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Contribution of the European Commission to the UN/ECE Conference on Financing for Development in the ECE region, Geneva 6-7 December

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The attached notes are a contribution of the European Commission to the four themes of UN/ECE Conference on Financing for Development, concentrated particularly on the EC assistance in the NIS. As an introductory remark, we want to stress that the transition in the countries of the former Soviet Union is a historically unique challenge. The magnitude of the tasks has only gradually been revealed. The role of the EU and more specifically the European Commission in this vast change is and can only be marginal, but nonetheless crucial. Many instruments work together to make up our contribution to the transition process. The four themes are therefore closely interlinked.

In the UN/ECE conference it is important to take account of the specificity of the challenges to the region's development, while at the same time use experiences of e.g. the transition in the candidate countries for EU Membership, albeit that the transition process was arguably easier in these countries in many cases, as well as of the world-wide experiences of development.

Theme 1: Mobilising financial resources for transformation and development – the domestic dimension

Background

The transition towards democracy and market economy in the countries of the former Soviet Union is a historically unique challenge. While the requirements needed for mobilising domestic and foreign resources are the same in principle for this region as for other regions of the world, the starting point is very different. The difficulties of this process has gradually become apparent to the countries concerned as well as to their partners, including the EU. Similarly, the differences between the NIS countries are steadily becoming larger.

The problems are well known and will not be gone into in depth here. The lack of mechanisms for mobilising domestic and foreign capital remains a major obstacle for development of a flourishing private sector. The banking sector is a bottleneck. After the Russian crisis of 1998, see theme 4, it remains very weak. Other obstacles are widespread corruption, malfunctioning tax system, lack of secure property rights, inappropriate accounting procedures and other aspects of corporate governance etc, as well as an unstable macroeconomic environment. In addition, the heritage of 70 years of communism is particularly important when it comes to aspects such as entrepreneurship. Many of the problems faced by the nascent private sector are echoed in the public sector. The mobilisation of resources for the public sector has by no means proven to be any easier.

The effect of the collapse of the previous system and of the often flawed and slow transition process has been a precipitous drop in the living standards all over the region. The effects of the falls have been compounded by very sharply increasing inequalities, within and between the countries. 10 out of the 13 countries in the region are now classified as low income. The historic subsidisation from the centre of the poorer parts, e.g. Central Asia, has ceased. The lack of macroeconomic stability with very high rates of inflation and a permanent financial crisis for the governments of the region have had severe effects in particular on the social welfare net, social sectors and on vulnerable groups and areas.

Obviously these major issues cannot be resolved from abroad; the main requirement is a consistent political will resulting in broadly based economic and social progress by the countries concerned.

The contribution of the EU concerning dialogue, exchanges, trade and investment

Even the brief discussion above shows that the transition calls for far-reaching changes of almost all aspect of society. In this process, aid-financed transfer of knowledge and resources are not necessarily the main contribution from the EU. The positive effects of trade and of exchanges between people as well as enterprises and institutions play at least a large a role. The EU therefore contributes in several ways to supporting the transition process: dialogue, trade, exchanges and aid. Aid is discussed under theme II.

The EU's relations and partnership with the New Independent States (NIS) are based on Partnership and Cooperation Agreements (PCAs), the Tacis Regulation and in the case of Russia and Ukraine, Common Strategies.

In order to reflect will of the EU to support the transition and take account of the new political and economic situation PCAs have been entered into between the EU and almost all NIS. Although each PCA is tailor-made for the partner concerned, collectively the agreements establish the framework for a broad-based and strong economic and political partnership between the EU and the NIS to develop closer political links, promote trade and investment, support the reform process and create the conditions necessary for the establishment of a future trade area (concerns only European NIS). The PCAs have common objectives and principles: the rule of law, observance of human rights, promotion of political liberty and the creation of a viable market economy.

PCAs can be described as a cross between standard framework agreements of the kind the Commission has signed with a number of countries round the world and the « Europe Agreements ». They include provisions on trade and investment but they do not offer concessions beyond those given to GATT/WTO partners. The PCA with Russia however includes a « rendez-vous » clause concerning the initiation of negotiations on a free trade agreement (FTA). The PCA's remove a large number of quantitative restrictions on exports and extends to Russia (Most Favoured Nation treatment i.e. the same treatment the Russia would receive if it were already a member of the WTO (not given to Russia by neither US nor Japan). In the same way, Russia extends MFN treatment to the EU.

Because they have entered into force only recently, the potential of the PCAs is still not fully exploited. The PCA institutions have however been set up and the dialogue intensified. Currently the options for streamlining the institutional set up is looked into.

Through the new Tacis Regulation which entered into force in January this year, the Tacis programme is being adapted to make it a better instrument for tackling the current problems of the NIS and to focus to a greater extent on supporting the objectives of PCAs. Among other areas the Tacis is foreseen to provide financing for support for institutional, legal and administrative reform and support to the private sector and assistance to economic development.

The EU's Common Strategies on Russia and on Ukraine, agreed under the Amsterdam Treaty, combines the MS's and the European Community policies and actions in new areas of EU competence such as foreign policy, security and fight against criminality.

Theme II: The Role of Official Assistance in creating the conditions for sustainable development

The role of aid in the transition process

The vastness and novelty of the task of transition to market economy and democracy could not have been resolved by any amount of foreign aid, much less by the amounts of funding that were actually made available. Any conceivable assistance programme could never have compensated for the lack of private finance in the countries concerned, due to the overarching importance of domestic factors, as outlined under theme I.

On a more specific Tacis oriented aspect, the situation in the countries today points to the limits of technical assistance. Some countries might be better off with instruments that could help buffer the social hardship of transition. However, the small size of the aid flows, not least Tacis, in relation to demands, justify an indirect, catalytic effort to support the transition process. This support should, in addition, concentrate on a limited number of areas in order to ensure maximum impact. These areas of concentration needs to be chosen not just on the basis of needs but taking the domestic situation, e.g. policy framework and political will, into account. The increasing heterogeneity of the region calls for gradual differentiation in this as well as other aspects.

The EU aid programme, in particular Tacis

By now, the EU can look back on its first decade of assistance to the Newly Independent States (and Mongolia). Assistance has taken a variety of forms, humanitarian aid (delivered through ECHO), rehabilitation, food security and most notably, technical assistance through the EU's Tacis Programme, which since its inception in 1991 has committed total of €4.226 billion in support of transition to market economy and democracy.

The EU and its Member States (whose figures on bilateral assistance programmes are not included in the above mentioned data) account for 59% of global assistance (including credit guarantees, private investment, debt rescheduling, strategic assistance, technical assistance, humanitarian and food aid) to the New Independent States.

In view of this track record, but also taking into account the ever more stretched budget for external assistance and the development of a Common Foreign and Security Policy aiming at harmonisation and co-ordination of all EU external assistance instruments, the EU is called to assess "lessons learnt", the impact its assistance had on the partner countries development and the appropriateness of the instruments applied.

The need for provision of assistance to the NIS was acknowledged immediately in 1991 and assistance was started as soon as practicable. The EU sought as well to institutionalise its relations with the countries concerned. The Union therefore negotiated with individual NIS the establishment of frameworks for strengthening of political and economic co-operation, the promotion of trade and investment and the fostering of harmonious relations, the PCAs, see theme I.

The Tacis programme is the main aid instrument under these agreements and supports the partners' efforts to consolidate democracy and complete the transition to market

economies. The priority areas of co-operation to be supported through Tacis are identified in a dialogue-driven approach (as opposed to demand-driven as in the first years of the programme) between EU and partner states. Increased importance is attributed to the concept of ownership of the reform process with the authorities of the recipient countries.

The dialogue-driven approach will enable the EU to better address the differing needs and priorities of the partner states through a clearer definition of the areas of common interest, including the need to promote democracy and the rule of law. Moreover, the new Tacis Regulation 2000-2006 emphasises concentration on fewer objectives and on projects of sufficient scale to have a significant impact. The concentration on a maximum of three thematic areas of co-operation in each country or multi-country programme seeks to reconcile the need to better focus assistance and the need to maintain flexibility.

Recognising that the development of private enterprise, and of the market economy, is frustrated in the partner states through lack of finance, the new regulation allows for Tacis funds to be used increasingly to support investment. A maximum of 20% of the annual programme budget can be used for economically sound investment financing in a few predefined areas such as promotion of SMEs and environmental infrastructure.

The introduction of these new opportunities for Tacis financing is coupled with the launch of a set of new instruments. Although technical assistance will remain the main Tacis instrument of co-operation, other mechanisms will be increasingly employed. The legal and regulatory framework and its enforcement remaining a priority, expertise from the public and as well as from the private sector will be in increasing demand. As a result, there will be a shift from the traditional technical assistance towards longer-term co-operation, e.g. through institution building partnerships, see also theme III.

Whereas technical assistance is considered to be particularly appropriate for the countries of the Western NIS, different approaches may be considered for the Caucasus, Central Asia and Moldova, which may eventually lead to the development of new instruments adapted for these states.

There are two major constraints for the effectiveness of EU assistance. One is the slow pace of delivery of aid, which is currently being addressed through the European Commission's reform of its external aid management. The reform should lead not only to better quality of assistance delivered, but also to a drastic cut in delivery time.

The second constraint concerns aid coordination. To enhance coordination and thus effectiveness of the EU's external action, ways are discussed to achieve this, notably between the Commission and Member States. Aid coordination must be led by the partner country and involve all donors. This is why a new initiative of the World Bank and IMF is attracting attention: The September 1999 Annual Meetings of the World Bank Group and the IMF endorsed the proposal that country-owned Poverty Reduction Strategy Papers should provide the basis for all World Bank and IMF concessional lending, and should guide the use of resources freed by debt relief under the enhanced HIPC Initiative. Seven of the 13 Tacis countries will be required to draw up PRSPs. Their potential importance is considerable, given that they will constitute the governments' own medium/long-term development strategy and, as such, should form the cornerstone for donor efforts. If they are to be of high quality, capacity building may be necessary and there may be a role for Tacis in this realm.

Theme III: FDI and the restructuring of transition and emerging economies

Foreign direct investment (FDI)

In this part, Russia is used as an example. The situation in most other NIS is worse. Exceptions are mainly a few countries rich in oil or natural gas, which are beginning to attract major foreign investment, e.g. Kazakhstan and Azerbaijan. However, for this sector special deals with the government can frequently overcome an innately unstable environment. On the other hand, for this reason even large investments are not always accompanied by the positive side effects of other kinds of FDI.

Foreign direct investment is a key instrument for developing a strong and dynamic private sector. It can support the transition to a market economy and the integration into the world market. In 1997, FDI in Russia (see table below) started to rise, but the total is still low due to a very low starting point but also to the difficulties touched upon under theme I as well as below.

Foreign Investment in Russia

(total in billions of USD)

1992	1993	1994	1995	1996	1997	1998	1999
-	-	1.05	2.80	6.51	12.30	11.77	9.5

(From Russian Economic trends, a publication of the Russian-European Centre for Economic Policy.)

Russia has so far not been able to attract FDI on a scale commensurate with the country's investment needs or its potential. The Russian government has declared that it intends to promote direct investment but actual policy has not always been consistent and credible. Nonetheless, in the economic plan adopted by the Russian government in July 2000 are included such points as improving the business environment, tougher bank regulation, and greater transparency of public finances. In addition, the Duma has adopted a law on foreign investment.

Some of the specific reasons for the low level of FDI in Russia as in the region are lack of predictability of trade policy, difficulties encountered by EU companies in gaining adequate recourse to the legal system, slow progress towards the restructuring of the banking system, inadequate protection of intellectual property rights, slow progress towards alignment with the norms and standards that prevail on the EU's internal market.

EU contribution to private sector development

The EU has made attempts to stimulate investment by promoting initiatives to bring enterprises together essentially by means of twinning and training NIS managers in EU enterprises. The Tacis Regulation provides specifically for a Community support to industrial cooperation. As regards exposure of NIS managers to EU business practices, the Commission has developed a training facility, now called the Managers' Training

Programme, which provides for 1 to 3 month internships in the EU, for a number of trainees between 500 and 1000 each year. On the other hand, the promotion of joint ventures or direct investment projects undertaken by SMEs has not met the expectations of the early 1990's. The level of investment already carried out demonstrate a very cautious assessment by EU SMEs of the opportunities, but also the risks and difficulties of this region. Bigger enterprises naturally look at it with a longer-term perspective. This is why the EU-Russia Industrialist Round Table, which is organised by the Commission, constitutes a very active and successful forum to promote cooperation between leading industrial firms. Promising contacts have been established in many key sectors as energy and telecommunications

EU intends to continue supporting the development of the private sector in the NIS based on the PCAs and on the EU's common strategies. Certain overall priorities of particular importance to private sector development and FDI are reinforced such as institution building through partnerships between public bodies and institutions from the civil society, investment support through increased cooperation with IFIs, and industrial cooperation. In the area of support to the development of small and medium-size enterprises, the main identified bottleneck, beyond the improvement of the regulatory framework, is access to finance. Finance dedicated to Micro and Small enterprises is now successfully developing throughout the NIS, thanks in particular to the support provided by the G7 and the Community to the Russian Small Business Funds. For medium-size companies, there is however a lack of available sources of finance to support their development at a moment when the exchange rates, after the 1998 crisis, generally favour local production over imports. To tackle this problem, Tacis intends to launch in 2001 in Russia a new programme, the SME Investment Support Programme, by which technical assistance will be provided, on a regional basis, to local banks to help them develop this new line of business, as well as to enterprises to upgrade their operations and ability to propose credible financing plans.

Trade

The EU is by far Russia's largest trading partner (close to 40% of Russia's trade). The EU-Russia bilateral trade increased over the period 1992-1997. In 1997 the EU imports from the NIS amounted to €2 billion, five times the volume of US-NIS trade. In 1998, the EU exports to Russia was reduced by 50% due to the depreciation and to various market access barriers.

The EU is by far Russia's largest trading partner (close to 40% of Russia's trade). The EU-Russia bilateral trade expanded rapidly over the period 1992-1997. After 1998, the EU exports to Russia has halved in value terms due to the devaluation of the rouble but also on the cumulative effect of various market access barriers. On the other hand, the Russian exports to the EU have dipped only marginally. Thus, Russia's trade surplus vis-à-vis the EU in 1999 amounted to circa €0.4 billion.

Trade is the dominant subject for the PCA machinery. Among the issues discussed, with particular relevance to trade and private sector development, are, in the case of Russia:

- Russian concerns about EU enlargement and its effect on trade patterns
- Future extension of European Investment bank (EIB) activities to Russia
- Russia's accession to the WTO

- Creating conditions for a possible Free trade Area .

Debt

A number of the NIS countries are coming close to having debt sustainability problems, notably five highly indebted low-income countries (Armenia, Georgia, Moldova, Tajikistan and Kyrgyzstan). This situation has arisen as a result of a combination of large fiscal and external shocks in the 1990s and the countries' inability or unwillingness to adjust fully to the changed external environment. Furthermore, some donors' support was initially granted on inappropriately hard terms. As a consequence, in the future excessive debt levels may have a serious stifling effect on growth and social expenditures. This situation is projected to improve only under very optimistic macroeconomic assumptions.

Theme IV: A regional perspective on global financial issues

Under this theme, the subject of cooperation with the IFIs, in particular in the aftermath of the Russian 1998 financial crisis is treated. See also above for the related themes of debt and PRSPs (Poverty Reduction Strategy Papers). Cooperation between the EC and IFIs has a considerable track record, covering a number of sectors and countries. A good example of successful past cooperation is the common reaction to the Russia crisis.

It may be noted that the link between the viability and stability of the domestic financial sector and the impact of international capital market volatility, one of the issues raised in the general paper under this theme, is very close in the region. The Russian financial crisis, with severe impact on the whole region, was set off by the Asian crisis, but its severity was undoubtedly caused by innate weaknesses of the Russian economy, in particular the financial sector, and of the Russian Government's finances. This illustrates that whatever the design of the future international financial architecture may be, the main line of defence against volatility and crises are sound domestic markets and institutions.

Cooperation with the World Bank

After the crisis broke out, the IMF and the WB sent a number of missions to Russia to discuss possible responses. Donors were consulted from the beginning given the amount of grant financed technical assistance considered to be needed. Only at a later stage was the Russian side involved by creating the Inter-Agency Co-ordinating Committee (IACC). The IACC includes representatives from the Central Bank, the Russian Bank Restructuring Agency, the Ministry of Finance, Ministry of Economics, the President's Administration and international donors (World Bank, IMF, EBRD, German Bundesbank, Japan Foreign Affairs Ministry, UK Department for International Development, US Treasury Department, USAID and Tacis). IACC's purpose is to discuss progress of banking sector reform and co-ordinate the work carried out in its Working Groups. The main results of the IACC meetings have been to stress issues of principle such as transparency and uniform and fair treatment of creditors and to initiate technical assistance projects in the areas covered by its Working Groups on e.g. Accounting in the Banking Sector, Banking Sector Restructuring Strategy, Legal Issues, Banking Supervision and Financial Infrastructure and Operations of Banks

The Commission decided in 1999 to concentrate on the framework conditions for the development of a stable banking sector (in particular Accounting and, to a lesser extent Supervision). The Tacis Bank Accounting Reform project is well underway. The Central Bank of Russia has become more open to foreign co-operation and has completely changed its attitude since the crisis.

Cooperation with EBRD

After the Russian crisis in August 1998, the Commission and EBRD decided to create a joint working group on assistance to Russia. It has examined the scope for improved coordination and better targeting of policies of the two institutions in the areas of (i) restructuring of the banking sector; (ii) support to small and medium size enterprises; and (iii) strengthening of the investment climate in all Russia. The joint working group has

achieved results in coordinating on-going activities in SMEs and Post-Privatisation assistance, assistance to banking and capital market sector as well as short term actions.

The mandate of the group was then widened to all NIS countries. It concentrates on exchanges of views at an earlier stage of the programming cycle, with a view to co-ordinate strategies in a number of sectors and to identify a limited number of major visible initiatives over the medium-term period. Sectors foreseen are industrial cooperation, improvement of the investment climate, the financial sector and environment

New initiatives

Recently further steps have been undertaken to reinforce EC/IFI cooperation and coordination. Wherever the EC and IFIs share a strategic interest and involvement in the same country or sector, cooperation between them in the region has the potential for enhancing the effectiveness of both organisations. Greater impact can be achieved, for example, through exploiting complementarities in the types of assistance provided by each institution and by providing coherent policy advice to partner governments in key sectors.

The new TACIS regulation – which provides the legal base for the Commission’s main technical assistance programme for the New Independent States and Mongolia - states that “the Commission shall ensure coordination and cooperation with the international financial institutions and other donors” (article 14). In addition, it will be possible, for the period 2000-2006, to allocate up to 20% of annual Tacis funds to investment financing. The new regulation specifies that this investment financing should normally be provided in the form of co-financing, rather than stand-alone projects in order to have a greater leverage.

The Memorandum of Understanding between the EC, the World Bank and EBRD, signed on 31 March 2000 aims at enhancing and systematising cooperation. Specifically, its objectives touch on the domains of assistance and policy advice and include

- Better coordination of technical and financial assistance, including parallel financing of projects;
- Reinforced cooperation on policy, programming and planning, leading to shared advice to partner governments on national priorities;
- Information sharing at an “earlier” stage than is currently the case – following a procedure which is to be developed - on country strategies, policy and sector work, programmes and projects.

The MoU also has a number of things to say on the means by which its objectives are to be reached:

- Regular exchanges between staff both at headquarters and in-country (including on a bilateral level);
- Annual high-level meetings for monitoring of coordination and the agreement of a joint indicative list of activities and projects for cooperation; an EC/IFI Cooperation Working Group will meet whenever appropriate to discuss past and future work in greater detail.

Most recently, the Commission communication on the reform of the management of external assistance (May 2000) makes clear that the quality of EC programming will be improved as part of the current reform efforts underway in the External Relations Commission services. Exploiting synergies and complementarities with IFIs is one of the stated objectives, and should contribute to the strengthening of programming. Cross-fertilisation and debate between the EC and IFIs could usefully contribute to a deepening of the analytical function.

The common thrust of the Tacis regulation, the MoU and the Commission communication is clear: cooperation between the EC and IFIs should be enhanced. The EC/IFI cooperation working group met recently for the first time to take forward work in a number of areas under the MoU, ranging from the environment and human development to the energy sector, trade and investment issues.

The possibilities for setting up new instruments will be explored, taking advantage of the scope of the new Tacis regulation. Amongst the sectors for which new instruments could be explored, the SME sector was mentioned as an immediate priority. It is therefore proposed to task the Working Group to explore the possibilities for deepening the cooperation between the two institutions in this direction.