing finance for the banking, corporate and infrastructure sectors. It intends to maintain its activity at this level over the next few years in recognition that financing conditions will remain tight and that the pace of recovery will be slow. To support this higher level of activity, in May 2010 the EBRD Board approved a temporary 50% capital increase for the Bank.

4. The report looks briefly at the causes of the crisis, and the main effects of the crisis on the region are then reviewed,³ followed by the response of the EBRD to the crisis, including a brief description of the Bank's main activities in certain countries. The lessons that can be learnt from the crisis for the region and some of the implications for the future activities of the EBRD are then reviewed.

2. The effects of the financial and economic crisis on eastern European economies

2.1. The causes of the financial and economic crisis

5. The crisis stemmed from a period of low interest rates in major Western economies, which contributed to an unsustainable credit and housing boom, especially in the United States. This was accentuated by the development of complex financial products based on the assets which were then traded among many major Western banks. In retrospect, it was apparent that neither the regulatory framework nor the ratings assigned to these products were sufficiently robust to reflect all the risks. Strains began to show in financial markets during the summer of 2007 as asset prices weakened and finally took full effect following the collapse of Lehman Brothers in September 2008. Uncertainties over the extent of individual bank holdings of these impaired assets led to a sharp rise in inter-bank lending rates as confidence in the main banking sectors declined, resulting in a drying up of credit.

6. Underlying these problems was the persistence of global imbalances. In a number of countries, such as the United States, where consumption was the main source of growth, both the trade and fiscal deficits widened; in other countries, including China, Germany and the major oil producers, economic growth largely

3. The EBRD has projects in 30 countries (although the Czech Republic has "graduated" from new operations). To illustrate some of the points in this report, reference is made where necessary to a selected number of countries. These are all the countries in the EBRD's regional grouping entitled Central Europe and the Baltic states (CEB) – Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia; Romania, which is one of the countries in the South-Eastern Europe group (SEE); Armenia, Azerbaijan, Georgia and Ukraine, which are included in the Eastern Europe and Caucasus group (EEC), and Russia.

reflected strong export growth. The resulting external surpluses, especially those earned by Asian countries, were then invested in United States securities. The resultant financing of the deficits delayed the need to curtail consumption in the West and to strengthen domestic demand elsewhere.

7. Initially, the transition countries were not seriously affected by the onset of the crisis, with the exception of Kazakhstan and to a lesser extent the Baltic states in 2007. Most countries recorded positive growth during the first half of 2008, and for many the main concern was with inflationary pressures as oil and commodity prices rose. However, once the crisis struck in September 2008, output fell sharply during the final quarter of 2008 and the first quarter of 2009 in most countries. The main reasons were the fall in export growth as demand weakened in major markets, especially within the European Union, the decline in external financial flows to the region (syndicated lending, bonds and foreign direct investment (FDI)) and a sharp tightening of domestic credit conditions. Countries most seriously affected were generally those with the worst financial imbalances, including a rapid growth of private sector debt, usually the result of excessive credit growth and large fiscal deficits.

2.2. The effects of the crisis on eastern European economies⁴

8. The transition region experienced a significant fall in output in 2009 – a decline of 6.1% of GDP, the largest of any emerging market region. Nevertheless, and in contrast to earlier crises in emerging markets, there were no systemic bank failures, no major currency crises and only a few countries experienced capital outflows. This partly reflected the responsible nature of the policy measures taken in most countries, supported where necessary by prompt and substantial financial assistance from the international financial institutions (IFIs) and the European Union.

9. Although virtually all countries experienced a decline in external demand, the extent of the fall in output varied considerably. Among the most seriously affected were Ukraine, the three Baltic states and Armenia, which all recorded double digit declines in GDP. In the Baltic states and Ukraine, the large declines reflected the adjustment to earlier economic imbalances, in particular rapid credit growth, much of it to property and construction, as well as the growth of private external debt. Ukraine was also affected by adverse movements in the terms of trade. In Latvia, the fall in GDP also reflected the authorities' decision to maintain the currency peg to the euro and limit the increase in the fiscal deficit with tax rises, spending cuts and public sector wage falls. Consequently, GDP fell by almost 18%, although the adjustment was supported by a €7.5 billion loan package financed primarily by the European Union and the International Monetary Fund (IMF). In Armenia, the fall in GDP was mainly the result of weaker external demand and lower remittances which affected construction activity.

10. By contrast, many of the oil and commodity producers continued to record positive growth. In Russia, however, output fell by 8% – the result of lower oil prices, weaker domestic and external demand and tighter credit conditions, accentuated by some capital outflows. Most of the commodity producers were able to draw on financial resources accumulated in stabilisation funds during earlier periods of strong export growth to offset some of the effects of the crisis.

11. In between these two groups of countries, there were many countries, especially in central Europe, where, although the fundamentals were generally sound, output fell as demand in the European Union, especially Germany, weakened. In the Czech Republic, for example, despite prudent macroeconomic policies and a generally conservative approach to banking, output fell by over 4% as exports slowed. Nevertheless, the IMF, in its most recent report on the Czech economy (March 2010), was confident that growth would recover this year, albeit at a slower pace than before the crisis. Output fell by some 7% in both Romania and Slovenia, mainly because of weaker external demand. In Romania, this necessitated a standby agreement with the IMF as part of a larger package of external assistance. The main exception in this group was Poland and the only country in the European Union to record positive growth (of 1.7%) in 2009. This largely reflected the responsible macroeconomic policies that had been pursued in earlier years, which enabled the government to provide a temporary fiscal stimulus, supported by a Flexible Credit Line from the IMF.

12. The effects of the fall in output spread quickly to the banking sectors of most countries. There was a sharp fall in the rate of credit growth reflecting the virtual cessation of syndicated lending, initial concerns over the intentions of foreign banks towards their subsidiaries and in some cases runs on deposits as confidence fell. The extent of the problems within the banking sectors varied. Latvia and Ukraine were among the worst affected, resulting in the nationalisation of a majority stake in the main bank in Latvia and a major bank

4. Most of the figures in this section are taken from the EBRD's transition report for 2009, supplemented by the EBRD's latest GDP growth revisions, published on 22 January 2010. See also the appendix for data published in May 2010.

restructuring programme in Ukraine, supported by the IFIs. In the case of Ukraine, the amount of capital in some large banks was seriously affected by a sharp fall in the exchange rate. In countries such as Russia and Poland, the authorities supported capital and liquidity in the sector with a range of measures. In other countries, including the Czech Republic and Estonia, banks were generally well capitalised and, with support from foreign parent banks, were able to withstand the shocks. Although there were a number of failures of local banks, mainly in Russia and Ukraine, overall the banking sectors proved resilient to the crisis, although this partly reflected the strength of IFI support in particular cases.

13. The impact of weaker demand on inflation and current accounts was largely as expected. For the region as a whole, inflation (as measured by the annual consumer price index (CPI)) is estimated to have fallen from an average of 11.9% in 2008 to 5.1% in 2009 as the rate of inflation fell in all but one of the countries (Uzbekistan). Most countries also recorded an improvement in their trade and current accounts as imports fell more quickly than exports, leading to a narrowing of the overall current account deficit for the region as a whole – from 7.6% of GDP in 2008 to 4.9% of GDP in 2009. In some cases, the extent of the adjustment was dramatic. In the Baltic states, for example, the large current account deficits of earlier years were turned into surpluses in 2009.

14. Flows of foreign direct investment (FDI) also fell sharply in 2009, mainly the result of a general loss of investor confidence, but in some countries reflecting the postponement of privatisation plans. Flows of FDI to the region as a whole had grown steadily to 2007 and remained at US\$108.3 billion in 2008. These flows then fell sharply to US\$50.2 billion in 2009, according to EBRD estimates, with most countries recording a decline. The steepest fall was in Russia, where FDI fell from US\$20.4 billion in 2008 to an estimated US\$0.7 billion in 2009, although the 2008 figure was exceptionally high compared with earlier years.

15. The most immediate impact of these macroeconomic numbers will be to slow and in some cases reverse the steady improvement in living conditions throughout the region. Unfortunately, there are no data yet available showing the impact of the crisis on household incomes and poverty. The unemployment data that is available for some countries (mainly central Europe) shows a gradual increase throughout 2009 to levels of around 8% to 9% by February 2010 in countries such as the Czech Republic and Poland. However, the rate was appreciably higher in some other countries, notably Latvia (21.7%), Lithuania (15.8%), Estonia (15.5%), the Slovak Republic (14.2%) and Hungary (11%).⁵ Unemployment is in any event a lagging indicator of current conditions and could increase in some countries as more companies either close or restructure.

16. One of the clearest indications that further adjustment will be required is the growth of non-performing loans in several countries. This is the result of weak profitability in the real sector, but will also affect bank profitability in the future. Between mid-2008 and September 2009, non-performing loans had risen sharply in a number of countries. They amounted to an average of some 7% of loans in the SEE and CEB countries (including 12% in Latvia) and 10% in Ukraine.

17. The authorities in most countries in the region took steps to ease monetary policy to mitigate the effects of the fall in output on living standards. They used a combination of lower interest rates, lower reserve requirements and followed an appropriate exchange rate policy. With the exception of Slovenia and the Slovak Republic, which have adopted the euro, and those countries with currency boards (such as Estonia and Lithuania) or fixed pegs (Latvia), most countries used their foreign exchange reserves to permit a nominal depreciation of their currencies, while generally attempting to maintain broadly stable conditions in exchange markets. Thus Poland, Hungary and the Czech Republic continued to let their currencies float, Russia and Georgia implemented step devaluations while others, including Ukraine, allowed their currencies to depreciate initially, followed by a managed floating (and supported by currency controls in Ukraine).

18. The ability to use fiscal policy to boost activity was, however, constrained in most countries by concerns over the risks of crowding out the private sector and the limited means of financing higher deficits from domestic sources. The fall in economic activity meant that fiscal deficits rose, a combination of lower tax revenues and some automatic stabilisers taking effect. However, with general government balances projected at 6% of GDP or above in several countries in 2009 (especially Latvia, Lithuania, Georgia and Romania), the emphasis is mainly one of constraining fiscal policy. In early 2010, the IMF confirmed that the aggregate public sector deficit (including the costs of bank recapitalisation) in Ukraine was 11.4% of GDP in 2009. The main exceptions were the oil and commodity producers in the region. Russia, for example, introduced a fiscal stimulus equivalent to 5% of GDP.

5. Seasonally adjusted data from Eurostat for February 2010, with the exception of Estonia and Lithuania where the data are for December 2009.

19. Progress with structural reform inevitably slowed in 2009 as governments focused on the immediate problems caused by the crisis, especially in their banking sectors. Thus, only eight countries received upgrades of their main transition indicators in the EBRD's annual review of the progress in transition.⁶ These included Croatia and Latvia for improvements in competition policy and Ukraine for the passage of a law on joint stock companies which should improve corporate governance. However, four countries received downgrades (including both Latvia and Ukraine) as some reforms were reversed. Nevertheless, measures such as the bank nationalisation in Latvia and the imposition of currency controls in Ukraine can be seen as a necessary response to the crisis. The number of downgrades was substantially less than the EBRD made in 1999 following the impact of the Russian crisis the year before.

20. The response of the population in transition countries to the crisis has been moderate to date, so domestic political stability has not been seriously affected throughout the region, with the exception of Kyrgyzstan. Under Article 1 of the agreement establishing the Bank, the EBRD can only operate in countries which are not only making progress with transition, but are also applying the principles of multiparty democracy and pluralism.⁷ The populations in some countries will have inevitably been dissatisfied with lower incomes and poorer prospects as a result of the crisis. The EBRD notes that between January 2008 and September 2009 there were either elections or leadership changes in 25 countries in the region.⁸ However, in only eight of these did the opposition take over power while in no cases did the new leadership adopt a more anti-reform policy stance. In the country arguably the most severely affected by the crisis – Ukraine – the presidential elections in early 2010 led to both a change of president and government with no suggestion that reform will be reversed.

2.3. The response of the EBRD to the crisis

21. The EBRD responded to the acute shortage of liquidity in the region with a substantial increase in the volume of its operations. In 2009, the Bank committed €7.9 billion in 311 projects in all 29 countries of operation (the comparable figures for 2008 were €5.1 billion and 302 projects). Disbursements amounted to a record €5.5 billion. The volume of activity with the private sector was 70% or more in all but two of the countries under review by the end of 2009. Russia accounted for almost a third of the activity with over €2.5 billion committed to 70 projects. The EBRD was also able to commence projects in its newest country of operations – Turkey – with commitments of €150 million. Perhaps the most significant change was the decision to substantially increase commitments to countries in the CEB region, arguably the sub-region most severely hit by the crisis. In recent years, the volume of new EBRD operations in these countries had declined, in some cases to very low levels, as a result of the policy of graduation.⁹ However, the EBRD responded rapidly to the changed circumstances in 2009 and provided €1.6 billion in response to the requests for additional funding from these countries.

22. The region's banking sector was in the most urgent need of support and it accounted for some 40% of the EBRD's total commitments during the year. This included support, usually recapitalisation or additional liquidity, for nearly 70 banks, which were either local banks or subsidiaries of EU-based parent banks. This included the Bank's participation in the Joint IFI Action Plan with the European Investment Bank (EIB) and the World Bank group whereby the IFIs agreed to commit a total of €24.5 billion (of which €6 billion from the EBRD) to provide additional capital and liquidity to the subsidiaries of Western banks in the region. By the end of 2009, €15 billion had been signed (€3.2 billion from the EBRD) with some of the EBRD funding channelled to small and medium-size enterprises (SMEs) through the partner banks. Funding under the action plan involved close collaboration with both the IMF and the EU to maximise the impact of policy dialogue.

23. The EBRD has also sharpened its focus in respect of lending to the real economy, including an internal reorganisation to bring all activities for the corporate sector under one department. Activity in 2009 included an increase in working capital to existing borrowers and an expansion of the Trade Facilitation Programme to €1.5 billion to help companies overcome the shortage of trade finance. In view of the limited capacity of

6. See Table 1.1 in "Transition report 2009", EBRD, London, November 2009. Eight countries received a total of 10 upgrades. Progress with infrastructure reform contributed to further upgrades for four countries of their overall infrastructure indicator.

7. The latest country strategies describe most of the countries under review as continuing to meet the conditions of Article 1, while some were committed to applying them.

8. See Box 6.2 in the "Transition report 2009".

9. In accordance with the Bank's Graduation Policy and the strategic view adopted in its CCR3 medium-term strategy, the eight transition countries that joined the European Union in May 2004 were expected to graduate by 2010. The Czech Republic graduated in 2007, and since then no new operations have been undertaken.

governments to invest in energy and infrastructure projects, the Bank participated in several important public sector projects, including motorway development in the Slovak Republic and improving energy efficiency in Romania.

24. Commercial bank lending to the medium, small and micro enterprise (MSME) sector fell in most countries in 2009 as credit conditions tightened and banks became more risk averse, although it is probable that demand for funding also fell somewhat. Since the EBRD normally lends to the SME sector via credit lines to domestic banks, the need to maintain lending to these companies was an important factor in the extent of the EBRD's support for the banking sector.

25. In 2009, the EBRD increased its lending for the MSME sector as a whole by €1.2 billion (of which €279 million was for micro enterprises), according to provisional data. By the end of the year, the EBRD's portfolio had increased to €3 billion (from €2.5 billion in 2008). The EBRD's outstanding portfolio to micro enterprises (normally not covered by the formal banking sector) rose, amounting to €767 million by the end of 2009. Micro enterprises in Russia and the eastern Europe and Caucasus countries (EEC) accounted for almost two thirds of this portfolio. Given the importance of this sector as a source of employment, the EBRD's contribution here was significant as survey evidence points to a sharp decline in the lending activities of micro-finance institutions in the region since the onset of the crisis. The EBRD's operations were supported by further growth in the technical support provided by the TAM/BAS programmes funded by donors and the Shareholders Support Fund.¹⁰

26. The EBRD has also established a reputation for achieving practical results through its lending under the Sustainable Energy Initiative (SEI).¹¹ The targets for the first three years of the programme were exceeded and in mid-2009, the EBRD launched a second phase of the SEI for the period 2009-2011. By the end of 2009, it is estimated that the Bank had invested a total of €4 billion in projects since the SEI was launched, two thirds of which were with the private sector. The main focus in these years has been on increasing the energy efficiency of electricity production and the industrial sector. It is also estimated that by 2009 the annual reduction in carbon emissions from the projects was some 25 million tonnes.

27. In addition to its project operations, the EBRD was also instrumental in the establishment of the Vienna Initiative (more formally known as the European Bank Co-ordination Initiative (EBCI)), which not only bolstered confidence in the region's banking sector at a critical juncture, but also helped to avoid a systemic banking crisis in parts of the region. As the financial crisis intensified, there were concerns that some foreign banks might take measures, perhaps in response to measures from home country supervisors, which would have restricted the lending activities of their subsidiaries in the region. A decision by just one or two banks to reduce their operations could have easily spread to other foreign banks, resulting in an acute shortage of liquidity in the region. This applied particularly to the CEB and SEE countries where the degree of foreign ownership in the banking sector is large.

28. In the absence of any existing institutional arrangements, the IMF, the EBRD and the European Union quickly established a forum whereby foreign banks, their subsidiaries, governments and regulators could meet to discuss the issues. The first meeting was in January 2009 and provided an opportunity for foreign banks to reaffirm their commitment to the region. Subsequent meetings enabled the participants to share information on a country basis once an IMF programme had been agreed and funding was supported by the Joint IFI Action Plan. Towards the end of 2009, 15 foreign banks had made commitments regarding their support for several countries which had received support from the IMF, including Hungary, Latvia and Romania. By the time of the second "Full Forum" meeting of the EBCI in March 2010 it was evident that the EBCI had contributed to banking stability in the region and could move on to discuss other issues related to cross-border lending.

29. The crisis inevitably had an adverse impact on the EBRD's financial performance. The Bank recorded a net loss on its operations in 2009 of €746 million, after a loss of €602 million in 2008. These losses, the first since the effects of the Russian crisis in 1998, were largely unavoidable in view of the decline in the value of the Bank's equity operations and the need to increase provisions to cover future potential loan losses. The Bank remains well capitalised. However, the strength of demand for EBRD financing led the EBRD's management to conclude that to maintain annual activity at €8-9 billion a year over the period of the forthcoming Capital Resources Review 2011-2115, the Bank needed a capital increase. In February 2010, the

10. The Turnaround Management programme (TAM) focuses on strengthening management for enterprises with between 200 and 2 000 employees, using foreign executives. The Business Advisory Service (BAS) uses local consultants to improve performance for firms with between 10 and 250 employees.

11. The EBRD established the SEI in 2006, a partnership with donors, to increase investments in energy efficiency and renewable energy.

Board of Directors approved a temporary 50% increase in the EBRD's capital from €20 billion to €30 billion (one billion euro of which will be from the Bank's reserves and the remainder callable), subject to ratification by the Governors.

2.4. Examples of the EBRD response in specific countries in 2009

30. The EBRD increased its commitments to the Russian Federation, the largest country of operations, by €2.5 billion in 2009, with substantial loans to the banking sector to help restore stability, as well as lending to the real sector. The crisis also emphasised the importance of funding for development of the infrastructure, especially the transport network, which is a necessary condition to achieve the broader policy goal of increasing the diversification of the economy. To this end, the EBRD signed a €500 million loan to assist with the modernisation of the railway sector. Loans to the infrastructure sector, as well as projects to promote greater energy efficiency, are likely to remain key areas of activity for the Bank.

31. The need to support the banking sector in Ukraine, the second largest country of operations, contributed to commitments amounting to €1.1 billion. Because of the urgent need to replenish banks' capital, a large proportion of the EBRD's support was either equity or subordinated debt. The EBRD signed a Sustainable Energy Action Plan with the government in June 2009 to improve energy efficiency. The EBRD also participated in the discussions with the government and other IFIs as to how best to prepare for reform in the gas sector.

32. There was a substantial increase in activity in the CEB area, as noted above. Hungary was the largest recipient, with most of the EBRD funding provided to support the banking sector as well as to modernise the gas sector. In Poland, commitments rose to some €400 million, with loans for the banking and non-bank financial sector accounting for more than half. In the Slovak Republic, the banks were generally well supported by their foreign parents so the EBRD was able to provide lines of credit to promote energy efficiency as well as to contribute to some large public-private partnership projects for motorway development. The EBRD's main project in the Baltic states was the purchase of a share in the main bank, Parex Bank. Although Slovenia was affected by the crisis, the EBRD's contribution was limited, mainly because of the government's earlier decision not to proceed with the privatisation of a major bank.

33. The EBRD more than doubled its annual commitments in Romania from €318 million in 2008 to €720 million in 2009. This reflected its decision to provide €1 billion of funding in 2009 and 2010 as part of the IMF/EU aid package for the country which had been agreed earlier in 2009. Most of the Bank's funding was for the energy, SME and corporate sectors.

34. Much of the EBRD's activity in the Caucasus was to support local banks, although total activity fell by about 10% in 2009. Georgia was the most severely affected of the three countries owing to the extent of the fall in external demand and FDI flows and because its main banks were reasonably well integrated with global financial markets. The EBRD provided subordinated debt and liquidity to two local banks to help maintain banking stability. In Armenia, the EBRD provided funding for banks and for the power sector. Azerbaijan was the least affected of the three countries, but EBRD operations continue to be constrained by the difficult business environment.

3. Drawing lessons from the crisis

3.1. Lessons for the region

35. Most countries in the region benefited from greater integration over the years. This took several forms including closer integration with European institutional structures, stronger trading links with western markets, especially for those countries which are members of the World Trade Organization (WTO) and much greater integration with the world's financial markets. However, the crisis also revealed that the extent to which the trade and financial links that had been developed could become channels of contagion for a crisis which started outside the region.

3.1.1. Strengthening the financial sector

36. Development of the banking sectors in the region was undoubtedly strengthened by the growth of foreign ownership of domestic banks, particularly in countries in the CEB and SEE regions. In these countries, the pace of financial intermediation was accelerated as domestic banks were able to strengthen their capital base and benefit from the financial expertise available from the parent bank, permitting an expansion in the range of products that could be marketed.

37. In retrospect, however, it was apparent that too much of the lending was in the currency of the parent bank – mainly dollar lending in the major CIS countries and euro lending elsewhere, as these currencies were cheaper and more accessible than the local currencies. This contributed to the rapid growth of domestic credit in many countries, much of it in foreign currency, while the associated increase in the external debt of the private sector left both the corporate and household sectors vulnerable to exchange rate risks. Nevertheless, during the crisis the foreign parent banks played an important role in stabilising the situation and limiting the extent of capital outflows. This was mainly through their support for their subsidiaries, backed by the Vienna Initiative. In this crisis, where the share of foreign ownership of banks in emerging Europe was higher than that of other emerging market regions, direct lending through subsidiaries proved to be more stable than cross-border lending.

38. The crisis suggested at least three broad policy conclusions. Firstly, while financial institutions are an essential part of a market economy, they exist to serve the real sector. Thus both the regulatory framework and the implementation of supervision need to be strengthened to ensure that banks have adequate capital, that responsible lending and investment practices are followed and that no institution becomes “too big to fail”. Secondly, for many banks in the region retail deposits remain an important source of funding. During the crisis, many authorities moved swiftly to increase the level of deposit insurance to bolster confidence. Continued confidence in these schemes will depend on ensuring that the enhanced levels of deposit insurance can be funded. Finally, there is a need to increase the availability of local currency financing.

3.1.2. Maintaining external trade

39. One of the reassuring aspects of the response to the crisis is that there has been no resort to protectionist trade measures, although clearly some countries have experienced currency depreciations. This was a significant outcome, especially as there was a sharp drop in the volume of world trade by more than 10% in 2009, according to the WTO. Although external demand is likely to remain weak, reflecting the gradual pace of recovery in the major markets in Europe, any move to increase protection to protect domestic markets would almost certainly limit the opportunities for export growth.

3.1.3. Implementing sound macroeconomic policies

40. One of the main lessons is that countries with sound macroeconomic policies, especially prudent fiscal policies, were best placed to respond to the crisis. The importance of implementing sound macroeconomic policies has been a consistent piece of advice from IFIs over the years. But it remains crucial for many countries in the region, where future health and pension obligations for an ageing population are likely to result in additional large expenditures, adding to the fiscal burden, despite the expected growth of private providers of such services.

41. There were also failures in the approach to macroeconomic policy. Lowering inflation remains a valid and necessary policy objective, but it is evident that too little attention was paid to the growth of bubbles in asset markets and how to deal with them. As some economists at the IMF have suggested, consideration needs to be given to the use of financial regulatory measures to support macroeconomic policy, as well as the possible use of capital controls to limit surges in capital inflows.¹²

42. The problems in the eurozone, especially the concerns as to whether Greece and possibly certain other countries can meet their debt obligations, has drawn attention to the role of the exchange rate, especially for those CEB countries which aspire to join the euro. As noted above, most countries in the region as a whole had floating rates and allowed their currencies to depreciate at the height of the crisis, thus contributing to the necessary adjustment. For the members of the eurozone (Slovenia and the Slovak Republic) and those countries which maintained their currency boards or hard pegs, there was little alternative but to accept domestic deflation to achieve the necessary adjustment. For many of these countries, the deterioration in some of the main indicators, including fiscal deficits and public sector debt levels, means that adoption of the euro (which some had hoped to achieve in 2010/2011) is likely to be delayed by a few years. For example, the Czech Government recently adopted a Convergence Programme intended to improve the fiscal position to enable it to adopt the euro by 2017. The main exception is perhaps Estonia which appears to be on course to adopt the euro at a relatively early stage. However, countries such as the Czech Republic, Poland and Hungary will have a few years of exchange rate flexibility to assist the recovery.

12. “Rethinking macroeconomic policy” by Olivier Blanchard, Giovanni Dell’Ariccia and Paulo Mauro, IMF Research Department, February 2010.

3.1.4. The importance of promoting reform

43. Countries which had made substantial progress with structural reform were generally better equipped to withstand the shocks, mainly because their institutions were stronger. The crisis was, however, an important reminder of the role the state has to play in a market economy, especially its interaction with the private sector. Even among some of those countries which had made steady progress with reform, the crisis revealed weaknesses in the quality and functioning of some institutions, perhaps most notably in the financial sector. A key factor is that it is not necessarily more regulation of markets that is required, but that regulation has to be more effective.

44. In its latest transition report, focusing on the importance of further institutional development, the EBRD identified some of the main transition challenges which remain in the corporate, energy and infrastructure and financial sectors, all of which are important areas of activity for the EBRD in the region as a whole.¹³ In general, the gaps are smallest for the CEB countries. The progress made in these countries partly reflected the need to align institutional frameworks with those of the European Union in the accession process, although more needs to be done in the difficult areas of finance, energy and strengthening competition policy. The largest gaps exist in the countries of central Asia and eastern Europe and the Caucasus, where progress is often hindered by state interference, difficult business environments and weak legal frameworks. In these countries, the gaps are large in energy and infrastructure as restructuring is at an early stage and sound regulatory frameworks have yet to be developed.

45. The depth of the crisis in some countries is likely to make it more difficult for governments to accelerate the pace of reform. However, reform remains an important objective. Much of the growth in the region in earlier years took advantage of low wage costs and some spare capacity. The strength of future growth is more likely to reflect the extent to which productivity can be raised and costs lowered as labour costs rise. This requires additional investment with further improvements in the business environment to attract it, supported by sound regulatory and legal frameworks, a strong competition policy and adequate social safety nets.

3.1.5. The advantages of further integration

46. The advantages of European Union membership or at least close association with it were demonstrated by the maturity of the general policy response to the crisis as well as the opportunity to access the additional finance that the EU (and other IFIs) made available. The EBRD is well placed to support those countries in SEE which are either EU candidates or are discussing the possibility of EU membership.

47. The EU established the Eastern Partnership in May 2009 to promote political association and economic integration between the EU and its six eastern neighbours. This initiative largely reflected the impact of the crisis on the institutions and economies of these countries. It is hoped that a combination of policy discussions and financial support will help to strengthen the economies of these countries and promote integration. Although the details of the Eastern Partnership are still being discussed, the EBRD is well placed to support activity in some of the priority areas (see below). This would build on the Bank's activities in these countries to date, some of which have been supported by the funds made available by the EU through the Neighbourhood Investment Facility (NIF). These have funded technical assistance related to projects for private sector development, infrastructure and the environment and for the EBRD amounted to €53 million in 2009, the largest source of grant funds for the EBRD.

3.2. Implications of the crisis for the EBRD

3.2.1. The economic background

48. The implications for the EBRD partly reflect how it can best respond to some of the lessons above, but also the nature of the economic environment in which it is likely to be working in the immediate future. By early 2010, the global economy and financial system were more stable than in 2009 and a gradual economic recovery was under way. The EBRD projects GDP growth for the transition region as a whole of 3.7% in 2010, gradually strengthening thereafter. However, projected growth this year comprises weak growth among the CEB and SEE countries of around 1%. This is mainly because of a combination of weak external demand,

13. See Table 5.5 of the "Transition report 2009". A total of 13 sub-sectors were identified. The approach involved an initial assessment of the quality and nature of market structure and market-supporting institutions one would expect to find in a market economy. A largely quantitative assessment was then made of the situation in each country, resulting in a conclusion as to whether the "gap" to be filled ranged from negligible to large.

slower credit growth because banks will be more risk averse and because of the need to reduce the fiscal burden over time. The regional average growth rate is boosted by stronger growth from commodity producers, although this is highly dependent on commodity prices. In Russia, for example, GDP growth is projected at 4.4%, which will assist the recovery of other CIS countries through a combination of a growing market and higher remittances. GDP growth is projected at 4% in Ukraine in 2010, although much depends on a new government reaching an early agreement with the IMF to enable the latter to resume lending.

49. However, a number of risks to recovery remain. These include the possibility of a very weak recovery among major economies, partly reflecting the difficult policy judgment as to when to begin withdrawing the monetary and fiscal stimulus. In addition, the risks of a sovereign default, which would affect the ability of governments in emerging markets to borrow, and a resort to protection, cannot be ruled out. Credit conditions are likely to remain tight as banks seek to restore their capital and deal with an expected increase in non-performing loans while some companies in the region will be vulnerable to higher interest rates. For most countries, other than the main oil and commodity producers, this points to a period of modest economic growth as domestic demand remains weak and external demand subdued.

3.2.2. Implications for the EBRD's operations

50. The immediate challenge for the EBRD is to maintain its increased volume of lending to support recovery in the region. This will partly depend on ratification of the capital increase as well as ensuring that the Bank has sufficient staff to deliver the planned increase in volumes. As several other IFIs are requesting additional capital to fund higher activity levels, often from similar groups of shareholders, it implies the Bank's management will need to pay careful attention to administrative costs to ensure that loans and investments are delivered efficiently.

51. There are also likely to be risks attached to the higher volume of lending. Much of the increase in lending in 2009 is likely to have been to major banking groups or corporates where the risks of lending were relatively moderate. In future years, however, assuming a gradual recovery in credit markets, and that the EBRD remains an additional source of lending, then it is possible that risks will rise as many of these prime borrowers are increasingly able to access private sources of funding. This is most likely to occur in those countries where the banking sectors remain weak and where it takes time for the authorities to implement the necessary stabilisation measures to correct some of the macroeconomic imbalances.

52. Some of the EBRD's activities should focus on ways to mitigate the worst effects of the crisis. It is inevitable that the region's financial sectors will continue to receive strong support from the EBRD, partly to ensure stability is attained, but also because of the importance of increasing funding for the MSME sector. The overall amount of funding is probably unlikely to match the support provided in 2009, mainly because many banks in the region now seem to have adequate liquidity so demand will be less. Within the financial sector there is scope for increasing the amount of local currency financing and developing local capital markets, as the EBRD has already noted, especially in those countries with relatively low interest rates. This would assist in reducing the high dependence on financing in foreign currencies which emerged in some countries. Ultimately, however, the health of banking sectors will depend on effective regulation rather than additional financial support.

53. In the context of the financial sector, the EBRD should have a role in the ongoing discussions about strengthening stability with respect to cross-border lending in Europe, building on its contribution to the Vienna Initiative. Although this may ultimately be a matter for financial regulators, it appears that more needs to be done to strengthen the co-ordination between supervisors as they seek to improve regulation at a national level.

54. Over time, relatively more EBRD funding could be directed towards the real sector, the ultimate source of growth. The EBRD may also have to consider providing more equity finance to companies in recognition of the tight lending conditions that are likely to prevail in the immediate future. One such example is the recent launch of a fund by the EBRD, the IFC and a private sector company, CRG Capital, to provide an initial €36 million to invest in the under-performing assets of companies with good management. Another example is the announcement of a fund to provide mezzanine financing. The EBRD will invest up to €50 million in a fund to be run by another private sector group, MMCE, to support private equity-backed acquisitions and provide additional funding to companies with sound business plans. Both funds are likely to focus mainly on companies in central and eastern Europe.

55. Despite the focus on the effects of the crisis, certain other programmes remain important. This includes lending to the early transition countries¹⁴ (ETC). Not all of these countries were necessarily as severely affected by the crisis as others, partly because their financial sectors were less integrated. However, they

include some where the reform challenges remain significant. Although the main oil and commodity producing countries in the region withstood the crisis fairly well, it is apparent that they remain highly dependent on the exports of a few major commodities and that policies to diversify their productive base have had only limited success to date.

56. Projects to improve energy efficiency have assumed even greater importance in recent years in view of the need to lower carbon emissions to tackle climate change. Following the launch of the second phase of the SEI in 2009, the programme will be one of the EBRD's core objectives during the next medium-term strategy. The EBRD's intention is to at least double the targets achieved under Phase 1, both in terms of volume of operations and reduction in emissions. This will include extending the programme into new sectors, such as buildings and transport, as well as biomass, which is one source of renewable energy.

57. Despite the lack of agreement at the United Nations Climate Change Conference in December 2009, some progress is being made. The Climate Investment Funds are an initiative developed by the IFIs and certain donor countries to finance projects to tackle climate change. The EBRD is currently developing projects for Ukraine and Turkey under one of the two Climate Investment Funds, the Clean Technology Fund, designed to support the development of clean energy technologies in some of the world's major emitting countries. Such measures represent important examples of how international co-operation could work in this area. The broader challenge for the EBRD is to increase the range of instruments it uses to channel these investments so that funding could be further increased if future international agreements lead to higher financing targets. The EBRD can also continue to demonstrate how best to involve the private sector in energy efficiency projects at a time when investment is likely to be constrained.

58. The crisis also emphasised the importance of effective Policy Dialogue, not only to help ensure the success of projects, but also to improve technical co-operation and focus on those areas where reform may need to be accelerated, particularly for those countries where the "transition gaps" are relatively large. This applies to those countries where the EBRD's involvement in public sector projects provide it with some leverage to ensure steps are taken to establish an appropriate regulatory framework for the sector. This could include the need to develop the institutional and legal framework to promote greater private sector participation via public/private partnerships and identify mechanisms that would provide more sources of local funding. In general, the EBRD would seem well placed to promote policy dialogue in view of its extensive knowledge of the region and in particular because of its presence through its regional offices and hubs.

3.2.3. *Related objectives*

59. Closer European integration is an objective the EBRD has always supported in practical terms through its projects. The EBRD will need to maintain its lending to those countries which are now European Union members until such time as they are once again able to access commercial sources of funding on appropriate terms. As noted earlier, although all the countries which became members of the EU in 2004 were expected to have graduated by the end of 2010, the EBRD Board agreed to continue operations while the crisis conditions persist. When global markets return to normal, capital flows resume and EBRD's additionality subsidies, the EBRD is expected to end its operations in these countries, taking into account specific country circumstances.

60. Continued support is also necessary for the EU candidates in South-Eastern Europe, while the EBRD would seem well placed to participate in some of the policy discussions as well as funding platforms that the EU has proposed for the "environmental protection" countries. This includes energy efficiency, good environmental governance and development of SMEs. The Bank's operations will be boosted by the EU's decision to allocate up to €50 million to SMEs under the "environmental protection" programme. Some €30 million will be shared between the EBRD and the European Investment Bank to support credit lines for SMEs, while the balance will be used to fund the EBRD's TAM/BAS activities.

61. Further collaboration with the other IFIs active in the region will also be necessary given that they have all also increased their activities. This includes the IMF through its specific country programmes, the EIB and the World Bank group (the latter two have increased their funding for banking and infrastructure in particular), as well as the EU whose support has included financial assistance for Serbia under pre-accession programmes.

14. This is an EBRD group of eight countries (including Armenia, Azerbaijan and Georgia). Under this programme, the EBRD focuses on smaller projects, mainly in the private sector. The approach is more streamlined, with the EBRD willing to accept more risk than normal, while observing sound banking principles.

62. The need for further co-operation with the EIB has been identified by Michel Camdessus in a report on the EIB which examines how the EIB's provision of external financing can be strengthened and European integration developed.¹⁵ The report notes the progress made following the signing of the Memorandum of Understanding between the EBRD and the EIB in 2006 and the more recent agreement on Turkey, but argues that further co-operation could maximise the opportunities for co-financing and avoid duplication. However, Camdessus also argues that more could be achieved by institutional change over the medium term and proposes two options for consideration. One of these – to establish a European Bank for Co-operation and Development – could cover the activities of the EBRD, EIB and the relevant external funding departments of the European Commission.¹⁶ The EBRD and all its shareholders will no doubt consider the implications of this proposal for the EBRD in meeting its own mandate.

4. Conclusions

63. The transition region experienced a sharp fall in activity as a result of the crisis, though the impact differed between countries. By early 2010, a gradual recovery was under way largely due to the soundness of the policy response and the speed and extent of the financial support provided by the EU and the IFIs. As credit conditions tightened, the EBRD faced a marked increase in demand for funding. The Bank responded with a substantial and unprecedented increase in the volume of its operations to assist countries in dealing with the crisis. Much of this was for the banking sectors in particular countries, not least for those in the CEB region. But the EBRD's qualitative contribution, through helping to formulate the Vienna Initiative to ensure foreign banks remained committed to the region, was also very significant.

64. The region had benefited from integration in all its forms in the years leading up to the crisis. However, the crisis revealed some downsides to integration, including the vulnerability to sharp falls in demand, the dangers of excessive foreign currency borrowing and the risks of inadequate co-ordination between home and host country financial supervisors of foreign bank groups. Important lessons must be drawn and these issues must be addressed, including improving competitiveness, increasing the amount of local currency financing and strengthening financial supervision. However, the main lesson is that those countries with sound policies and which had made most progress in reform were best equipped to respond to the crisis.

65. The immediate challenge for the EBRD is to maintain the higher volume of activity as long as there is a demand for this increased funding, as reflected in the temporary nature of the 50% capital increase. Although the policy of graduation has been postponed until crisis conditions recede, as demand for funds from this group of countries is expected to taper off over time, there must be uncertainty as to the rate at which funding for Turkey and climate change will grow. Although both of these activities are necessary, a clarification of "transition challenges" may be needed. However, perhaps the single most important aspect of the EBRD's operations over the years has been to promote the development of the private sector throughout the region. Maintaining this focus will not only enable the EBRD to continue to fulfil its original mandate, but also ensure that it contributes to further European integration and responds to the challenges posed by climate change.

15. "European Investment Bank's external mandate 2007-2013, mid-term review; report and recommendations of the Steering Committee of 'Wise Persons'" (chaired by Michel Camdessus), February 2010.

16. It is also proposed that the new bank could finance social projects and could therefore also include other institutions such as the Council of Europe's Development Bank.

Appendix – Macroeconomic indicators and projections for the transition region (EBRD data and forecast of May 2010)

	Average GDP growth %				Inflation (average) %			Fiscal balance % of GDP		Current account % of GDP		Net foreign direct investment % of GDP	
	2008	2009	2010	2011	2008	2009	2010	2008	2009	2008	2009	2008	2009
Central Europe and Baltic states													
Croatia	2,4	-5,8	0,3	1,8	6,1	2,5	2,5	-1,4	-3,3	-9,2	-5,2	6,6	4,1
Estonia	-3,6	-4,1	-0,4	3,3	10,4	0,0	2,4	-2,8	-1,7	-9,4	4,6	3,7	1,3
Hungary	0,6	-6,3	1,0	2,3	6,1	4,2	3,0	-3,8	-4,0	-7,0	0,2	2,6	0,2
Latvia	-4,6	-8,0	-3,0	3,0	15,4	3,5	-3,0	-4,1	-9,0	-13,0	9,4	3,2	0,3
Lithuania	2,8	-5,2	-1,5	3,0	11,0	4,5	-0,2	-3,3	-8,9	-11,9	3,8	3,2	0,3
Poland	5,0	1,7	2,6	3,3	4,3	3,5	2,5	-3,7	-7,1	-5,1	-1,6	2,2	2,0
Slovakia	6,2	-4,7	3,4	3,4	4,6	1,5	3,0	-2,3	-6,8	-6,6	-3,2	3,2	-0,5
Slovenia	3,5	-7,8	1,3	2,2	5,7	1,0	2,0	-1,7	-5,5	-6,2	-1,0	1,0	-2,0
South-Eastern Europe													
Albania	7,0	2,8	1,4	3,1	3,4	2,2	2,5	-5,7	-6,9	-15,7	-15,3	7,0	7,6
Bosnia and Herzegovina	5,4	-3,4	0,3	1,7	6,5	0,0	2,0	-3,1	-4,0	-15,0	-8,8	5,4	2,9
Bulgaria	6,0	-5,0	-1,2	3,0	12,3	2,7	1,9	1,8	-3,9	-24,0	-9,4	17,0	12,5
Montenegro	7,0	-5,3	0,1	2,0	7,4	3,4	1,5	1,5	-3,0	-33,6	-18,7	16,7	14,5
Romania	7,1	-7,1	0,0	3,0	7,9	5,6	3,8	-5,4	-8,3	-11,6	-4,5	4,6	2,9
Serbia	5,5	-3,0	2,1	3,2	11,7	8,4	6,0	-2,4	-4,5	-17,2	-5,5	5,3	4,2
"The former Yugoslav Rep. of Macedonia"	4,8	-0,7	2,2	2,5	8,3	-0,8	2,0	-1,0	-2,9	-12,8	-7,0	6,3	2,5
Eastern Europe and the Caucasus													
Armenia	6,8	-4,2	10,0	3,0	9,0	3,4	7,0	-1,7	-7,5	-11,5	-15,2	7,8	8,0
Azerbaijan	10,9	9,3	6,0	5,0	20,8	2,5	5,0	25,5	9,4	35,5	14,8	-1,2	-2,1
Belarus	10,0	0,2	3,5	4,0	14,9	12,8	6,9	1,4	0,4	-8,4	-13,1	3,6	3,7
Georgia	2,1	-3,9	3,5	4,5	10,0	1,7	5,0	-6,4	-9,4	-22,7	-16,1	12,2	8,3
Moldova	7,2	-6,7	4,0	4,2	12,8	0,1	7,5	-1,0	-6,8	-16,7	-10,7	11,2	2,2
Ukraine	2,2	-5,1	4,0	4,0	25,2	15,9	11,0	-3,2	-11,4	-7,1	-1,7	5,5	4,0
Russia	5,6	-7,9	4,4	4,6	14,1	11,7	6,9	4,8	-6,2	6,1	4,0	1,2	-0,6
Turkey	0,9	-4,7	5,9	4,0	10,4	6,3	9,6	-2,2	-5,5	-5,6	-2,2	2,1	1,0