Department of Finance Canada
Ministère des Finances Canada

Report on Operations Under the European Bank for Reconstruction and Development Agreement Act 1994

Canada

Fin/TB Library - Bibliothèque Fin/CT
3 0145 00082292 1

TABLE OF CONTENTS

FINANCE - TREASURY BOARD
LIBRARY - REC'D

APR
AVR 4 1995

FINANCES CONSEIL DU TRÉSOR
BIBLIOTHÈQUE - REÇU

I. INTRODUCTORY NOTE

Article 7 of the European Bank for Reconstruction and Development (**EBRD**) Agreement Act states that:

> "The Minister [of Finance] shall cause to be laid before each House of Parliament by March 31 of each year, or if that House is not then sitting, on any of the 30 days next thereafter that it is sitting, a report of operations for the previous year, containing a general summary of all actions, including their human rights aspects and sustainable development aspects, taken under the authority of this Act"

Canadian participation in this institution was authorized under the EBRD Agreement Act, promulgated on February 1, 1991. This report reviews the operations of the EBRD during 1994.

Headquartered in London, the EBRD is a multilateral development bank designed to further economic development and social progress among the countries of Central and Eastern Europe and the former Soviet Union. As stated in its Articles of Agreement, the main purpose of the EBRD is to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in those countries committed to the principles of multiparty democracy, pluralism and market economics.

The EBRD is distinct from the other multilateral development banks in that its primary focus is financing for the emerging private sectors in the countries of Central and Eastern Europe and the former Soviet Union. The Bank provides loans, equity investment and financial guarantees. The activities of the EBRD are divided into ordinary and special operations, depending on the source of funding. Ordinary operations are those financed from the ordinary capital resources which comprise the Bank's subscribed capital, market borrowings, and income from ordinary loans and investments. Special operations are those financed from Special Funds for specifically designated purposes outside the Bank's regular activities -- e.g. technical assistance.

The objectives which underlie Canada's membership in the Bank include the following:

- To support the commitment of the countries of Central and Eastern Europe and the former Soviet Union to multiparty democracy, the rule of law, and respect for human rights;
- To foster the transition toward open, market-oriented economies, and private and entrepreneurial initiative; and
- To integrate these countries more securely into the international economy.

The Bank is meeting these objectives and, with the arrival of Mr. de Larosière as President of the EBRD a year and a half ago, is doing so in a cost efficient manner. Mr. de Larosière has worked to significantly improve the cost effectiveness of the Bank. Nevertheless, Canada will continue to press for responsible management of the Bank and progress on cost efficiency.

II. MANAGING CANADA'S INTEREST IN THE EBRD

(a) Canadian Representatives

The highest authority in the Bank is the Board of Governors. Each member country is represented by a Governor and an Alternate Governor. The Honourable Paul Martin, Minister of Finance, is the Canadian Governor and Mr. Gordon Smith, Deputy Minister of Foreign Affairs, is the Alternate Governor.

The Board of Directors is responsible for the general operations of the Bank and is composed of 23 members. The EBRD Charter requires that non-European members elect 4 Directors. Canada, the third largest non-European shareholder, after the U.S.A. and Japan, elects its own Director. Mr. John Coleman is the Canadian Director. He also serves as Director for Morocco. Mr. David Horley is the Alternate Director.

Canadian participation in the EBRD is coordinated by the International Trade and Finance Branch of the Department of Finance, in consultation with the Department of Foreign Affairs and International Trade (**FAIT**). These departments conduct regular analyses of policy papers and lending programs to ensure that EBRD activities and operations are consistent with its mandate and support an effective use of resources. In addition to this report, Parliament is informed of the activities and operations of the EBRD though appearances by Departmental officials before its various committees.

(b) Voting Record

The Canadian Director opposed the following two Bank policies in 1994:

- The *Staff Compensation and Benefits Proposals for 1995* on November 1, 1994 because of lower pay increases envisaged in other international institutions, especially the International Finance Corporation, and the pay freeze being enforced in the Canadian public service.
- The *Accommodation Policy* on February 21, 1994 because it was too generous and out of line with those of comparable institutions.

(c) Governance Issues in 1994

The key governance issues at the EBRD in 1994 included: (1) achievement of the portfolio ratio; (2) actions taken by the Bank to improve cost efficiency; (3) strategy for the future; and (4) cost of the Board of Directors.

(i) **The portfolio ratio.** The Bank's Articles of Agreement require that a global minimum of 60 per cent of the Bank's operational commitments, i.e. approved and signed financings, directly support the private sector. At the end of 1994, the cumulative share of such commitments was 62 per cent, the first time that this global ratio was achieved. In 1994, the portfolio ratio reached a record 73 per cent.

(ii) **Actions Taken by the Bank to Improve Cost Efficiency.** The 1994 achievements have resulted in sharply increased productivity with a rise in operational volume, particularly in more difficult areas. Moreover, these achievements were accompanied by savings in the zero-nominal growth administrative budget for 1994, thus reflecting continued budgetary discipline and control. The results were lower cost per project and improved responsiveness to client demand.

(iii) **Strategy for the Future.** Shortly after his arrival, President de Larosière set up an internal Task Force on Operational Priorities to review the Bank's operational priorities over the medium term. At their Annual meeting in St. Petersburg on April 18-19, 1994, Governors endorsed actions taken by Bank management, and the following directions for the future:

- a sharper focus on private sector development;
- activity in all countries of operations;
- more effort to reach local private enterprises;
- a recognition of the critical role of financial intermediaries; and
- a more active approach toward equity investments.

In 1994, the Bank made significant progress in these directions: 73 per cent of signed commitments were in the private sector; commitments were signed in all countries of operations on the basis of approved country strategies; small- and medium-sized (**SMEs**) and local industries through financial intermediaries; and equity investments now account for over 15 per cent of cumulative Bank operations, compared to less than 12 per cent in 1993.

(iv) **Cost of the Board of Directors.**

The EBRD Board of Directors' share of the administrative budget in 1993 was about 12.4 percent, i.e. three times that of other regional banks. At the Bank's Annual Meeting of the Board of Governors held in April 1994, a number of Governors, including Secretary of State Doug Peters, led the charge in requesting a review of the cost of the Board of Directors to achieve substantial budgetary savings.

Directors have been encouraged to make further progress on reducing these costs before the next Annual Meeting of the Bank's Governors in London in April 1995. Three main options have been considered. A first option would be to have a smaller number of Directors -- more in line with that of other multilateral regional development banks -- who would be paid by the Bank and located at the Bank's Headquarters. A second option is a non-resident Board where Directors would not be paid by the Bank. A third option would be to keep the number of Directors at current levels, but have the Bank pay for fewer positions in each Director's office.

(d) Funds Subscribed and Committed

Canada has a 3.4 percent share of the EBRD's authorized capital. Canada has subscribed to 34,000 shares valued at ECU 340 million (equivalent to US$396,783,400 at the agreed exchange rate of ECU 1 to US$1.16701), of which 30 percent is to be paid in over five years starting in 1991, and ECU 238 million remains subject to call. Payments for the paid-in capital are made, at least half in cash with the remainder in notes.

Canada has already made the following paid-in capital payments in US dollars:

Installment	Year	Cash	Notes	Encashment of Notes
First	1991	11,903,502	11,903,502	11,903,502
Second	1992	11,903,502	11,903,502	3,967,834
Third	1993	11,903,502	11,903,502	7,935,668
Fourth	1994	11,903,502	11,903,502	11,903,502
TOTAL		47,614,008	47,614,008	35,710,506

At the end of 1994, there was US$11,903,502 of notes still outstanding. The last installment of US$23,807,004 will be made in FY 1995-96.

In addition to its subscription to the Bank's capital, Canada established in January 1992, a C$1 million Canadian Technical Cooperation Fund (**CTCF**). The main purpose of this Fund is to provide funds for the Bank to hire Canadian individuals and firms as consultants working on activities related to Bank projects. The CTCF is administered by the EBRD in consultation with Bureau of Assistance to Central and Eastern Europe of the Department of Foreign Affairs and International Trade. The CTCF was replenished by a further C$1 million in 1993 and C$400,000 in March 1994. In December 1994, it was replenished by an additional C$5 million which will be paid over a three-year period.

In addition, Canada has a technical cooperation agreement worth C$1.125 million with the EBRD to cover the contracting of Canadian expatriate management for the Russian Project Finance Bank.

Canada is also a participant in the Nuclear Safety Account (**NSA**). In March 1993, it contributed C$7.5 million to the operations of the NSA. With respect to the replenishment of the NSA (mentioned in the *Nuclear Safety Account* section above), the Canadian contribution remains to be decided.

(e) EBRD Financing Benefitting Canadian Firms

In addition to the objective of assisting in the development of a strong private sector in Central and Eastern Europe and the former Soviet Union, Canada's participation in the EBRD has stimulated growing interest among Canadian firms in commercial opportunities within the region.

International competitive bidding (**ICB**) procedures are required by the Bank for procurement for development projects, but are not required for procurement for merchant banking activities. However, in the latter cases, the Bank monitors developments to ensure that best commercial practices are being followed.

At the end of 1994, three ICB contracts totalling C$4.7 million had been awarded to Canadian firms:

- Ontario Hydro won a project management contract of C$1.3 million for the implementation of Kozloduy' nuclear project in Bulgaria;
- Etude Economique Conseil was awarded a C$338,000 contract to undertake a study of the Hungarian Telecommunications Company ; and
- Harbison Fischer won a C$3.1 million contract to supply bottom hole sucker rod pumps for the modernization of Petrom in Romania.

In addition, Northern Telecom (U.K.) is the lead partner in a joint venture which won a C$17.2 million contract for the supply, installation and commissioning of a telecommunications project in Bulgaria.

In 1994, no new merchant banking projects benefitted Canadian firms. At the end of 1994, there had been three projects which benefitted Canadian firms, all in the oil and gas sector in Russia (see our 1993 Report).

In 1994, Canadian firms also won C$1.4 million of consultant contracts. This figure includes contracts awarded under the Canadian Technical Cooperation Fund, which is directly tied to Canadian individuals and firms. Table D provides information on consultancy services for EBRD projects.

(f) Canadian Personnel

There were 21 Canadians on the staff of the EBRD at the end of 1994. All but three of these individuals were in senior banking and managerial levels. Canadians accounted for about 5.5 per cent of staff in senior positions, and 4.4 per cent in other professional levels in 1994. Both these figures are well above our 3.4 per cent shareholding in the Bank.

(g) Activities of Canada's Office at the EBRD

(i) Role of the Office of the Director for Canada

The Director for Canada fills two generally complementary roles in his work at the Bank. He must work in the best interests of the Bank while ensuring that he also presents and defends Canada's economic and political interests. The coincidence between the Bank's fundamental objectives and Canada's foreign policy, economic and trade interests ensures that the Canadian Director's responsibilities towards the Bank and Canada seldom diverge.

The Office therefore divides its time between:

- the work of the Board of Directors in approving policies and projects; and
- work with Canadian investors, equipment suppliers, financiers and consultants who wish to participate in Bank projects.

The Office of the Canadian Director also represents the Government of Morocco which holds a relatively small share of the Bank's capital.

In terms of development of Bank policies, the Office of the Director for Canada has stressed the adoption of standard loan and investment products, transparent and expeditious procedures for processing projects, and continued commitment to administrative efficiency and cost control. The emphasis on transparency is particularly beneficial to Canadian firms wishing to exploit the market of the Bank's countries of operations since it allows open and fair access to business and procurement opportunities.

(ii) Policy and administration of the Bank

In 1994, the Canadian Office was active in promoting the following improvements in the policies and administration of the Bank:

- supported a zero nominal increase in the 1994 budget;
- worked to achieve a modest 3.5 per cent increase in the 1995 administrative budget of the Bank;
- opposed proposed salary increases for both Directors and staff;
- successfully pushed the Bank to become more active in countries of strong interest to Canada such as Ukraine;
- encouraged the Bank to decentralise more of its activities and to increase its involvement with the local private sector, including small- and medium-sized enterprises;
- encouraged the Bank to adopt more innovative venture capital and small business loan programmes and to expand its investments in local financial intermediaries; and

- supported the Bank's more active role in promoting policies and legislation which favour foreign investment in countries of operations through appropriate project conditionality and through making representations to governments.

(iii) **Promotion of Canadian Interests**

The three members of the Canadian Office made a total of six trips to Canada to meet with business people, conduct seminars, speak at conferences, and consult with Government officials. The members of the Office also visited several of the Bank's countries of operations (Russia, Ukraine, Kazakhstan, Moldova, Hungary, and Uzbekistan) to further Canadian business interests in the region. In addition, 1994 also saw the Office hold the first two EBRD Procurement Seminars in Toronto and Montreal as well as organise at the Bank's headquarters a briefing session for Canadian bankers based in Europe.

In terms of promotion of Canadian companies participation in Bank operations, the Office of the Director for Canada has emphasised private sector investments in addition to public sector opportunities. The December 1994 signing of a framework agreement between the Bank and the Export Development Corporation (**EDC**) will provide particular support to potential Canadian investors in the region by encouraging co-financing of Bank operations with EDC. The Office received in the order of 150 visits as well as some 250 additional enquiries during the year. In addition to the investment projects involving Canadian firms already approved by the Bank, a number of large private sector projects were under active discussion at year end in the mining, oil & gas, airport development, pulp & paper, and telecommunications sectors.

Canadians play an active role in the Bank, well illustrated by the fact that one out of every 20 employees of the Bank is a Canadian citizen. Canadians occupy a number of key positions, including the Director of Personnel, two Directors of Country Teams, and the Bank Resident Representatives in Moscow (Russia), Kiev (Ukraine), Warsaw (Poland) and Minsk (Belarus).

In the course of 1994, The Canadian Director was elected by his colleagues to chair informal meetings of the Board of Directors and of the Board Steering Group. Flowing from Canada's chairmanship of the G-7 Economic Summit in Halifax later this year, the Canadian Director convenes weekly and ad hoc meetings of G-7 Directors.

III. REVIEW OF THE REGIONAL DEVELOPMENTS

(a) Progress in Transition in Central and Eastern Europe

Positive real output **growth** in 1994 appears to be widespread in Central and Eastern Europe (with the exception of Bulgaria and Romania), although its strength and sustainability varies greatly (see table 1). Albania has the fastest growth rate at 8 per cent, with growth in the Czech Republic, Hungary, Poland, and the Slovak Republic in the 1-5 per cent range. Agriculture has rebounded in most countries from the declines induced by drought and restructuring in 1992 and 1993, and is making a strong contribution to growth. An exception is Poland, where poor weather conditions will lead to a fall in output.

Investment is now showing signs of recovery -- from a low base -- in Poland, the Czech Republic, and Hungary. In the two former countries, investment in machinery and equipment is particularly strong, but in Hungary the rapid growth relates mainly to public construction. The recovery in aggregate investment follows a long period of rising imports of investment goods, suggesting that restructuring has been progressing for some time.

Chief sources of the recovery in aggregate demand in 1994 are strong growth of exports from all countries to the OECD area, primarily western Europe, and, in the more advanced countries, private consumption. With respect to **exports**, Poland and Slovakia led the way with growth of 20 per cent, followed by Hungary with growth of 12 per cent after a steep fall in 1993. It appears that the rise in exports is broadly based across commodity groups. With respect to **private consumption** in the more advanced countries, real wages have been rising and, with some stabilization in the labour market, household real incomes have tended to rise or at least stabilize. Buoyant tax receipts may indicate that entrepreneurial incomes have also grown strongly. **Unemployment** has fallen in the Czech Republic and Hungary, and in Poland it has remained steady, but at a relatively high level. In the other countries, unemployment has continued to increase, but only by about a percentage point. In nearly all countries, the share of long term unemployed increased. Employment increased in the Czech Republic and stabilized in Hungary and Poland.

Rising exports have helped to reduce **current account deficits** in all countries except Hungary. In that country the increase in the deficit has been financed in part by increased foreign debt and a decline in net foreign assets. Current account balances in all countries have been improved by devaluation and import surcharges (Bulgaria, Hungary, Romania, Slovakia) and by tighter fiscal and monetary policy (Bulgaria, Romania, Slovakia).

Debt reduction agreements were concluded by Poland and Bulgaria covering debt to banks and to official creditors. In 1994 Poland's debt was reduced from US $47 to $39 billion, with most repayments occurring only after the year 2000. Bulgaria's bank debt was reduced from US $8.9 to 6.0 billion.

Macroeconomic stabilization appears to be under control in Poland and the Czech Republic. In the other countries, stabilization policy needs to be tightened or firmly maintained. In Hungary a substantial fiscal tightening is planned for 1995, which may depress output in the next two years. In Slovakia, Romania, and Bulgaria stabilization packages were put in place in 1994. If held to, these packages will also likely limit growth prospects in the near term, before strong and sustainable growth, led by the nascent private sector, is achieved.

Significant **structural changes** have taken place in countries in which macroeconomic stabilization and liberalization are advanced. Most countries have made substantial progress in liberalizing the external trade and foreign exchange system, and in liberalizing prices and promoting price competition. Both large- and small-scale **privatization** and measures to promote **enterprise restructuring** are well along in the Czech Republic, Hungary, Poland, and Slovakia. As a result, although many large-scale state-owned enterprises are still struggling to survive, small privately-owned firms have proliferated. Partly through transfers of titles under the privatization programmes, and partly through the emergence of new firms, the share of the private sector in GDP is now close to or exceeds 50 per cent in Albania, the Czech Republic, Hungary, Poland, and Slovakia. The sectoral composition of output and employment has also changed, with the share of services, especially trade, banking, insurance, and communications expanding rapidly in a number of countries.

Prospects for GDP growth in Central and Eastern Europe depend on the interaction between the stage structural reforms have reached and the stance of stabilization policy. In Poland and the Czech Republic growth seems soundly based and should remain in the range of 4-5 per cent over the near term. Here structural reforms are well advanced, so that continued tight monetary policy and fiscal restraint should not hinder short term growth prospects. Elsewhere the immediate priority is either to tighten stabilization policy or maintain programmes already in place. This will be most difficult in Romania and Bulgaria, where structural reforms are less well established and macroeconomic disequilibria greater. The necessity to maintain stabilization policy over the time needed to ensure success and progress in structural reform will likely limit growth prospects in the near term.

Table 1: Key Macroeconomic Variables, 1994
(estimates)

	Real GDP Growth (%)	Unemploy-ment (%)	Inflation (%)	Current Account (US $b)	Fiscal Deficit/DGP (%)
Albania	8.0	19	27	0.0	...
Bulgaria	-2.0	13	81	-1.3	-7.0
Czech Rep.	2.4	4	9	0.6	0.0
Hungary	1.0	11	19	-3.5	-6.5
Poland	4.5	17	30	-1.3	-4.0
Romania	0.0	11	156	-0.7	-3.5
Slovak Rep.	4.4	14	14	-0.4	-5.0

Sources: IMF, *World Economic Outlook*, October, 1994; OECD, *OECD Economic Outlook*, December, 1994.

(b) Progress in Transition in the Former Soviet Union

Most of the new independent states of the former Soviet Union (**FSU**) have initiated comprehensive structural reform and the privatization of state enterprises. Structural reforms such as price and trade liberalization, enterprise restructuring, financial sector reform, and privatization have created the foundation for a market economy and removed the underlying causes of financial instability in several countries. As Table 2 suggests, however, the pace of reform differs substantially across these countries. The most uniform progress with structural reform has been made in the area of **price liberalization and competition.** On the EBRD's scale of 1-to-4, where 1 implies little or no progress with reform and 4 implies a market economy, ten of the fifteen FSU-states had achieved a level of 3 by mid-1994. By end-1994, Ukraine, Belarus, Kazakhstan and Georgia had also liberalized most prices as part of broadly-based economic reform programs. Only Turkmenistan maintains widespread price controls.

By the end of 1994, several states of the FSU had also made far-reaching progress with reform of the **trade and foreign exchange system.** The most rapid progress has been made in the Baltic states of Estonia, Latvia, and Lithuania, where there are few import or export quotas, little direct government involvement in external trade, and nearly full current account convertibility at a unified exchange rate. In Estonia and Latvia, and to a lesser extent in Lithuania, the liberalization of the external sector combined with financial stability has led to an export boom and a rapid reorientation of trade towards the industrial economies of western Europe. Russia and the Kyrgyz Republic have also made significant progress with trade and foreign exchange market liberalization. Although some import quotas remain, they now have nearly full current account convertibility at a unified exchange rate.

One of the outstanding issues with regard to Russia's foreign trade regime is the oil and gas sector. Although the formal system of oil export quotas has been abolished, there is a possibility that these might be replaced by domestic production quotas -- which would leave effective controls virtually unchanged. Furthermore, foreign investors face frequent changes to the tax and regulatory system governing the oil and gas sector, as well as uncertainty associated with access to Russian pipelines. Substantial private investment in Russia's energy sector will not be forthcoming unless these issues are resolved in a transparent manner. This is a serious problem not only for Canadian and other firms but for the Russian economy, since the energy sector offers the potential of rich and relatively rapid benefits for Russia if foreign investment can be tapped to develop its energy sector.

In other countries such as Kazakhstan, Armenia, and Uzbekistan, the external sector has been partially liberalized, but restrictions remain on numerous imports and on the foreign exchange market (dual or multiple exchange rates, quantitative restrictions on foreign exchange transactions etc.). Meanwhile, Ukraine and Belarus -- which ranked only 1-out-of-4 in the category of foreign trade and exchange market liberalization by mid-1994 -- have put comprehensive trade reform measures in place in recent months as part of broadly-based economic programs supported by loans from the IMF. In Azerbaijan, Turkmenistan, and Tajikistan, the external sector is still characterized by widespread import controls and limited access to foreign exchange.

Privatization is well-underway in the FSU, with most progress being made with the **privatization of small enterprises** -- state-owned enterprises with fewer than 50 employees. Estonia, Lithuania, and the Kyrgyz Republic have already completed comprehensive and well-designed small-scale privatization programs. By mid-1994, these countries had sold (or shut-down) all small state-owned companies. Russia, Latvia, Armenia, and Uzbekistan have also completed most aspects of the privatization of small enterprises, but certain issues relating to ownership and the transferability of assets need to be resolved. In Ukraine, Belarus, Kazakhstan, Georgia, and Tajikistan, a substantial portion of small enterprises has been privatized but political opposition to reform and administrative bottlenecks have slowed the pace of small-scale privatization. Meanwhile, in Azerbaijan and Turkmenistan the privatization of small enterprises has yet to begin.

TABLE 2

Progress in Transition in Central and Eastern Europe and the former Soviet Union

(see below the classification system used for transition indicators*)

Countries	Private Sector Share of GDP** (%)	Enterprises			Markets and Trade		Financial Institutions
		Large-scale Privatization	Small-scale Privatization	Enterprise Restructuring	Price Liberalisation and competition	Trade and Foreign Exchange system	Banking Reform
Albania	50	1	3	2	3	4	2
Armenia	40	1	3	1	3	2	1
Azerbaijan	20	1	1	1	3	1	1
Belarus	15	2	2	2	2	1	1
Bulgaria	40	2	2	2	3	4	2
Croatia	40	3	4	2	3	4	3
Czech Republic	65	4	4	3	3	4	3
Estonia	55	3	4	3	3	4	3
FYR Macedonia	35	2	4	2	3	4	2
Georgia	20	1	2	1	2	1	1
Hungary	55	3	4	3	3	4	3
Kazakhstan	20	2	2	1	2	2	1
Kyrgyzstan	30	3	4	2	3	3	2
Latvia	55	2	3	2	3	4	3
Lithuania	50	3	4	2	3	4	2
Moldova	20	2	2	2	3	2	2
Poland	55	3	4	3	3	4	3
Romania	35	2	3	2	3	4	2
Russian Federation	50	3	3	2	3	3	2
Slovak Republic	55	3	4	3	3	4	3
Slovenia	30	2	4	3	3	4	3
Tajikistan	15	2	2	1	3	1	1
Turkmenistan	15	1	1	1	2	1	1
Ukraine	30	1	2	1	2	1	1
Uzbekistan	20	2	3	1	3	2	1

Source: Transition Report (EBRD, October 1994).

* The classification of transition indicators uses a scale from 1 to 4, where "1" implies little or no progress with reform and "4" implies a market economy.

** Rough EBRD estimate as of mid-1994.

With regard to the **large-scale privatization** (medium-and-large-sized enterprises) Russia, Estonia and Lithuania are in the lead. The privatization of state enterprises in the industrial sector is nearly complete in these countries. The Czech-style program of mass privatization adopted in Russia in 1992 has led to the privatization of over 70 per cent of enterprises in the manufacturing sector. Privatized and new private enterprises now account for nearly 80 per cent of employment in Russia's manufacturing sector. Furthermore, the vouchers (coupons redeemable for enterprise equity) distributed to every Russian citizen in late 1992 as part of the privatization program have spawned a growing secondary market in equity and allowed Russians to profit from economic reform. In the second half of 1994, the Russian authorities embarked on the second stage of the privatization program, in which the government will sell its remaining stakes in most large industrial enterprises directly to the market. This process is expected to be complete by the end of 1996. Progress with large-scale privatization in the agricultural and mining sectors has, however, been far slower and less coherent. A majority of large farms remain state-owned and issues relating to the ownership and use of land remain unresolved. Furthermore, in most FSU states political opposition to agricultural reform is strong, particularly from neo-communist parties.

In most other FSU states, comprehensive plans for large-scale privatization have been developed, but few sales have taken place. Ukraine, Kazakhstan, and Belarus have drafted mass privatization schemes such as the one adopted in Russia.

The liberalization of external trade and domestic prices, and the privatization of state enterprises have produced substantial benefits in the countries where these reforms are well established. The freeing of prices has eliminated the shortages of key consumer goods which were once characteristic of the "Soviet era", has reduced excess liquidity in the economy, and has led to a more efficient allocation of resources. The deregulation of prices has also removed many of the incentives to engage in black market activity. The efficiency of resource allocation has been strengthened by privatization, as enterprises shed excess labour and make production and investment decisions based on market forces. Privatization has also contributed to fiscal adjustment by removing the burden of money-losing state enterprises from public finances. Furthermore, privatization and economic deregulation have produced large and growing private sectors. In Russia and the three Baltic states, the private sector accounts for over 50 per cent of GDP. Meanwhile, trade liberalization has strengthened price deregulation and reduced monopoly power in the FSU (which, by virtue of the industrial structure inherited from central planning, was substantial) by subjecting domestic producers to competition from the rest of the world. Foreign trade liberalization has also expanded the availability of consumer goods in the FSU, and provided new export markets in industrial countries.

The benefits of these structural reforms will not be fully realized, however, unless the authorities in the FSU take resolute action on two fronts: enforcement of financial discipline in the economy, and financial stabilization. Although other structural reforms have been speedily implemented in many FSU states, governments have been slow to put in place measures to enforce (or harden) the budget constraints facing state and newly-privatized enterprises, and to promote a more efficient allocation of capital. The key reforms in this regard are **enterprise**

restructuring and **banking sector reform.** Estonia is the only FSU state in which meaningful progress has been made in both these areas. The authorities there have (through a combination of tight macroeconomic policy, privatization, the enforcement of bankruptcy legislation, and the creation of a competitive banking sector) created the structures necessary to promote corporate governance. In all other FSU states, enterprise restructuring has proceeded very slowly, with most governments loathe to pursue policies that would lead to additional (though transitional) output and employment losses.

The lack of progress with enterprise restructuring and banking reform undermines the allocative role of the price mechanism. Because enterprises in most FSU states still do not face a credible threat of bankruptcy, they have little incentive to respond to market forces. The result, in most countries of the former Soviet Union, has been a rapid accumulation of inter-enterprise arrears. This privately-generated liquidity not only erodes the price mechanism but makes it more difficult for the monetary authorities to influence liquidity conditions in the economy.

The benefits of structural reform are also threatened by the lack of progress in reducing macroeconomic imbalances and reining in inflation. With the notable exception of the Baltic states -- particularly Estonia and Latvia -- most FSU-states have been unable to bring about a lasting decline in inflation. In Russia, Ukraine and Belarus, for example, monthly inflation remains above 10 per cent per month, or 200 per cent per year. The factors underlying high inflation in these countries are large budget deficits financed by printing money, and directed (central bank) credits to money-losing state enterprises. High inflation has deterred domestic savings and foreign investment and, thereby, has deprived these countries of the financing necessary to foster sustainable economic growth.

IV. BANK OPERATIONS AND ACTIVITIES

Although the past year was essentially a year of consolidation after three years of rapid expansion in operations, the Bank exceeded its operational targets with financial results above expectations. In addition, for the first time since its inception, the Bank met the portfolio requirement under its Charter which stipulates that not more than 40 per cent of its total commitments be provided to the state sector. The Bank also achieved a broad geographical diversification, with a marked increase in the use of equity investments.

The budgetary discipline which was initiated in the second half of 1993 under its new President, Jacques de Larosière, was consolidated in 1994 with tighter management of administrative expenses and firmer control systems, producing savings in the administrative budget. This reflects President de Larosière's priorities to restore and strengthen the Bank's credibility, put in place a more efficient organizational structure, and more clearly define objectives and missions.

(a) Objectives and Benefits

The primary purpose of the EBRD is to foster the transition towards democracy and open market-oriented economies, and to promote private and entrepreneurial initiative in the countries of Central and Eastern Europe and the former Soviet Union. The Bank's mandate gives special emphasis to the promotion of democratic institutions and human rights in its countries of operations.

The Bank offers a full range of funding on market terms including:

- Loans with maturities of up to ten years for commercial enterprises and up to fifteen years for public infrastructure projects;
- Equity investments; and
- Selected financial guarantees and underwriting facilities. (Note, the Bank does not issue guarantees for export credits nor undertake insurance activities.)

The Bank was initially established with two operations departments -- i.e. Merchant Banking and Development Banking. In November 1993, Directors approved a re-organization of the operations departments into a unified Banking Department, headed by two Vice Presidents. Following the departure of Vice President Mario Sarcinelli (Region South) in April 1994, the Banking Department was consolidated under First Vice President Ronald Freeman.

In carrying out its functions, the Bank works in close cooperation with member countries and international organizations, such as the International Monetary Fund (**IMF**), the World Bank Group, the Organisation for Economic Co-operation and Development (**OECD**), the

European Commission (EC), the European Investment Bank (EIB), and United Nations (UN) and its various specialized agencies.

Canada continues to support the EBRD as a catalyst to private sector development in a region dominated for decades by inefficient state-owned enterprises. The transition to open market-oriented economies in Central and Eastern Europe and the former Soviet Union will ultimately result in a stronger, more robust world economy. Global trading opportunities will similarly be enhanced as Canadian and other companies enter these new markets.

(b) Environmental Concerns

The Bank is directed under its Articles of Agreement to promote environmentally sustainable development in the full range of its activities. To address the broad range of environmental issues in Central and Eastern Europe and the former Soviet Union, the Bank has adopted a two-fold operational strategy which involves both program- and project-specific approaches.

- The program approach aims at joint action to address regional-scale issues. Currently, this is focused on the Baltic and Danube regions. In addition, the Bank is also participating in the Black Sea Environmental Program.
- The project approach aims to solve specific environmental problems through investment, combined with appropriate policy and institutional measures.

Many of the Bank's operations include a specific environmental focus. In 1994, the Bank's environmentally-oriented infrastructure projects included the Tallinn Water and Sewerage Municipal Enterprise project in Estonia and the rehabilitation and improvement of municipal water services in five Romanian cities. In addition, the EBRD financed 12 technical cooperation operations which provided support for the preparation of environmental infrastructure projects.

(c) Multiparty Democracy and Pluralism

Article 1 of the Bank's Charter limits its operations to countries committed to and applying the principles of multiparty democracy and pluralism. In practice, the Bank's operations have, in fact, been closely tied to its country strategies regarding democracy and good government. The monitoring performance in this area is done in close cooperation with the European Union, the Organization for Security and Cooperation in Europe (OSCE), the Council of Europe and Ministries of Foreign Affairs of various member states.

If a country of operation implements policies inconsistent with the Bank's mandate in the area of multiparty democracy and pluralism, the Bank has the power to postpone, restrict or suspend some or all of its operations.

(d) EBRD Resources

The activities of the Bank are divided into ordinary operations and special operations, depending on the source of funding:

(i) Ordinary Capital Resources

The authorized capital of the Bank is ECU 10 billion[1] (C$17 billion), divided into 1 million shares. Nearly all of the authorized capital has been subscribed (see Table A). The authorized capital is comprised of paid-in shares and callable capital. The callable capital of ECU 7 billion is subject to call only in the unlikely event that it is required to meet the Bank's financial obligations to bondholders.

Paid-in capital of ECU 3 billion is being provided in hard currency by shareholders in equal annual instalments over five years, half in promissory notes and half in cash. At the end of 1994, ECU 2.27 billion had been paid-in. The remaining ECU 0.73 billion is to be paid in 1995.

In 1994, the Bank's assets grew from ECU 7.0 billion to ECU 7.5 billion. Its disbursements in 1994 were 43 per cent greater than 1993. At the end of 1994, project disbursements reached ECU 1.1 billion. In spite of difficult market conditions in 1994, the Bank reported a net income of ECU 1.0 million (compared to a net income of ECU 4.1 million in 1993).

(ii) Market Borrowings

The Bank borrowed funds equivalent to ECU 910 million from international capital markets in 1994. Funds were raised in eight different currencies and swapped into floating rate instruments, primarily in US dollars, ECU and deutschemarks.

Cumulative borrowings by the Bank at year-end 1994 totalled ECU 2.9 billion (including two borrowings of C$250 million each in 1993) with an average maturity of 4.8 years at an average cost of funds of LIBOR minus 37 basis points.

Standard & Poor's has assigned AAA long-term and A-1+ short-term ratings to the EBRD debt issues, reflecting the Bank's strong capital-asset ratio. Moody's has similarly rated the EBRD long-term bonds triple-A.

(iii) Technical Cooperation Funds

Cooperation Funds are grants from bilateral donors to finance technical assistance activities which facilitate the preparation, financing and implementation of projects. During the

[1]The European Currency Unit (ECU) is the unit of account for all EBRD transactions. The ECU is a composite currency, consisting of the fixed amounts of the currencies of the twelve member states of the European Economic Community (EEC). At the end of 1994, one ECU had a value of C$1.7224.

year, the Bank signed eight new Cooperation Fund Agreements with bilateral donors. As of the end of 1994, the Bank had entered into 35 bilateral agreements with an aggregate amount of ECU 233 million. Of this amount, the Bank had committed to a total of 817 technical cooperation projects with a value of ECU 223 million (C$384 million).

(iv) **Nuclear Safety Account**

In March 1993, the Nuclear Safety Account (**NSA**) was established at the initiative of G-7 countries to address safety improvement measures not covered by bilateral programs in countries of Central and Eastern Europe and the former Soviet Union. This multilateral fund is administered by the Bank on behalf of, and under the general direction of, the contributing member countries.

At the end of 1994, 14 donor countries and the European Commission had made pledges in the amount of ECU 154 million (C$265 million). For its part, Canada had contributed C$7.5 million. At the end of 1994, two grants had been approved by contributors to upgrade Nuclear Power Plants (**NPPs**) in two countries -- i.e. ECU 24 millions for the Kozloduy NPP in Bulgaria, and ECU 33 millions for the Ignalina NPP in Lithuania. In addition, two other projects are being developed by contributors in the Russian Federation -- i.e. ECU 30 millions for the Leningrad NPP and ECU 45 million for the Novovoronezh and Kola NPPs.

As the current project pipeline is expected to exhaust current resources, a replenishment of the NSA will be required before further assistance can be provided. At the Naples Summit, the G-7 leaders agreed to provide US$200 million toward an Action Plan to support the closure of Chernobyl nuclear power plants in Ukraine. The Action Plan also provides for the replenishment of the NSA. To date, the exact size of the replenishment of the NSA remains to be decided.

(e) **Loans and Equity Investments**

The Bank's project portfolio continued to grow during 1994. Directors approved 109 projects in 1994 in the Bank's countries of operation, bringing the total number of projects approved since the inception of the Bank to 251. Cumulative approvals at the end reached ECU 5.8 billion (approximately C$10 billion) -- of these, 65 per cent were in the private sector and 35 per cent were public sector loans (see Table B). For the first time, the Bank reached its required global portfolio ratio. Based on private sector commitments (i.e. financings approved and signed), this ratio reached 62 per cent at the end of 1994.

While the Bank had approved investment projects for 24 countries by the end of 1994 (compared to 19 countries at the end of 1993), the five most active borrowers account for almost two-thirds of all operations. The Russian Federation is the largest recipient with 16.9 per cent of the Bank's commitments.

The financial sector formed the largest individual sector in the Bank's portfolio at the end of 1994 (see Table C). Approximately 35 per cent of the EBRD's financing activities were directed to support financial intermediaries in 1994. Infrastructure projects to support private sector growth also remain prominent, particularly in the areas of transport, telecommunications, and energy and power generation.

V. CONCLUSION

Four years after the inception of the Bank, developments in the region have clearly demonstrated that the EBRD is playing an important role. The speed at which the Bank has grown since it started operations in April 1991 is impressive. The Bank has approved more than 251 operations and committed close to C$10 billion to the region. In addition, it has approved more than 877 technical cooperation projects which have committed an additional C$384 million.

Canada remains confident of the Bank's continuing strong commitment to provide effective assistance to the countries of the region in the difficult and challenging process of economic transition.

VI. <u>POSTSCRIPT</u>

Further information on the EBRD can be found in its Annual Report. The EBRD's Annual Report can be obtained in writing to:

European Bank for Reconstruction and Development
One Exchange Square,
London, EC2A 2EH
United Kingdom
Tel: 011-44-71-338-6541
Fax: 011-44-71-338-6100

Staff of the Canadian Director's Office at the EBRD may be reached as follows:

Mr. John Coleman, Director	Tel: 011-44-71-338-6457
Mr. David Horley, Alternate Director	Tel: 011-44-71-338-6509
Mr. François Lecavalier, Assistant	Tel: 011-44-71-338-6458
Mrs. Diana Price, Secretary	Tel: 011-44-71-338-6507
	Fax: 011-44-71-338-6062

TABLE A

Statement of Capital Subscriptions
(ECU millions)

	Callable Capital	Paid-in Capital	Total Capital
Recipient Countries	861	369	1,230
G-7 Countries			
Canada	238	102	340
France	596	256	852
Germany	596	256	852
Italy	596	256	852
Japan	596	256	852
United Kingdom	596	256	852
United States	700	300	1,000
G-7 Total	3,919	1,680	5,599
Other Non-Recipient Countries	2,319	916	3,055
Unallocated	81	35	116
Total	7,000	3,000	10,000

TABLE B

LOANS AND EQUITY INVESTMENTS BY COUNTRY

	Cumulative to December 31 1993		1994		Cumulative to December 31 1994	
	(ECU millions)	(%)	(ECU millions)	(%)	(ECU millions)	(%)
Regional	100.8	3.0%	94.5	3.9%	195.3	3.4%
Albania	34.1	1.0%	14.6	0.6%	48.7	0.8%
Armenia	46.8	1.4%	18.6	0.8%	65.4	1.1%
Azerbaijan	0.0	0.0%	43.4	1.8%	43.4	0.8%
Belarus	76.4	2.3%	68.2	2.8%	144.6	2.5%
Bulgaria	114.9	3.4%	15.2	0.6%	130.1	2.3%
Croatia	0.0	0.0%	95.1	3.9%	95.1	1.6%
Czech Republic	280.3	8.3%	202.0	8.4%	482.3	8.4%
Estonia	71.0	2.1%	33.4	1.4%	104.4	1.8%
FYR Macedonia	24.6	0.7%	54.3	2.3%	78.9	1.4%
Georgia	0.0	0.0%	14.8	0.6%	14.8	0.3%
Hungary	575.6	17.1%	166.9	6.9%	742.5	12.9%
Kazakhstan	100.0	3.0%	11.9	0.5%	111.9	1.9%
Kyrgyzstan	0.0	0.0%	16.2	0.7%	16.2	0.3%
Latvia	39.8	1.2%	19.7	0.8%	59.5	1.0%
Lithuania	38.0	1.1%	44.8	1.9%	82.8	1.4%
Moldova	0.8	0.0%	24.5	1.0%	25.3	0.4%
Poland	550.1	16.4%	350.4	14.5%	900.5	15.6%
Romania	402.7	12.0%	68.3	2.8%	471.0	8.2%
Russian Federation	469.7	14.0%	604.3	25.1%	1,074.0	18.6%
Slovakia	183.7	5.5%	89.3	3.7%	273.0	4.7%
Slovenia	154.4	4.6%	154.5	6.4%	308.9	5.4%
Turkmenistan	0.0	0.0%	36.7	1.5%	36.7	0.6%
Ukraine	8.0	0.2%	153.9	6.4%	161.9	2.8%
Uzbekistan	91.8	2.7%	13.0	0.5%	104.8	1.8%
Total	3,363.3	100.0%	2,408.7	100.0%	5,772.0	100%

Source: EBRD Annual Report for 1994.

TABLE C

LOANS AND EQUITY INVESTMENTS BY SECTOR

	Cumulative to December 31, 1993 (ECU millions)	(%)	1994 (ECU millions)	(%)	Cumulative to December 31, 1994 (ECU millions)	(%)
Finance, business	703.9	20.9%	927.8	38.5%	1,631.7	28.3%
Transport	609.7	18.1%	491.6	20.4%	1,101.3	19.1%
Telecommunications	593.4	17.6%	202.9	8.4%	796.3	13.8%
Energy/power generation	331.1	9.8%	233.1	9.7%	564.2	9.8%
Manufacturing	348.6	10.4%	210.9	8.8%	559.5	9.7%
Extractive industries	438.9	13.0%	42.8	1.8%	481.7	8.3%
CEALs, co-financing lines & RVFs*	140.9	4.2%	164.7	6.8%	305.6	5.3%
Commerce, tourism	80.1	2.4%	57.7	2.4%	137.8	2.4%
Agribusiness	54.7	1.6%	63.9	2.7%	118.6	2.1%
Community, social services	62.0	1.8%	13.3	0.6%	75.3	1.3%
Total	3,363.3	100.0%	2,408.7	100.0%	5,772.0	100.0%

* CEALs: Central European Agency Lines
RVFs: Regional Venture Funds

Source: EBRD Annual Report for 1994.

TABLE D

1994 CONTRACTS TO CONSULTANTS

Bank Budget and Technical Cooperation (TC) Funds

Nationality of Consultant	No. of Contracts	TC Fund (M ECU)	% of Value	Bank Fund (M ECU)	% of Value	Total (M ECU)	% of Value
Australia	1	0.14	0.27%	0.00	0.00%	0.14	0.20%
Austria	10	0.77	1.51%	0.05	0.25%	0.82	1.16%
Belgium	16	0.86	1.68%	0.85	4.28%	1.71	2.41%
Bulgaria	1	0.00	0.00%	0.01	0.05%	0.01	0.01%
Canada	12	0.54	1.06%	0.28	1.41%	0.82	1.16%
China	1	0.00	0.00%	0.02	0.10%	0.02	0.03%
Cyprus	1	0.00	0.00%	0.03	0.15%	0.03	0.04%
Czech R.	1	0.00	0.00%	0.01	0.05%	0.01	0.01%
Denmark	13	1.87	3.66%	0.06	0.30%	1.93	2.72%
Finland	12	0.39	0.76%	0.17	0.86%	0.56	0.79%
France	55	3.93	7.69%	3.65	18.37%	7.58	10.68%
Germany	25	4.03	7.89%	0.05	0.25%	4.08	5.75%
Greece	1	0.00	0.00%	0.03	0.15%	0.03	0.04%
Hungary	7	0.52	1.02%	0.02	0.10%	0.54	0.76%
Iceland	2	0.03	0.06%	0.01	0.05%	0.04	0.06%
Ireland	16	2.59	5.07%	0.09	0.45%	2.68	3.78%
Israel	4	0.23	0.45%	0.05	0.25%	0.28	0.39%
Italy	14	2.69	5.27%	0.00	0.00%	2.69	3.79%
Jamaica	1	0.00	0.00%	0.01	0.05%	0.01	0.01%
Japan	1	0.08	0.16%	0.00	0.00%	0.08	0.11%
Luxembourg	2	0.09	0.18%	0.00	0.00%	0.09	0.13%
Netherlands	37	6.32	12.37%	0.26	1.31%	6.58	9.27%
New Zealand	1	0.00	0.00%	0.01	0.05%	0.01	0.01%
Norway	5	0.49	0.96%	0.25	1.26%	0.74	1.04%
Philippines	2	0.03	0.06%	0.01	0.05%	0.04	0.06%
Poland	3	0.04	0.08%	0.12	0.60%	0.16	0.23%
Portugal	2	0.15	0.29%	0.04	0.20%	0.19	0.27%
R. of Korea	1	0.27	0.53%	0.00	0.00%	0.27	0.38%
Romania	2	0.00	0.00%	0.01	0.05%	0.01	0.01%
Russia	12	0.31	0.61%	0.14	0.70%	0.45	0.63%
Slovak R.	1	0.00	0.00%	0.02	0.10%	0.02	0.03%
Slovenia	4	0.04	0.08%	0.03	0.15%	0.07	0.10%
Spain	12	1.52	2.98%	0.05	0.25%	1.57	2.21%
Sweden	11	2.24	4.38%	4.33	21.79%	6.57	9.26%
Switzerland	13	0.91	1.78%	0.29	1.46%	1.20	1.69%
Turkey	6	0.00	0.00%	0.35	1.76%	0.35	0.49%
Ukraine	3	0.00	0.00%	0.01	0.05%	0.01	0.01%
United Kingdom	279	16.29	31.88%	7.48	37.64%	23.77	33.50%
United States	43	3.72	7.28%	1.08	5.44%	4.80	6.76%
TOTAL	633	51.09	100.0%	19.87	100.0%	70.96	100.0%