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EIB Group's activity in 2004

The European Investment Bank lent a total of EUR 43.2bn (2003: 42.3bn) for projects furthering the European Union's objectives. Financing in the EU-25 Member States totalled EUR 39.7bn (including EUR 3.8bn in the 10 new Member States), while EUR 3.5bn was made available in non EU-countries.

Lending in the Accession Countries (Bulgaria, Romania) amounted to EUR 119m, and in the Western Balkan countries the EIB assisted development projects to the tune of EUR 461m.

Lending in support of EU development policy totalled EUR 2.9bn. Under the Facility for Euro-Mediterranean Investment and Partnership, loans amounting to EUR 2.2bn were made available. EUR 440m went to the Cotonou partners (the African, Caribbean and Pacific countries), EUR 100m to South Africa and EUR 233m to Asia and Latin America.

In 2004 the European Investment Fund (EIF) - the EIB Group's specialised venture capital arm and guarantee instrument - acquired holdings worth EUR 358m in venture capital funds, bringing its aggregate portfolio to EUR 2.8bn, and provided a total of EUR 1.4bn in guarantees for SME portfolios of financial intermediaries.

To fund its lending, the EIB raised an aggregate amount of EUR 50bn on the international capital markets through 282 bond issues in 15 currencies.

As at 31 December 2004, the EIB's outstanding loans amounted to EUR 265.8bn and outstanding debt to EUR 214.8bn.

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EIB annual press conference

*Presenting the EIB Group's results for 2004 to the accredited international press, EIB President **Philippe Maystadt** and Vice-President **Wolfgang Roth** reviewed the Bank's performance and outlook for its main operational priorities, as well as its role as the leading international non-sovereign borrower. Within that context, particular emphasis was given to the Group's support for economic and social cohesion in the enlarged EU and to implementation of the Lisbon strategy through the Innovation 2010 Initiative (i2i).*

Both speakers also outlined the Bank's strategy of focusing on value added, i.e. more quality than quantity, rather than growth for the sake of growth. This means that, for all operations that it finances, the Bank ensures:

1. *consistency between lending operations and the priority objectives of the EU,*

2. *quality and soundness of the investment project,*

3. *particular financial benefits obtained by the use of EIB funds and the need for such benefits in order to accelerate desired investment.*

In practical terms, the EIB's objective is to limit lending growth within the EU-15 to a nominal 2% per annum, while stepping up lending in the new Member States more rapidly to reinforce the EIB's contribution to these countries' economic catching-up process. Likewise, lending to Accession and Candidate Countries as well as to non-EU countries could continue to grow at a more sustained pace. The main lending priorities will remain the same.

The press release and a collection of background notes on key topics prepared for this event are available on the EIB website under www.eib.org/news/events.

Economic and social cohesion in the enlarged EU (EUR 28.5bn)

Fostering the EU's cohesion by contributing to the reduction of imbalances between regions is the EIB's prime task and its first operational priority. With the Union's eastward enlargement, this priority has become even more important since all of the new Member States qualify as designated assisted areas.

Within the EU-25 countries, individual loans (loans for individual projects appraised by the Bank) worth EUR 21.5bn were granted in 2004 for investment contributing to the strengthening of the economic potential of assisted areas. A further EUR 7bn was made available as credit lines (global loans) to partner banks for the financing of SME ventures and smaller-scale public investment. The total lending of EUR 28.5bn for regional development represents some 72% of the EIB's aggregate lending within the EU-25.

The main sectors of lending in regional development areas were transport and telecommunications infrastructure (accounting for 39% of the individual loans granted), investment in industry and the services sector (20%), urban infrastructure (14%) and health and education infrastructure (11%). In the new Member States the EIB continued its efforts to support foreign direct investment, as this contributes to the transfer of both know-how and capital into the region and, therefore, to the modernisation and restructuring of industry.

Cooperation with the European Commission's Regional Policy Directorate-General has been further intensified, notably in order to improve coordination of the EIB's activities with the operations of the Structural Funds that are now also available to the new Member States.

Examples

- ***Renovation of social housing in urban renewal areas in Wallonia (Belgium)***
- *Stainless steel mill in Tornio (northern Finland)*
- *Road and urban infrastructure improvements in Brandenburg (Germany)*

Innovative and knowledge-based European economy (EUR 7bn)

Examples

- ***Pharmaceutical R&D - Schering AG (Germany)***
- *R&D activities focusing on diabetes treatment - Novo Nordisk A/S (Denmark)*
- *Broadband cable telecom network Galicia (Spain)*
- *Laser for large electron-accelerating synchrotron - Sincrotrone Trieste Scpa (Italy)*

Through its "Innovation 2010 Initiative" (i2i), the EIB supports the EU's Lisbon Strategy for the creation of an information and knowledge-based economy. The EIB's target is to mobilise EUR 50bn by the end of the decade in order to increase the EU's innovative capacity and enhance its longer-term competitiveness.

For the period 2004-2006 alone, the EIB's target is to provide EUR 20bn in medium or long-term financing in the key fields of education and training, R&D and the dissemination of knowledge (launch of innovative products, processes and services, particularly in the private sector), and the creation and dissemination of ICT (hardware, content and applications, notably e-services). This package includes lending for the Quick Start Programme of the innovation part of the European Action for Growth.

So far the EIB has lived up to its commitments under i2i. By the end of 2004, total loans approved since the start of i2i

Examples

- *High-speed rail line Milan-Naples*
- *Austria - Croatia motorway (Corridor X)*
- *Prague - Dresden motorway (on Pan-European Corridor IV Berlin - Istanbul)*
- ***Madrid - Barcelona - French border high-speed rail line***

in 2000 amounted to EUR 34.4bn, and loan contracts already signed stood at EUR 24.1bn. In 2004, some 60 i2i loans totalling EUR 7bn were provided (2003: EUR 6.2bn; 2002: EUR 3.6bn).

Lending under i2i since 2000 has been divided between three key fields: R&D and downstream investment (42%); education and training for furthering employability (29%); and ICT (29%). Projects supported range across the EU-25. About three quarters of total lending has been within regional development areas, in order to help bring these less developed regions into the knowledge-based economic fold. Some 80% of the total lending has been in the private sector. With a full i2i pipeline at present, the EIB is set to meet its objective of mobilising EUR 50bn in support of the Lisbon Strategy by 2010.

Financing R&D and innovation involves different risks from those encountered in financing physical assets. The EIB has therefore gradually expanded its capacity to grant loans that entail a higher lending risk by increasing the funds allocated for its Structured Finance Facility (SFF). Loans under the SFF will be made available more widely for higher-than-usual risk operations in the field of R&D and innovation.

The EIB has also taken action to cater better for the specific financing needs of enterprises of intermediate size (mid-caps, i.e. businesses with more than 250 but fewer than 3 000 employees), particularly for financing R&D. Efforts are currently being made to further develop new financial instruments that combine loans and grants (typically from the EU, but also from national budgets), the aim being to enable more resources to be mobilised for R&D and innovation.

The European Investment Fund (EIF) supports the Innovation 2010 Initiative by taking equity stakes in venture capital funds. In 2004, the EIF acquired holdings worth EUR 358m (2003: EUR 135m), expanding its portfolio of participations to EUR 2.8bn, spread over some 200 funds operating in the EU-25. Last year's commitments, involving 15 venture capital funds, represented a good range of operations in Italy, Spain, France, the UK and Germany, as well as some operations in the new Member States. The EIF operates as a fund of funds, with a bias (two thirds of its portfolio) towards funds specialising in early-stage financing (primarily ICT and life sciences) and the high-tech sector. It is now one of Europe's largest venture capital providers in this segment. Recently, the EIF broadened its investment policy to include mid and later-stage funds. Over 80% of the resources it has invested to date has been provided by the EIB, with further capital coming from the Commission.

The venture capital market still faces a difficult environment, particularly in the early-stage segment. The participation of private investors remains fragmented, mainly because of the uncertain economic situation and strong risk aversion. In such difficult times the EIF's presence in the market is all the more important as a stable source of funds and thus in helping to attract private sector financing.

The EIF further assists the investment activity of SMEs indirectly by providing guarantees for the SME loan portfolios of financial institutions and public guarantee agencies. In 2004, the EIF provided a total of EUR 1.4bn in guarantees for SME portfolios, bringing its guarantee portfolio to EUR 7.7bn. These guarantees facilitate the securitisation of such portfolios or reduce regulatory capital allocation to such assets, which gives banks greater scope for lending to SMEs.

Trans-European Networks (EUR 7.9bn)

Efficient transport, energy and information networks are vital for the economic integration of the enlarged EU. In response to the successive EU initiatives identifying Trans-European Networks (TENs) in the EU-25 and the remaining Accession States, the EIB has scaled up its lending in support of TENs, which it has already been heavily involved in financing over the last 10 years. The EIB is giving particular attention to the TENs-related part of the Quick Start Programme (QSP) of the European Action for Growth. Up to EUR 25bn will be made available in the period 2004-2006 for transport TENs, particularly projects under the QSP. In special cases it will be possible for loans to be granted for up to 75% of the investment costs and for periods of up to 35 years, with flexible repayment terms.

In 2004, loans signed in support of TEN projects within the enlarged EU totalled EUR 7.9bn, of which EUR 6.6bn for transport and EUR 1.3bn for energy schemes.

Environmental protection (EUR 10.9bn)

In 2004, the EIB signed individual loans for environmental projects totalling EUR 10.9bn, of which EUR 10.4bn in the EU-25 (EUR 9.8bn in the EU-15). The EIB's target of devoting 30-35% of its total annual individual loans in the EU-25 and the Accession Countries to environmental projects was exceeded. Most of the lending was directed to the urban environment (EUR 6bn), i.e. urban transport and urban renewal.

The EIB has attached greater importance to renewable energy. At the International Conference for Renewable Energy in Bonn (2004), the EIB pledged to increase renewable energy's share of total new electricity generation capacity financed by the Bank in the EU from some 15% at present to 50% by 2010, including a greater share for non-wind power. This is in line with the EU's target to increase renewable energy's share of electricity generation in the EU-25 to 22% by that time. The EIB, in furtherance of the EU's Lisbon Agenda, is also considering funding renewable energy projects involving new and innovative technologies that, although not meeting the Bank's standard criteria for economic viability, can demonstrate that they have the potential to become economically viable within a reasonable timeframe.

In support of climate change policies, the EIB launched new initiatives in 2004: the EUR 500m Climate Change Financing Facility to assist European businesses participating in the EU's Emissions Trading Scheme inaugurated in January 2005; the EUR 10m Climate Change Technical Assistance Facility, providing conditional grant finance for the identification of projects in transition and developing countries that are linked to the Emissions Trading System; and the Pan-European Carbon Fund, which is intended to support the trading of emission rights and is under detailed discussion with the EIB's cooperation partner, the World Bank.

The EIB's approach to environmental protection and climate change is set out in the Bank's Environmental Statements (2003 and 2004), which have been published on the Bank's website.

Support for EU development and cooperation policies (EUR 3.5bn)

In 2004, lending under FEMIP totalled a record EUR 2.2bn, split between four key fields: the private sector (33%), transport (30%), energy (25%) and the environment (8%). FEMIP aims to develop the private sector and social and economic infrastructure in the Mediterranean Partner Countries, with a view to preparing

Examples

- *Extension and upgrading of Vienna's main wastewater treatment plant (Austria)*
- ***Offshore wind farm in south-east Denmark***
- *Modernisation and extension of public transport network in greater Lyon area (France)*

• *The EIB has attached greater importance to renewable energy*

• *Lending under FEMIP totalled a record EUR 2.2bn*

Examples

- ***Construction of a gas pipeline between Egypt and Jordan***
- *New power plant in Mauritania*

them for the Euro-Mediterranean free trade area envisaged by the Barcelona Process for 2010. The Facility provides the business community (including foreign investors) with access to financial products that are not easily available in the region (long-term loans, risk-sharing finance, risk capital and funding for technical assistance).

In the ACP (African, Caribbean and Pacific) countries, 2004 was characterised by a slowdown in activity, reflecting the economic situation in the ACPs, a halt to lending in countries such as Côte d'Ivoire and Zimbabwe, and the constraints linked to the Cotonou Agreement. Perceptions of high risk and administrative obstacles hampered foreign direct investment. However, potential projects are increasingly being identified and the environment for private sector investment in the ACP countries is steadily but surely improving.

EIB lending for projects located in Asia and Latin America totalled EUR 232.9m, of which EUR 167.3m in Latin America and EUR 65.6m in Asia.

Borrowing activities in 2004

The EIB strengthened its leading role in the international bond markets. The volume of borrowing increased by 18% to EUR 50bn, raised through 282 transactions in 15 currencies. Issuance in EUR (35% of total funding) and USD (36%) provided the largest share, followed by GBP (19%). The three core currencies (EUR, GBP, USD) thus together accounted for 90% of funding. Currency diversification continued, with issuance in 12 additional currencies (10% of funding), mainly those of new and future EU Member States.

In its funding strategy, the EIB continued to pay close attention to quality of execution and secondary market performance, which helped EIB bonds remain a stable store of value. In addition, the Bank stayed responsive to opportunities for targeted and structured issuance. This strategy enabled the Bank to increase its issuing activity substantially, while playing a pathfinder role, notably by developing new areas of long-dated issuance, inaugurating issuance in new currencies and reviving issuance in dormant segments. The market's positive response to the Bank's funding strategy was underlined by the exceptional range of top awards bestowed on the Bank for its funding activities (see box).

The EIB, as the European Union's financing institution contributing to the achievement of the Union's policy objectives, feels duty-bound to be highly transparent and provide a maximum of information

Benchmark issuance delivered improved liquidity and a wider range of maturities for investors. About 25% of total funding in 2004 was in maturities of ten years or longer. In EUR, a pioneering new 15-year issue for EUR 4bn created a long-dated benchmark segment alongside leading sovereigns. It contributed significantly to diversification of the investor base in Europe, notably among long-dated investors such as insurers and pension funds. In USD, the Bank was unique among international borrowers in issuing in all key benchmark maturities from two to ten years. This also helped to diversify the investor base. USD placings with US investors grew, with on average one-third of USD benchmark issues being placed with US accounts. In GBP, the Bank doubled the number of benchmark taps and provided liquidity in maturities up to 2054.

The Japanese market remained a large source of funding, for issues in JPY as well as in foreign currencies. The stronger regional presence in non-core dollar markets benefited from the revival of dormant segments, notably in AUD and CAD. The Bank also doubled its issuance in ZAR, reinforcing its position as the largest foreign issuer. A further source of diversification came from issues in synthetic Turkish liras and Russian roubles, where cash flows are denominated in USD.

Another important area of development was in currencies of new and future EU Member States, where issuance amounted to EUR 1.2bn. In this region the Bank not only strengthened liquidity and offered a wider range of maturities, but also issued in three new currencies (the Maltese lira, Slovenian tolar and Bulgarian lev), in each case being the first AAA-rated or sovereign-class issuer other than the national government. As in previous years, the Bank was the largest issuer in the new and future Member States other than local sovereigns. The further growth in local currency borrowing also supported EIB lending activity and the Bank's position as the largest lender in the region.

Transparency

The EIB, as the European Union's financing institution contributing to the achievement of the Union's policy objectives, feels duty-bound to be highly transparent and provide a maximum of information. As a bank, however, it also has a duty to protect the legitimate commercial and market-sensitive interests of its clients. Between these two interests, the EIB has to strike a balance. Establishing transparency is an ongoing process. In recent years the EIB has made great progress; efforts to improve transparency will continue.

The guiding principles of the Bank's transparency policy were laid down in "Transparency - Report and Prospects", which was published on the EIB's website in 2004. This document reviews the Bank's public information policy and proposes wide-ranging enhancements. A second key document, also published on the Bank's website in 2004, is the "Statement on Governance at the EIB".

Greater transparency also fuels the dialogue with civil society, in particular non-governmental organisations (NGOs), which, as public-interest groups, have a valuable input into policy development. They help to ensure that institutions such as the EIB are sensitive and more aware of local issues and can provide useful additional information at project level.

Borrowing Activities : 2004 Awards

The Bank received an exceptional array of awards for its funding activities in 2004. There were several awards from IFR, widely considered to be the Oscars of the capital markets. Not only did the Bank receive the top award among all borrowers in all asset classes globally, 'Borrower of the Year', but also separate awards for best borrower in Europe and among Supranationals/Sovereigns/Agencies globally. These are 3 of the 8 flagship IFR awards accorded to borrowers globally, an unprecedented number for the Bank and exceptional in the market. In addition, the Bank's 15-year EUR benchmark received an IFR award for best bond issue among Supranationals/Sovereigns/Agencies. Furthermore, the Bank received multiple awards in the poll conducted among market participants by Euroweek, including the flagship awards for 'Most Impressive Borrower' and 'Most Innovative Borrower' (in both cases ranked 1st), 'Most Aggressive Borrower on Pricing' (ranked 3rd), as well as 'Deal of the Year' and several other awards.

From IFR, based on extensive feedback from market participants:

• Borrower of the Year (for all borrowers and asset classes globally)
• European Borrower
• Agency/Supranational Borrower
• Supranational/Sovereign/Agency Bond (EUR 4bn EARN 04/2020)

From poll conducted by Euroweek among market participants:

• Most Impressive Borrower of 2004
  – No.1: European Investment Bank
• Best Supranational/Agency
  – No.1: European Investment Bank
• Most Innovative Borrower
  – No.1: European Investment Bank
• Most Aggressive Borrower on Pricing
  – No.3: European Investment Bank
• Overall Deals of the Year
  – No.1: EIB, EUR 4bn 4.625% April 2020, ABN Amro, Citigroup, Deutsche Bank
  – No.5: EIB, USD 1.5bn 4.625% May 2014, JP Morgan, Morgan Stanley, UBS
• Deals of the Year by Category
- Category: USD Sovereign/Supranational/Agency:
  – No.1: EIB, USD 1.5bn 4.625% May 2014, JP Morgan, Morgan Stanley, UBS
- Category: EURO Sovereign/Supranational/Agency:
  – No.1: EIB, EUR 4bn 4.625% April 2020, ABN Amro, Citigroup, Deutsche Bank
• Deals by Currency
- Category: New Zealand Dollar:
  – No.1. EIB, NZD 200m 6.5% September 2014, RBS (only deal voted)
- Category: Emerging Markets:
  – No.2: EIB, HUF 46bn 9% July 2007, Deutsche Bank

From Euromoney:

• Best Supranational Borrower in Western Europe 2004

From MTN-I, for issuance in structured and plain vanilla format using the MTN issuance programme:

• Innovation and Achievement Award 2004

• 3 Deals of the Year
  – JPY 50bn Japanese CPI-Linked Notes
  – EUR 190m/EUR 250m CMS Spread Target Redemption Notes
  – EUR 625m CMS Periodic Capped Floating-Rate Notes

The 2005 EIB Conference on Economics and Finance, held on January 20, was devoted to public-private partnerships - or PPPs for short - as an alternative way to finance and provide infrastructure services. The conference brought together researchers and practitioners from numerous countries and institutions to shed light on a topic at the heart of the EIB's mission. Having been closely involved in the development of the European PPP market over the past decade and a half, the EIB has an obvious interest in following and contributing to the evolving analysis of the economic pros and cons of PPPs. To this end, the conference covered topics related to the economic role of infrastructure; the economics of infrastructure finance and provision; and experiences of countries in applying PPPs.

Innovative financing of infrastructure:

the role of Public-Private Partnerships

by Timo Välilä
Economic and Financial Studies

The conference day commenced with an overview of the long-term evolution of European infrastructure investment and its possible economic repercussions. **Timo Välilä** of the EIB's Economic and Financial Studies division described trends in public and private infrastructure investment over the past three decades. As a share of GDP, public investment has trended down in all non-cohesion countries, with the EU-15 average almost halving from 4.5 to 2.5 percent of GDP since the early 1970s. The decline has been particularly steep in Austria, Belgium, Denmark and the UK, but even in those countries the stocks of public capital assets have not been eroded. This suggests that the current level of public investment, while significantly lower than earlier, remains high enough to cover the depreciation of public capital. Even so, the stocks of public capital have been surpassed by public debt in most EU-15 countries in the course of the past two decades, suggesting that persistent fiscal problems have eroded the net worth of governments. Against the background of such fiscal problems, the emergence of privately financed infrastructure as an alternative to public infrastructure investment is hardly surprising. Although private infrastructure finance through PPPs has spread across Europe, its magnitude and systemic importance remain small to-date. Only in the UK and Portugal are PPPs significant in terms of both the number of projects undertaken and their size relative to public investment. All in all, the conclusion that emerges is that while the declining public investment and emerging private investment through PPPs have been important developments qualitatively speaking, their quantitative importance should not be exaggerated.

Turning to the economic impact of infrastructure investment, **Jakob de Haan** of the University of Groeningen in the Netherlands distilled some lessons about the link between public investment and economic growth from a review of a large body of empirical studies. Such studies face numerous challenges, including the specification of how exactly infrastructure affects growth: does a road boost growth because it is a production factor in its own right; because it boosts total factor productivity; or because it lowers transportation costs? Further challenges arise from the presence of non-linearities in the relationship between public investment and growth due to congestion and network effects; from spill-over effects, with neighbouring countries' infrastructures affecting one another; and from the fact that not only does public investment affect growth, but the causality might also run in the opposite direction. All such challenges aside, de Haan concluded that there is some consensus in the more recent literature that public investment does indeed stimulate economic growth, but that the impact is much smaller than suggested in earlier literature. In addition, there is evidence that the causality between infrastructure investment and growth runs both ways, and that the magnitude of that impact varies significantly between countries, regions and sectors. De Haan concluded by listing the optimal size of public capital stocks; determinants of public investment; and the role of infrastructure maintenance among possibly fruitful avenues of future research.

The second session of the conference focused on the economics of infrastructure finance and provision. To set the stage for subsequent presentations, Timo Välilä reviewed the main economic issues relating to PPPs from both microeconomic and macroeconomic perspectives. The fact that a PPP combines a public policy objective of the public sector with the profitability (cost efficiency) objective of the private sector may, under certain circumstances, allow the supply of infrastructure services at lower cost than traditional public provision (i.e. "value for money" is created). Preconditions for the superiority of a PPP include the contractibility of the service in question; importance of adopting technological innovation for cost efficiency; absence of too strong a negative impact of cost efficiency on service quality; and the presence of positive synergies between the various phases of the project. The fulfilment of these conditions can imply microeconomic (project-level) gains from choosing the PPP option, but there is no automatic way by which such microeconomic gains translate into macroeconomic benefits, notably higher economic growth, as there is no guarantee that the resources "freed up" by cost savings for other purposes are used in a productive way. For that reason - and also because the current accounting rules for

Timo Välilä

Jakob de Haan

Mathias Dewatripont

Patrick Legros

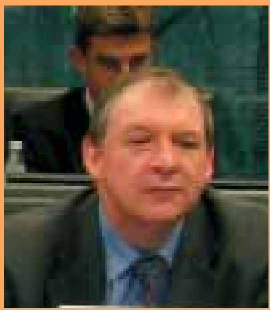
Paul Grout

PPPs may introduce an unwarranted bias in their favour - macroeconomic considerations should not play a role in choosing between traditional public procurement and a PPP; that choice should be based on microeconomic cost efficiency considerations only.

Mathias Dewatripont and **Patrick Legros** of Université Libre de Bruxelles elaborated on conceptual issues relating to risk transfer and contract design in the context of PPPs. Recognising the positive role of outside finance in assessing and monitoring projects, they stressed that outside equity may also compromise the private partner's incentives to put in effort to deliver high-quality services, as part of the return on such effort accrues to outside equity investors. That risk is smaller, though, in the case of outside debt finance due to the absence of dividend payments. As regards the design of PPP contracts, Dewatripont and Legros focused on how contract design can impact the occurrence of cost overruns. They concluded that while the tightness of contract design (completeness of contract) may reduce cost overruns, it does not necessarily reduce total costs, as competition for the market is reduced by tightening the contract design. This possibility lends further support to the desirability of an outside project monitor, such as a big debtholder, who has strong incentives to monitor the project, but whose presence does not have a major negative impact on the private partner's incentives to exert high levels of effort.

Turning to the measurement of value for money, **Paul Grout** from the University of Bristol in the UK summarised an array of possible value for money tests and analysed their pros and cons. Such tests can, according to Grout, be broadly classified into full cost-benefit tests; comparisons of only costs between the public and private (PPP) alternatives; comparisons of available private alternatives; and viability tests of a specific project. Most countries conducting explicit value for money assessments use comparisons of costs only between the public and PPP alternatives, often making adjustments for quality differences between them. This type of test relies on the construction of a public sector comparator, which is notoriously difficult. A major potential source of error is the discount rates chosen for each

Armin Riess



Campbell Thomson

Patricia Leahy

Rui Sousa Monteiro

Christian von Hirschhausen

The 2005 EIB Conference served the interests of not only the Bank, but many policymakers and private sector participants alike

set of flows. Such problems are alleviated or even eliminated if the comparison is limited to the available private alternatives. The benefits of this type of test are the greater, the more competition can be ensured at the bidding stage. Conversely, in the absence of competition at the bidding stage, the public sector comparator becomes critical - and particularly difficult to get right. As the risk of undertaking an unviable project is likely to be greatest in this case, a viability test just considering the net present value of the project might be the best available option.

The afternoon session of the conference sought to derive some lessons from practical experiences with PPPs. **Armin Riess** of the Economic and Financial Studies division of the EIB posed the question whether the PPP model is applicable across sectors. Whether the provision of a public service benefits from bundling the building and service provision stages - i.e. whether a PPP is superior to traditional public procurement - depends on a variety of criteria. Of particular importance are: the ease of contracting on the service; the scope for financially profitable and socially beneficial cost saving; and the scope for financially profitable but socially harmful (i.e. quality-reducing) cost saving. Based on these criteria, Riess argued that bundling may be superior in the case of roads, bridges, tunnels, water and waste disposal and non-core services in sectors such as health and education (hospital or school accommodation, cleaning, catering, etc.). In contrast, the provision of core services in the health, education and prison sectors (clinical, education and penal services, respectively) as well as IT services might not be good candidates for PPPs due to the difficulty of contracting on them. Rail networks might also not qualify for bundling because of possibly negative synergies between the building and operating phases (investment in safety, while socially beneficial, would

increase costs). When comparing these suggestions with the real - world occurrence of PPP projects, Riess pointed out that there is some mapping between the conceptual criteria for bundling and the real world - especially outside the UK - but this mapping has not necessarily come about as a result of economic considerations alone.

Campbell Thomson of Operations Evaluation at the EIB presented the findings of an evaluation of PPP projects financed by the EIB. He emphasised that the EIB is neutral on the question of whether projects are procured by PPP or traditional public procurement, in line with EU policy, but the use of PPPs is seen as a means of attracting private sector funding into the provision of public infrastructure, providing the economic fundamentals of the project are sound. A number of potential benefits from EIB involvement in the process were identified, both financial (availability and cost of EIB funding; longer loan maturity) and non-financial (project validation and catalytic effects; skills transfer; and possible political effects). On the question of how EIB-financed PPP projects have performed, Thomson concluded that the projects were more likely to be implemented on-time and on-budget, but that there was evidence that optimistic demand forecasts were compromising the efficiency and financial sustainability of some projects. However, the key finding of the evaluation was that, in reality, the choice was not so much between a PPP and traditional public procurement, but between a PPP project and no project, at least in the short to medium term. Key factors for success were the level of competition and the clarity of the project's specification.

Focusing on lessons from the UK experience, **Patricia Leahy** of the National Audit Office of the UK distinguished between organisational and transactional success factors. The former include the clarity of the PPP framework, responsibilities and processes; experience in the public sector; and the effectiveness of how the partnership is managed over time. Transactional success factors, in turn, include the clarity of contractual requirements and service standards; encouragement of innovation in meeting such standards; and the optimality of risk allocation. Sectors where PPPs have been successful in the UK include prisons, roads, property, and accommodation services in the health and education services - in other words, in major capital projects needing maintenance. In contrast, PPPs have not worked in IT projects or in projects with disproportionately high transaction costs.

Rui Sousa Monteiro of Parapública SA reviewed the Portuguese PPP experience to-date. While PPPs have enabled an acceleration of infrastructure development and an improvement of service to end-users in Portugal, they have also encountered delays and cost overruns; suffered from suboptimal risk sharing; and raised the issue of their long-term affordability from a fiscal policy viewpoint. To improve the PPP framework, institutional changes have been initiated, including the creation of a PPP unit at the Ministry of Finance; the construction of a public sector comparator has been made a requirement; and measures have been taken to foster competition in procurement. Sousa Monteiro emphasised that PPPs have not only contributed to the provision of infrastructure in Portugal, they have also acted as a vehicle for public sector reform by focusing the public sector on performance and end-user satisfaction.

Christian von Hirschhausen of the Berlin University of Technology and DIW Berlin explored the use and potential of PPPs in new EU Member States. Against the background of vast needs for infrastructure renewal and expansion, combined with tight public finances, PPPs could appear attractive in these countries. However, von Hirschhausen pointed out that structural reforms in infrastructure sectors have generally been slow; changes of government and, e.g., transport policy frameworks have been frequent; and infrastructure planning has not been done at a network level. Consequently, PPP projects undertaken so far have been characterised by frequent renegotiations, cost overruns, and overall short-termism. Nevertheless, there is some evidence that the relevant political and economic institutions are becoming more stable over time and that PPPs, in comparison with traditional public procurement, are gaining ground.

Taken together, these presentations and the lively discussion that they inspired went some way in articulating and clarifying the conditions under which public-private partnerships may be a viable option to traditionally procured public investment projects. In so doing, the 2005 EIB Conference served the interests of not only the Bank, but many policymakers and private sector participants alike.

The proceedings of the conference will be published in the tenth volume of EIB Papers, which will be available in June 2005 and can be ordered free of charge from infoefs@eib.org or accessed via the Internet at www.eib.org/efs.

The financing of Trans-European Networks (TENs)

As the financing institution of the European Union, the EIB plays a key role in funding the trans-European transport and energy networks (TENs) and their access systems. The development of these networks is a vital factor in the Union's economic and social integration and the advancement of its less favoured regions. Accordingly, TENs are included among the Bank's priority objectives.

*by Juan Manuel Sterlin Balenciaga
Communication and Information Department*

Since 1993, when the EU Member States agreed in the Maastricht Treaty on the need to develop Trans-European Networks (TENs), the Bank has become the leading source of bank finance for such investments, lending over EUR 71 billion. The EIB has been involved in the implementation of 12 of the 14 priority transport projects and 8 of the 12 priority energy TENs schemes pinpointed by the Essen Council in December 1994.

Large-scale involvement

Over the last 10 years, the EIB has made a significant contribution to the expansion of these networks in the Union by financing projects in all sectors: roads (road and motorway construction and upgrading in Greece, Portugal and Spain); rail (construction of high-speed lines in France, Belgium, the Netherlands, the UK, Spain and Italy); ports (expansion or modernisation of port infrastructure in Spain, Greece, the Netherlands and Sweden); airports (upgrading of airport facilities in Italy, Greece, Germany and Ireland) and energy (production and transmission of electricity or gas in the UK, Italy, Ireland and Denmark).

Over the last 10 years, the EIB has contributed enormously to the expansion of these networks in the Union by financing projects in all sectors: roads, rail, ports, airports and energy

This drive inside the European Union is matched by the EIB's activity outside the EU. In line with the strategy set out by the pre-accession agreements and the Pan-European Conferences of Transport Ministers in Crete (1994) and Helsinki (1997), the Bank has devoted over 40% of its lending in the Accession States to solving communications problems. Thus, loans have been advanced for the construction and upgrading of roads and motorways in Poland, Slovenia, Bulgaria and Romania, the rehabilitation of railway lines in Hungary and the Czech Republic and the modernisation of port infrastructure in Latvia and airports in Lithuania and Estonia.

More broadly, in the context of the new "European Neighbourhood Policy" and the Facility for Euro-Mediterranean Investment and Partnership (FEMIP), the Bank is also financing a number of transport and energy projects contributing to the improvement of communications links between the enlarged Union and its neighbours.

EIB "value added" for TENS

The EIB has developed a specific approach to financing such projects, which require significant funding as well as a comprehensive technical and environmental input. In addition to bringing to bear its substantial financial capacity, focused on the very long term (25 years or more), the Bank is able to enhance a project's financial environment by offering pre-financing and repayment terms tailored to the project cycle, taking account of prior studies, conducting financial engineering to enable risks to be shared with other investors and mobilising other sources of bank finance (or EU grants) in the assembly of effective financing packages.

The catalytic effect of the Bank's input is most evident in the case of projects structured as public-private partnerships (PPPs), which combine the inherent advantages of both sectors in the creation of such infrastructure. Through its financing of PPPs, the EIB also plays an essential role in helping the Member States to build their organisational capacity in this area.

The Action for Growth and the 30 priority projects

The EIB was actively involved in the preparation of the European Action for Growth. Adopted by the Brussels European Council in December 2003, this initiative aims to strengthen Europe's long-term growth potential through increased investment in TENs, as well as in innovation and R&D.

In the TENs sector, the European Action for Growth has identified 30 new priority projects totalling an estimated EUR 600 billion. These projects were selected on the basis of their long-term strategic importance for the integration of the internal market in the enlarged Union, along with their degree of maturity, economic and financial viability, impact on growth and leverage effect on private capital. Most of the new priority projects are rail schemes (21 of the 30), but road, port and airport schemes are also included.

In addition, the Commission's priority list of TEN-Energy projects (TEN-E) comprises a total of 10 electricity and natural gas transportation schemes, ranging from small cross-border power links to transcontinental gas pipelines.

Within this renewed framework, the Bank has established a new TENs Investment Facility (TIF) designed to invest EUR 50 billion in this sector by the end of the decade, half of which by end-2006 for the most advanced of these projects.

The Bank's operations will involve both conventional long-term lending with very long maturities and appropriate grace periods and the introduction of pioneering financial instruments designed to address the risk issue and hence serve as a catalyst for private-sector investment in TENs financing. These instruments include in particular:

- A **Structured Finance Facility** (SFF), with a reserve of EUR 500 million (of which EUR 100 million for projects in the Mediterranean region), for financing private, public or semi-public special purpose vehicles (particularly in cross-border PPP projects) on a risk-sharing basis.
- With the support of the Community budget, the EIB has created a **TENs Risk Capital Facility**, endowed with EUR 90 million, to assist projects directly (in the case of very large-scale projects) or via specialised venture capital companies which the Bank helps to set up and which can inject equity into transport infrastructure projects and offer additional gearing to that provided by banks.
- **Guarantee** schemes especially tailored to large-scale TENs projects. To this end,

EIB operations in support of Trans-European Networks and corridors in neighbouring countries 1993-2004

in addition to EIB guarantees, the Action for Growth provides for the creation of a Community Guarantee Instrument for TEN-transport, financed from Community resources, to provide additional support for projects as traffic "ramps up" right after project completion. The European Commission is currently finalising a proposal to the Council on the Instrument, which is expected to be approved in 2005.

• Support for **capital market financing of TEN projects** and in particular infrastructure **securitisation**, a procedure by which an operator sells in advance the revenues generated by an investment in return for the pledging of the project's assets and remuneration of the risk borne by the investor providing the funds. Such arrangements are increasingly being used to pre-finance transport infrastructure, e.g. Metronet for the renovation of the London Underground, two sections of the London-Channel Tunnel rail link (CTRL), ISPA for the Italian TAV (high-speed) rail network, and the purchase of rail freight wagons by AAE. The EIB is closely monitoring these mechanisms and occasionally participates as an investor or guarantor. The next step would be to assist the creation of securitisation trusts making it possible to co-finance TENs projects on an ongoing basis within a group of committed investors. The Bank is currently in exploratory talks with a number of potential partners (monoline insurers, pension funds, banks, etc.) to gauge market interest in this type of arrangement.

The EIB and PPPs

PPPs represent a new approach to building infrastructure and delivering public services. Their main attraction lies in the increased efficiency and effectiveness achieved by sharing a project's risks, which are shouldered by those best able to manage them: the construction and operational risks are borne by private enterprise, while public authorities take on the responsibility for establishing and maintaining a balanced legal and economic framework throughout the life of the project. In addition, PPPs enable public authorities to create public service infrastructure while staggering the burden of their investment over time and, in certain cases, allowing off-balance sheet commitments.

The vast majority of the EIB's PPP lending is concentrated in the transport sector (85% of total approvals) and health and education (13%). Water/sanitation and energy (2%) are the two other main PPP sectors.

The EIB has invested some EUR 17.4 billion in a range of transport PPPs such as (to mention only a few important road and rail projects): toll motorways in Portugal; numerous motorways in Spain; the Rion-Antirion bridge in Greece; the Millau viaduct in France; the Dutch section of the PBKAL high-speed train; the Øresund link between Denmark and Sweden; the renovation of the London Underground and the A2 motorway in Poland.

In this area, the Bank works in close cooperation with the main players in this type of project: the European institutions, public authorities and the private sector. In addition, the Bank has set up a dedicated inter-directorate unit enabling it to play to the full its role of giving advice and transferring know-how in the structuring of PPPs.

*NB: a new publication on "**The role of the EIB in Public-Private Partnerships (PPPs)**" is available on the EIB's website at: http://www.eib.org/publications/publication.asp?publ=189*

This briefing paper mainly addresses the following topics:

- *the lessons drawn by the Bank from the financing of PPPs;*
- *the issues to be resolved in the establishment of national PPP programmes;*
- *the catalytic role that the Bank can play in this form of private sector financing of public infrastructure services.*

The 30 priority transport projects

1	*High-speed train/combined transport north-south (Berlin-Erfurt-Halle/ Leipzig-Nuremberg & Brenner axis Munich-Verona & Messina bridge)*
2	*High-speed train PBKAL (Paris-Brussels-Cologne-Amsterdam-London)*
3	*High-speed train south (Madrid-Barcelona-Perpignan-Montpellier & Madrid-Vitoria-Dax- Bordeaux-Tours & Lisbon/Porto-Madrid*
4	*High-speed train east (Paris-eastern France-southern Germany including Metz-Luxembourg branch)*
5	*Conventional rail/combined transport: Betuwe line (Rotterdam-Dutch/German border- Rhine/Ruhr)*
6	*High-speed train/ combined transport, France-Italy-Slovenia-Hungary (Lyons-Turin & Turin-Milan-Venice-Trieste-Koper-Dikava & Ljubljana-Budapest)*
7	*Greek motorways (Pathe & Via Egnatia) & Sofia-Kulata - Greek/Bulgarian border motorway & Nadlac-Sibiu motorway*
8	*Portugal/Spain multimodal link*
9	*Conventional rail link Cork-Dublin-Belfast-Larne-Stranraer*
10	*Malpensa airport, Milan*
11	*Øresund fixed rail/road link between Denmark and Sweden*
12	*Nordic triangle rail/road*
13	*Ireland/United Kingdom/Benelux road link*
14	*West coast main line (rail)*
15	*Galileo*
16	*Freight railway line Sines-Madrid-Paris*
17	*Railway line Paris-Strasbourg-Stuttgart-Vienna-Bratislava*
18	*Rhine/Meuse-Main-Danube inland waterway route*
19	*High-speed rail interoperability on the Iberian peninsula*
20	*Fehmarn Belt railway line*
21	*Motorways of the sea*
22	*Railway line Athens-Sofia-Budapest-Vienna-Prague-Nuremberg/Dresden*
23	*Railway line Gdansk-Warsaw-Brno/Bratislava/Vienna*
24	*Railway line Lyons/Genoa-Basel-Duisburg-Rotterdam/Antwerp*
25	*Motorway route Gdansk-Brno/Bratislava/Vienna*
26	*Railway line/road Ireland/United Kingdom/continental Europe*
27	*"Rail Baltica" line Warsaw-Kaunas-Riga-Tallinn*
28	*"Eurocaprail" on the Brussels-Luxembourg-Strasbourg railway line*
29	*Railway line of the Ionian/Adriatic Intermodal Corridor*
30	*Inland waterway Seine-Scheldt*

The 10 priority electricity and natural gas transportation projects

Electricity	
1	*France-Belgium-Netherlands-Germany: electricity network upgrading in order to resolve congestion in electricity flow through the Benelux.*
2	*Borders of Italy with France, Austria, Slovenia and Switzerland: increasing electricity interconnection capacity.*
3	*France-Spain-Portugal: increasing electricity interconnection capacity between these countries and for the Iberian peninsula and grid development in island regions.*
4	*Greece-Balkan countries-UCTE System: development of electricity infrastructure to connect Greece to the UCTE System*
5	*United Kingdom-Continental Europe and N. Europe: establishing/increasing electricity interconnection capacity and possible integration of offshore wind energy.*
6	*Denmark-Germany-Baltic Ring (including Norway-Sweden-Finland-Denmark-Germany): increasing electricity interconnection capacity and possible integration of offshore wind energy.*
Natural gas	
1	*United Kingdom-Northern Continental Europe, including Netherlands, Denmark and Germany-(with connections to Baltic Sea Region countries)-Russia: gas pipelines connecting some of the main sources of gas in Europe, improving the interoperability of the networks, and increasing the security of supply.*
2	*Algeria-Spain-Italy-France-Northern Continental Europe: construction of new gas pipelines from Algeria to Spain, France and Italy, and increasing network capacity in and between Spain, Italy and France.*
3	*Caspian Sea countries-Middle East-European Union: new gas pipeline networks to the European Union from new sources, including the Turkey-Greece, Greece-Italy and Turkey- Austria gas pipelines.*

The EIB is committed to continuing its current role as a significant source of long-term finance for the water sector throughout the EU-25 to fund capital investments that comply with EU objectives. In the United Kingdom, the EIB's finance diversifies the funding available to the sector, the cost of which is incorporated in the WACC by the Regulator and helps the sector meet the substantial investment challenges of continued improvement in public services and environmental standards.

by Thomas C Barrett, Director, Directorate for Lending Operations in Europe

EIB financing for the water sector in the UK

The European Investment Bank (EIB), as the long-term financing institution of the EU, is driven by the policy objectives of the European Union. In the field of the environment, notably in the water sector, the Bank finances projects that protect and improve the natural and built environment and promote sustainable development. In 2004, EIB lending to the water sector (EUR 2.1 billion) accounted for 5% of its total lending of EUR 43.2 billion.

The EIB has been a major source of financing for the UK water industry since the 1970s, both before and after privatisation in 1989. The EIB's policy in the UK water sector is to allocate its financing to capital investments that comply with environmental objectives as set out by the Drinking Water Inspectorate and the Environmental Agency, which in turn reflect the common standards agreed by all EU Member States in EU Directives. The aim of the investments selected is to ensure that borrowers can implement national and EU environmental standards. EIB finance can also be utilised for major sector investments that contribute to the economic development of areas classified as regional development areas. The Bank has financed investments that meet these objectives with all ten water and sewerage companies in England and Wales. Comparable investments in Scotland and Northern Ireland are also under consideration.

In its determination published in December 2004 for the upcoming regulatory period 2005-2010, OFWAT, the UK Water Regulator, gave weight to ensuring customer benefits through reduced tariffs as well as ensuring the sector's ability to finance its requirements through the debt and equity markets and maintaining a solid investment-grade rating. The Bank expects the industry's aggregate cash flows to remain inherently stable and predictable. Nevertheless, the challenges for the industry are very substantial given the continuing need to undertake additional investment and to achieve increased operational efficiencies consistent with health and safety requirements. While the underlying business risk of the sector can be considered low as a result of the regulatory framework, the actual outcome of each company in the coming regulatory period will nevertheless vary and remain highly dependent on the individual performance and managerial effectiveness of each company.

Following OFWAT's price review for 2000-2005, which strongly emphasised tariff reductions, a variety of financing models emerged for the sector that aimed to use increased levels of debt financing given the perceived low return on equity. The result of both these developments was that the sector's credit quality gradually slipped and the rating agencies downgraded their assessments from mid to high single A ratings to a mid and low single A range, in some cases down to the BBB category. Due to this development, the regulated water companies can now be broadly divided into three clusters (i) companies with the

traditional equity model with ratings in the single A range, (ii) a middle layer with ratings falling to triple B, but still based on the equity model, and (iii) the low or non-equity highly geared companies. The EIB has monitored this evolution of the sector and, subject to investments meeting the Bank's policy objectives, will continue to do so as the Bank can add value and assist the sector in achieving its objectives as it is one of the least-cost providers of long-term funding and contributes to the diversification of funding for the industry. In addition, the benefit of the EIB's long-term financing in lowering the overall cost of capital is ultimately passed on to the consumer throughout the WACC set by the Regulator and is reflected in consumer tariffs.

The water sector will be challenged further in the future by the more stringent EU standards envisaged by the Water Framework Directive. The Directive establishes the objective of achieving higher minimum ecological quality of inland surface water, transitional waters and groundwater by 2015. The ramifications of the volume of investment that will be required by the UK water industry are still being investigated. But it is likely that substantial additional investment will be required to increase the level of tertiary treatment, reduce the frequency of storm overflows and the impact of resource abstractions on rivers with low flows. The Directive's introduction of incentives for more efficient water use may also encourage higher levels of customer metering. Some commentators are indeed concerned that the objectives are so extensive that there may be insufficient time to meet them by the 2015 deadline.

In the future, the focus of EIB lending for the water sector will continue to be on the new EU Member States as well as others that require major investment to catch up with EU Environmental Standards. The UK water industry sees an important continuing role for the EIB in the sector in line with EU objectives. The EIB is prepared to continue its financing role in partnership with the UK water companies in so far as this shows continued value added as already achieved by investment in higher standards over the last 30 years since the UK joined the European Union. ◻

New publication: The EIB and the water sector

A new publication on the EIB and the water sector is available in the Publications section of the EIB website (www.eib.org/publications). This document outlines the Bank's policy in the water sector and its activity in this domain, both within and outside the EU.

Over the past 10 years, from 1995 to 2004, EIB finance totalling EUR 15 billion - one fifth of all the Bank's "environmental" loans - has been allocated to the water sector. The Bank has thus helped to carry out both public and private projects in various fields such as the supply of drinking water, water distribution, sewage disposal and wastewater treatment, as well as flood protection and coastal erosion, rainwater drainage, etc. In accordance with the EU directives, the EIB supports projects that contribute to integrated and sustainable management of natural resources.

Cooperation with the IDB in the Caribbean and Latin America

by Alberto Barragán
Head of Division
Lending Operations in Latin America

On 13 December 2004, the Inter-American Development Bank (IDB) and the European Investment Bank (EIB) signed a Memorandum of Understanding aimed at enhancing coordination between the two Institutions in Latin America and the Caribbean region.
The agreement, signed in Washington by IDB President Enrique V. Iglesias and EIB Vice-President Isabel Martín Castellá, will lead to a more focused approach on individual project financings and generate synergies between the respective functional advantages and regional specialties of the two Institutions.

Two major players in the region

The IDB is an international organisation established to promote the economic and social development of its borrowing member countries. It is the largest multilateral lender in Latin America and the Caribbean and a key provider of non-reimbursable technical assistance.

The EIB operates in Latin America under mandates from the EU Council. Under its current mandate for operations in Asia and Latin America (ALA III), the EIB may lend up to EUR 2 480 million during 2000-2006 to support projects of mutual interest to the EU and the partner countries in Asia and Latin America. EIB lending in Latin America supports mainly private sector investment projects carried out by subsidiaries of EU companies or joint ventures involving EU companies, and projects enabling high levels of technology transfer from Europe or resulting in environmental improvements and regional integration. The EIB has signed individual Framework Agreements with most Latin American countries, which regulate its relations with the local governments.

The EIB operates in the Caribbean under the Cotonou Agreement of 23 June 2000. The Cotonou Agreement provides for funding from the Investment Facility (IF) and from own resources in the ACP (African, Caribbean and Pacific) countries. The Investment Facility is financed from the European Development Fund and managed by the EIB. The EIB also uses its own resources to provide finance to promoters in ACP countries through a wide range of instruments, which can be tailored on a project-by-project basis to meet the specific needs of clients. A combination of different instruments may be used to support the same project. Resources available through the IF amount to EUR 1 700 million over the period 2003-2007. EIB own resources available for the ACP countries in the same period amount to EUR 2 200 million.

Supporting projects which contribute to the economic and social development of the Latin American and Caribbean regions

Mutual understanding and motivation

The EIB and the IDB engage in ongoing cooperation based on the parallel financing of projects. Both parties believe that deepening and extending their current cooperation, taking into consideration their respective comparative advantages, will result in the increased efficiency and effectiveness of their activities in the region.

By signing this MoU, the EIB and the IDB agree to strengthen their coordination with the aim of supporting projects of common interest which contribute, on the one hand, to the economic and social development of the Latin American and Caribbean regions, and on the other, to further facilitation of the financing of investment projects of mutual interest for Latin America, the Caribbean and the EU.

The new MoU aims to optimise the combination of the EIB's financial strength and private sector orientation with the IDB's political reach and coverage of Latin America and the Caribbean and capacity to identify and implement projects with both public and private partners.

Functional synergies are expected from the IDB's ability to use various instruments, such as loans and guarantees, to promote private sector investment in Latin America, which will allow both institutions to jointly explore possibilities for supporting private investment in the region. On the other hand, the EIB's experience with public-private partnerships in Europe and other regions, its know-how in the prioritisation and planning of investment projects and its ability to support large-scale infrastructure schemes will also be of benefit to joint activities.

Under the new MoU, the IDB and the EIB will also be able to deepen and expand their cooperation in support of regional integration strategies such as Plan Puebla Panamá and the Initiative for the Integration of South American Regional Infrastructure (IIRSA).

The combination of the EIB's access to European investors and the importance of foreign direct investment for the region will play a catalytic role. The EIB will profit from closer cooperation with the largest multilateral lender in Latin America and the Caribbean in the implementation of its corporate operational policy objective of supporting EU development and cooperation policies with partner countries.

The European Investment Bank already has a Memorandum of Understanding with the World Bank aimed at enhancing donor coordination in the Middle East and North Africa/Southern Mediterranean region (see EIB Information No 117). The text of the MoU between the EIB and the IDB is available in the publications section of the EIB's website www.eib.org. □

Economic Transition in Central and Eastern Europe

“Economic Transition in Central and Eastern Europe: Planting the Seeds”, Cambridge University Press, 2004 (362 pages), is the second book on economic transition co-authored by **Daniel Gros** (Ceps, Brussels) and EIB Chief Economist **Alfred Steinherr**. Their first book was Economic Transition in Central and Eastern Europe: Winds of Change, published in 1995 by Pearson Publishers London.

The focus then was on the burning question of “how to organise transition”? Should reforms proceed gradually or with a “big bang”? If the former, what is the sequencing of reforms? And, concretely, how to reform?

Addressing new questions

Ten years later, in the early 2000s, transition countries had experimented with all available strategies, instruments and reform goals. The research question was no longer the theoretical question “what to do?” but the empirical question “what worked and why?” This new book provides answers to that question and is thus a very useful complement to the first book rather than a substitute for it.

To assess the success or failure of reform action or inaction, the authors first attempt to measure whether transition is complete in each country. In the popular debate, transition to and convergence with Western standards of living are often considered one and the same. However, transition can be defined as a process of shedding the characteristics of a communist-type society and adopting a market-based economy embedded in a democratic society with extensive private property rights. That society could be poor, and many societies across the world are, so that higher living standards are clearly only a by-product of transition and not its essence.

The statistical tests show that transition countries fall into three categories. The first category, comprising all the central European and Baltic states, had by 2000 completed transition and as a result had already started on a vigorous growth process. These countries were also able to satisfy the membership criteria set by the European Union and duly became members on 1 May 2004. The countries of South-Eastern Europe represent a second category in which considerable progress has been achieved but much still remains to be done. All the countries of the former Soviet Union, except the Baltic States, fall into a third category. For those countries, transition is still a long path requiring substantial efforts and reforms both of political society and of the economy.

Ingredients for success

The question of the right strategy - “big bang” vs. gradualist - has also found a clear answer. Those countries that tackled reforms comprehensively and accepted democratic decision-making all fared much better than those that retained autocratic decision-making and introduced partial reforms step by step. Some countries, particularly those new countries of the former Soviet Union, started off with more difficult conditions, hampered by the need to set up the institutions of an independent state from scratch, unsure about their political future and unfavoured by geography. Geography favours small countries close to the sea and close to rich neighbours with open borders. But despite these unfavourable starting conditions, all these countries of the former Soviet Union could have done better with more determined reform efforts.

From all these points of view, central Europe was in a much more favorable position. Most of the Central European countries are small, lie close to the rich markets of the EU, have a tradition of independent states, were eager to make their future as a member of the European family and found it not difficult to accept the basic political values of the EU and their institutional embodiments. At the beginning of the reforms they eagerly copied and adopted the institutions of EU countries.

Institution-building has turned out to be the most difficult part of transition. The road map provided by the EU made the job somewhat easier. Soon the new member countries found out, however, that they could do better and, in order to accelerate convergence, had to go beyond adopting the institutions of EU member countries. For example, several Central European countries had the political courage - which no old member country has so far plucked up - to allow a large part of the domestic banking system to be controlled by foreign banks. Similarly, whilst old member countries experience difficulties in reforming their institutional set-up, new member countries showed much more flexibility in implementing uniform tax systems with a lower tax rate applied to a larger tax base.

Rapid reforms, comprehensive reforms, openness in foreign trade, welcoming of foreign investment, replacing political decisions by market decisions and accepting the rule of law: these have been the basic ingredients of success. For many specific reform measures, experience has shown that the optimal decision depends on precise circumstances. For example, for large countries such as Russia a flexible exchange rate seems to be best. That was one of the lessons of the financial crash in 1998. For small countries with very extensive trade with the European Union, a fixed exchange rate works well. Countries that have difficulties in establishing a reputation, or countries that are very small, benefit from binding their hands and establishing a currency board. De facto, countries with a currency board are for all practical purposes enjoying the benefits of membership of the European Monetary Union.

As transition is not finished in South-Eastern Europe and in the former Soviet Union, a lot still needs to be done in more difficult contexts. The book deals with these problems in detail and proposes workable solutions. □

New control structure at the EIB

As from February 2005, the EIB's Operations Evaluation (EV) and Internal Audit (IA) have been merged to form a single, autonomous department: Inspectorate General - Evaluation and Internal Audit (IG). The creation of the Inspectorate General underlines the importance attached by the EIB to its two main, independent, ex post control functions. In particular, the new structure reflects the contribution of evaluation activities to the attainment of the Bank's strategic objectives and their positive impact on operational performance, accountability and transparency.

The new department will continue to be responsible for the Internal Control Framework and all fraud investigations. Creation of the Inspectorate General will foster increased synergy between EV and IA and, in particular, a more coordinated approach to their work programmes. Moreover, in addition to current services, IG will provide, when required, an independent recourse mechanism for investigating complaints that the European Ombudsman considers to be outside his remit.

All services of the new department will be provided to the EIB Group. IG will be placed under the functional responsibility of EIB Vice-Presidents **P. Sedgwick** (for Internal Audit services) and **S. Niinistö** (for Evaluation services). In connection with the creation of this new structure, Mr **P. Maertens** has been appointed Inspector General (Head of the Department). He will report to the President and be responsible for consultation, liaison and cooperation with the Audit Committee and external bodies in accordance with IA's charter and EV's terms of reference. Mr **A. Sève** has also been appointed Head of Division (EV). □

info

The information magazine of the European Investment Bank Group

Turkish Earthquake Rehabilitation and Reconstruction Assistance (TERRA)

The Turkish Earthquake Rehabilitation and Reconstruction Assistance Facility (TERRA). An envelope of EUR 600 million was approved in 1999 and used in support of a EUR 1.5 billion reconstruction project established by the Turkish Government (EUR 450m, TERRA 1), as well as for a global loan to help restore the industrial fabric affected by the earthquake (EUR 150m, TERRA 2). The financing thus contributed to both priority rehabilitation and reconstruction work for economic infrastructure and private sector projects.

A devastating earthquake shook the Marmara region of Turkey in August 1999. Nearly three months later, another earthquake struck further to the east. As a result there were 15,000 known deaths and 29,000 injuries, with 800,000 people being left homeless and some 300,000 buildings damaged or destroyed. In addition to the loss of life and physical destruction, the economic damage was considerable. Forty per cent of Turkey's industrial base is in the earthquake region, a region well known for significant seismic activity.

In an immediate response to the disaster, the European Council adopted in November 1999 the EUR 600 million TERRA (Turkey Earthquake Rehabilitation and Reconstruction Assistance) Mandate. The financing was advanced for priority rehabilitation and reconstruction work for economic infrastructure and private sector projects in the devastated regions.

The rehabilitation works covered five provinces hit by the earthquake. The contribution for the city of Adapazari provides a very good example of the support given. Six years after the catastrophe it is remarkable to see how the city of Adapazari, one of the worst affected areas, has recovered. Although many inhabitants left the shattered place in the days and weeks after the quake, Adapazari has been rebuilt and is today a thriving modern city, owing to well-targeted measures and substantial financial aid from the EIB. Reconstruction work started in the immediate aftermath of the disaster. Destroyed buildings were rebuilt according to earthquake-safe standards, limiting the damage of a possible future quake. The old city has thus been reconstructed and in addition a new city has been built 10 km to the north on land that is much more earthquake-proof from a geological point of view, the old and the new part of the city being linked by a boulevard.

During the last five years, the EIB has helped the region with its funding and by providing specialists in urban planning and architecture. Today, Adapazari's population is steadily increasing and its economy is growing faster than it did in the years before the earthquake. Horrific though the destruction was, it has been followed by a phoenix-like rebirth. Works in the other municipalities and areas were equally successful.

A new brochure on EIB lending in Turkey is available on the EIB website www.eib.org (Publications).

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Please consult the Bank's website for any change in the list of existing offices and for details on offices which may have been opened following publication of this brochure.

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