Bubbling under the surface:

The role of western public finance in the crisis hitting central and eastern Europe

An assessment of the policy responses, and the dangers therein

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Introduction

The liberalisation of financial markets and the entry of foreign banks have played a central role in the extension of the current crisis to central and eastern European (CEE) economies. They contributed directly to the increased reliance on cross-border borrowing, foreign currency lending, a boom in lending to households for consumption and mortgages, and related real estate booms in many economies.

The role played by foreign banks in helping create financial and economic vulnerabilities in the region is very clear and compelling. Institutions that are part of the orthodox economic establishment – including the International Monetary Fund, the Bank for International Setttlements and the European Central Bank – have acknowledged various aspects of that role. Indeed, *The Economist* (November 27) has noted that it was foreign banks' "risky lending that inflated the property bubbles, now popped, and also financed huge current-account deficits in such places as Latvia and Bulgaria."

In contrast, Manfred Schepers, European Bank for Reconstruction and Development (EBRD) Vice President for Finance, was recently quoted saying that "the crisis originates in the confluence of problems both at home and abroad ... This crisis was not caused by market reforms".

The distance between this assessment and that of most observers underscores the difficulties facing CEE economies as their economic recovery and Green investment programmes depend almost wholly on public bodies such as the **EBRD, the European Investment Bank (EIB) and the European Commission (EC)** – institutions that, as this report details, have played important roles in imparting and supporting the unsustainable 'economic miracle' in the CEE region that is now unravelling.

The EC continues to promote 'structural reform' along the lines of the Lisbon Strategy, giving particular emphasis to the need to push for further labour-market 'flexibility' and reductions of regulations on small and medium enterprises as part of their response to the crisis. It is also proposing to escalate its support to a range of established private power generators installing the highly problematic 'carbon capture' technology. Together with the EIB, it continues to rely on PPP financing schemes in its recovery investment plans. Both institutions are also pouring billions of euros into a number of competing private car manufacturers.

And both the EBRD and EIB continue to rely on private banks to deliver much needed credit inflows into small and medium enterprises. Even in the best of times, the capacity and willingness of private banks to uphold social and environmental standards in the deployment of such funds is questionable. There certainly has been very little transparency enforced by European institutions on this account. In the current crisis, these issues are **compounded** by the difficult situation in which banks find themselves, making it more likely that funds will either be hoarded or loaned with marginal concern for social and environmental standards.

Yet a certain tone of defiance is being maintained within western corridors of financial power. At the launch in late November 2008 of the EBRD's Annual Transition Report for CEE countries (the bank's annual assessment of the region's economic health), and amidst the for once gloomy growth projections, the EBRD's Chief Economist Erik Berglof declared:

> "The fact that the economies that are most open and most dependent on external finance are those that are hit most should not mean that the economies should turn inward and reverse transition; the conclusion that there is no turning back."[1]

The EBRD's Transition Report for 2008 awarded Hungary the top marks for the region's economies in the bank's evaluation of the corporate sector, the trade market system, the financial sector and infrastructure. Hungary scored 3.96 on a scale of 1 to 4+.

What is being done, and what is to be done?

The financial and economic crisis unravelling across the world economy has fundamentally changed economic policy imperatives for states and international financial institutions, including those operating at the European level. Three broad imperatives govern the formulation and implementation of economic policy across most state and non-state institutions: The stabilisation of financial systems, the mitigation of the crunch on credit extended to firms and households, and the provision of economic stimulus through state spending.

It is too early to be able to identify exactly how different institutions will attempt to pursue these imperatives. But it is possible to identify the issues and tendencies framing the work of particular institutions by examining their recent policy work, their particular political commitments, their announced policy responses to the crisis, and the ways in which they have set out to implement them.

In this sense the current situation offers the opportunity to **articulate policies favourable to progressive social and environmental aims** not only as morally or politically desirable, but as integral parts of effective and transformative plans for economic recovery. While today's policy makers are unlikely to be moved by such arguments at this point, broader layers of social actors engaged in debates about the crisis most definitely will.

It will be through their mobilisation that political climates will shift in favour of progressive social and environmental goals, paving the way for tangible improvements in policy.

This report seeks to provide guidance for this work by considering the context, formulation and delivery of crisis response policies by the EC, the EIB and the EBRD in relation to the CEE economies. It does so by offering a detailed discussion of the crisis and its impact in European and CEE economies, and a series of individual discussions on each institution based on recent work, policy commitments, announced policy responses, and recent policy implementation.

Key areas of concern – and for discussion

CEE Bankwatch Network, a network of non-governmental organisations with a presence in 12 of the CEE region's states, is proposing for discussion and debate with the people, the governments and financial institutions of the region and western donors to the region several key issues.

These are the issues that resonate throughout this report's assessment of how public funds have contributed to the crisis, and how public funds are being lined up for counter-crisis deployment:

1. The vital importance of **transparency** in ensuring that public money in the crisis context is being deployed in an open

and robust manner so as to ensure genuine environmental and social "value added". Already in this context, the EIB's on-lending to private banks – that in turn should extend credit to cash-starved small and medium-sized enterprises – is setting off some alarm bells about private bank 'hoarding of funds'. This kind of lending from the EIB is expected to amount to billions of euros.

2. The clear need for public money now to do more and to do it faster should not compromise the **environmental and social due diligence** of these public institutions. Similarly, national and EU laws should be upheld and insisted upon in the face of potential panic measures to stimulate economies, potentially at any cost.

3. The stated preference of these institutions for private sector involvement in infrastructure stimulus measures via **public-private partnerships (PPPs)** requires vigorous debate in the CEE region. Already concerted promotion of PPPs is being witnessed in the region, with little sign that some of the standard problems that accompany them - including long-term budget burdens, poor value for money, and excessively generous guarantees for the private sector - are receiving the proper public airing. Equally, as this report discusses, serious question marks are now being raised about the marginal stimulus effects that are likely to accrue by engaging the private sector so extensively in times of recession.

4. In early March 2009 the EIB approved EUR 3 billion in loans to the **European car industry** under its new European Clean Transport Facility (ECTF). This is portrayed as 'green' investment to reduce CO2 emissions from new cars, yet it requires manufacturers only to comply with the heavily watered-down EU legislation that they would have to comply with anyway.

   The ECTF does not address the issue of overcapacity in the European car industry, estimated at around 20 per cent, neither does it address the need, long recognised by European transport and sustainable development policy, to promote a shift to rail, urban public transport, walking and cycling. In addition it has been shown that if all vehicles on the market were currently equivalent to state of the art, CO2 emissions would already be 20-25 percent lower than today, even without a move to hybrid engines or engine downsizing.[1]

5. If, as the president of the EBRD, Thomas Mirow, recently publicly stated "the crisis should be the moment to lay the foundations for future sustainable growth", will the EBRD be urgently undertaking a serious re-think of its **"transition impact"**, the underpinning of each and every one of its lending projects?

   Remarkably, real environmental change (as opposed to the introduction of environmental management systems) and social considerations have up to now had no central relevance in the EBRD's lending blueprints, and there can surely be no better moment in time for this to be rectified. Likewise the current crisis has amply illustrated the need to question an assumption that permeates the EBRD's project assessment and evaluation criteria: that private sector involvement and the introduction of market mechanisms are an inherent good.

While not central to Bankwatch's basic mission that focuses on public banks, we also see that debates on the desirability of banking systems based on state, cooperative and mutual banks, including institutions specialised in financing environmentally progressive projects, are urgently needed across the continent.

Overview of the institutions on a crisis footing – and under pressure to deliver

CEE economies in the European Union now find themselves more dependent than ever on various EU institutions and policies. Crisis management intervention by EU institutions into the region can be divided into two broad forms: financial and fiscal.

Financial measures do not involve state or EC expenditures, budgets or deficits. The European Central Bank has provided significant financial support to banking systems across the EU. The EC and ECB, together with the IMF, have also provided funds to local central banks to help them defend their currencies. These policies have been aimed at stabilising overall financial systems and supporting the free movement of capital in CEE economies facing external imbalances.

Fiscal measures have involved various forms of investment expenditure by the EC in CEE economies. Those have centered on the European Economic Recovery Plan[3], and on changes to the patterns of payments in the Cohesion Policy.

Approximately 4 percent of the total funds committed by the EC for the region in the 2007-13 budget period have been advanced to be spent during 2009. The EC has also allowed CEE states to 'back-load' their required co-financing of this investment towards the end of the budget period. Overall this represents a **fiscal stimulus of EUR 9.8 billion**, with little to no immediate spending requirements imposed on strapped local national treasuries. In the current situation, **this is as much of a fiscal stimulus as many CEE economies will get this year.**

At the financial level, it is clear that EU interventions have sought to maintain financial orthodoxy. It has supported private banks, and sought to support the currencies of members outside the Euro in a setting of free capital flows.

At the fiscal level, the policy climate within the EU reflects all previous political commitments and pro-market biases. While the EC promises to ensure economic recovery measures promote Green investment and social well being, its plans and actions continue to be guided by the pursuit of 'structural reforms' set out by the Lisbon Strategy.

In relation to environmental sustainability, while some positive steps have been taken in support of housing upgrades and renewable wind energy, most efforts look likely to target PPP financed roads, support to individual auto companies, and EUR 1.05 billion in loans to support controversial, as yet unproven 'carbon capture' technologies.

It is too early to ascertain exactly what impact the advances in Cohesion Policy investment are having on CEE economies. The first full disclosures will only come in the national strategic reviews due at the end of this year. Yet there are compelling economic, political and budgetary reasons to expect existing large infrastructure projects financed through some type of PPP to benefit most significantly from this policy shift.

Once initiated, public infrastructure projects generally have high stimulus effects. The EC is very insistent on the need to court private investment sources, particularly in transport infrastructure. This despite the existing scepticism of the stimulus impact of incentives to private investment in the current climate, expressed most recently by a group of IMF economists[4]. Finally, existing budget allocations, which are the starting point for any advances, already favour such projects. There is no suggestion from evidence on the policy climate in the EC that strong objections to such outcomes would be raised.

EBRD money (for more details, see pages 19-23)

The financial and economic crisis has had a very direct impact on EBRD programmes, portfolio and clients. Many of the recipients of EBRD financial support are banks and other financial enterprises facing severely adverse market conditions. This includes **dozens of banks** in which the EBRD has ownership stakes.

Similarly, many high-profile projects involving non-financial corporations and smaller firms have been put at risk by the crisis and the collapse in private-sector financing. The EBRD's response to the crisis looks to be significantly conditioned by the need to provide emergency support to existing commitments and interests.

Broader political pressures and commitments bearing on the EBRD are also likely to condition its work in the next period. At the behest of the World Trade Organization, the EBRD has made support to international trade finance a central part of its crisis response policy. In addition, policy statements, new programmes, and declarations by top EBRD officials suggest **little capacity for critical assessment** of past work in CEE financial sectors or willingness even to relax the organisation's commitment to privatisation and private-sector channels, even in light of compelling empirical evidence.

EIB money (for more details, see pages 24-27)

The EIB's reaction to the crisis is strongly shaped by its existing policy commitment to the private sector, and the current political pressures bearing upon it within the EU.

The EIB's response reflects its longstanding growing commitment to large infrastructure programmes, and its growing fondness for PPPs and other mechanisms to **promote private sector investment**. Road and rail building involving PPPs are central to its plans, as are the new JEREMIE and JASPERS programmes aiming at facilitating large infrastructure projects in EU-12 economies and private investment in small and medium enterprises across the EU.

Reflecting political pressures from the auto industry and its supporters, the EIB's plans look set to involve considerable support to individual auto manufacturers, including uncoordinated support to individual research efforts. Evidence discussed below suggests lending of this type will take up resources equivalent to the bulk of new financing earmarked for 'energy, climate change and infrastructure' under the EIB's crisis recovery plans.

The EIB is also committed to provide significant resources to help finance SMEs and mid-sized corporations through the private banking sector. This policy relates to two concerns. It seeks to allocate finance to enterprises currently starved of credit. And it makes precious wholesale funds available to recipient banks, which can derive margins between cheap EIB funds and loan rates. The EIB has made no attempt to justify its reliance and support to private banks, despite the very high-profile problems they have created for themselves and the broader economy.

In fact, the deepening of the crisis, particularly in CEE economies, will likely increase pressures on banks. Credit flows will suffer even deeper disruptions, and many banks operating regionally will teeter on the edge of bankruptcy. Reflecting political pressures from a number of EU states directly exposed to bank collapses in the region, it is possible that EIB work in CEE economies in the near future will involve participation in significant European-level interventions to support currencies and bailout private, foreign banks.

The EIB's policy commitments to the private sector and mass infrastructure are firm and unlikely to change. Yet its obvious susceptibility to political pressures from the EU does raise the possibility of eventual policy changes in response to shifting public moods. Even in the current context, it looks like the Bank may be set to allocate significant resources to genuinely renewable energy sources, at least in western Europe.

Setting the scene

A crisis – and constraints of a worn policy consensus

The banking crisis that started in the US during the autumn of 2007 has grown into an international financial catastrophe of historic proportions. After helping misallocate *trillions* of dollars in predatory loans borrowers could never repay, and placing themselves in risky financial positions with paper-thin capital reserves, many leading international banks have failed. Bear Sterns and Lehman Brothers are no more. Many others have zombied on, requiring regular infusions of fresh public money not to collapse. Fears of mounting losses and bank failures have led to bank runs, a general loss of confidence in banks, and a deep freeze of international credit markets.

The collapse of credit has strangled economic activity across the world, threatening the deepest and most widespread economic recession since the 1930s. Yet it is not simply the depth of disruption that makes this crisis severe. In many countries households have entered the recession with unprecedented levels of debt. Concerned about their future earnings and saddled by debt payments, households are unlikely to respond quickly to government efforts to encourage demand. Similarly, poorly capitalised banks facing mounting asset losses will continue to contract lending in order to rebuild capital reserves. As a result, the current recession is likely to be protracted.

Many developing and transition economies are being hit particularly hard by the crisis. The 'credit crunch' cut off inflows of credit on which a number of economies, particularly in central and eastern Europe (CEE), had become reliant. In addition, during the generalised financial panic triggered by the collapse of Lehman Brothers, many international investors took a 'flight to quality', selling assets held in developing and transition economies and putting their money in US Treasury Bills or other hard-currency government liabilities. This development had a serious impact on many CEE economies, where financial liberalisation helped the development of economic imbalances and financial vulnerabilities in recent years.

Many local currencies look vulnerable to speculative attacks as the withdrawal of investments from CEE economies put downward pressures on exchange rates. The resulting devaluations would be devastating, as many debtors, including millions of households, owe debts denominated in hard currencies. Outflows of capital have helped tip local economies into their own recessions. Those will generate significant losses for banks operating locally, adding to investors' concerns about those economies, placing additional pressure on currencies and increasing capital outflows. In CEE the situation looks set for a devastating downward spiral.

Against this grim international setting the stated economic policy priorities have been redefined. In advanced economies three overriding priorities dominate policy-making:

1. The stabilisation of the financial system

2. The resumption of lending to firms and households

3. and stimulating ailing economies.

In pursuing these aims governments in the US and Europe have shown some degree of pragmatism, carrying out policy interventions that would have been unthinkable a short six months ago. Base interest rates have been brought down to historical lows. States have bailed out and acquired controlling stakes in many major international banks. Governments are drawing up and implementing significant stimulus spending plans, which include at least a verbal commitment to investment in innovative Green technologies. And central banks have engaged in some measure of direct lending to firms, bypassing clogged private channels of finance in the banking system.

At the same time there has been no significant political shift from the pro-market, pro-liberalisation consensus that conditioned the crisis and its spread.

Even in areas where it is increasingly clear that a commitment to market 'solutions' is severely curtailing efforts to stabilise economies and minimise the damage wreaked by recession, states continue to insist on them. They have refused to intervene into the running of banks that are effectively nationalised. They look to private banks in order to help deliver credit to the real economy. They are opposed to writing off household debt. They insist on courting private co-investment, tailoring many state expenditure plans to attract private capital. And they intend to keep boosts to fiscal spending, including Green investments, as temporary.

Nowhere are the costs of the commitment to economic orthodoxy clearer than in developing and transition economies hit by the crisis. Western governments, international financial institutions (IFIs) and local governments have been opposed to the imposition of restrictions on capital movement. In that setting the only option open to defend the value of domestic currencies is to try to convince international investors not to withdraw their money by raising domestic interest rates and cutting fiscal deficits. **These policies will greatly exacerbate the recessions and the social toll on those economies.**

They also leave CEE economies almost completely dependent on the IMF and European institutions for the implementation of any crisis response programmes. Local states have little fiscal or political scope to pursue policy responses to the crisis similar to those being followed in advanced economies. They have few means and little political will to intervene more radically into their foreign-dominated banking systems. Bank stabilisation depends on the actions of foreign banks' head offices, states and banking supervisors in Austria, Italy, Germany, Greece, Belgium and Scandinavian countries, where there is diminishing political will to spend public money to support banking systems abroad. Similarly, broader fiscal boosts and policies aimed at restoring lending and economic activity depend significantly on financial flows delivered by the EC's Cohesion Policy, the European Investment Bank, and the European Bank for Reconstruction and Development. As a result local states have little leverage in relation to these institutions.

Delayed impacts in central and eastern Europe

The initial impact of the crisis on CEE economies took place through disruptions in financial markets. Banks operating in the region were not highly exposed to toxic US subprime mortgage assets. In CEE members of the EU, foreign banks account for at least 70 percent of domestic banking markets. But the foreign banks present belong to a layer of 'second-class' international banks that took advantage of geographical, economic and policy proximity to expand significantly into those markets as they were opened. The Austrian, Italian, Greek, German, Scandinavian and Belgian banking organisations that came to dominate local markets by and large centered their international strategies on CEE economies, and had not looked for expansion into US based financial markets.

The behaviour of these foreign banks spared the region from the crisis' earliest spasms, as they did not experience substantial subprime associated losses. But it also created distinctive vulnerabilities. Specifically, CEE economies experienced a boom in cross-border borrowing by banks, starting in 2004 when most of them became full EU members. Freezing international money markets ensured that by early 2008 such borrowing became increasingly difficult. The panic and 'flight to quality' following the collapse of Lehman Brothers significantly worsened the situation, helping shape a dramatic reversal of debt flows into these economies, hitting the Baltic and Hungarian economies particularly hard.

Since October 2008, this reversal of capital flows has been associated with mounting concerns about possible devaluations of local currencies in the Baltics, Hungary, Ukraine and Bulgaria, fueling further outflows. There are ongoing questions about whether those governments would be unable to maintain the stability of their currencies. With the exception of Euro-zone Slovenia and Slovakia, other CEE economies remain vulnerable to the possibility of contagion from crises in those countries. Given the high levels of **debt denominated in hard currency** owed by firms and households across the region, significant devaluations would instantly bankrupt many of them and seriously damage local economies. Concerns about this possibility themselves fuelled further outflows, adding to pressures on local currencies.

In a setting where national governments have been unwilling and unable to impose restrictions on outflows of capital, support from international institutions was **the only recourse to defend national currencies**. The IMF, ECB and European Commission provided billions of euros in loans to a number of central banks for that purpose. The IMF has agreed multi-billion Euro loans to help support Latvia, Hungary and the Ukraine. The ECB has advanced a loan to Hungary, as well as a Euro liquidity enhancement facility to the Polish central bank. And the European Commission itself has agreed to provide EUR 6.5 and EUR 3.1 billion to Hungary[5] and Latvia[6], respectively, to help support their currencies.

As is always the case with all these official capital inflows, the recipient countries are being required to maintain austere fiscal positions by significantly cutting government spending.

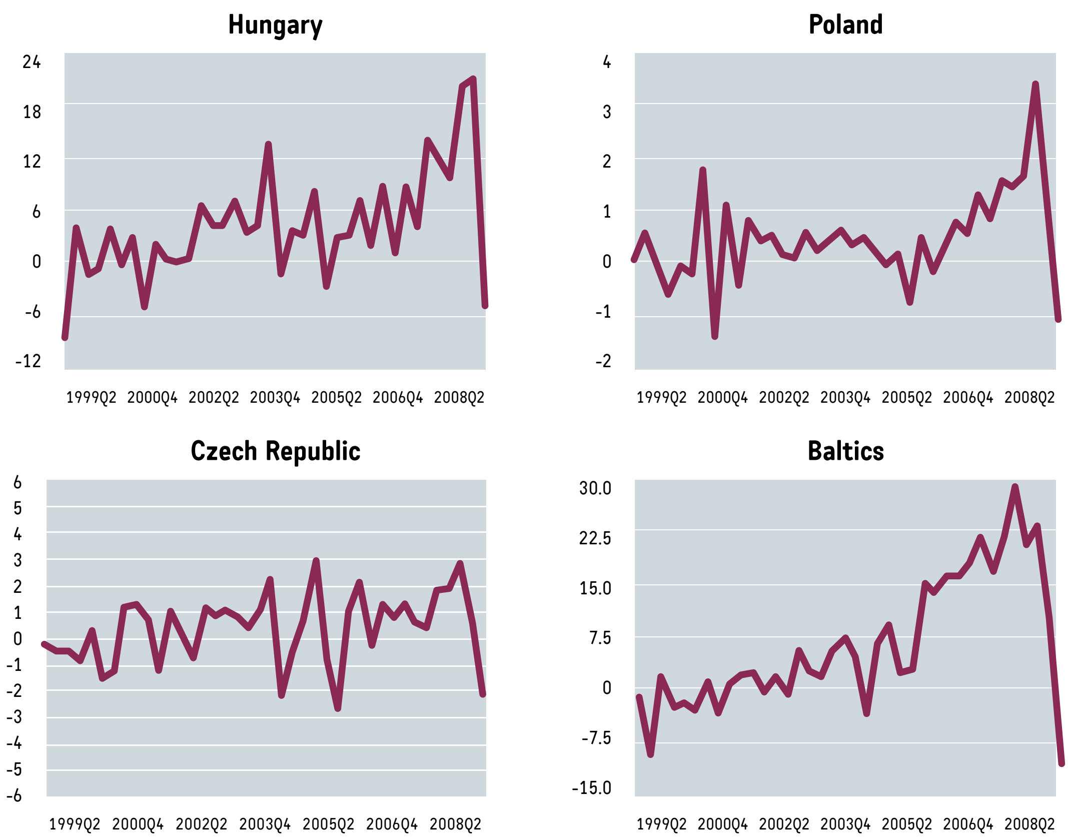

Figure 1 — Effective international loan inflows, 1999 Q2 - 2008 Q3 (percent of GDP)
Calculated from IMF, WB, BIS, OECD Joint External Debt Hub Data. See www.jedg.org

For the time being, these interventions have stabilised local currencies. But there are very difficult economic and financial conditions ahead. The collapse in foreign borrowing has led to a collapse of credit to all areas of local economies. As in the rest of Europe, this 'credit crunch' has helped trigger a recession, which is being compounded by the collapse of export markets in Western Europe, and the high rates of interest and low fiscal deficits required to defend national currencies.

Local recessions will add to the banks' problems by adding losses to their local portfolios. Record levels of credit allocated to individuals during the boom will likely be followed by high and unexpected levels of losses. The ratings agency Moody's has recently noted[7] its concern about the impact of the downturn on banks in eastern Europe. Stresses on those banks will likely reawaken concern about CEE economies, encourage capital outflows, reduce the availability of private credit, and add to speculation about currency devaluations. The situation in those economies looks set to deteriorate dramatically in coming months. Economies outside the EU and those outside the Euro zone look particularly vulnerable to speculative attacks.

Foreign banks, IFIs, and the crisis in CEE economies

The liberalisation of financial markets and the entry of foreign banks have played a central role in the extension of the current crisis to CEE economies. They contributed directly to the increased reliance on cross-border borrowing, foreign currency lending, a boom in lending to households for consumption and mortgages, and related real estate booms in many economies.

The EU, EIB, and EBRD (along with the World Bank and IFC[8]) played **active roles** in promoting these developments, even as evidence on their potentially harmful effects mounted, as an integral part of their support for privatisation and financial liberalisation. The pro-market biases exhibited in this support for foreign banks are still evident in the crisis response programmes pursued by these institutions.

Over the past ten years foreign banks have come to dominate most CEE banking systems. Policy advocacy in favour of foreign-bank entry was primarily pursued by the World Bank, whose economists provided the salient theoretical and empirical papers in support of the policy. The IFC provided considerable financial support to foreign banks around the world, as did the EBRD and the EIB across CEE. After more than a decade of this policy the evidence from Latin America, South East Asia, Turkey and CEE economies suggests that foreign banks have primarily imported some of the main practices responsible for the crisis in the US.

They reoriented credit to the household sector in the form of credit card, consumer and mortgage loans. And, with the help of the IFC and EBRD, helped make host banking systems increasingly dependent on international money markets for their funding.

In the CEE economies this took a particularly dangerous form.

Foreign banks introduced the practice of taking low-interest loans in hard currency in international markets and using them to make loans in host economies denominated in foreign currency. A number of factors helped establish this risky practice in CEE economies.

Speculation about eventual entry into the Euro area helped convince some agents that the risks of such loans were low and temporary. As noted by the IMF in an official Article IV Consultation Report in 2007[9], Austrian banks possessed considerable (and profitable) experience in this type of operation in their home market, where Swiss Franc borrowing had been widespread. Soon after their arrival in CEE economies, those banks extended those practices to new markets. The IMF also noted[10] with reference to Romania and Bulgaria that many foreign banks are very large in relation to their operations in CEE economies. This may have encouraged them to take on undue levels of risk, as possible losses would be proportionately small for their own operations, even when devastating for host economies. Finally, the interest rate differentials between loans in home currency and those denominated in Euros or Swiss Francs made those loans appear very attractive to borrowers and profitable to banks.

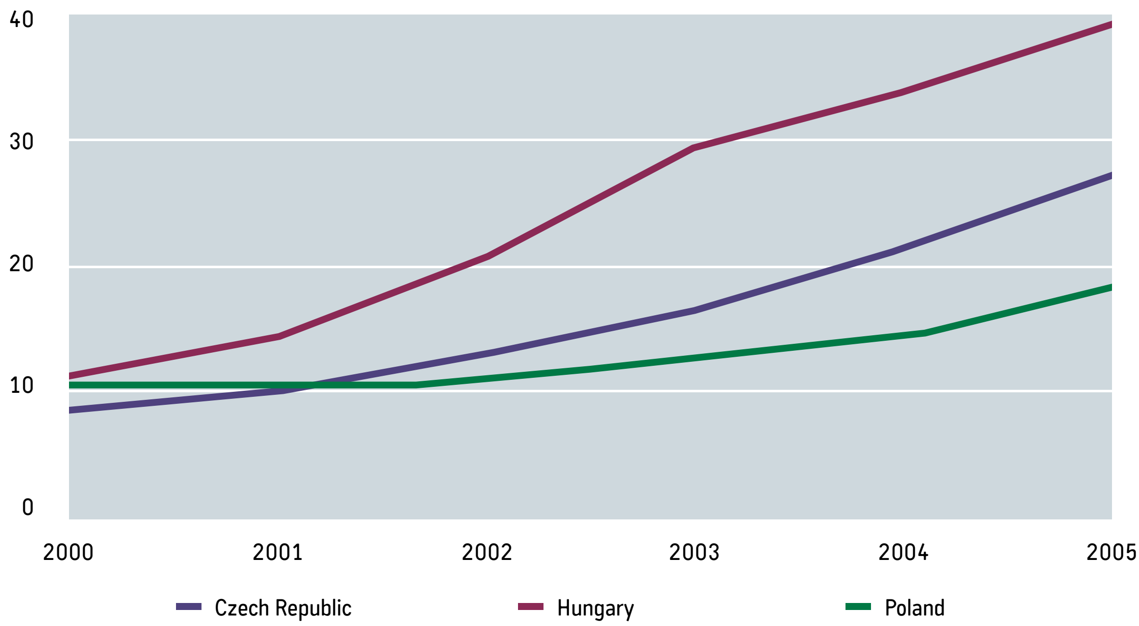

Figure 2 — Ratio of household debt to personal disposable income, 2000-2005 (Percent)
Source:Global Financial Stability Report (2006), IMF

This lending shared important features with **subprime loans** in the US. First, it often contained predatory elements, taking advantage of documented tendencies by ordinary borrowers to focus exclusively on immediate monthly repayments instead of overall debt burden when taking on a mortgage. As with 'teaser rates' in the US, banks played up low monthly payments and higher loan amounts that could be obtained with foreign currency loans, often without explaining the risks posed by exchange-rate movements. Concerns were raised about a lack of such explanations to borrowers. In its 2007 Article IV Consultation Report on Austria, the IMF suggested that programmes implemented in Austria to require lenders to educate borrowers about the risks of foreign exchange loans be extended to the operations of Austrian banks across CEE.

Second, foreign banks helped place ordinary borrowers in risky speculative financial positions, sustainable only through a combination of ongoing rises in home prices and a possible future adoption of the euro by the host economy. And third, this lending was driven and boosted by easy access to cheap wholesale funds in international money markets.

Concerns about the implications of this type of lending for financial stability were raised a number of years ago. The IMF reportedly produced an internal document[11] in the summer of 2006 explicitly questioning the wisdom of these activities. The Bank for International Settlements also noted concerns about the rise of this lending in Poland, as early as 2004[12]. Yet, as with the IFC and World Bank, the EBRD and EIB remained enthusiastic about foreign banks, providing billions of euros in support to those institutions across CEE economies.

Foreign currency loans, however, are only half of the problem weighing down on CEE economies. The credit booms they helped finance were accompanied by a reorientation of credit towards households led by foreign banks. In Estonia loans to individuals rose from 10.9 to 46.3 per cent of all lending between 1995 and the summer of 2008. Between 2001 and 2008 such loans rose from 6.8 to almost 40 percent of all loans by the top five banks in Bulgaria. In the Hungarian financial system, one third of all lending was allocated to households by early 2008.[13] This reorientation of credit significantly increased increased levels of household debt in the region.

Increases in consumption and mortgage credit were associated with consumption booms, which helped deteriorate external balances. Imports rose, and trade deficits widened for most regional economies. As a result, current account deficits deepened in most countries, staying negative in all except oil-exporting Russia.

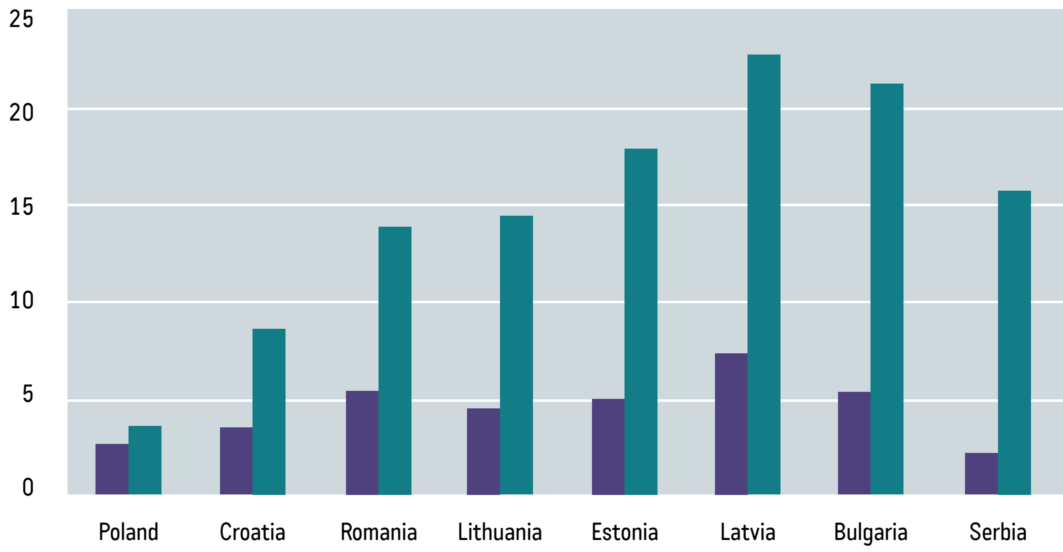

Figure 3 — Current account deficits, 2001 and 2007 (Percent of GDP)
Source: IMF World Economic Outlook

The credit boom also helped trigger real estate bubbles in the Baltics, Hungary, Bulgaria and the Czech Republic over the same period. The European Central Bank raised concerns about the possible growth of credit-fuelled bubbles in Central and Eastern Europe as early as 2005[14].

The IMF also noted concerns about these developments in its 2006 Global Financial Stability Report. Its main conclusion, however, was that to reduce the resulting vulnerabilities, local economies needed to pursue 'prudent macroeconomic policies'—that is, maintain orthodox fiscal positions and exchange-rate policy. Intervening to correct these imbalances was ill-advised as 'Direct controls on lending are often circumvented and distortionary'. But at least the IMF was clear that instabilities were developing.

Despite their clear contribution to the current crisis in CEE economies, foreign banks have been among the few sources of private capital inflows since the panic of October 2008. Parent banks continued to service and support branches and subsidiaries across the region. This slim lifeline is very likely to snap in the next few months. Recessions in the region will inflict losses on their balance sheets, raising the possibility of financial panics, devaluation and further losses. Well aware of the prospect, these banks have started to lobby the European Commission for a range of financial support programmes for CEE economies that are inside and outside the European Union.

The scale of losses could easily exceed the capacities of the banks in question and their home country states. Austrian banks have over EUR 220 billion in assets in the region, which equates to about 65 percent of its GDP of roughly EUR 340 billion. A devaluation and recession in the region that led to 10 percent asset losses for Austrian banks would leave a hole in their capital amounting to more than six percent of Austria's GDP. It is unlikely that the Austrian authorities would be in an economic or political position to help their banks recapitalise their CEE operations.

It is thus not surprising that the Austrian government is lobbying the EC for up to EUR 150 million to help all regional economies defend their currencies. The Hungarian government has also pushed[15] for a bank bailout for CEE economies of up to EUR 190 billion. Yet despite concerted efforts by many states and European banks operating in CEE economies, the EU has so far rejected all calls for substantial financial support for the region's banks, choosing instead to participate in a more modest EUR 25 billion programme with the World Bank.

The EU and Cohesion Policy

Broad European response to the crisis

The European response to the crisis has included a number of fiscal, regulatory, financial and monetary dimensions. Its central aims have been to stabilise the financial system, loosen monetary policy, alleviate the 'credit crunch' by providing and encouraging finance flows to the economy, provide a considerable fiscal stimulus. In pursuing these aims, western European states, the European Central Bank, and the European Commission have shown a considerable capacity to announce and implement unorthodox and unprecedented measures, including the commitment to place Green investments at the heart of economic recovery plans. At the same time, interventions consistently betray a commitment to existing pro-market policy biases that will seriously impair the achievement of stated economic and environmental goals.

This is very clear from interventions into the banking and broader financial system.

The vast majority of western European states have intervened heavily in their domestic banking sectors. They have provided them with liquidity, guaranteed customer deposits, and facilitated mergers that would have been unthinkable in normal times. States have also taken up equity stakes in a number of banks, becoming in some cases majority owners.

The European Commission (EC) has expeditiously approved the implementation of this range of measures, consistently judging them not to be in breach of EU competition standards. While national and European policy makers have demonstrated their willingness to allocate public money to rescue banks, they have also shown a remarkable reluctance to intervene into the management of banks, let alone nationalise them. The public has been left with rapidly deteriorating public finances, banks still in the hands of those who helped create the current crisis, and banks focussed first and foremost on rebuilding their own levels of capitalisation.

The European Central Bank (ECB) has been an integral part of attempts to stabilise the financial system and restore some level of lending to the real economy. It has tried to ease the strain on European banks by accepting an unprecedented range of assets banks can pledge as collateral in order to obtain low-interest loans from the ECB. Through such measures the ECB has taken on significant risks associated with such assets and the banks to which it has extended credit.

The ECB has also aggressively cut interest rates in the Euro zone. This measure will most likely yield limited benefits as banks will tend to hoard most of the new liquidity offered by the central bank, and not lend it on to the real economy.

Significantly, the ECB has also provided support to the Hungarian and Polish central banks, ultimately aimed at helping them sustain their currencies. While this has helped alleviate the pressures on those currencies, the ECB and other European institutions vehemently oppose the implementations of restrictions on capital flows, which may give CEE economies a measure of protection from the current international financial turbulence.

Regarding the real economy, European plans centre on the European Recovery Plan, which pursues four central aims:

1. To stimulate demand and consumer confidence.

2. To help minimise job losses and facilitate rapid transitions back into employment

3. To pursue 'structural reform' in line with the Lisbon Strategy

4. To promote the shift to a low-carbon economy.

Central to the pursuit of these aims is a fiscal budget boost across the EU of EUR 300 billion, EUR 170 billion of which is to be delivered by national governments in a position to implement fiscal expansions. This is to include moving forward existing plans for public investment plans. A number of priority actions, 'grounded on the Lisbon Strategy', will also be implemented to 'implement structural reforms'.

Among the requirements and constraints it is advancing for this fiscal boost, the EC is specifically recommending that it:

- **Conforms with the Growth and Stability Pact.** This includes a requirement that the boost be temporary and reversed after the short-term needs are fulfilled. Adhering to the Stability Pact following the current deficits will impose serious pressures for spending cuts in the future. The report already makes recommendations of where such cuts should be made, noting the need to ensure *'long-term sustainability of public finances, in particular through reforms curbing the rise in age-related expenditures'*. In other words, plan cuts in retirement and public health benefits in the future.

- **Includes tax cuts and reductions in social contributions paid by employers.** In general, tax cuts are well known to have at best limited stimulus value. Cuts in payroll taxes and employment social contributions do reduce employment costs and may make a short-term difference at the margin in defending certain jobs. At the same time, this policy shifts the deficit impact of the fiscal stimulus from the general budget to the budgets for social programmes. When the time for cuts arrives in the future, this arrangement will tend to make it much easier to impose the cuts needed to conform with the Stability Pact on social spending.

- **Promotes 'structural reforms'.** This includes market reforms and 'reducing regulatory and administrative burdens on businesses'. The latter demand has a long association with complaints by business lobbies concerning compliance with labour, environmental, health and safety, and standards regulations. In addition, the EC suggests fiscal programmes support 'employment and facilitating labour market transitions.' While this includes calls for a number of measures to help those who lose their jobs it is also linked with the need to achieve 'flexicurity', an EU-phemism for degrading labour contractual standards.

- **Is delivered as much as possible through private channels with private co-financing.** This is to include channelling funds through the private banking system, with the use of public guarantees, loan subsidies, and risk sharing facilities to encourage private co-financing. TEN-T projects with increased use of private sector participation through public-private partnerships (PPPs) are also favoured. The EIB and EBRD are central to these plans. The EIB will also disburse an additional EUR 10 billion earmarked for small and medium enterprises, and another EUR 1 billion to medium corporations. The EBRD is also to beef up its programming (see below).

Pro-environment and 'social good' impacts dangling on the crisis response margins

The EC's commitment to market liberalisation, 'structural reform', and support for private-sector 'solutions' greatly limit its capacity to deliver socially and environmentally progressive crisis response measures.

The evidence accumulating on how the EC will actually be implementing the plan also raises serious concerns about its environmental impact. Some positive measures have been taken, but they are dwarfed by concrete measures that will have seriously adverse long-term environmental consequences.

On the positive side, the EC has relaxed restrictions on the use by new member states of the European Regional Development Fund for housing. Such funds may now be used for financing national, regional, or local plans to assist low-income households in the installation of better insulation, roofing, double-glazed windows, solar panels, and new boilers. No concrete plans are being advocated, only the previous restriction on the use of these funds for individual housing by new Member States is being lifted.

At the same time, the EC has so far put only one concrete proposal for moving forward investment plans to help provide a spending boost. This centres on the Trans-European Network – Transport (TEN-T). In late March the EC will launch a EUR 500 million call for proposals for 'shovel-ready' TEN-T projects where construction can start before the end of the year. **There are risks that the already insufficient implementation of environmental standards is likely to decrease even further in the name of achieving 'timely' stimulus results.**

The EC is also mobilising the EIB to increase its broadly defined 'climate change, energy security and infrastructure' financing by up to EUR 6 billion per year. Even when these monies are not allocated to energy security and infrastructure, there is little evidence that they will be allocated to the most effective 'climate change' projects. As the discussion on the EIB below shows, in the first eight weeks of this year EUR 3.5 billion have been requested by auto manufacturers and categorised under the 'climate change and infrastructure' category. Support for the industry is widespread, including from the Czech Presidency, which will be putting forward in the Spring a full proposal for 'a European car fleet renewal'[16] to be supported by the EC.

Finally, the EC has given a very clear indication of its current priorities in funding 'smart investment' as part of economic recovery policy. It has been trying to allocate a total of EUR 5 billion not spent from previous budgets across a range of communication and energy projects. Significantly, while just over one tenth of this is slated for allocation to support offshore wind generation, a full quarter is to be allocated to support the development of 'carbon capture' facilities. Such support would help entrench a technology that perpetuates the use of fossil fuels, helps block the development of genuinely renewable energy sources, and fails to deliver timely reductions in carbon emissions even on its own terms. This points to a very weak political commitment to qualitative technological upgrades in energy production, and an all-too-familiar willingness to provide mass financial assistance to established private carbon energy producers.

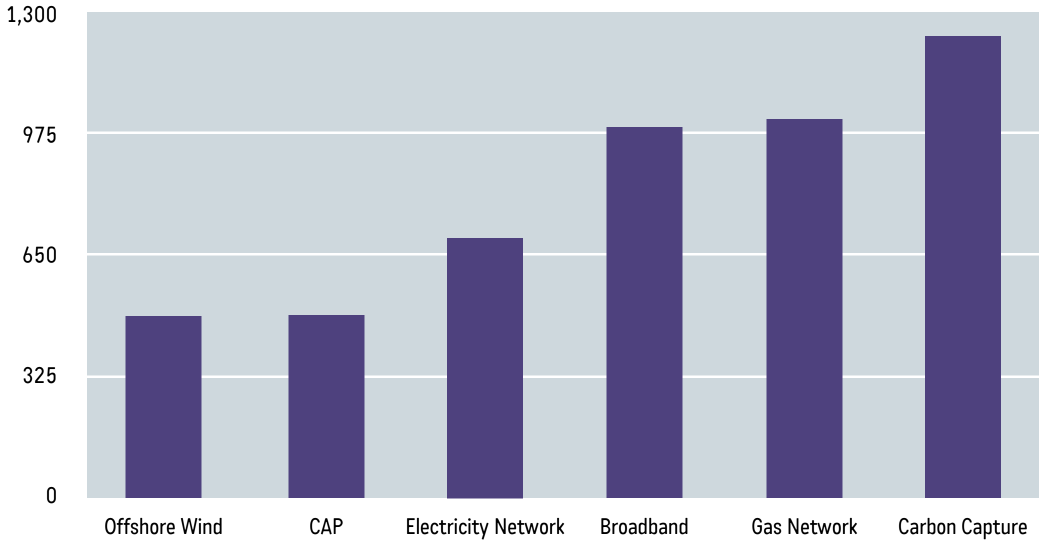

Figure 4 - Announced EC direct investment from unspent monies, by industry (EUR million)
Source: EC IP/09/142[17]

Imperatives and likely changes to Cohesion Policy funds

Changes to Cohesion Policy funds have been placed at the centre of European recovery plans. They involve large amounts of money, with EUR 346 billion already allocated for expenditure during the 2007-13 budgeting period. The various funds already account to about 50 percent of all public investment in a number of CEE economies. **In the current situation, these outlays will become even more central to the fiscal policies of those governments.**

The central measures regarding Cohesion Policy Funds are changes to the disbursement schedules for the Structural Funds. Some allowance is being made for advancing the disbursement of funds allocated for the entire 2007-13 period. In addition, compliance with co-financing requirements is also being made more flexible. National governments can shift their required co-payments towards the end of the budgeting period. Together, these measures allow for increased infusions of EU money without damaging the short-term fiscal position of national states. The potential benefits to CEE economies are obvious.

A total of EUR 4.58 billion[18] is to be advanced to new Member States in the EU-12 from their 2007-13 Structural Fund allocations. An additional EUR 240 million will be advanced from Cross-Border Cooperation allocations. Notably, there are to be no new advances made on allocated Cohesion Funds in addition to those approved before the October crisis, which totaled EUR 2.37 billion. Total advances (old and new) to be made in 2009 to EU-12 economies add up to EUR 9.8 billion in 2009, accounting for about 4 percent of committed funds. This money is to be used centrally in advancing investment planned within previously agreed financial envelopes, although provisions are being made for re-prioritisation, 'with a view to accelerate the spending in the areas with more growth potential.'

It is possible to anticipate the broad tendencies likely to appear in the disbursement of advanced Cohesion Policy funds. There are economic, political and budgetary reasons to expect ongoing – or near-start – large infrastructure projects financed through PPP schemes to become the principal recipients of advanced funds.

- **Economically, heavy infrastructure projects are noted for their high stimulus effects.** Moody's recently estimated[19], based on the current US situation, that for every dollar spent through fiscal policy in infrastructure, the economy will grow by an additional USD 1.59. The only other areas of fiscal expansion with higher effects are increases to unemployment benefits, and food aid to the poor.

  Arguments along these lines will likely be used across Europe to push new funds towards the heaviest infrastructure projects already in progress, as increasing their scales can deliver large investments much more quickly than by starting new ones. In this regard it is important to note that US estimates have **not incorporated the effect of PPP structures**, which impose high costs and significant transfers to corporations in the investment process. Interestingly, the Moody's figures estimate that transfers to the corporate sector (in the form of corporate tax breaks) yield a miserable USD 0.30 in additional output for every dollar transfered. Particularly in times of crisis, cash flows to corporations will most likely end up saved.

- **Politically, there is a strong commitment across European institutions to private co-financing.** In the current situation, private co-financing will likely not be forthcoming for most projects. A state-led infrastructure project involving PPP schemes - usually generous and low-risk for the private partners - may appear relatively attractive to the public sector. Co-financing other projects, involving investments in the private sector, are much less attractive during a crisis of this magnitude. Private appetite will most likely favour infrastructure projects, helping to push policy in that direction.

- **The structure of Cohesion Policy budgets and of the stimulus plan tend to favour already privileged sectors—transport infrastructure in general and road building in particular are already prominent among these.** Driving large relative volumes of new investment through such projects will be easier, as it would not likely require time-consuming processes to 're-prioritise' allocations. In contrast, it will be very difficult to prioritise investment areas receiving relatively small shares of existing total financing commitments, as that would require 're-prioritisation', which will most likely be approved only for the most 'shovel-ready' projects.

EBRD: Circling the wagons

The financial and economic crisis has had a very direct impact on EBRD programmes, portfolio and clients. Many of the recipients of EBRD financial support are banks and other financial enterprises facing severely adverse market conditions. This includes dozens of banks in which the EBRD has ownership stakes. The EBRD's response to the crisis looks to be significantly conditioned by the need to provide emergency support to existing commitments and interests.

This poses a number of potential problems. An orientation of financial support to *existing* clients during a general crisis raises possible conflicts of interest, particularly when the EBRD has equity stakes in recipient firms and a related political interest in them as **'demonstrations' of private-sector success stories.** The broader question must be posed: Are these the best allocations of precious resources mobilised by *development banks* during a catastrophic economic crisis?

Direct role in the crisis

> 'Cutting edge is a phrase not often applied to development banks. But the European Bank for Reconstruction and Development's strategy in helping to develop securitization structures for financial institutions in central and eastern Europe fits the bill. Asset-backed securities are rare in the region, but the multilateral is at the forefront of the product's development and expects to participate in a handful of deals over the forthcoming months. In December, the EBRD's shareholders approved the first securitization that the bank will be involved in: a transaction from Russian Standard Bank (Bank Russky Standart) backed by consumer loans that could amount to as much as €70 million.'
>
> *— 'EBRD fast-tracks asset-backed securities', EBRD Feature Story, 2006*[20].

The EBRD has played a central role in helping develop the financial and economic vulnerabilities currently compounding the troubles facing CEE economies. Its programmes directly helped increase consumer indebtedness, fuel consumption and real estate booms, and disseminate originate-and-distribute business models that made local banks across CIS economies more reliant on international money markets.

The EBRD did this by:

- **Promoting and financially supporting foreign banks with equity and loans.** Throughout this decade, the EBRD took on significant equity uptakes in European foreign banks operating across the region. This included interests of EUR 100 million in Raiffeisen[21] and USD 100 million in Swedbank[22], along with many other uptakes in the subsidiaries of other foreign banks across the region. The EBRD also provided hundreds of millions of euros worth of loans to Raiffeisen, SocGen, Volksbank, Erste, and KBC, among others[23].

- **Providing similar support to dozens of local banks, many of which were actively turning to credit to individuals.** Many of these banks are based in CIS economies. One notable such concern is Bank Center Invest in Russia[24], which has received considerable EBRD equity[25] and credit[26]. Its portfolio of consumer, car and mortgage loans to individuals stood at 11.3 billion Roubles at the end of 2007, accounting for a full 40 percent of all loans. Another significant recipient of EBRD equity[27] and loan infusions[28], this time in South East Europe, is Banca Transilvania in Romania[29]. Just over 40.8 percent of this lender's portfolio by the end of 2007 was allocated to credit to individuals. This bank also boasts of its role in supporting the development of the private medical sector in the country through its BT Medical Division, which helps finance independent practices. This aim is perfectly aligned with the mandate of the EBRD, which at the end of 2007 held a strong 15 percent equity stake in the bank.

- **Leading the development of local markets for mortgage-backed and other asset-backed securities.** Like the International Finance Corporation, the EBRD provided considerable technical[30] and financial support[31] for the establishment of these markets, focusing on CIS economies. For the EBRD, private home ownership

> 'is widely seen as one of the keys to fostering economic prosperity, political stability and wider equality. With the rate of private home ownership now exceeding 80 percent in many transition countries, it is evident that there is a huge capital stock that can be mobilised as collateral to secure loans for financing not only property acquisition but also improvements, business activities or **personal consumption**.'
> *—Mortgages in transition economies[32], EBRD, p 4 (emphasis added).*

As its disclosures make clear, the EBRD extended almost USD 400 million in loans to banks earmarked for mortgage lending between 2006 and 2008 in CIS economies and Serbia. It also provided considerable support for the development of secondary mortgage markets, including securitisation.

The EBRD also held in its own Treasury investment portfolio a **substantial share of residential mortgage backed securities**[33]. In 2006 those accounted for 17.4 percent of the Bank's Treasury investments, falling to a slightly lower 14.8 percent by the end of 2007. It is unclear how much the Bank has lost through those investments.

This direct involvement and financial, political and institutional commitment fundamentally conditions the EBRD's reaction to the crisis. It is not approaching the situation as a potential source of help to CEE economies as a whole, but more like a vested party standing to lose much if particular enterprises fail. The EBRD has equity interests in about 100 financial institutions in the region; it is a creditor to roughly 200. This greatly limits the usefulness of its interventions.

Policy response to the crisis

The EBRD Board adopted a Crisis Response Package[34] in early December 2008. The package includes an expansion in financing volumes by 20 percent to a total of approximately EUR 7 billion in 2009. Half of the EUR 1 billion in new financial funds are earmarked for the new member states of CEE, in line with EC plans. The EBRD will be using its own reserves to increase its funding.

Unsurprisingly, the first stated aim of the Package is to help stabilise the region's banking sectors. The EBRD also aims to ensure financial flows to the real sector continue, particularly to small and medium enterprises. It is also extending support to the broader corporate sector, and expanding its financing of trade in the region, which has suffered from a severe evaporation of funds as a result of the crisis.

A close examination of the actions the EBRD has already undertaken, as well as those in the project 'pipeline', broadly confirms this orientation, as well as a noticeable focus on CIS economies. But it also points to an institution circling its wagons and focusing its support on existing clients, raising the obvious question of whether this is the best policy response to help CEE economies weather the crisis. The EBRD is also fully engaged with international efforts spearheaded by the WTO to try to support the financing of international trade.

What has actually been done in response to the crisis?

As of February 20, projects specifically aimed to address the crisis have been approved in three broad areas: support to banks, infrastructure projects, and funds for small and medium enterprises. Table 1 summarises the projects in question.

Table 1 - EBRD approved crisis response projects as of 20 February 2009

Recipient	Type	Country	Amount, US$	Aims
Uraltransbank	Bank	Russia	12m	Loans to strengthen balance sheet
Bank of Georgia	Bank	Georgia	100m	Convertible Loans to support capital base and inject short-term liquidity
Spurt Bank	Bank	Russia	10m	Loans to strengthen balance sheet
Raiffeisen Bank Aval	Bank	Ukraine	75m	Loan to increase capitalisation and strengthen balance sheet
Ukraine Rail	Infrastructure	Ukraine	62.5m	Loans to finance purchase of freight wagons to help renew rolling stock
Russian Railways	Infrastructure	Russia	130m	Loan to finance fleet renovation
Banca Transilvania	SME Loans	Romania	125m	Loan for onlending to SMEs
Transcapitalbank	Trade	Russia	30m	Increase to finance facility for trade

Obtained from EBRD and the Financial Crisis in Central and Eastern Europe[35], Project Disclosures

So far project responses have included USD197 million to support banks, USD 30 million to support trade finance, USD 192.5 million to support infrastructure, and USD 110 million to support lending to small and medium enterprises.

A closer look at these projects casts further light on the imperatives governing the EBRD's response. The Bank has significant equity stakes in all of the banks involved in these operations. This raises important questions about the Bank's motivations in providing support. There is no reason to believe narrow pecuniary considerations account for this focus. More significant is the political commitment the EBRD has to private institutions it has prominently promoted for their 'demonstration' effect in promoting privatisation and market-base processes.

This leaves open the question of whether supporting these particular institutions, through the particular chosen mechanisms, is the best way to support CEE economies during the financial crisis. Notably, all of the banks in question have business models centered on allocating credit to individuals. Such loans impose heavy burdens on individual households, and are very likely to go bad at unexpected rates during the developing recession. As such, they have the serious potential to contribute to financial instability and recession. It is unclear how supporting such institutions is the best way to support improved long-term economic performance in host economies.

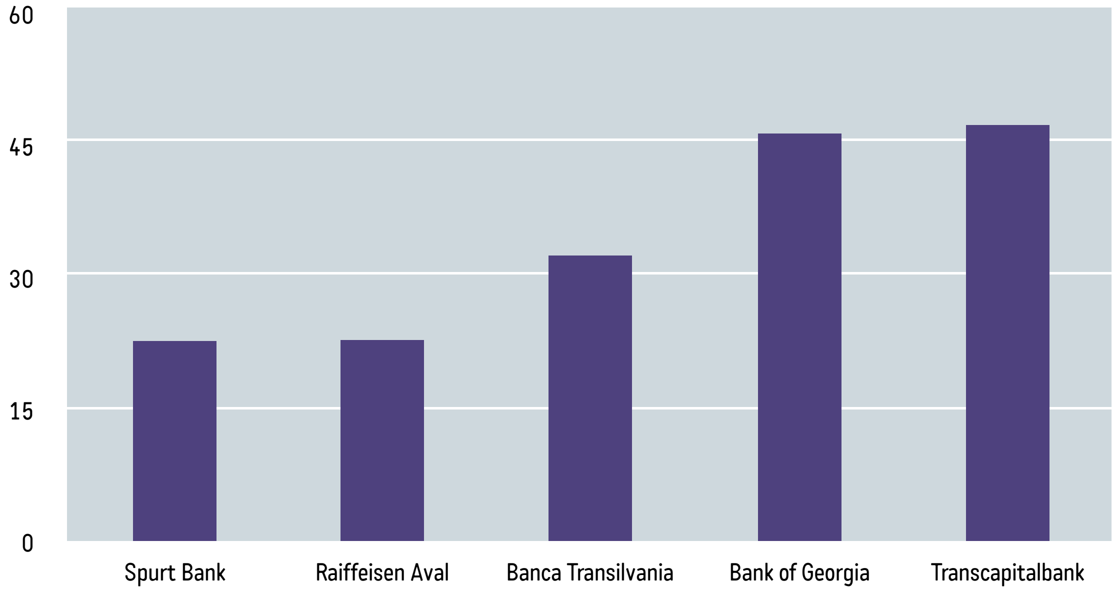

Figure 5 - Loans to households by EBRD clients receiving assistance, 2007 (Percent of total)
Calculated from individual bank Annual Reports for 2007

Table 2 shows the sectoral breakdown of these newly projects, comparing them to the full breakdowns for 2006 and 2007.

Table 2 - Breakdown of disclosed EBRD financing projects for selected periods

Sector	2006	2007	Dec08 - Jan09
Financial	44.73%	37.94%	42%
Energy	8.14%	11.01%	11.20%
Infrastructure	16.94%	16.76%	0%
Other Corporate	30.20%	34.30%	9.10%
Special Mid-Sized Corporate Facility			37.90%
Total Finance (US$ milion)	4936.2	5583.3	660.7

Source: EBRD Annual Reports for 2006 and 2007[36], and Project Disclosure documents

The Mid-Sized Corporate Support Facility is a major, large-scale component of the EBRD's crisis response. It aims to fill in financing holes created by the cuts in commercial bank lending for corporations. The EBRD hopes this will be accomplished directly, as well as by signalling to private commercial banks the EBRD's commitment to the firms in question, thus encouraging significant levels of co-financing. Significantly, the Facility will only be open to **existing EBRD clients**, expected to be about 25 corporations.

Funds from this Facility may be used for:

- **Working capital**, that is funds to purchase inputs necessary to sustain activities.
- **Balance sheet consolidation**, that is restructuring of debts and possibly assets.
- **Completion of existing investment programmes**, to allow EBRD supported projects to be concluded.
- **Small new investments limited to improvements of production facilities or energy efficiency.**

It remains to be seen if the requisite environmental and social standards can be maintained under this new Facility, where speed of disbursement is seen to be key.

EIB: Keeping things private

The European Investment Bank has an established record for both its capabilities and problems. It is one of the world's largest international financial institutions, with annual financing volumes of EUR 45 billion in recent years, which are now being increased to about EUR 60 billion. Historically it has been capable of working with states and, unlike the EBRD, it has no chartered commitment to focus its projects to the private sector. Its central institutional aim is the vague commitment to furthering the interests of the European Union by making long-term finance available.

The vagueness of its chartered aim and the relative public obscurity in which it operates create significant problems. The Bank is **notoriously lax** about enforcing even basic EU environmental and social standards in its programmes, particularly in overseas projects. Its project emphasis has been in heavy transport infrastructure projects. More recently, its specific policy objectives have included the promotion of regional integration, energy security, and the promotion of the private sector.

Reflecting these developing aims, the EIB has launched a number of initiatives with the EC to help promote private capital in infrastructure projects and in financing micro, small and medium enterprises. JEREMIE is a programme seeking to act as an investment broker between micro, small and medium enterprises and various sources of private capital. JASPERS is a programme focusing on helping EU-12 states prepare and manage large infrastructure projects funded by EC Cohesion Policy funds. Its focus is on projects involving TENs, broader urban, rural and air transport investment, environmental sustainability, and PPPs.

PPPs have become an important policy area for the EIB, and it is currently one of the biggest funders of such projects in Europe, mainly in transport but also in health and education and water and wastewater treatment. In 2007, 15 percent of its TEN-T and broader transport projects involved PPPs, and the aim has been to broaden that involvement. The EIB has been involved in helping spread the use of PPPs[37], including through the establishment of the European PPP Expertise Centre.

Its work in CEE economies broadly reflects these priorities. Table 3 summarises the bank's recent allocations of finance to the region, which totalled EUR 35 billion between 2003 and 2008.

Table 3 - EIB allocations of finance in CEE economies, 2003-07 and 2008 (percent)

Sector	2003-07	2008
Energy	3.55%	2.25%
Communications (including Transport)	41.36%	40.78%
Water Management and Sundry Infrastructure	12.10%	19.34%
Industry, Service and Agriculture	18.10%	12%
Education and Health	7%	9.6%
Global Loans	17.7%	16.4%
Total Financing (€ million)	27,358	7,739

Source: EIB Statistical Report 2007[38], 2008 figures calculated from Finance Contracts Signed[39]

The figures make very clear the EIB's general emphasis on transport in CEE economies. Across the six years, EUR 14.5 billion was allocated to transport and telecommunications infrastructure. Although disaggregated figures across both categories are not given for CEE economies, in the overall EU allocations, transport infrastructure accounted for more than 80 percent of 'communications' financing.

Also notable are the volumes advanced as credit lines in CEE economies, which amounted to EUR 4.85 billion between 2003 and 2007. In 2008 alone, credit lines amounted to EUR 1.27 billion, EUR 1.09 billion of which were extended to foreign banks. These are Global Loans extended to banks operating in the region, who in turn lend the funds on in accordance with the project's aims. In CEE economies this has meant billions of Euros advanced to Unicredit, Raiffeisen, Volksbank, Intesa, Kommunalkredit, SocGen, Citibank, Hansa Bank and others, in the form of low-cost, publicly brokered funds. Like the EBRD and IFC, the EIB has played a part in supporting foreign banks in the region.

There appears to be a division of labour between them in this regard, as the EIB has not supported banks in the CIS, while the EBRD and IFC have focused on those economies, with selected projects in CEE economies. At the same time, the EIB's funds have generally been earmarked for onlending to small and medium enterprises. In this regard EIB support to foreign banks in the region has been of a somewhat different character to that given by the EBRD.

Still, this significant allocation of publicly-brokered funds raises serious questions given the extent to which these banking institutions have been responsible for predatory lending, helping fuel consumption and real estate bubbles, and increasing host economies' reliance on funds from international money markets.

Policy reaction, trends and debates

The EIB is an integral and quantitatively significant part of the policy response to the crisis being implemented by the EU. The volumes of finance generally involved in EIB programmes make them good potential candidates to deliver policy spending. The EIB's board announced its 'anti-crises measures'[40] in December 2008. They involve an increase in lending volumes of about 30 percent, or EUR 15 billion per year, during 2009 and 2010, and are centered on:

- **Providing financial support through banks to SMEs and mid-sized corporations.** Along lines similar to those pursued by the EBRD, the EIB is trying to fill the enormous gaps in financing of these enterprises left by the crisis. This will involve an additional EUR 3.5 billion in annual lending.

- **Measures targeted at 'energy, climate change and infrastructure, including clean transport'.** As the EIB itself explains, 'This includes a clean transport facility for the automotive and other transport industries, their original equipment manufacturers and component suppliers. The facility will target significant CO2 reduction through research, development and innovation expenditure, as well as tangible fixed assets in related infrastructure and proA total of up to EUR 13 billion is to be allocated to this area each year.

- **Increases to 'convergence' lending.** This is aimed specifically at helping relieve the financial stresses affecting EU-12 economies, and involves EUR 2.5 billion in additional loans to the region. A total of EUR 5 billion from total convergence lending is to be allocated 'to help support SMEs through the local banking sector in Central and Eastern Europe and candidate countries'. The EIB has also noted it is 'prepared to increase this in the next two years if necessary'.

- **An increase in the EIB's capitalisation.** As with any bank, the EIB needs to increase its capital base if it is to enhance its lending. For this purpose, the bank's subscribed capital will increase by €67 billion, leading to an increase in paid-in capital of €3.35 billion.

  It is too early for these priorities already to have established a trail of approved projects from which to examine their actual implementation. However, a close examination of disclosures of received projects for EU economies 'under consideration' so far this year (as of 19 February) gives useful indications of what the EIB's crisis management plan will look like on the ground.

  The EIB is in reality - despite its mandate to promote EU policy - a 'demand driven' organisation, but its official announcements and unofficial contacts have a great bearing on the type of projects that approach it for finance. Unsurprisingly, the pool of the latest projects 'under consideration' already reflect the broad priorities sketched out in December.

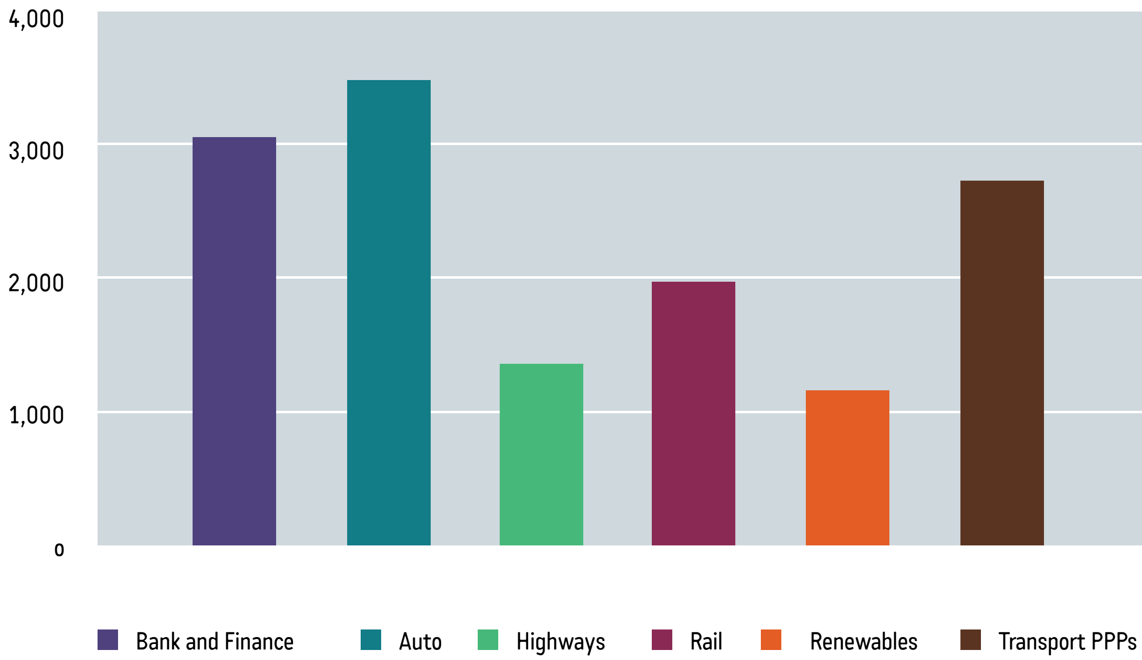

Figure 6 - EIB projects under consideration disclosed between 1 Jan and 19 Feb 2009 (EUR million)
Calculated from EIB Projects to Be Financed[41] - disclosures made between 1 January and 19 February 2009.

The details behind these potential allocations give reasons for concern about the environmental and social impact of the EIB's crisis response. Four broad observations can be made from these figures:

1. **The EIB's penchant for large infrastructure projects and PPPs is evident.** All railway construction under consideration involves significant PPPs or PFIs. Similarly, about half of the funds being considered for highway construction are to finance PPP projects in Portugal and the Netherlands. While not yet evident from the figures above, infrastructure projects will likely be prominent in CEE investments made by the EIB. Its promotion of JASPERS, which figures centrally in EC and EIB crisis plans, explicitly aims to increase the volume of such projects financed from Cohesion Policy funds in CEE economies. The EIB is likely to seek out 'synergies' in its regional programming by supporting related projects. As a result, programmes in CEE economies may be more significantly oriented to large infrastructure programmes.

2. **There are possible significant allocations to genuinely renewable energy sources.** These include support for production of photovoltaic cells and offshore wind generation of electricity. So far these projects are concentrated in Germany and Belgium. Their size suggests that the EIB is willing to allocate considerable resources to these purposes during the crisis, at least in western Europe.

3. **Effective bailouts to auto manufacturers are at the centre of the EIB's plans.** By mid-March 2009 the EIB had already approved EUR 3 billion in loans to the auto industry under its European Clean Transport Facility, with a further EUR 2.8 billion expected by May—a considerable fraction of the total extra allocation for 'energy, climate change and infrastructure'. The ECTF projects involve manufacturers based in western Europe seeking support for their individual plans to upgrade powertrain technology.

   This type of funding serves more as bailouts of failing individual corporations than as a coherent plan to foster technological breakthroughs in auto technology. Interestingly, at the same time the EIB is planning a EUR 600 loan to help Ford finance the construction and operation of a vehicle and engine plant in Romania[42]. Uniquely, the project makes no mention of any environmental aims. It is motivated simply on its potential contribution to the development of the regional car industry, the development of a cluster of suppliers, and to the stabilisation of 3,900 jobs and creation of new ones at the Craiova site. In addition a EUR 100 million loan for Volkswagen is envisaged in India for a new car manufacturing facility.[43] This raises the prospect of EIB funds supporting automotive R&D in Western Europe (however problematically), while financing the expansion of productive capacity in countries with lower costs.

4. **Support to private banks is an important component of EIB plans during this crisis.** Despite the role private banks have played in misallocating credit and hoarding capital in the current crisis, the EIB has placed them at the centre of policies aimed at supporting SMEs and mid-sized corporations. A full 23 percent of all disclosed disbursements under consideration are to involve flows of capital to private banks.

   In fact, this is an important part of a broader policy to support private banks with public money during the crisis. The banks secure access to precious low-cost funding from the EIB, and make a margin when lending it on to recipient enterprises. The need to support private banks, including by bailing out some, is likely to increase (particularly in CEE economies) as the crisis deepens. While Austrian and Hungarian efforts to secure substantial European funds to bail out and help stabilise CEE banking systems have failed, the EIB will be prominent in any such efforts. This includes the recently approved EIB, EBRD and World Bank plan to provide almost €25 billion[43] to support banks in CEE economies.

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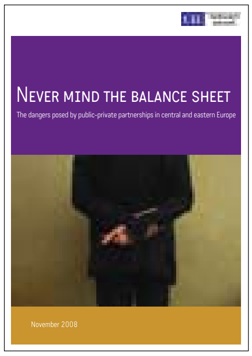

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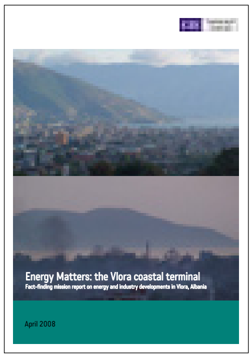

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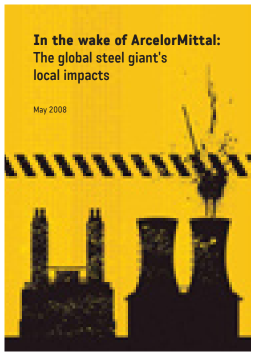

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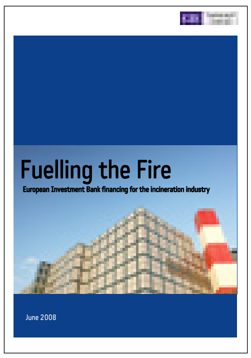

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"Economic recovery and green investment programmes for CEE states depend now almost wholly on public bodies such as the EBRD, the EIB and the European Commission – institutions that have played important roles in imparting and supporting the unsustainable economic miracle in the region that is now unravelling"

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