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" Financing and Development "

- Key issues, and the nature and impact of EIB lending

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Financing and Development

- Key issues, and the nature and impact of EIB lending -

1. Introduction

Development can be defined as a process that enables people to attain a better way of life. As there are several aspects of life, development has a variety of dimensions, ranging from cultural, social, political, to economic issues. Economic development itself has many facets such as raising per capita income; reducing the number of people that live in poverty; creating employment; and protecting and restoring the natural environment.

The accession countries of Central and Eastern Europe[1], which are the focus of this paper, undoubtedly strive for progress in development. Notwithstanding the multi-dimensional nature of development, this paper concentrates on the link between finance and economic growth. A variety of reasons motivates this focus. Most importantly, it rests on the optimistic – though admittedly controversial –view that economic growth is a vehicle for attaining a better way of life.

To appreciate the challenge facing the accession countries, one must remember their current level of development. At present, the average GDP per capita in accession countries is only 15 percent of the EU average (at purchasing power parity exchange rates the ratio is about 40 percent).[2] Average figures unavoidably mask regional disparities and, indeed, per capita income ranges from about € 1 440 in Romania and Bulgaria to almost € 10 300 in Slovenia, which compares to a figure of about € 21 200 in the EU. To complete the snapshot, it is worth noting that real output in some accession countries (e.g. Romania, Bulgaria and the Baltic countries) remains below its pre-transition level.[3] It is evident that the accession countries continue to have a long way ahead and that they will need decades to approach the level of income in more advanced economies.

Against this background, this paper reflects on the determinants of economic growth (section 2), highlights the role of finance in accession countries (section 3), describes the nature and impact of European Investment Bank lending to these countries (section 4), and concludes with a brief outlook on the role of finance in development (section 5).

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1 These countries are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia.

2 International Monetary Fund, *World Economic Outlook*, September 2000.

3 ibid.

2. Setting the scene: some reflections on the determinants of economic growth

This section starts with a non-technical presentation of the bare bones of the model that economists have used, in theory and practice, to analyze the link between saving, investment, and economic growth; it then outlines some of the model's limitations; finally, the section stresses the importance of sound policies in stimulating economic growth.

2.1 The standard model of finance and development

Analyzing the determinants of economic growth has a long tradition in economics. In the 1950s and 1960s, research in this field focused on the link between saving, investment, and growth. This strand of research became known as neoclassical growth theory.[4] Interest in the determinants of economic growth resurfaced in the 1980s. This time the focus of research - baptized endogenous growth theory - was on the role of technological progress and imperfect competition in economic growth.[5]

The neoclassical growth model is a suitable framework for describing the importance of finance for development.[6] Assuming for a moment an economy with no links to the rest of the world, the gist of the story is this: the level of saving sets the level of investment, which - in turn - determines output growth given the efficiency of investment and other inputs such as labor. Telling this story backwards indicates how much finance is required to achieve a certain growth target: to attain output growth of z, it is necessary to invest x which, in turn, requires an equal amount of saving.

Allowing for links with other countries, the reasoning changes somewhat. Total saving now comprises a national and a foreign component, with foreign saving reflecting capital imports. In economically less advanced countries, national saving - though financing the lion's share of investment - normally falls short of the investment needed to achieve a certain income growth target. Therefore, to realize this target and close the income gap with more affluent countries, the use of foreign saving is inevitable.[7]

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4 The literature on neoclassical growth theory is enormous. In essence, research in this field was triggered by the seminal contributions of Ramsey (1928), Solow (1956) and Swan (1956).

5 Early contributions came from Romer (1986) and Lucas (1988).

6 Hernández-Catá (1989) provides a succinct presentation of this approach for an open economy.

7 Note that the extension of the model to an open economy calls for a distinction between output and income. For countries that use foreign saving, income is lower than output because of the cost of foreign finance. Note further that for the use of foreign saving to be reasonable at all it is implicitly assumed that the (net) marginal product of capital is larger than the real remuneration of foreign finance.

However, the availability of foreign saving does not imply that the level of national saving is irrelevant for economic growth because external finance can offset any shortfall in national saving. On the contrary, empirical evidence suggests that economic growth is positively correlated with national saving. There are at least three reasons for this. First, international capital mobility is not perfect and, therefore, foreign saving cannot fully compensate for a lack in national saving. It follows that – all other things equal - investment and growth are lower the lower are national savings. Second, swings in foreign saving are not uncommon. In these circumstances, national saving reduces the vulnerability of capital-importing countries to an abrupt reversal in capital flows. This tends to enable a steadier path of investment and growth. Finally, national saving itself has potential to strengthen a country's creditworthiness and thus encourages the inflow of capital - and this at more favorable terms. All other things equal – and assuming that imported capital is employed efficiently – investment and growth will be higher.

2.2 Limitations of the standard model

Obviously, this simple model has its limitations and some of them have been addressed in the framework of endogenous growth theory. It is not the intention to present this strand of research in this paper. Instead, let us explore a more basic issue.

To set the stage, note that the title of this paper *Financing <u>and</u> Development* deviates from the theme of the conference *Financing <u>for</u> Development*. What appears to be a minor modification has been done on purpose and reflects more than semantics. In essence, *for* implies that the causality runs from finance and investment to development and growth, with the former stimulating the latter. This logic, which underlies the standard model presented above, is intuitively appealing but controversial.

On the one hand, there have been a number of empirical studies that confirm the positive impact of investment on growth.[8] This also applies to infrastructure investment, including transport, telecom, energy, and urban infrastructure. The experience of fast-growing Asian countries, for instance, suggests that this type of investment can be vital for stimulating private investment in industry although the payoff of infrastructure for economic growth may often be overestimated.[9] Still, there is little doubt that a well-developed infrastructure is indispensable for achieving sustainable economic growth.

8 In support of this view see, for instance, DeLong and Summers (1991).

9 Barro (1996), for instance, has made this point.

On the other hand, there have also been studies that found only weak support for the impact of investment on growth.[10] These studies present evidence that growth and investment are jointly encouraged by parameters such as a reliable legal framework, an efficient and impartial public administration, low government consumption, and price stability. Favorable values of these parameters enhance the prospects for economic growth and, thereby, create profitable investment opportunities.

There has been a similar debate concerning the link between financial development and long-run economic growth.[11] While there is no doubt about a strong and robust correlation between finance and growth, the direction of cause and effect is unclear and there is no universal answer to the question of whether finance leads or follows economic growth and development. For some countries, Germany for instance, empirical evidence suggests that financial development leads and, thus, promotes economic growth. Conversely, in the case of countries such as the United States there appears to be abundant evidence that economic growth takes a leading role and contributes to both banking system and capital market development.

All this suggests that the relationship between finance, investment, and growth is more complex than the standard model predicts and that there are many other factors at work. Economic policies seem to be of particular importance.

2.3 Economic policies

That growth and investment are jointly encouraged by sound economic policies is a key message of many studies on growth and development, such as the World Bank's 1993 study on the high-performing Asian countries.[12] This study emphasized an array of policies that foster growth and development.

To begin with, economic growth needs a reliable legal framework and strong institutions, including an efficient and impartial public administration. Without this, people's efforts to improve their lot and, by extension, an important engine of economic growth is stifled from the outset. And then, policies that ensure macroeconomic stability and a stable and secure financial system are of critical importance. Furthermore, there is ample evidence that openness to international trade and foreign direct investment spurs economic growth. More generally,

[10] Proponents of this view include Barro and Sala-i-Martin (1995)

[11] For a succinct review of this debate see, for instance, Arestis and Demetriades (1997).

[12] The long-term economic performance of these countries can continue to be considered exemplary despite the financial crisis that adversely affected these economies in 1997-98. Since then, Asian economies have bounced back and while the crisis certainly revealed weaknesses of the "Asian model" to growth and development, it does not put into question the general thrust of this model.

experience in a number of countries indicates that relying on markets is good for economic growth.

Having emphasized the merits of markets, it should be noted that government intervention could surely be beneficial for growth if it successfully corrects market failure. In these circumstances, government intervention leads to a more efficient allocation of resources and thus stimulates growth. This type of government intervention concerns support for research and development, market-driven environmental regulation, and the regulation of natural monopolies, for instance. It also includes investment in infrastructure and in health and education.

2.4 A summary

To foster development it is crucial to create a virtuous cycle of finance, investment, and growth. Macroeconomic stability, adherence to the rule of law, market-friendly policies, and capital accumulation all have to contribute to the creation of such a cycle. It is clear that investment and finance are necessary but not sufficient for economic growth and development. In fact, there is risk of exaggerating the role of investment and finance per se. After all, centrally planned economies did not suffer from a lack of investment. On the contrary, they achieved high rates of capital accumulation. The problem was that to a large extent investment was either inefficient or allocated to sectors that did not contribute to the standard of living. With this caveat, the next section turns to the role of finance in accession countries.

3. Finance and development in accession countries

The section starts with a sketch of economic progress in accession countries, the remaining income gap between these countries and the European Union, and of the role of finance in reducing this gap. It then covers in more detail the contribution of national and foreign saving in the development of these countries. The section concludes with an introduction to the task of international financial institutions in promoting development.

3.1 Ten years of transition and challenges ahead

The transition from plan to market is now in its second decade. In the early stages of transition, macroeconomic stabilization and building the foundations of a market economy took center stage. Macroeconomic stabilization has been essentially achieved in all accession countries, except for Romania, and the challenge in the future will be to hold the course. Progress has also been made in setting up functioning market systems but, inevitably, this will take longer to complete than stabilization.

Given the progress in establishing stable market economies, the emphasis has been shifting toward growth and development. The underlying objective is to catch up with living standards in the West. This will take decades even if real output and income in these countries were to grow at an average rate of, say, 5 percent a year for some time to come. Indeed, evidence from other countries suggests that – over long periods of time – the difference in per capita income growth between less developed regions, on the one hand, and more advanced regions, on the other, does not usually exceed an annual average of 2 percentage points.[13] The process of catching-up therefore seems to face a speed limit.

However, to reach the speed limit it is important to create and maintain conditions that are conducive to growth and investment. Mindful that the provision of finance is only one of these conditions, let us assess the investment and financing requirements of accession countries. While it would go far beyond the scope of this paper to forecast the investment needs in accession countries, it is possible to come up with a fairly realistic illustration of what is involved.

Suppose that accession countries have to invest the equivalent of 25 percent of GDP to achieve the desired income growth target – which seems to be a reasonable proposition given experience elsewhere. As to the share of national saving in GDP, the current ratio of about 22 percent appears to be a defendable hypothesis given the current level of income in these countries and the prospect of rising income in the future. Consequently, the use of foreign saving to the tune of 3 percent of GDP would be inevitable to achieve the goal of catching up with living standards elsewhere in the world. On the basis of an estimated GDP of currently around € 400 billion, these ratios would imply annual investments of € 100 billion, national savings of € 88 billion, and foreign savings of € 12 billion.

Naturally, the actual situation could diverge substantially from these figures. In any case, national saving will have to finance the bulk of investment whereas foreign saving is likely to remain a non-negligible component. The challenge is to mobilize and use these savings in an efficient manner. This is the theme of the next two sub-sections.

3.2 Mobilizing national saving [14]

The mobilization of national saving essentially involves three steps. First, there must be “real” saving in the sense that economic agents do not want to spend their income in full. Only then is it possible to release resources for investment. Second, except for firms’ own funds (including retained earnings) savings need

[13] On this see, for instance, Barro (1997).

[14] The following draws on the *World Economic Outlook* (September 2000) and the *International Capital Markets* (September 2000) of the IMF.

to be collected through the financial system. Finally, scarce saving has to be allocated to profitable investment, a task that is again carried out by the financial system. An efficiently functioning financial system is therefore crucial for the mobilization and allocation of national saving.

Given the importance of the financial system, it is useful to briefly characterize the situation in accession countries. Despite remarkable progress in establishing functioning financial systems, they remain underdeveloped by international standards. A variety of indicators substantiate this observation. First, financial depth - measured as the ratio of broad money to GDP - stands at around 30 percent. This is only half of the level in France and Germany. It is also lower than in countries that have reached a similar income level. Second, the public sector absorbs the bulk of bank lending and, as a result, lending to private enterprises accounts for a meager 10-15 percent of total lending, which compares to a share of more than 60 percent in the EU. What is more, private lending in percent of GDP is lower than in countries that have attained a similar level of income. In addition, there continues to a shortage of long-term finance. Finally, government debt dominates domestic bond markets and so far the issuance of corporate bonds has been limited.[15]

Developed financial systems comprise a banking sector and capital markets. In establishing **banks** that are guided by market forces, all major accession countries have eventually embarked on privatization and foreign ownership. Countries pursued this strategy at different speeds and with more or less vigor, however. Some countries, notably Hungary, recognized early that creating a market-driven banking sector virtually from scratch would benefit from opening the sector to foreign investors. This has contributed to the transfer of banking know-how, the recapitalization of existing banks, and the creation of competition among banks. At end-1994, banks in Hungary that were majority-owned by foreign banks accounted for 20 percent of total bank assets. Since then, foreign-owned banks have become even more important: banks that are majority-owned by foreign investors now account for around 60 percent of bank assets. If one looks at the proportion of bank assets that belongs to banks in which foreign investors have a stake in excess of 40 percent (rather than the majority), the significance of foreign investors in Hungary is even higher. Judged on this basis, foreign-dominated banks currently represent 80 percent of bank assets.

In other countries, including the Czech Republic and Poland, privatization got off to a slower start and foreign ownership came in rather late in the transition

[15] In Hungary and Poland, government bonds (issued mainly by the central government but also by municipalities) and treasury bills account for almost 100 percent of the value of outstanding bonds. In the Czech Republic and in Slovakia, respectively, the government share is estimated at 66 percent and 74 percent, respectively. However, this understates the dominance of the state. This is because the remaining 34 percent and 26 percent, respectively, includes bonds that are state-guaranteed and/or have been issued by state-owned enterprises.

process. Since the mid-1990s, this has changed however. In both countries, banks that are majority-owned by foreign institutions currently account for more than half of bank assets. It seems fair to say that this belated move toward foreign ownership has been triggered by the desire to put the banking sector on a sound footing after years of crises. Foreign investors were instrumental in reducing the cost of restructuring and recapitalizing troubled banks.

So, despite different speeds, foreign-owned banks currently control the majority of bank assets in many accession countries. Given the geographical proximity of the EU and for cultural and historical reasons, the majority of foreign banks operating in Central and Eastern Europe have their parents in the EU, notably in Austria, Germany, Italy, Belgium, and the Netherlands. But US banks are also present in the region.

Capital markets – mainly bond and equity markets - constitute the second pillar of a functioning financial system. As in most EU countries, bank intermediation continues to dominate the financial system. Still, all accession countries have advanced in creating conditions for non-bank financial markets.

In the context of macroeconomic stabilization programs, accession countries introduced strict limits on central bank lending to governments. As a result, governments had to use non-inflationary debt finance to cover budget deficits. For this reason, accession countries have seen a rapid development of domestic currency bond markets. The downward trend in inflation as a result of successful macroeconomic stabilization has stimulated the issuance of bonds with longer maturities and consequently yield curves have lengthened.

Nevertheless, financial markets are still underdeveloped. They are dominated by government bonds while the emergence of corporate bond markets is still in its infancy. Market capitalization is low in most countries. Likewise, there is a lack of liquidity, which in - in part - reflects investors' preference for holding bonds to maturity.

The further development of capital markets is likely to take time. In any case, it is debatable how far these countries should go in setting up their own capital markets. As these countries will integrate further with the EU in the process of preparing for membership in the EU and – eventually – EMU, existing and well-developed security and stock exchanges in the EU could carry out any level of non-bank financial intermediation between domestic savers and users of funds. Obviously, this applies mainly to wholesale intermediation and it is line with the move toward merging exchanges that is gaining momentum in the EU. It seems equally clear, that accession countries nevertheless have to further develop the retail segment of their capital markets with a view to mobilizing non-bank financial saving.

3.3 Foreign saving

It is useful to start with a review of the size and composition of the flow of foreign saving to the accession countries.[16] In 1991-99, the cumulative current account deficit (excluding official transfers) of these countries is estimated to have amounted to USD 98 billion. During the same period, net external financing (including official transfers) totaled USD 154 billion. It follows that financing was far in excess of current account financing requirements. Accession countries were thus in a position to accumulate foreign exchange reserves, which went up by USD 63 billion.[17]

Around 88 percent of foreign saving came from private sources, with only 12 percent reflecting the activities of institutions such as the IMF, the World Bank, the European Bank for Reconstruction and Development (EBRD), the European Commission, and - last but not least - the European Investment Bank (EIB). Figures for the period as whole inevitably disguise important changes in the composition of foreign saving during the period. In the early years of transition, official flows accounted for most of the external financing. This has changed over time, however, and private funds have increasingly replaced official sources of finance. In particular, in more advanced accession countries - such as the Czech Republic, Hungary, and Poland - private flows make up virtually all external financing. On the whole, the shift from official to private inflows went along with progress in economic reforms.

Given the increasing share of private flows in foreign saving it is useful to look at a particularly beneficial component, namely foreign direct investment. Like external borrowing, this type of resource transfer constitutes a claim on the future output of the recipient country. In contrast to external borrowing, however, this claim is contingent on the investment having demonstrated its contribution to increasing the output of the recipient. In light of this, the larger foreign direct investment is relative to the current account deficit the more sustainable is this deficit. Another advantage of foreign direct investment is that it not only constitutes a stable source of external finance but also fosters the transfer of technological and managerial know-how from advanced countries, thus contributing powerfully to economic growth. Overall, one can draw considerable comfort form the use of foreign direct investment to finance a considerable share of current account deficits in accession countries.

16 The following figures are based on the database of the Institute of International Finance.

17 Two comments may be helpful. First, the totals do not match exactly because of errors and omissions. Second, in the standard model of finance and development sketched above, the possibility of accumulating foreign exchange reserves has been ignored for simplicity. With an increase in foreign exchange reserves, foreign saving exceed the gap between targeted investment and national saving since part of the foreign saving is used to build up reserves. Vice versa, with a decline in reserves, foreign saving would not have to cover the full investment-saving gap.

Foreign direct investment accounts for a substantial part of net private flows to accession countries. For example, in 1999 several countries attracted foreign direct investment that was almost as high as their current account deficit. In the Czech Republic, it even exceeded the deficit by a considerable margin. To a large extent, foreign direct investment has been associated with the privatization of state-owned enterprises, which is now almost complete. But greenfield investments have also occurred and are likely to continue with the prospect of EU membership. It is noteworthy that foreign direct investment has continued to grow in the aftermath of the financial crises of the late-1990s, and it is likely that foreign direct investment will continue to play a significant role even when privatization has been accomplished.

3.4 The role of international financial institutions

It has been argued above that official capital inflows have become less important with progress in implementing economic reforms. This is true in absolute terms as far as balance of payments support is concerned. But it also applies in relative terms as far as the financing of projects is concerned. Nevertheless, there continues to be scope for international financial institutions (IFIs) such as the EIB to contribute to the financing of investment and growth.[18] This relates, in particular, to support in favor of infrastructure investment and other projects requiring long-term finance, which remains in short supply in many accession countries. In addition, to the extent that these institutions mobilize national saving - rather than transferring resources from abroad - they can help develop local bond markets and thus encourage financial sector development in accession countries.

To prepare the ground for presenting the nature and impact of EIB financing it is useful to note that the accession process and eventual EU membership give rise to substantial infrastructure investment in transport, telecom, energy, and urban infrastructure, with the latter including water supply and wastewater as well as solid waste treatment facilities. Annual investment for projects in these sectors will evidently depend on the speed of bringing the quality of infrastructure to EU standards. In addition, the manufacturing sector will have to make substantial investments with a view to eventually complying with EU environmental legislation. Overall, there seem to be plenty of opportunities for bilateral and multilateral lenders and the European Commission to contribute to the further development of Central and Eastern Europe.

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18 For a concise discussion of the future role of international financial institutions see, for instance, Hurst and Perée (1998).

4. Nature and impact of EIB lending

4.1 Mandate and pre-accession facility

It has been just over ten years since the EIB was first called to provide financial assistance to Central and Eastern European countries. Since May 1990, successive decisions of the EIB's Board of Governors, at the invitation of the Council of Ministers, have allowed the EIB to develop a substantial activity in the region. The latest mandate (March 2000) provides for lending of € 8.7 billion during a period of seven and half years.[19] This was preceded by another decision of the EIB's Board of Governors, taken in early January 2000, on the renewal of the EIB's own pre-accession facility.[20] This facility, of an indicative amount of € 8.5 billion for a period of three and a half years, confirmed, once more, the importance that the EIB attaches to properly serving the objective of enlargement set by the European Union and its commitment to European integration.

When granted under the mandate, EIB loans are covered by an EU budgetary guarantee. Loans granted under the EIB pre-accession facility are at the EIB's own risk. The parallel use of the pre-accession facility and the lending mandate since 1998 has allowed a harmonious development of the EIB's activity in all countries of the region. In general, the EIB's activity is based on project and sector requirements and there are no country ceilings or quotas. Overall, since 1990, the EIB has committed some € 12 billion for projects to the accession countries of Central and Eastern Europe with a fairly balanced regional breakdown as shown in Chart 1.

4.2 Terms and conditions of EIB lending

The EIB grants medium and long-term loans, with the duration depending on the nature of the project and the life of the assets financed. In general, loans can be for up to 10 to 12 years for industrial projects and 12 to 15 years (or even up to 20 years and above in well justified cases) for infrastructure projects. Such maturities include a suitable grace period on repayment of principal, depending on the project's construction period. In general, the debt repayment profile reflects specific project requirements.

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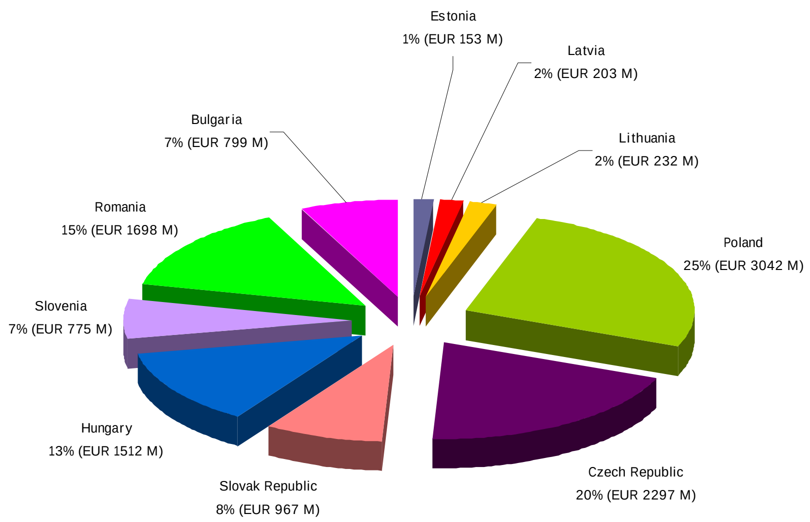
[19] This lending mandate covers all accession countries of Central and Eastern Europe together with Albania, Bosnia-Herzegovina, and FYR Macedonia (with Croatia to be added soon).

[20] This facility currently covers the accession countries of Central and Eastern Europe but also Cyprus and Malta. Turkey is expected to become eligible for funds under this facility in the near future.

Chart 1: EIB lending by country, 1990 to mid-2000



As with other IFIs, the EIB’s interest rates closely follow its funding cost. Interest rates do not vary with the nature of the project or its location, or with the nationality or type of borrower. Rates are set for each of the currencies with which the EIB operates.

The EIB is a complementary source of funds and, within the framework of an appropriate financing plan, can provide up to 50 percent of the cost of a project. The EIB's financing activities are, therefore, always undertaken in conjunction with the promoter's own resources and other sources of finance. In practice, banks and other credit institutions (public and private) – including other IFIs as well as the European Commission – often cooperate with the EIB in drawing up the overall financing package of a specific project.

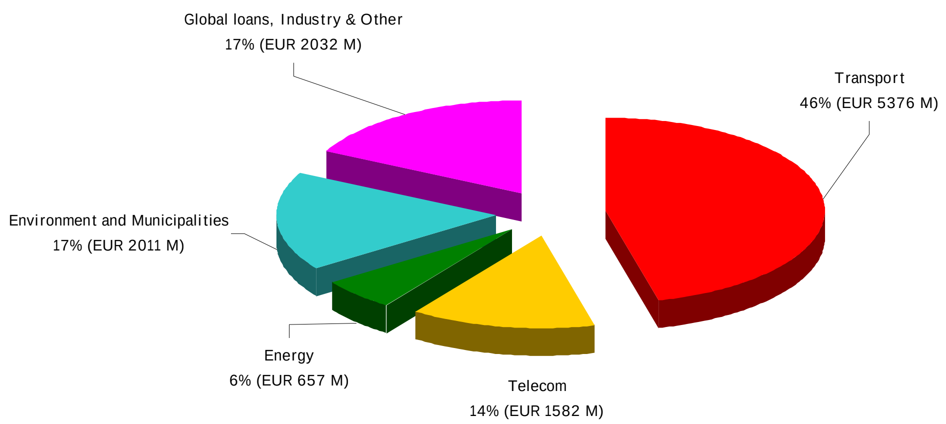
The EIB’s lending decisions are taken on the basis of in-depth project appraisals that are carried out by multi-disciplinary teams from the EIB, usually consisting of a financial analyst, an economist, and an engineer. Borrowers in accession countries have appreciated the experience that the EIB services have developed over the years from the EIB’s work in the EU. All project appraisals include an environmental impact assessment with an identification of possible problems as well as solutions.

4.3 Sectors of activity

As mentioned above, the bulk of EIB lending has so far concentrated on infrastructure development. There are two related reasons for this. First, much of the infrastructure in accession countries was - and in places still is - in dire need of modernization and extension. Second, the intention to join the EU has created the need for additional investment, notably in transport, telecom, energy, and in water supply as well as in wastewater and solid waste management. In part, this need is related to the obligation of accession countries to accept and implement the *acquis communautaire*, i.e. the full body of EU laws and regulations.

Interestingly, but not surprisingly, the EIB's activity in the accession countries mirrors in more than one ways the EIB's activity in the existing Member States of the EU and draws on its experience from previous enlargements. In translating the EU policy objectives into practice, the EIB has consistently supported projects serving EU priority objectives in all countries concerned. EIB lending has focused on projects that (i) helped the development and expansion of Trans-European Networks (TENs), particularly in the field of transport and telecommunications, but also of energy; (ii) served environmental protection objectives, particularly in the field of municipal investments; and (iii) facilitated the financing of industry as well as small and medium-sized enterprises (SMEs) and thus the creation of employment and regional development. Chart 2 shows the sectoral breakdown of EIB lending in accession countries, which will be considered in more detail.

Chart 2: EIB lending by sector, 1990 to mid-2000



Transport has been the dominant sector of EIB lending, representing about 46 percent of the EIB's total lending to the region. The support for this sector covered all modes of modern transport, from roads, railways, and ports to airports. This emphasis on transport reflects the priority attached to the sector by both the accession countries and the EU; in fact, an adequately developed trans-European transport network is key for strengthening the development of the internal market. It also shows the suitability of the EIB’s financial product for transport investment, which usually requires large amounts of finance and long maturities.

Telecommunications has also been an important beneficiary of EIB lending (14 percent). The investments supported have concerned both fixed telecommunications networks and mobile telephony in practically every single accession country. Already suffering for long from a lack of new equipment and from neglected maintenance of existing assets, the sector found itself faced with a radical change of economic patterns coupled with a rapidly changing technological environment. All this has led to an urgent need for substantial investments in the sector. The EIB has thus contributed to improving and developing the telecommunications network at European level, facilitating the liberalization of the sector, and to promoting the development of the internal market. It may be worth noting that most of the telecommunications operators in accession countries have been (or are in the process of being) privatized and government involvement is thus decreasing. In preparing for EU membership, the majority of these countries have made a commitment to open up the sector to competition.

Environment has been an area of specific attention. The EIB, in addition to looking carefully into the possible environmental effects of each project and - where appropriate - requesting the adoption of suitable mitigating measures, has also developed and intensified its activity in support of investments addressing environmental issues or with a high environmental component. The EIB's lending to environmental and other municipal infrastructure of environmental significance (basically water and wastewater, district heating, and environmentally sound urban transport projects) has reached about 17 percent of total lending. Such investments constitute an important element toward compliance with EU regulations and are thus important for the accession countries to achieve membership. This applies in particular to projects in favor of water supply and wastewater treatment where considerable investment will be necessary for many years to come. Noteworthy that EIB financing offers maturities and grace periods that permit an acceleration of such investments while allowing for an appropriate development in tariffs. Consequently, this activity is a priority of the EIB.

Industry and SMEs have accounted for 17 percent of total EIB lending, which helped in developing and modernizing the industrial base in accession countries. Most of the finance in this area has been made available in the framework of lines of credit to suitable financial intermediaries (global loans). Direct loans concerned a few large industrial investments, often promoted by industrial groups operating world-wide, but having chosen to establish plants in the accession countries in order to benefit from the advantages of fast growing economies and/or lower costs of labor, particularly in areas undergoing radical industrial restructuring. Support to industry and the development of SMEs has particular potential for creating employment.

Energy investments have accounted for around 6 percent of the EIB's activity. Well diversified, it included projects concerning the generation, transport, and the distribution of electricity as well as the production, storage and distribution of natural gas. In general, EIB support for projects in the energy sector aims at fostering a diversified, rational, and environmentally sound use of energy.

4.4 Mobilizing national and foreign saving

Section 2 stressed the role of national and foreign saving in financing investment and growth. The EIB has contributed mainly to the transfer of foreign saving but - to the extent possible - has also intermediated national saving.

In intermediating between foreign and national savers, on the one hand, and national borrowers, on the other hand, the EIB uses all major internationally traded currencies, taking into account the preferences of the borrower and availability of a currency. To the extent possible, the EIB also borrows in the domestic capital markets of the accession countries and lends the proceeds in local currency, helping its borrowers to avoid the foreign exchange risk.

In this context, it is useful to give a short account of the EIB’s support to the new capital markets in accession countries during the past years. The EIB has been able to contribute to the development, growth, deepening, and diversification of existing market structures, bringing them in line with current structures in the EU and establishing new techniques devised in line with international practices. The EIB has launched bond issues on Euro-markets in Czech Koruna, Estonian kroon and 'synthetic' Polish Zloty (settled in DEM or €) to encourage the growth and internationalization of such new capital markets. It has also placed its AAA-rated bonds on the Hungarian domestic market – issued under the Hungarian Forint domestic Debt Issuance Program of HUF 50 billion (currently some € 190 million) –, and on the Czech domestic market with a Czech Koruna Debt Issuance Program of CZK 30 billion (some € 86 million). The EIB’s aim also is to gradually build up the maturity profile on the various bond issues in order to offer reasonably long-term lending opportunities in the domestic currency. Thus far, this could be achieved with the establishing of a 10-year benchmark bond issue on the domestic CZK market as well as a 15-year zero coupon bond launched on the CZK Euro-market, tenors not yet issued by the Czech government itself. In Hungary, the EIB has so far launched three domestic issues in HUF all of which were in the 5-year maturity and in floating rate as well as fixed rate format.

In sum, the EIB is making efforts to increasingly mobilize national saving by issuing bonds in local financial markets. In some case, it has effectively contributed to an extension of the yield curve. Overall, there remains considerable potential for the EIB to help further developing local financial markets.

4.5 Cooperation

The EIB is a partner in development and, therefore, attaches high priority to close cooperation with other IFIs, bilateral lending institutions, and domestic and foreign commercial banks. Commercial banks are likely to play an increasingly important role in projects promoted by private or municipal borrowers as co-financiers and/or as guarantors to the EIB's loans.

Maximizing the impact of the EU contribution

In the context of the EU pre-accession strategy, the PHARE [21] program managed by the Commission has been supplemented by two new grant instruments also managed by the Commission and foreshadowing the Structural Funds – ISPA [22], which provides support to investments in transport and environmental protection and SAPARD [23], designed to channel grants into agricultural reforms and rural development. Cofinancing with ISPA helps the EIB to speed up implementation of numerous transport and environmental schemes in line with EU standards and raise the quality of life in the region. Cofinancing with PHARE will now focus on regional development programs and projects in sectors other than transport or environment. An appropriate blending of EU grants with EIB loans increases the synergies of the overall EU contribution to the preparation for accession.

Cooperation with other IFIs

The EIB cooperates closely with other project financing institutions such as the World Bank group, the EBRD, the Nordic Investment Bank, the Nordic Environmental Financing Corporation, the Council of Europe Development Bank, as well as with specialized banks from the member states or other countries with development programs for the region. Cofinancing as such, while

[21] **P**oland and **H**ungary: **A**ction for the **R**econstruction of the **E**conomy. This program is currently the main channel for the EU's grant assistance with countries of Central and Eastern Europe. Set up in 1989 to support economic and political transition, initially in Poland and Hungary, it currently covers 13 partner countries from the region.

[22] **I**nstrument for **S**tructural Policies for **P**re-**A**ccession. This program is directed mainly towards aligning the applicant countries on Community infrastructure standards, particularly in the transport and environmental sectors.

[23] **S**pecial **A**ccession **P**rogramme for **A**griculture and **R**ural **D**evelopment. This program aims at helping applicant countries to deal with the implementation of the acquis communautaire as it relates to the Common Agricultural Policy as well as the structural adjustments in their agricultural sectors and rural areas.

of primary importance during the early years of transition, is now modulated by country and sector development and is more frequent in countries experiencing a weak macroeconomic environment or sectors in which reform have been slower to progress.

Cooperation with the banking community

In most countries, EIB involvement in projects has acted as a catalyst to encourage other lenders to participate in the financing. In this context, it is important to note that the EIB can bring to bear its considerable experience in arranging appropriate structures and risk profiles for funding operations, whilst the provision of long-term finance offers promoters a product, which is seldom available in the local market. Furthermore, the EIB usually lends somewhat less than 50 percent of investment cost, thus leaving sufficient space for the involvement of other funding sources. In the more developed accession countries with more sophisticated banking systems, the EIB seeks to work alongside commercial banks either through intermediation and/or guarantee structures or by providing just one specific element of the required finance.

5. Conclusion and outlook

This paper has emphasized that investment and finance are necessary, but not sufficient for economic growth and development. Equally important are sound economic policies that create investment opportunities and foster an efficient mobilization and allocation of national and foreign saving.

National saving will remain the major source of finance even in the accession countries of Central and Eastern Europe where investment requirements will exceed national saving for some time to come. While firms' own funds will continue to be a crucial part of national saving, funds that are collected and allocated through financial systems will become increasingly important. Against this background, further progress in developing efficient financial systems will stay high on the development agenda.

At the same time, foreign saving will continue to be an important complement to national saving. As in recent years, private inflows will account for the bulk of this and ideally one would like to see foreign direct investment to play a significant role.

Within this framework, the EIB will continue to support the development of accession countries both via external financing and the mobilization of saving in domestic markets. The focus of its lending will remain on helping to prepare these countries for EU membership, including the development of an efficient infrastructure, which is a prerequisite of profitable private sector activities. In addition, using its global loan instrument, the EIB aims at further promoting the development of the SME sector.

The enlargement of the EU to Central and Eastern Europe will be a historic achievement. The goal of bringing the region back to its pre-War position as a full and equal participant in Western European society justifies considerable effort by all the development institutions that are involved in the process. Close collaboration between multilateral and other official sources of finance is also a prerequisite if the time needed to complete this transition is to be minimized.

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