

Multilateral Development Banks in Europe

INTRODUCTION

This article gives a presentation of the major multilateral development banks (MDB's) currently active in Europe, outlines the most relevant issues of MDBs, and categorises MDB's into two groups according to a major attribute. In the first group, which includes the Council of Europe Development Bank (CEB) and the European Investment Bank (EIB), the founders are also the main borrowers (or guarantors). From the borrowers' point of view, this model of funding is in competition with traditional State funding methods (eg. treasury bonds). Experience shows that even for countries with good sovereign credit rating (eg. Germany) it is worth joining such MDB (I will refer to them as Self Financing MDBs, SFMDB, as Member States establish these institutions to finance their own needs).

In the case of the second group of MDBs, the countries that mainly subscribed the MDB's capital and the borrowers (or guarantors) do not match (the most relevant MDB of this group is the World Bank, but the EBRD has similar structures).

However there are no distinct borders between the two types of models: the EIB for example finances projects in accession countries as well, but for the

operation it is important (in particular for the credit rating) to have a lending structure that is not too burdensome for the MDB. When the credit rating of the borrowers does not provide any more sufficient guarantees, the financing of the MDB becomes more difficult. When the lending conditions worsen for the borrowers of the MDB, the states with the best credit rating (from the portfolio of the MDB) may decide to abstain from borrowing, making the credit structure (and the MDB's credit rating with it) even worse. This happened in the case of the EBRD recently. Some eastern European countries are moving toward financing with EIB and CEB rather than apply for the more expensive EBRD or World Bank loans, as their sovereign credit rating is improving (as these countries have already joined the CEB, and the EIB has also turned toward accession countries).

Apart from this criterion, there are attributes that apply to both types of MDBs. A few general characteristics distinguish the MDBs from private financial institutions and bilateral donors:

- their multilateral shareholding structure and preferred creditor status;
- a subsidised capital base and access to other subsidies (in particular applies to the World Bank model);
- international legal personality (distinct from that of the civil law).

In broad terms, MDBs provide loans primarily to governments. Therefore they extend a form of budgetary finance. In exchange for this finance, the borrowing governments commit to implement reforms such as sectoral adjustment and institution-building programmes and undertake public investments in human and physical capital. In their operations with low-

income developing countries, MDBs provide loans on concessional terms that are effectively a blend of loans and grants. The financing provided by the EBRD and the International Finance Corporation (an affiliate of the World Bank) is primarily (in the case of the EBRD) or entirely (as in the case of the IFC) granted to the private sector on terms that are intended to fully reflect the risks involved. The first model (SFMDBs) is following a different pattern in its own activities, as it is operating mainly in developed countries.

The first chapter of this article emphasises the unique characteristics of these institutions that provide a comparative advantage in providing finance. The selection, monitoring and enforcement mechanisms bear some surprising similarities to those of micro-finance banks, which like the MDBs seek to penetrate financial market segments not reached by private finance because of high risk and weak or non-existent institutions for the enforcement of financing agreements. The commitment of governments to the policy reforms and changes (or to promote certain objectives) in government practices embodied in MDB conditionality and their monitoring and enforcement measures are fundamental to MDB operations.

THE ROLE OF MULTILATERAL DEVELOPMENT BANKS

As their name suggests, MDBs, and in particular the second group, should provide finance for investments in human and physical capital that promote development. The interpretation of this broad mandate, however, has changed significantly over time (The American Journal of International Law XC, 214).

In their initial decades of operations, the WB and the European MDBs financed primarily public sector infrastructure projects through the provision of sovereign loans to countries. The EBRD - the fourth major regional development bank of the second model beside the African Development Bank (AFDB), Asian Development Bank (ADB) and Inter-American Development Bank (IDB), established between the late 1940s and the mid 1960s - was founded in 1991 following the fall of the Berlin Wall and was given a mandate to finance investments, mostly in the private sector, that foster the transition to a market economy in the transition countries of central and eastern Europe and the former Soviet Union.

The MDBs have become excellent diversification capabilities for investors

The EIB however is financing projects in developed areas, to improve the effectiveness and the economic development of the European Union. The CEB is somewhere in between the World Bank and the EIB in its activity. The CEB is acting in more or less the same geographic area as the EIB, but it is trying to finance projects of social importance, in a region where social issues have different meanings than in developing or least developed countries.

The rapid development of international capital markets in the 1990s and the recent experiences of developing countries and transition economies have prompted many reassessments of the roles of the MDBs. The MDBs have become excellent diversification possibilities for investors. The growth of global private capital flows and the development of domestic financial systems have expanded access to commercial finance by governments and private

entities alike. At the same time, most of these countries have achieved significant progress in liberalising markets and trade, stabilising their economies and abandoning State-led strategies of economic development, and creating conditions conducive to private investment. The EBRD is unique among the MDBs in having both a political and an economic mandate. The Agreement Establishing the EBRD calls for it to "*foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics.*"

The private sector operations of MDBs can help to strengthen the investment response to reforms by mitigating risks associated with government policies (particularly the introduction and implementation of new measures), by demonstrating successful innovations in technologies, skills and business practices, and by strengthening the process of competition through support for market entry and production linkages. The possibility of co-financing provides opportunity not just to multiply the effect of the resources of an MDB, but to introduce projects to market financing for their future existence.

Concerning some MDBs, there are proposals for reforms, involving a significant broadening of the roles of the MDBs beyond their comparative advantage derived from their unique institutional arrangements. However, MDBs may not be transformed into primarily fiscal agencies for the provision of grants for development, transition and poverty relief purposes. In particular for SFMDBs, independence is crucial to ensure the financial markets that

provide their funding. Currently there is a tendency for the EIB to be involved in the Development policy of the European Union. However, being the EIB still strictly a Bank, the EU external development policy activities are backed by state guarantees or subsidies.

There may well be need for increased funding of grant-based activities, but MDBs should not be principally engaged in such activities. Especially in the case of SFMDBs it is important to ensure the market of its integrity and independence. The main focus of the activities of MDBs should remain within the traditional borrowing-lending; however, the shareholders of MDBs may allocate some of their earnings and accumulated reserves to special purposes such as the International Development Agency (IDA), the Heavily Indebted Poor Countries Initiative (HIPCI), or Pre Accession Facilities and the Mediterranean facility (at EIB). The subsidies received by the MDBs are not wasted on inefficient bureaucracies, but this implies that in some cases there might be lack of surveillance for the project monitoring, in particular concerning the application of environmental standards. In the case of SME support, there is usually an intermediary institution (retail bank or payment agency) to implement the aims of the project concerned. The MDBs, however demonstrate that they can use effectively the resources that they receive. The EIB and the CEB has concluded several capital increases, sometimes financed by their own activities, without further financial contribution of their members. To the extent that an MDB can demonstrate both the need for its services and its effective response, it

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encourages shareholders to allocate the MDB the necessary resources. If effectiveness is demonstrated and the need for an MDB's services is increasing, it will be allowed to build up its capital and to expand (as for the case of the EIB).

COUNCIL OF EUROPE DEVELOPMENT BANK

Set up in 1956 by the Council of Europe (CoE) to provide solutions to the problems of refugees, the Council of Europe Development Bank (CEB) is not just the first bank of the MDBs analysed in this article, but also the first MDB in Europe. The most distinctive feature of the Council Of Europe Development Bank is being a multilateral development bank with a social vocation. Since its creation, there have been several new admissions, the latest being the admission of accession countries during the second half of the 90's. In order to maintain the sound operation of the Bank, it is important to maintain a membership with financially sound states. Otherwise the credit rating of the Bank may be reduced, since the lending is proportionate to the shares in the subscribed capital.

Therefore the CEB is partial agreement of the CoE members. Some of the more hazardous countries could not join the CEB, as their accession would have threatened the sound operation of the Bank. Currently the CEB has 35 Member States. Its primary purpose remained to help in solving the social problems with which European countries are faced as a result of the presence of refugees, displaced persons or migrants or of victims of natural or ecological disasters. The Bank also finances projects in the sectors of job creation in small

and medium-sized enterprises, social housing, health, education, protection of the environment, rural modernisation, rehabilitation of disadvantaged urban areas and rehabilitation of the historic heritage. In 1999 the name has been changed (from Social Development Fund to Development Bank), and since its creation several new priorities have been added to the activities of the Bank. The latest but strongly increasing area of activity is the support of small and medium enterprises. However the social priority of the activities of the CEB remained intact, a distinctive character at a compared level.

The CEB is the oldest, yet the least known MDB in Europe. It is significantly smaller than the EIB, and the intermediation in the lending is more relevant. A significant attribute of the Bank is that it is relatively unknown, not just among the beneficiaries of the projects, but it is a rather less known institute within the framework of the CoE itself. The reduced awareness of the Bank is also due to the fact that governments are likely to “forget” to mention the origin of the support that they are providing, making increased political capital among possible voters. This “invisibility” (which is the cost of using governments as intermediaries instead of building out its own monitoring system) is present in most multilateral development banks. In the case of the CEB it is justified by the fact that the loan commitments are rather proportionate to the amount of capital subscribed (borrowers borrow proportionately to how much they contributed to the subscribed capital of the Bank).

The Council of Europe Development Bank provides a low-cost source of funding for projects dedicated to the above-mentioned priorities. It is up to its

member states to submit suitable projects in these fields, which have a direct positive impact on improving the well being of the local population. This is after all the essence of the social role, which is the aim of the Bank's existence.

THE EIB GROUP

Established to give practical expression to financial investment objectives of the European Union, the EIB Group consists of the European Investment Bank (EIB) and the European Investment Fund (EIF). Within the Group, the EIB provides long and medium-term bank loans while the EIF specialises in venture capital operations and providing guarantees for SMEs.

The EIB was set up in 1958 by the Treaty establishing the European Community in order to facilitate, through its financing operations, investments contributing to European integration and the development of economically weak regions. It operates in all sectors of the economy, providing repayable loans but not granting aid. The EIB is more focused on economic development and competitiveness than on social issues.

The EIF was established in 1994 to promote the development of SMEs (small and medium size enterprises) by financing venture capital funds investing in enterprises undergoing rapid expansion or operating in the new technologies sector. The EIF also extends guarantees to the banking community for fostering the provision of medium and long-term loans to SMEs. The concerted action of the EIB and the EIF enables the EIB Group to help SMEs expand and adapt to changes in the European economy.

The owners of the EIB are the Member States of the European Union. The

individual Member States are represented on the Bank's decision-making bodies, which are deliberate and take their decisions independently. This is also one of the most common bases of the critics. The EU institutions are not really represented in the decision-making organs. The EIB's Statute specifies the decision-making structure and each body's responsibilities. The EIF's main shareholder is the EIB, alongside the European Union represented by the Commission and over twenty EU banking establishments. Its tripartite structure allows it to act effectively as a catalyst for support from other financial institutions for the projects, which it finances or guarantees.

The EIB enjoys its own legal personality and financial autonomy within the Community system. The EIB's mission is to further the objectives of the European Union by providing long-term finance for specific capital projects in keeping with strict banking practice.

According to the Brochure of the EIB there are three main benefits of financing operations throughout the EIB or EIF:

- Favourable financing cost, derived from market rates but established on a non-profit-making basis;
- Ability to make available large amounts over long terms;
- Catalytic effect of EIB financing in mobilising the participation of other banking or financial partners in the project.

As Europe's bank for capital investment financing, the EIB directs the bulk of its activity (85%) towards promoting the European economy. In addition, in the context of the EU's development aid and cooperation policies, it operates in over 150 countries outside the Union: in the countries seeking EU

membership, the Balkans, the Mediterranean Partnership countries, Africa, the Caribbean and the Pacific as well as Asia and Latin America. Perhaps the most significant attribute of the EIB is its mere size. It is many time bigger than the other two MDB, in fact the EIB is shareholder of the EBRD

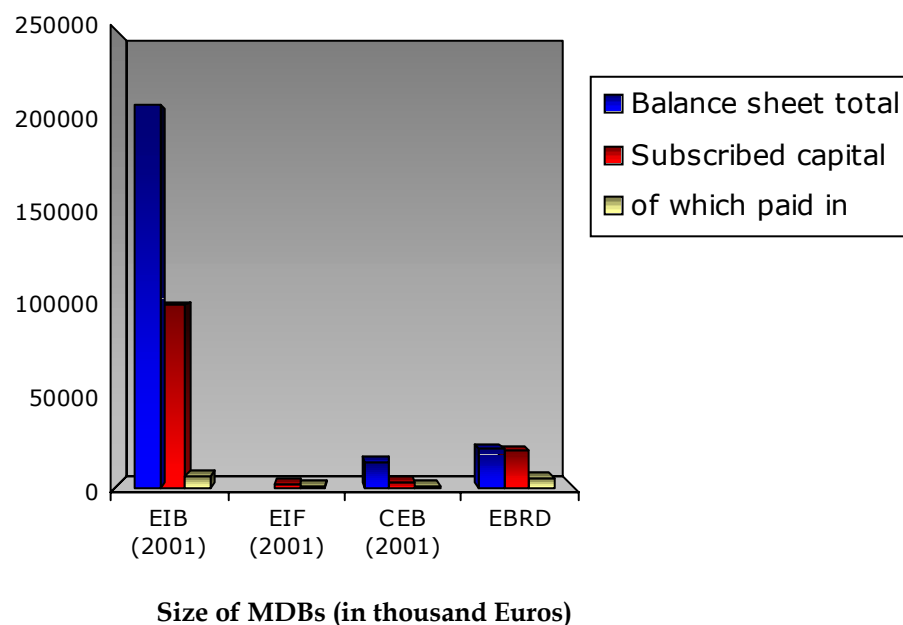
Public-sector bodies and enterprises in the private sector are eligible to receive loans from the EIB. Major projects (over 25 million euros) are financed by individual loans. Small and medium-scale ventures and smaller-scale infrastructure projects (from 20 000 euro) are financed by means of global loans, i.e. in cooperation with regional banks, which are better acquainted with local conditions. As mentioned before, the EIB focuses on competitiveness rather than social issues.

THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

The most recent of the European MDBs, the European Bank for Reconstruction and Development (EBRD) was established in 1991. It was created to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the countries of central and eastern Europe and the Commonwealth of Independent States (CIS) committed to and applying the principles of multiparty democracy, pluralism and market economics.

The EBRD may not have a history comparable to the other major MDB's, yet as having the largest membership its recent history has been very active. New members joined and some members went through changes during the last decade, that drives them toward other MDBs.

The EBRD seeks to help its 27 countries of operations to implement structural and sectoral economic reforms, promoting competition, privatisation and entrepreneurship, taking into account the particular needs of countries at different stages of transition. Considering the geographic area of



activity this is a much more difficult task, than in the case of the EIB or the CEB. The countries of the former Soviet Union have different standards in anti-corruption and transparency. This also affects the quality of projects financed by the EBRD. Through its investments the EBRD aims to promote private sector activity, the strengthening of financial institutions and legal systems, and the development of the infrastructure needed to support the private sector. The Bank is promoting sound banking and investment principles in its operations.

In fulfilling its role as a catalyst of change, the Bank encourages co-financing and foreign direct investment from the private and public sectors, helps to mobilise domestic capital, and provides technical cooperation in relevant areas. The role of EBRD was particularly important in the initial phase of the privatisation in transition economies. It works in close cooperation with international financial institutions and other international and national organisations. In its activities, the Bank promotes environmentally sound and sustainable development.

CONCLUSIONS

In this article I tried to give an introductory view to the role of MDBs. The presented MDBs differ in size, means of action in their membership, and partly their priorities. However, they all have something in common. All three connects the market-based financing with problems that are usually solved by governments' intervention. However, MDBs may not be transformed into fiscal agents for allocation of grants. There may be a need for such fiscal agencies, but it is far from clear that the MDBs should be transformed into them. As long as the risks in providing finance to developing countries and transition economies remain high and the institutional mechanisms for enforcing financing agreements and reform commitments by governments remain limited, the MDBs should retain their unique role in providing finance to their countries of operation. Nevertheless, this should not be an indefinite task and, with progress in development and transition, their roles should evolve and eventually recede and come to an end.

There are, however, a few issues of current importance. One such issue is the preferred creditor status of the MDBs and the extent to which it is a desirable feature of their institutional arrangements. It is fundamental both to the financial viability of the MDBs and to the nature of their financing operations.

The second issue focuses on the role of the MDBs in the private sector. The majority of the analyses focus on the public sector operations of the institutions. This is of course the main area of activity for the MDBs. However, the experience of developing countries and transition economies has shown that the process of adjustment and adaptation in the private sector to reforms of government policies and practices is neither automatic nor assured. While there can be strong resistance to change in the private sector, MDB private sector operations can demonstrate successful ways to adapt, as well as sound business practices. There are of course potentially strong complementarities between the public sector and private sector operations of the MDBs.

As development proceeds, the role of MDBs gets more and more relevant

A third issue relates to the allocation of subsidies received by the MDBs. Based on the experience of the past few years, the bulk of the subsidies received by the institutions from their shareholders has been accumulated in reserves, thereby allowing the institutions to expand their operations. The challenge for the MDBs is to demonstrate clearly that they have the capacity to use these resources effectively and that this expansion is justified. This requires

assessments both of the effectiveness of their operations in terms of fostering development or transition and of the availability of finance from alternative sources, including commercial lending.

A further issue is the difference between the SFMDBs and the MDBs where mainly developing or transition countries are the borrowers. In Central and Eastern Europe a process is going on involving a shift toward EIB and CEB financing from the previously World Bank and EBRD dominated lending. Nonetheless, these countries had to make important steps toward economic integration and fiscal stability, to be accepted into the CEB, and the European Union in the future (as much of the EIB lending is related to the accession in this area). In fact the EIB is becoming more important as a lender in Central and Eastern Europe than the World Bank, partly because it lends on much more favourable conditions than the World Bank or the EBRD.

The final issue is the budgetary constraint of borrowing states, and it is related to MDBs active in EU or accession countries. These countries are limited in their borrowings by the Stability and Growth Pact, and the criteria of Maastricht. This problem is more relevant for the SFMDBs, which are bound by their priorities (such as industries, or social matters) in providing loans. Borrower countries may not borrow over their limit of public debt.

The process of economic development and the transition process should be time-limited. Of course, even in the case of the transition process, the day that victory can be declared lies some distance away. As one looks further east, the day of graduation recedes steadily further into the future. The development process for the least-developed countries may well take decades

rather than years. The role of MDBs is more ensured for many decades. The role of SFMDBs is related to developed countries, some of the transition countries already shifted toward SFMDBs, and their role may gain further importance in the near future.

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