Overseas Development Institute

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THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

Among multilateral development banks the EBRD is unique in a number of respects: the speed of its creation; its overtly political objectives (to foster multiparty democracy and market economies in the former communist countries of Central and Eastern Europe); its membership; its mandate to help develop the private sector. It is also the first such body to have its headquarters in the UK.

Of particular concern for developing countries is the question whether the Bank will divert resources from them to Eastern Europe. There are also questions about the balance between member control and managerial freedom; about the need for public financing of private ventures; and about the consistency of its objectives with the financial terms it will be able to offer. This paper sketches the history of the Bank, describes its objectives and structure, and flags some of these emerging issues.

The creation of the EBRD

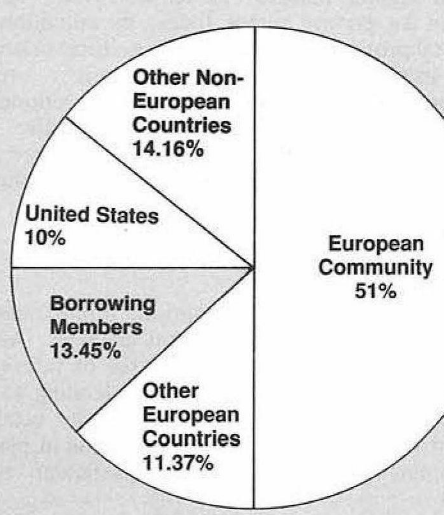
After the collapse of Communist regimes in Eastern Europe in the last quarter of 1989, the West moved rapidly to pledge support for new leaders committed to market economies and pluralist democracies. While most governments thought in terms of bilateral aid, France proposed a bolder initiative: the creation of a new international development bank to help finance Eastern Europe's transition.

When President Mitterrand introduced this idea at the annual summit of the 12-nation European Community in December 1989, it was promptly endorsed. The French probably had their own reasons for proposing the bank, not the least to provide some counterbalance to the prospect of a Europe dominated by German economic might. It could also enhance the economic union of Europe; its President-Designate Jacques Attali has already suggested that the EBRD could be 'the embryo of a confederation of Europe, as the European Coal and Steel Community was the embryo of the Common Market in the fifties, and is styling it the Bank of Europe. In any case, the idea of a new bank for Eastern Europe held a political appeal that no EC government felt able to resist.

The Community decided to open creditor membership in the bank to countries outside the region. The USA was lukewarm at first, not least about the membership of the Soviet Union. Recognising that the EBRD would happen in any case, however, it swallowed its doubts and joined, along with the Soviet Union, making the new bank the first such institution to include the two superpowers in its membership. Also noteworthy among the creditor shareholders are Egypt, South Korea and Mexico.

Developments then moved at remarkable speed. The first talks were held in January 1990, with 36 nations present and with President Mitterrand's adviser, M. Attali, providing much of the driving force. By the seventh meeting, in April,

Box 1. EBRD Membership Shares



* Includes East Germany, (1.55%).
Source: Draft Articles of Agreement of the European Bank for Reconstruction and Development.

Borrowing members are: Bulgaria, Czechoslovakia, Hungary, Poland, Romania, USSR and Yugoslavia. East Germany is also listed in the articles as a recipient but, because of the accelerated timetable of integration with the Federal Republic, will cease to exist before the articles come into force. It is not yet established whether the Federal Republic will be permitted to borrow from the Bank in respect of projects in the territory of the former Democratic Republic.

Other European members are: Austria, Cyprus, Finland, Iceland, Israel, Liechtenstein, Malta, Norway, Sweden, Switzerland and Turkey.

Non-European members are: Australia, Canada, Egypt, Japan, South Korea, Mexico, Morocco, New Zealand and the USA.

European Community membership includes the EC Commission and the European Investment Bank, as well as the twelve Community member countries.

representatives of 40 nations and two European institutions had reached agreement on the bank's charter, its initial size, and the distribution of power among shareholders. At a final negotiating session in May, the bank's membership appointed M. Attali as President-Designate and agreed to locate the institution in London. The Articles of Agreement were formally initialled by its member states in May 1990. From start to finish, the new bank was agreed in just five months.

The Articles come into force when they have been ratified by states representing at least two-thirds of the total shareholding and the present estimates are that this will be achieved by the first quarter of 1991, although that could be delayed by resistance from critics within the US Congress. In the meantime, President-Designate Attali has been given

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a wide-ranging mandate by prospective members to begin preparations immediately. These authorise him to prepare detailed organisational proposals and recruitment procedures, and to draft the Bank's first three-year business plan. He may also undertake such other preparatory work as he regards necessary, including preparatory visits to prospective Eastern European borrowing countries.

He has resources too, notably an ECU 10m ($13m) advance from the European Investment Bank (EIB), temporary accommodation in London and a number of professional staff on loan from their governments. He hopes to have a total staff of around 100 in place by the time the Articles come into force, rising to 500 or more by the end of the first five years.

The EBRD Mandate

The EBRD shares many characteristics of other multilateral development banks. Like them, it will channel funds from international capital markets to its borrowers but it is distinctive in its private sector focus, its commitment to environmental protection and its overtly political orientation. As stated in its charter, the Bank's broad aim is '. . . 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.'

Political Objectives

This explicit commitment to political transformation is unprecedented among the multilateral agencies. Although by no means immune from the pressures of international politics (e.g. the World Bank suspended lending to China after the killings in Tiananmen Square), the established development banks deal with the governments in place and do not confine themselves to any particular type of government.

The decision to give EBRD such a mandate reflects Western determination to sustain the region's break with communism. It also draws attention to the lively foreign policy interest which the major shareholder countries will have in the success of the Bank. Political conditionality is not expected to pose much of a problem, for the time being at least, in Czechoslovakia, Hungary, and Poland. Most observers believe the new governments in these countries are deeply committed to multiparty democracy. However, the situation in Bulgaria, Romania, Yugoslavia and in the Soviet Union is less clear. The EBRD could find itself engaged in difficult debates over certain loans. For example, might Moscow's response to events in Lithuania be deemed as sufficiently 'undemocratic' to prompt a veto? The EBRD's overtly political nature will make it vulnerable to pressures from shareholder governments and legislators.

Private Sector Focus

A second unique feature of the EBRD is that the majority of its exposure will be to the private sector, through loans and equity investments. Specifically, at least 60% of the Bank's total annual loans and investments must go to the private sector, and at least 60% of the Bank's exposure in any one country over the first five years must be in the private sector or in state-owned enterprises that are shifting to private ownership and control. The remaining 40% of the EBRD's resources may finance the public sector.

While it is not seen as an agency for the provision of soft aid, the EBRD's charter provides for the creation of Special Funds which would be additional to its ordinary capital resources and could be financed by voluntary grants or concessional finance which could permit soft loans. One possible use for such Funds would be to finance the provision of technical assistance, which the Bank is also encouraged to provide, rather than supply it on commercial loan terms. However, no member state has yet stated an intention to contribute to such Funds and they may prefer existing mechanisms for providing soft aid.

While participants in the EBRD agreed from the start that the basic purpose of the Bank should be private sector development, the formal restriction on public sector support is largely due to US insistence. In fact, the Bush administration initially opposed any EBRD funds going to the public sector, arguing that this would amount to subsidising failed socialism. With a similar concern in mind, the EBRD's members quickly agreed that the Bank should not make programme loans to governments. Only project finance will be allowed. This too goes against the grain of recent development bank policy.

In the event, provision for up to 40% exposure in public sector projects was included, for two main reasons. First, the private sector in the region is so small that it was feared the Bank would have had a hard time finding clients. More fundamentally, it was argued that Eastern Europe's new governments have a major role to play in the transition to market economies, e.g. in strengthening the run-down infrastructure, and in fostering development of the financial system (capital markets, banking systems, and regulatory agencies) upon which private enterprise depends. Public money will also be needed to cushion the harsh social impact of the transition, including unemployment and a sharply increased cost of living. Governments will also have to assume major responsibility for urgently needed environmental reforms.

Environmental Protection

Provisions in its Articles for environmental protection are the third unique feature of the EBRD, with a commitment 'to promote in the full range of its activities environmentally sound and sustainable development' and to report annually to its Board on this subject. Although other multilateral development banks have become increasingly sensitised to the need to include environmental concerns in their project selections, they do not have the same constitutional commitment to this and East European borrowers will need to exercise particular vigilance to ensure that their projects for EBRD funding are environmentally sound.

Structure of the EBRD

Financial Role

With an initial capital base of ECU 10bn ($13bn), the European Bank is somewhat smaller than other regional development banks — but its seven borrowing members are in a rather different position from Third World countries. Estimates vary greatly, but there is no doubt that per capita incomes in EBRD's borrowers are higher than in most developing countries. Eastern Europe is also industrially more developed, despite its need for modernisation. Few economists are willing to put a price tag on the transition to capitalism because so much is unknown. The UN Economic Commission for Europe recently estimated the region's external needs at nearly $17bn a year for the next four years. However, there are real doubts about whether the region will be able to absorb the levels of finance that industrial creditors are planning to mobilise. The countries of Eastern Europe need technical assistance in countless areas — to train accountants, bankers, factory managers; to set up capital markets; to liberalise investment codes; and so on — before they can put large-scale investment to productive use. They need to establish market structures before they can absorb a lot of capital, at least in the private sector. The EBRD's immediate use to them will lie in its ability to help with this process, of which the Bank's technical assistance programmes are likely to be of particular value.

However, it will make quite a modest contribution to the region's investment needs. Its capital base has been described as less than half the cost of cleaning up Poland's power industry alone. Theoretically, it could lend up to $2.4bn a year but is unlikely to approach this lending level for some years. Preoccupied with hiring staff and getting organised, the Bank may take some time to get off the ground. Even then, the laborious business of identifying, appraising and approving projects will constrain lending — the two larger established regional development banks, with far more borrowers, still lend only $2-3bn a year after decades of experience.

There are also questions about the ability of some recipient countries to service additional foreign debts, for EBRD loans will not be cheap. The Bank will be on-lending money which it has raised in international capital markets using its paid-in capital as security, with a modest mark-up to cover costs. The terms on which it will lend have yet to be determined. It can expect to get the same AAA-rating as the World Bank and its on-lending terms may therefore be similar. Loans from the World Bank's IBRD window currently charge a little under 8% interest, typically with grace and repayment periods of 3-5 and 15-20 years respectively.

For creditor countries, the new Bank offers some commercial benefits. Private firms will have access to procurement contracts for goods and services funded by the Bank, which can provide a low-risk entry into a difficult business environment. In a co-financing capacity, the Bank will share the risks of private and other lenders.

The capital base

The European Bank will be financed, and its membership represented, in much the same way as other multilateral banks (see Box 1). The USA will be the single largest shareholder, with 10% of total votes. However, together, the 12 members of the European Community and two European institutions — the Commission of the European Communities and the European Investment Bank — will hold a 51% majority of votes. The Soviet Union and other Central and Eastern European members (excluding East Germany) will between them hold a little under 12%.

The EBRD will have 23 Executive Directors on its Board, representing its 42 members. The EC and its two institutions will appoint eleven of them; of the balance, four each will come from other European creditors, East and Central European borrowers, and non-European members. From the latter group, the USA, Japan and Canada will each appoint one director.

The shareholders will provide the EBRD's initial capital of ECU10bn. Of this, 30% will be paid in equal annual instalments over five years. Up to half of this 30% can be paid in promissory notes, with the balance in cash. The UK's share will be about £600m, of which £180m will be paid in over five years. The balance will remain 'on call', essentially to provide collateral for market borrowings. The adequacy of its capital base will be reviewed at least every five years.

The 30% ratio of EBRD's paid-in capital is high compared to other development banks. The World Bank's ratio, for example, averages only 7.5%. The main reason for this is the high proportion which the EBRD will be investing in private enterprise, without government guarantees. On the same grounds, 100% of the capital of the International Finance Corporation (IFC) is paid in, because it invests exclusively in the private sector and thus faces the greater risk associated with non-sovereign loans.

Policy control

Prior to the activation of the Articles of Agreement, there are two-monthly meetings of representatives of all member states. Once the Articles are in force, the Board of Governors will be the ultimate decision-making body, meeting at least annually. For the purposes of day-to-day control, however, there is planned to be a resident Board of Directors meeting frequently. Each member will have a number of votes proportional to the size of its shareholding.

The mechanics of policy control will depend upon the nature of the issue at hand. There are complicated provisions for voting on the Governing and Executive Boards. Thus:

- Only a simple majority of votes will be needed to approve loans and take other decisions on the Bank's everyday business. The 12 EC members and the two European institutions represented on the Board thus hold the power to wield day-to-day control.
- A majority of not less than two-thirds of total votes will be necessary on matters of general policy.
- At least two-thirds of Governors representing 75% of votes will be needed in order to suspend or modify lending to a country found not to be complying with the political and economic goals of the Bank.
- At least three-quarters of Governors representing 85% of votes will be needed to approve any change in a member's eligibility to borrow. This means that the USA and Japan, for example, acting together, would hold veto power on this issue.

These rules may prove decisive but in practice the EBRD will seek to operate by consensus. To judge from practices in other multilateral banks, the Bank's President and senior staff will try to iron out differences between Executive Directors informally, before bringing the loan up for a vote. When their mediation fails and issues are controversial enough to be forced to a vote, decisions will require a two-thirds majority, so the EC of the Twelve will not be in a position to use its 51% of votes to force policies on other shareholders.

Unresolved Questions

There are three major unresolved areas of controversy. These concern the degree of managerial freedom, doubts about the underlying clarity of the concept of the EBRD, and the danger that the EBRD will divert resources from developing countries.

Managerial freedom versus political supervision

There is an inherent tension between the political remit of the Bank and its President-Designate's view that it must operate rather as a merchant bank. At an early meeting of the Bank's transitional governing body, he put forward ideas that would have given him greater freedom to operate in that way than the heads of existing regional development banks have, with a corresponding diminution in the powers of the Executive Board. The reaction of some shareholders was negative and the Board is likely to insist on retaining for itself greater decision-making powers than Mr Attali would choose.

There are strong arguments in his favour, however. The managements of the IMF, in particular, but more recently the World Bank and some of the regional banks, have been hamstrung by the tight leash held by their resident Boards and by political interference by Directors of major shareholders on behalf of (or against) particular recipient countries. Moreover, such short-leash control is likely to be particularly inappropriate given the EBRD's mandate to develop East and Central Europe's private sector, which will probably require it to operate more like a merchant bank than an international bureaucracy. Moreover, a resident Executive Board which meets frequently and scrutinises day-to-day work in detail is very costly, both financially and in terms of staff and management time.

Against this, the political nature of the Bank tells against the extent of discretionary power that the President-Designate would like. The Bank's creation was essentially an act of foreign policy and this means that its major shareholders will want to retain substantial control over its dealings with the former communist countries.

Consistency between ends and means

Three questions can be grouped under this heading: Why is a public agency needed for lending to the private sector? Is the 60:40 split between lending to the private and public sectors appropriate? Are the terms of its lending consistent with its objectives and economic realities?

In answer to the first of these it can be argued that provision of public capital support is justified because lending to East European entrepreneurs will involve a degree of risk that would discourage private sources of finance from responding adequately. This is partly because of the parlous state of their economies and the inadequacy of the supporting infrastructure. Political uncertainties and the unsettled framework of economic policies are likely to be a particularly potent disincentive. Enforcement of better environmental standards will also lower financial rates of return. By offering credits on rather better terms than are likely to be available privately and by creating the possibility of risk-spreading through co-financing arrangements, the EBRD would be able to help entrepreneurs with projects that might otherwise never get off the ground. Against this, however, it could be asked whether the only modestly better terms available from EBRD will be a sufficient improvement to meet this need. To insist on near commercial terms may invite project failures and defaults.

The 40% upper limit on lending to the public sector, on which the US, UK and Japan were particularly insistent, reflected the political orientation of the Bank's mandate and was intended to safeguard its management against what was feared to be an almost bottomless pit of requests for public sector infrastructural projects. As such, it did not represent an economic or technical judgement about the optimal balance between the two (which, in any case, will vary from one country to the next). It is at least open to argument that a higher level of public sector infrastructural investment would be desirable in order to create the physical environment favourable to profitable private enterprise, but the Bank's hands will be tied.

A further question about the suitability of the Bank's terms relates to its impact on the external debt situations of borrowing countries. The external debts of Bulgaria, Hungary and Poland are three to four times as large as their annual export earnings — ratios comparable with those developing countries officially classed by the World Bank as 'severely indebted'. In due course, obligations to the EBRD will begin adding to the burden, even though only a minority of its loans will constitute sovereign debt. It is likely that EBRD will claim the same preferred lender status as that of other multilateral development banks, making it all the harder to deal with the resulting difficulties. Indeed, the wisdom of the core decision to assist the countries of Eastern Europe with loans carrying near-commercial terms can be questioned. The official view is that the debt problem must be dealt with separately from the financing role of the EBRD (although the Bank is supposed to co-ordinate with the IMF on this matter). To some, that will seem a sensible, indeed unavoidable, course. To others it will represent another example of poor co-ordination between financial and other policies affecting the heavily indebted countries.

A diversion from developing countries?

Much concern has been expressed that the political transformation of Eastern Europe will result in a diversion of assistance from developing countries. Some diversion seems inevitable, at least of personnel and private investment. Will EBRD add to that?

By sharing risks and offering co-financing, EBRD is likely to stimulate foreign private investment in Eastern Europe. There are fears that some of this will be at the expense of investments which would alternatively have gone to developing countries, worsening their development prospects. Against this, it can be argued that there is no fixed amount of foreign investment so that at least part of the new investment in Eastern Europe will represent a net addition to what otherwise would have occurred.

Box 2 suggests that the World Bank will lose staff to the EBRD and that these losses could affect its lending operations in developing countries to a modest extent. On the other hand, if the World Bank does reduce its new lending to East Europe once the EBRD goes into business, that could release more finance for lending to developing countries.

Box 2. Implications for the World Bank

The World Bank has been active for several years in four of the EBRD's borrowers: Hungary, Poland, Romania and Yugoslavia.

All but Romania are also members of the IFC. Czechoslovakia and Bulgaria join the World Bank towards the end of September 1990. Both agencies have plans to expand their operations in the region: the World Bank has pledged some $5bn to its current European borrowers over the next three years and the IFC is deepening its involvement by acting as an adviser on financial reform and privatisation, in addition to its investments. On the other hand, a World Bank Senior Vice-President has said that the World Bank expects to play a diminishing role in East Europe as the EBRD becomes established.

If it conforms with precedents set by other regional banks, the EBRD will follow the lead of the World Bank and IFC in countries where those institutions have established a presence, although there may be competition for bankable projects, at least at first. The EBRD's private-sector mandate will bring it into especially close contact with the IFC. Neither the IFC nor the World Bank, however, played any formal role in the creation of the EBRD and staff at these agencies are watching to see how relations will develop.

Fears that the EBRD will divert financial resources away from the World Bank group are probably exaggerated, since the Bank will be borrowing from the huge resources of international capital markets, using relatively small contributions from member governments as security. Although the US Congress may balk at a funding request for EBRD, it is unlikely to cut World Bank support in order to finance it. At worst, Congressional legislation authorising the EBRD may be "taken hostage" in order to force approval of other legislation.

There may be a more immediate impact on personnel. Some of the 6,000-plus World Bank and IFC staff members, especially Europeans, may be tempted to move to the EBRD, although this should not be on a scale to affect lending operations in developing countries.

Perhaps the biggest question here is whether the financing of the EBRD will divert bilateral aid money. This will be decided by each donor. There may be some who do divert, although most will probably not. In the British case, the government has gone on record to state that its assistance to Eastern Europe is separate from and additional to existing planned aid for developing countries. So far it has been scrupulous in observing that, and the Overseas Development Administration is even receiving a supplement to its running costs for the small unit within it responsible for EBRD affairs.

How the dynamics will work out may be another matter, however. The diversion of attention and changes in priorities resulting from the Eastern European transformation could mean that future aid programmes will be smaller than they otherwise would have been, and current assurances provide only limited safeguards against a longer-term diversion of assistance from developing countries.

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