

**Long Term Strategy for the EIB; analysis and some suggestions**

**Report prepared for DFID**

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### **Introduction**

This study analyses elements for a long term strategy for the EIB. It starts by evaluating development criteria for financial allocations in the new External Lending Mandate. Section I

examines potential future demand for IFI borrowing with a special focus on the EIB. Section II starts by emphasising the pro-cyclical nature of private flows then looks at current trends emphasising the concentration of private flows to certain countries and finishes by exploring future scenarios for developing countries private borrowing and implications for IFIs. Section III evaluates the EIBs approach to risk and risk sharing and makes recommendations for improvements. Section IV focuses on new instruments that the EIB could develop or act as market makers for, as well as new demands, emphasising climate change. Section V concludes with suggestive new roles and instruments for the EIB in the next decade.

## **I Development criteria for financial allocations in the new ELM**

The European Investment Bank (EIB) had commitments outside the European Union (EU) of 5,130 million euros in 2005. The distribution values of these commitments across regions are presented in Table 1.

Table 1: EIB Commitments outside of the EU  
Year 2005

Region	EUR million	% of Total
Russia plus South-East Europe	1,498	29.2
South Africa plus ACP countries	682	13.3
Asia and Latin America	756	14.7
Mediterranean Partner Countries (FEMIP)	2,194	42.8
Total	5,130	100

Source: Adapted from EIB information magazine, 2006; reproduced in Grainger-Jones and Laing (2006).

Table 1 shows that of the EU's total commitments outside of the EU in 2005, nearly 43 per cent were to the Mediterranean partner countries, and other 29 per cent to Russia and South-East Europe. These two figures put together amount to over 70 per cent of total EIB lending going to neighbourhood lending; this implies loans to middle-income countries outside of the EU, which either are part of Europe or at least border the continent. Of the total commitments in 2005, less than 30% were to other middle-income countries around the world. The whole Asian and Latin American regions were allocated just 15 per cent of EIB total external commitments.

The EIB external loan mandate is being reviewed at present, so that a new mandate can be established for the years 2007-2013.

A proposal being circulated at present suggests increasing the EIB external lending to 33 billion euros over the 2007-2013 period (an increase of nearly 59 percent over the 2000-2006 period), and to distribute these resources geographically as follows: 24 billion euros to Russia, the South East and East Europe and FEMIP countries, and 7.5 billion to Asia, Latin America and South Africa. This means that still over 70 per cent of the total will go to countries that are in Europe, Central Asia, the Mediterranean and Middle-East, while just 22 per cent go to the majority of developing countries. Therefore little change is under consideration. Furthermore, it is somewhat surprising that the proposed total share of lending going to the majority of developing countries (the non-neighbourhood lending) would actually seem to fall in relation to the 2005 distribution.

The new loan mandate could, however, be seen as an opportunity to make the distribution of the EIB external lending more development oriented. This is consistent, for example, with the EIB's own vision, as set out in its New Strategy document (EIB, 2005): "Clearly the New Frontier for the EIB lies outside the EU; this is where the Bank must prove its worth as a development partner". This emphasis on development criteria, however, needs to be balanced with the EIB's history and its comparative advantages, its relatively recent expansion into neighbourhood countries, where it is seen to have an important role, and the broader discussion of an international development architecture.

A possible development criteria that could be used for the EIB external loan new mandate is to link it to supporting growth which will contribute to poverty reduction in developing countries, so as to – among other objectives – help meet the MDGs. Calculations adapted from Gottschalk (2004) for external financing needs to support rapid growth – and more important, to support growth required to halve extreme poverty by 2015 around the world – are reported in Table 2.

Table 2: Net External Financing Needs of Developing Regions, for 2004-2010 and 2004-2015

Developing Region	US\$ Billion ( 2002 constant prices)	% of Total	% of regional GDP
East Asia & Pacific	55.2	17.2	1.6
South Asia	36.9	11.5	3.4

Middle East & North Africa	67.5	21.0	6.5
Sub-Saharan Africa	61.9	19.2	10.8
Europe & Central Asia	24.1	7.5	1.1
Latin America & The Caribbean	76.3	23.7	2.6

Source: adapted from Gottschalk (2004).

For East Asia & Pacific and Europe & Central Asia, the calculated financing needs are annual averages over the 2004-2010 period, based on growth projections of the Global Development Finance 2004. For South Asia, Middle-East & North Africa, Sub-Saharan Africa and Latin America & The Caribbean, the financing needs are annual averages over the 2004-2015 period, based on growth required for halving extreme poverty by 2015. The growth rates under the poverty-reduction scenario are drawn from Hanmer et al. (1999) and reported in DFID (1999). For Latin America & The Caribbean region, the figures differ from Gottschalk (2004) in that 1) efforts to meet the 2015 poverty reduction target are partly met through additional growth and partly through better income distribution; 2) assumptions on saving rates are less heroic 19% of GDP over 2004-2008 and 22% of GDP over 2009-2015.

The reason why current growth rates are used for East Asia and the Pacific, as well as Europe and Central Asia, is that if current rates are sustained, these regions can easily meet the MDG of poverty reduction. For Middle East and North Africa, as well as Latin America, these regions need to accelerate their growth to meet the MDGs so the rates used are the ones that would achieve these aims (see also footnote Table 2). For South Asia, the same criteria (meeting poverty reduction targets) are used, though at present it is growing more rapidly<sup>1</sup>.

The regional groupings in Table 2 are somewhat different from those in Table 1; in addition, these groupings include low-income countries, for statistical reasons, given that to separate them out would require quite a time consuming separate exercise. But they give us a good grasp of how much the current regional distribution of resources from the EIB can be changed if the main criteria were to better reflect financing needs that support growth for poverty reduction in the developing world. EIB lending would have an important role to play as – though private lending has increased significantly in recent years – less than 20 MICs have gained steady access to private markets; access is generally volatile and often limited to shorter maturities (Leipziger, 2006). There is also the risk of sharp slowdowns of the world economy and of private flows, as

<sup>1</sup> For South Asia to continue growing at current rates, it would need higher net external financing needs than those reflected in Table 2.

well as potential increase in its cost (d'Arista and Griffith-Jones, 2006, see also below for a more detailed discussion).

Table 2 shows that developing Asia, Sub-Saharan Africa (where most of ACP countries are located) and Latin America together have financing needs that account for over 70 per cent of total financing needs of the developing world. This is in sharp contrast with the less than 30 per cent committed by the EIB for the same regions, as reported above. This would indicate that if purely development criteria would be used (linked to growth necessary for meeting the target of halving poverty by 2015) around 70% of EIB lending would go to Asia, Latin America and Sub-Saharan Africa. Naturally, as mentioned above, there are other considerations especially in the short to medium term, such as the need for a more gradual change in the structure of EIB external lending, the possible need for some specialisation by the EIB on economic grounds or geopolitical realities. However, in the long term, the development criteria may become more central, especially if the neighbourhood countries' needs are met from other resources and it is seen that some of the features of the EIB (expertise in infrastructure, speed and low cost of loans, ability to raise funds very cheaply on international capital markets) can offer specific value added to meeting development needs in middle income countries (see also below, for potential needs of developing countries). Additionally there may be advantages for a European RDB, reflecting a more European perspective on development needs, to play a role in lending to developing countries. If such a scenario arose in the long term, for example, 50% of EIB external lending could go to Asia, Latin America and sub-Saharan Africa and 50% of EIB external lending could go to neighbourhood countries. This change should be accompanied by greater attention to the development impact of the projects it finances (EIB, 2005, op cit) and other possible changes. Such long term considerations may need to be considered in the discussion of the distribution, for the 2007-15, though changes in distribution should be gradual.

This development criteria is consistent with what the EIB has financed in the past, and with what it has valuable expertise in: supporting infrastructure projects. Also, it could be consistent with the EU-Africa Infrastructure Partnership Fund (see Grainger-Jones and Laing, 2006). Developing countries increasingly need infrastructure investment in face of their deteriorated infrastructure and growing demand for their primary exports, and – significantly in the context of EIB ample expertise – infrastructure to support increased regional integration. Regional integration of infrastructure systems across borders would facilitate such exports, including to the EU. As pointed out, the EIB has a great deal of accumulated expertise and successful experience in infrastructure lending, as well as attractive features for developing countries, such as low cost and

quick “turn around time” for project preparation and approval (Dutch Government, 2006). It would be desirable if this expertise of the EIB is put to good use, especially to support development and poverty reduction around the world. Clearly, the EIB would need to develop further its institutional expertise to lend in developing countries; partnerships (e.g. via co-financing) with regional or national development banks (or other partners) may be helpful, as this could combine the EIB’s expertise in infrastructure and financial engineering with more detailed local or regional knowledge.

Last, but certainly not least, there seems to be a clear case for increased EIB lending throughout the developing world for promoting environmental protection and improvement under the Kyoto Protocol to reduce Climate Change; again EIB expertise in the European context could be effectively applied in a development context (see below).

## **II. Demand for IFI borrowing focussing on the EIB**

### **1) Introduction: The enduring pro-cyclical nature of private capital flows and associated vulnerabilities**

The last three decades have made developing countries, and particularly those more integrated into global private financial markets swing to the rhythm of highly pro-cyclical private flows. Capital flow volatility has had a direct major effect on the balance of payments and domestic financial market and through them on domestic economic activity and other macroeconomic variables (Griffith-Jones and Ocampo 2006; Eichengreen and Hausmann 2003; IMF, 2006).

In developing countries, fluctuations in capital markets are reflected in the pro-cyclical pattern of spreads (narrowing during booms, widening during crises), variations in the availability of financing (absence or presence of credit rationing) and in maturities (reduced availability of long-term financing during crises)

Volatility in financial markets is partly transmitted to developing countries through public-sector accounts, especially through the effects of the availability of financing on government spending, and of interest rates on public sector debt service payments. In many, particularly commodity-dependent developing countries<sup>2</sup>, the links between the availability of financing and commodity prices reinforce the effect that both have on public sector accounts. However, the most important effects of capital-account fluctuations are on *private* spending and balance sheets. Capital-account cycles, their domestic financial multipliers and their reflection in asset prices became the major determinant of growth volatility.

Though private capital flows have had many positive effects, their volatility and sudden major reversals have had very problematic effects on developing economies. The most serious are frequent and highly developmentally costly crises. Eichengreen (2004) estimated that over the past 25 years, income of developing countries was 25% lower due to currency and debt crises; he estimated the average annual costs of crises at over US\$100 billion. The output losses for the four countries hardest hit by the East Asian Crisis (Indonesia, Korea, Malaysia and Thailand) represented **72% of their combined GDPs during 1997-2002**. indeed, Indonesia experienced larger falls in output and increases in poverty, during the Asian crisis than the United States during the Great Depression (Griffith-Jones and Gottschalk, 2006).

We will argue that two central roles of MDBs and RDBs to help overcome, or at least greatly mitigate, these major problems are: a) provide (partial) counter-cyclical financing for middle-income countries, when private markets dry up and b) increasingly important, help develop innovative market instruments that better share risks through time between developing country borrowers and creditors, as well as investors. It is noteworthy that senior policy-makers from MICs have highlighted the importance of MDB support in these two roles (interview material and World Bank survey of MICs).

This catalytic and innovative role by MDBs and RDBs could significantly increase the developmental benefits, and sharply reduce the development costs of private flows initially for middle-income countries but in the future hopefully also for low income countries. We will discuss several of these instruments (especially guarantees, local currency bonds and GDP-linked

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<sup>2</sup> Notably in Latin America, the Middle East and Africa

bonds) in some depth in sections III and IV below. It is important, however, to stress here that financial innovation which is developmentally desirable does not necessarily lead to its spontaneous adoption by private markets. This is due to problems such as initial lack of critical mass and product uncertainty, large externalities as well as coordination problems and competition in financial markets implying that the private individual incentive to develop such an instrument can be far lower than the social benefits, both for creditors and for debtors (Borenztein and Mauro, 2004).

The combination of counter-cyclical financing by MDBs, the encouragement by MDBs of market instruments that better distribute the risk faced by developing countries throughout the business cycle (GDP-indexed bonds and local currency bonds), as well as instruments used by MDBs, such as guarantees, that can encourage more stable flows could significantly **reduce the risk of future debt and currency crises**. Indeed, one of the key aims of MDBs in present and future should be to **mitigate** the procyclicality of private flows, as well as complementing them.

Clearly MDBs and RDBs have central roles beyond the two outlined above: 1) financing low-income countries, 2) helping fund sectors, even in middle-income countries, for which private financing is not available for good projects (e.g. in infrastructure) and 3) supporting the provision of global and regional public goods. We will explore those further below. However, first we turn to the issue of drivers for demand for IFI borrowing.

2) **Current private capital flows are strong but potentially remain highly pro-cyclical in nature, generating risks for developing economies**

Current conditions for many IFI borrowers are exceptional in both the real economy and in financial markets and have followed buoyant trends since 2004. However these have been driven by positive economic and financial cyclical factors in this period and as such seem to continue to follow the established pro-cyclical pattern of private capital flows. Although some fundamental conditions have improved in this period, the structural vulnerabilities caused by pro-cyclical flows may remain largely unmitigated.

In the real economy many developing economies have experienced GNP growth and macroeconomic stability. The average growth rate of MIC's over the 2002-2005 period was 5.8%<sup>3</sup>. Growth has been strongly supported by rapid growth both in the US and especially China, with related strong export demand for developing countries. Commodity prices have been buoyed by

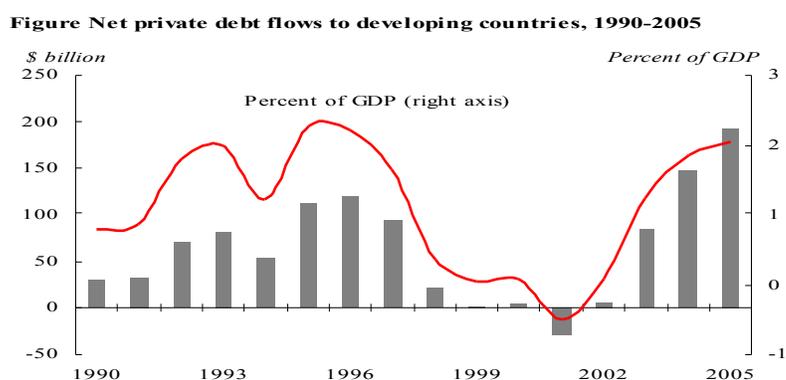
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<sup>3</sup> Source: World Bank. Growth rates are heavily influenced by China and India. If these two countries are excluded, the average growth rate in MIC's over the past four years declines from 5.8% to 4.3%.

strong global demand, including from China, and by political events in oil-producing areas. Those developing countries who are net exporters of commodities have benefited. FDI also continues to grow and MNC activities continue to develop, especially in services and manufacturing<sup>4</sup>. These positive factors have also allowed strengthening of domestic fiscal positions in many developing countries, rapid build up of foreign exchange reserves and smaller foreign currency sovereign borrowing. However in the event of a downturn in global growth, or other major change, many of these positive factors will reverse and apparently structural changes may be temporary.

Financial markets have supported expansion of private capital flows, with flows hitting a record high in 2005, surpassing for debt flows even the pre-1997 record (See figure 1), however, as % of GDP these debt flows are slightly lower than per-1997. The key point in Figure 1, however, is that it shows how variable private flows are (especially debt ones) and the extent to which the last two years seem exceptionally good, when compared with most of the 1990-2005 period.

Figure 1. Net private debt flows to developing countries, 1990-2005 (Source: World Bank)



Source: World Bank

In 2005, emerging market bond spreads have reached historical lows for both public and private borrowers (See figure 2). Figure 2 also shows the sharp volatility of spreads since 1990. Equity

<sup>4</sup> See Chapter 3 IMF Emerging Market Financing Flows

markets have been largely buoyant. Typical maturities in bond and loan markets have increased<sup>5</sup>. Many global investors now say Emerging Markets are mainstream asset classes.

Figure 2. Emerging market bond spreads, 1991-2006 (Source: World Bank)



### 3) Current conditions are expected to moderate and capital flow gaps be significant

However, this optimism seems vastly exaggerated; two important features linked to both structural and cyclical factors indicate continued limitations with private finance and therefore, a continued important role for MDB and RDB lending.

- a. Continued limited participation in capital inflows leave many developing countries needs unmet

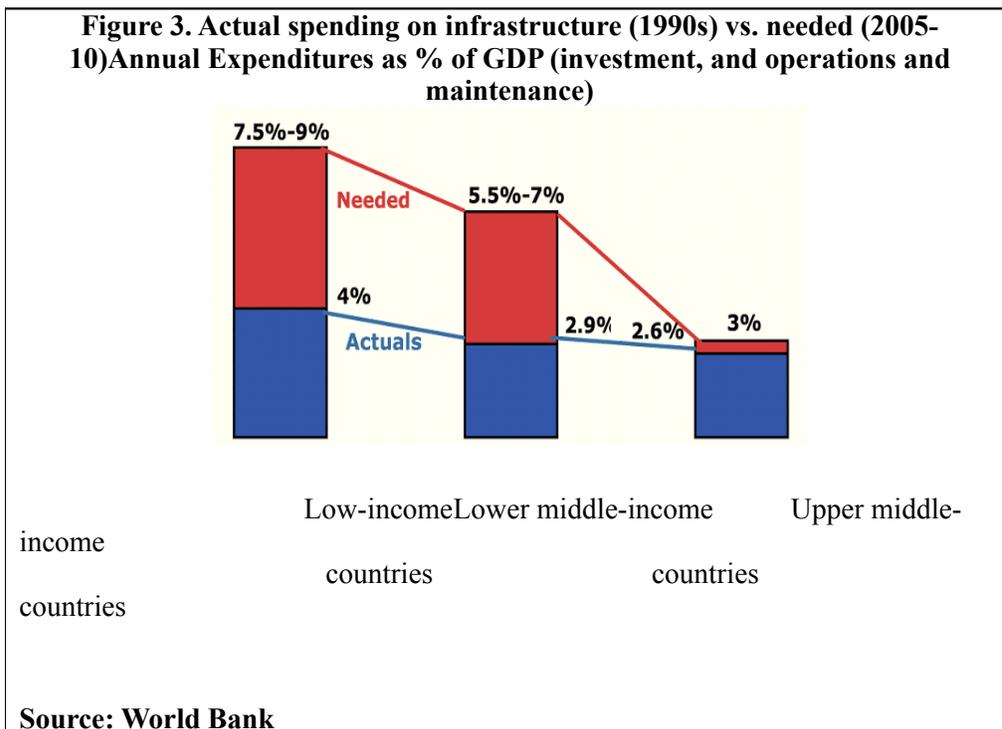
Firstly, the participants in the above conditions remain limited and most international private capital flows remain channelled to higher middle-income countries and creditworthy borrowers, with little channelled to the lower middle income and poorest countries<sup>6</sup>. Private capital flows, while being more widely disbursed than prior to the Asian crisis, are nevertheless largely concentrated in a very limited number of countries. According to World Bank estimates, ten countries account for 70 percent of emerging market sovereign bond issues, and less than a dozen MIC's can be regarded as established bond market borrowers able to access the market regularly at relatively stable spreads. **Gaps in spending on infrastructure** in many of these upper middle-income countries are relatively small but substantial gaps remain in low income and lower

<sup>5</sup> Average maturities of international bonds and notes issued by emerging market entities reached 13.5 years in 1<sup>st</sup> quarter 2006. Some issuing countries maturities significantly exceeded this such as a 31 year Brazilian bond, a 22 year Republic of Iraq bond or a 25 year bond by the Philippines. Source: BIS

<sup>6</sup> UNDESA World Economic and Social Survey 2006

middle-income countries (See figure 3). For more detailed discussion of infrastructure see below and box.

These continued structural gaps between demand for borrowing and private flows especially for low-income, but also for many low-middle income countries remain a key area for IFI involvement and are likely to remain so for quite a long time, as overcoming market and policy imperfections is likely to be slow.



Three further points seem very relevant in relation to infrastructure investment needs and a potential role for the MDBs and the EIB in particular.

As discussed above, there are huge unmet needs of infrastructure in developing economies. To illustrate briefly with South and East Asia, there is much consensus in a variety of studies that in South Asia “extending access to infrastructure services to both businesses and households (especially the poor) will be critical to sustaining the regions high growth rates and ensuring its benefits are shared with the regions large number of poor. Investment climate surveys routinely show infrastructure as a leading impediment to business growth in South Asia – with shortcomings in electricity service identified as the greatest obstacle to business operation... Hundreds of millions of people have no access to basic services...”

East Asia’s strong growth and rising incomes are outpacing infrastructure development. High growth is placing increasing pressure on existing infrastructure across the region (for more details, see World Bank, 2005; ADB/JBIC/WB,2005 and Jones, 2006). The latter study estimated infrastructure needs in East Asia at US\$200 billion a year, over the next five years. Other sources offer estimates of sectoral needs. The Camdessus Report on water and sanitation, for example, estimated developing countries’ investment needs in that sector alone at \$US49 billion annually until 2015.

Secondly, the recent development of internationally comparable datasets and an intensified research effort have allowed the following empirically based general conclusions (Estache, 2004; Jones, 2006):

- i. There is strong international evidence that infrastructure investment is central for both accelerating growth, reducing inequality and making growth patterns more pro-poor. For example, the World Bank (2005) has estimated that increasing Latin America’s infrastructure investment to East Asian levels would imply increasing that region’s annual GDP growth by 1.4 -1.8% and reduce income inequality by 10 - 20%.
- ii. Additional growth and poverty reduction benefits are associated with particular sectoral investments, notably in water and sanitation, roads and information and

communication technologies. Rural and feeder roads seem to have a particularly high impact on growth and poverty reduction.

Naturally, the specific needs will vary on a region by region and country by country basis. Possible future work on detailed scenarios for infrastructure and other gaps could provide far more detailed scenarios of demand projections.

An important issue to explore – probably jointly with the EIB and other MDBs – is the sectoral comparative advantages of private and public (national as well as international) finance for different sectors. For example, in some countries, e.g. China (Jones, 2006) or Chile (interview material)<sup>7</sup>, private financing has had a significant role in developing major road networks where this is clearly profitable. There may, however, be risks (e.g. regulatory risks) that even in those type of countries the private sector does not want to assume; governments, as well as MDBs such as the EIB, could help either by co-financing or by providing guarantees (see below) if necessary to attract such private investment. Similarly, it may be easier – in some more creditworthy countries – to attract private investment in ICT and power, if profitable. Private investment in these sectors would release, in those countries, public and MDB resources for investments in less profitable in the short term, but developmentally essential, due to clear positive impacts on the poor, sectors such as rural and feeder roads, as well as water and sanitation for the poor. In less creditworthy and poorer countries, it may be more difficult – and or costly in terms of contingent liabilities – to attract private financing even to sectors, such as major road networks or power, and therefore this will need to be funded for a long period more by governments, from their own resources, supplemented by loans from MDBs (including where relevant the EIB) to the public sector.

The very wide range of market access of even middle-income countries, even in times of privileged market access as 2006, (see above) can be seen in Table 3 below for Asia.

**Table 3 Country Credit Ratings, 2005**

<b>Country</b>	<b>Local Currency</b>	<b>Foreign Currency</b>
China	A+	A
India	BB+	BB+
Indonesia	BB-	BB-

<sup>7</sup> Interview with former minister of Public Works, later President Ricardo Lagos.

Malaysia	A+	A-
Kazakhstan	BBB+	BBB
Papua New Guinea	B+	B
Philippines	BB+	BB
Thailand	A	BBB+

Source: Fitch Rating Report

To summarise, there is a strong general case for MDBs and RDBs to increase their own lending, as well as help catalyse (through innovative mechanisms) private investment and lending in infrastructure. In terms of private investment (both domestic and especially international) this has fallen significantly after crises in the 1990's and has recovered only partially. National governments tend to have limited space for sufficiently large investments to meet remaining needs; therefore, the role that MDBs and RDBs can play is particularly crucial in this area as the long-term maturities of their loans, their ability to continue lending to countries with good fundamentals even when private markets are hit by risk aversion and the technical expertise they can provide, are particularly valuable.

The EIB seems very well placed to increase its role in infrastructure lending/catalysing private flows in developing countries. It has a very long history within Europe of financing/co-financing important sectors of infrastructure (Griffith-Jones and Steinherr, 2006). According to the Dutch Report, in 2004, the EIB played an important role in financing infrastructure in MICs by providing 20% of MDB committed loans to that sector. Most importantly, as the DFID (2006) Report points out, "EIB's current advantage is clearly on large, infrastructure projects". A number of evaluations points to the EIB's "strong technical expertise in infrastructure and good competence in sector/project engineering and the financial design of such projects". Clearly an important effort would have to be made to increase expertise of EIB staff in infrastructure investment in developing countries. One complementary possibility is to collaborate more closely with regional development banks, or even with national development banks. Thus, the EIB would provide its more general knowledge of infrastructure and financial engineering and the regional and development banks could contribute local knowledge.

b. Current access to financial markets may fall, possibly sharply

Secondly, the current conditions can be explained by cyclical factors and may represent the peaking of the pro-cyclical credit cycle of flows to developing countries<sup>8</sup>. (Further discussion underpinning this conclusion is included in the box scenarios below). A retrenchment from peaks

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<sup>8</sup> Source: World Economic and Social Survey 2006.

is expected because of a slowdown of global growth as US deficits unwind and global inflation pressures are managed.

The likely impact of this for developing countries is a retraction of funds to marginal borrowers into what are considered less risky investments and a re-opening of the borrowing gap currently covered by private flows. For example for developing countries, the IMF (2006) estimated that less than 50% of current credit spread improvement was attributable to improved fundamentals with cyclical market conditions being the “crucial” factor<sup>9</sup>, estimating a least a 50% reversal of credit spread reduction as conditions change , even for those developing countries currently experiencing favourable access to private capital flows.

A detailed analysis of countries and sectors that will be impacted would be a fruitful area for additional study. However we would broadly expect retrenchment of investors into the large Asian countries (notably India and China), those countries in Eastern and Central Europe who are new EU members or with shorter term prospects for EU membership and into the high growth sectors dominated by MNCs. Gaps would open in poorer countries in Europe, Asia and Latin America and the fledging interest in African countries from investors would end. We also expect flows into essential but non-global sectors including infrastructure (see box), non-mineral commodities and agriculture to contract significantly.

Contraction in this context means both an absolute unavailability of funds (credit rationing) and/or a deterioration of conditions to borrowers. The latter would include credit spread increases, reversion to non-local currencies (e.g. USD), a smaller proportion of credit available to the local private sector (usually seen as more risky), declines in maturity and increases in requirements such as collateral or guarantee structures. Such developments would lead to increasing vulnerability in borrowing economies as these changes in financing both create absolute capital needs gaps, increased foreign exchange and maturity mismatches in available financing and make existing debt burdens less sustainable, if spreads increase sharply.

### c. Concluding Remarks

In examining future IFI borrowing demand the potential gaps represent an essential area to fund in order to underpin macroeconomic stability and continued long term growth and poverty alleviation in the face of cyclical slowdown in the global economy, an increase in risk aversion or a reduction of global liquidity. Failure to do so will reverse gains for developing countries during

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<sup>9</sup> See IMF Financial Stability report 2006 Chapter 1 “Global Financial System Resilience in the Face of Cyclical Changes”. Based on Emerging Market Bond index cash spreads

the period of global economic growth and reopen economic vulnerabilities, for example to debt crises. It is essential that IFI's mandate remains open to anticipating and acting to stem these financing gaps in the long term.

#### **4. Expected Scenarios for Future Developing Country Borrowing and IFI Implications**

In assessing future demand for IFI borrowing it is crucial to place estimates in the context of broad economic and financial system conditions. We have prepared three scenarios showing what we consider to be the best, worse and mid case scenarios for these broad conditions based both on our own understanding and discussion in the IMF Global Financial Stability Report 2006.

##### **WHAT ARE THE POSSIBLE SCENARIOS FOR GLOBAL AND EMERGING FINANCIAL MARKETS: BEST, WORSE AND MID CASE?**

###### **BEST CASE: A CONTINUATION OF CURRENT BULLISH CONDITIONS**

- Continued buoyancy in global growth, controlled inflationary pressures and constant interest rates in G10 countries (Excluding Japan) with any “shocks” such as increases in oil and other commodity prices or political events continuing to be absorbed without major problems. WTO led liberalization would progress in the medium term. US deficit continues to be financed by inflows from non-US private investors and Asian central banks. No retrenchment in investor appetite for US assets occurs.
- Bond and equity markets continue to be strong globally with upward growth and continued low volatility. Investor liquidity remains high and risk aversion low ensuring the search for yield continues
- In Emerging Markets investor sentiment in both financing and FDI remains at its current strong levels. No expansion of credit spreads from their current historical low occurs. Structural deepening of bond and equity markets continues and Emerging Markets assets continue to become increasingly mainstream. Broadening of countries that attract financing and FDI from global investors as search for yield and domestic growth continues to offer compelling investment opportunities.
- Historical experience of these conditions is the current conditions and has been similar since 2004.

###### **WORSE CASE: A DISORDERLY UNWIND OF GLOBAL IMBALANCES**

- A sudden and disorderly unwinding of global imbalances and a collapse in global financial markets led by a collapse in US asset values. Accompanied by a vicious circle of retraction in investor risk appetite and liquidity leading to a prolonged depression and slump in financial markets. As well as shocks noted previously, a worse case could also see a rise in protectionism and a fall in demand for developing country exports and a sharp fall in commodity prices.
- In Emerging Markets the increase in risk aversion and fall in liquidity is extreme and disorderly and leads to a collapse of asset prices, sharp devaluation of exchange rates and panic withdrawal of foreign capital. Post crises markets are localized and thin and financing is limited. Bond and equity issuance become very limited and credit rating downgrades occur for both government and corporate borrowers. GNP would be negatively impacted by commodity price falls with sharp drops in exports from commodity dependent developing economies.
- Historically examples of this type of scenario were seen frequently in the last three decades, for example in the 1997 Asian Crisis and the Russian, Mexican and Argentina crisis: there is some small risk that this scenario could be even worse.

**We anticipate the mid-case scenario to be the most probable in line with mainstream economic expectations and see the scenario leading to a pro-cyclical but ordered retrenchment of private capital flows back towards long-term averages.**

**MID CASE: RETRENCHMENT TO LONG TERM AVERAGE CONDITIONS**

- Moderate slow down from current growth with controlled, but distinct, inflationary pressures and constant or slightly increased interest rates in G10 countries. Continued support of the US deficit by Asian inflows but some medium term slowing of demand for USD assets as structural imbalances are unwound over a prolonged period. Liberalization of trade and investment and financial markets would stagnate with no further progress made in WTO talks but equally no mainstream rise in protectionism. Moderation in commodity prices as demand weakens.
- Continued stability in Asia, notably China and India, but no change in central and Emerging Europe from current moderate development driven vulnerabilities (Current account deficits, rapid credit growth and rising external deficits). Declines in value of exports for commodity dependent economies with resultant deterioration in fiscal positions and foreign exchange reserves.
- Stability in major assets markets but with retrenchment to long term averages for asset values including stable or declining equity markets, reversal of credit spreads from current historical lows and moderate increases in investor risk aversion and volatility. Responses in financial markets to any shocks occur but are limited and short term.
- In Emerging Markets credit spreads widen and there is significant retraction in those instruments and countries seen as representing higher risk. Liquidity and maturity retrenches and reversal of deepening of local bond and equity markets occurs in all regions. Financing becomes increasingly concentrated in mid income countries' governments and little is available for less creditworthy countries; far less available for private sectors.
- In FDI reduced risk appetite amongst MNC's leads to increased concentration in favored countries, notably China, India and selected Latin American countries (e.g. Brazil and Mexico) but a withdraw or continued absence from other developing countries including Africa (With the exception of South Africa), South East Asia and smaller Latin American and Central and Eastern European economies
- An example of these types of conditions was seen for a short period in May 2006 when markets suffered a series of declines. Declines started in Icelandic equity markets, a relatively unimportant market globally, but spread to other major world markets including both equity and bonds, although contagion was short lived and recovery occurred. However as well as the contagion, it was also notable that worse suffering markets were Emerging Markets where equity markets declined on average by 11% with some markets declining by up to 24%, currencies depreciated by up to 14% and government bond yields jumped noticeably.

## 5. Literature Survey

It is interesting that most major reports, even though approaching the subject from different analytical and ideological perspectives, have emphasised the essential role that multilateral development banks (MDBs) will continue to play in the international financial system<sup>10</sup>.

The United States Department of the Treasury (2000) argued strongly for an important financial role of MDBs in both poor and middle-income countries, given fragile access of the latter to private capital markets. It argues – as have others, e.g. the Dutch Report (2006) – for improved coordination among MDBs. It was one of the first to stress the role of MDBs' lending as a catalyst for private lending.

Two independent reports, one UN Report, and a major private sector report take a similar line on the essential role that MDBs must play, with some differences in emphasis. The EGDI-IDS Report (2000) emphasised, among the key roles for these institutions, financial resource mobilisation and provision of global and regional public goods. This report stressed that such functions would remain important under different scenarios, though clearly more essential in bad times. This comprehensive report, as well as Stiglitz (1999) and reports written by developing countries, academics and policy-makers emphasised the need for multilateral development banks to be intellectually diverse in their approach.

The Gurria and Volcker Report (2001), based on the Commission on the Role of MDBs in Emerging Market Economies, emphasised that given “...the volatility of global financial markets, **access by these countries to private capital can be unreliable, limited and costly**...even when their long run growth prospects are strong” (my underlining). This report also emphasised the need to strengthen the relationship between the MDBs and the private sector, especially for encouraging infrastructure investment in developing economies. Particular emphasis was placed on guarantees, especially those that cover government and regulatory risks, given MDBs “knowledge of the policy and institutional environment, technical and financial competence in infrastructure, and their ability to help governments commit to appropriate policies”.

The 2005 UN Financing for Development Report (UN, 2005) emphasised the importance of lending to both low and middle-income countries by MDBs and placed special importance on MDBs acting as a counter-cyclical balance to fluctuations in private capital markets (an aspect increasingly stressed in different reports, for example the World Bank) and also acting as catalysts

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<sup>10</sup> An exception was the Meltzer majority Report (Meltzer et al, 2000) that proposed reducing sharply the role of multilateral bank lending to developing countries with access to private capital markets.

for private sector investment. It stressed that the latter, via co-financing with the private sector or via guarantees, “should become one of the priorities for multilateral financing in future”. Like the G-24 (that represents developing countries at the IMF and World Bank), this Report expressed that developing countries are concerned about the “high cost

of doing business with MDBs”. Also, the UN Report (2005) emphasised the growing roles of MDBs as “market makers” for example via the sale of carbon credits under Kyoto. It urged MDBs and RDBs to extend this role of “market maker” more, for example, to loans in local currency and to GDP linked bonds, where the associated lending could be later securitised and then sold on international capital markets (discussed further below).

It is interesting that the private sector World Economic Report (WEF, 2005) partly develops a similar line. For example, they emphasise the critical role of MDBs to “exercise leadership in first time transactions” where they would act as catalysts; they urge funding to be provided to cover large transaction costs for such first operations. More broadly, the WEF Report argues that there are huge investment gaps in developing countries (see above). They stress the increasingly large unused capital in MDBs, which they stress is paradoxical at a time when “the international community is trying to mobilise resources for poverty alleviation”. They emphasise the need for MDBs to both make larger loans, as well as “wider use of risk mitigation instruments to alleviate part of the risk faced by investors to stimulate private investment”. They stress the need to change the corporate culture and the incentive systems in the MDBs, so as to move these institutions towards risk mitigation instruments. A more detailed discussion of these instruments follows in the next section.

### **III EIB's approach to risk and recommendations for improvement**

#### **1) Guarantees received by the EIB**

Overall the EIB benefits from very strong guarantees from the European Commission which we describe below. In what follows, we will first describe the level and nature of the guarantees received by the EIB. One key question, which we will pursue afterwards but wish to pose here, is why is the EIB so risk-averse in its own lending, demanding so many counter-guarantees from its borrowers (which in some regions, e.g. FEMIP restricts its ability to lend) when it *already has strong guarantees from the Commission*. Given the high backing the EIB has from its' shareholders and the Commission, should it not be far more willing to take more risk by, for example, lending to fairly creditworthy customers for profitable projects, even if these cannot obtain a counter-guarantee? Such an approach could allow the EIB to lend far more, for example, to the private sector in FEMIP and other lower-middle income countries. (It should be mentioned that reportedly the World Bank also demands counter-guarantees )

The current European Commission guarantee system for the EIB has two components: a blanket guarantee and a risk-sharing scheme.

##### a) Blanket guarantee

The guarantee is restricted to 65% of the aggregate amount of the credits opened, plus all related sums. Within this aggregate ceiling, defaults on individual loans are de facto covered up to 100%. The guarantee covers all credit risks unless the risk-sharing arrangements apply, in which case the Community Guarantee covers only specific political risks whereas non-political risks are borne and mitigated by the EIB (notably for loans to the private sector). The blanket guarantee refers to the total amount guaranteed without distinguishing between regions. The overall ceiling of the credits opened is equivalent to €20,060 million (see table below).

##### b) Risk-sharing

The risk-sharing scheme separates the commercial and political risks in the Community guarantee. The EIB has been asked in a European Council decision to secure, where possible, adequate non-sovereign third-party guarantees or other security for commercial risks, with the Commission guarantee in that case covering only specific political risk (currency non transfer, expropriation, war or civil disturbance, and denial of justice upon breach of contract).

The Council Decision invites the Bank “to aim to cover the commercial risk on 30% of its lending under this Decision from non-sovereign guarantees as far as possible on an individual mandate basis. This percentage shall be expanded upon whenever possible insofar as the market permits.”

According to the European Commission Report (2006), the EIB will continue to extend the volume and the scope of its operations without Community guarantee wherever appropriate. In particular, over the period 2007-2013, financing in Croatia, Turkey and the Former Yugoslav Republic of Macedonia would increasingly take place under the Pre-Accession Facility made available by the EIB, which should be extended over time to cover the rest of the Western Balkans, in line with progress of their accession process. The EIB indicative lending without Community guarantee in this region would amount to around €4 billion over the period 2007-2013. The Bank would also increase its lending in Mediterranean countries without EU guarantee coverage, building upon the already existing ‘Nice’ Facility, to an indicative amount of around €2 billion over the period 2007-2013. In light of past experiences (Beijing airport project), the Bank could also foster the practice of financing at its own risk strategic *ad hoc* projects in investment grade countries, notably in Asia and Latin America.

The Commission's proposal clarifies the nature of the guarantee coverage which will be limited to risks of a sovereign or political nature. The Community guarantee will provide a full coverage for financing operations entered into with or guaranteed by the State. Also, operations entered into with local authorities or government-owned and/or controlled entities can be fully covered, where such operations have an appropriate EIB credit risk assessment, taking into account the credit risk situation of the country concerned.

The political risks covered under the Community guarantee will be those established under the current mandate, i.e. non-transfer of currency, expropriation, war or civil disturbance and denial of justice upon breach of contract. In order to align the implementing provisions for the coverage of these risks, notably denial of justice upon breach of contract, with MIGA provisions, some technical adjustment will be introduced in the guarantee agreement between the Commission and the EIB.

Finally, the Commission proposes to extend the guarantee coverage to both types of financing operations mentioned in the EIB Statute, i.e. loans and guarantees. Under the existing mandates only loans are covered. This extension will not imply any material change in the types of projects to be financed by the EIB. For both loans and guarantees, the Community guarantee will cover sovereign or political risks and thus the risk borne by the Community budget will be equivalent for both types of operations (under equivalent conditions). A technical modification of the Guarantee Fund Regulation is necessary to accommodate this extension.

## **2. Progress towards the risk-sharing objective?**

As explained above, the Community Guarantee covers all credit risks, unless the risk-sharing arrangements apply, in which case the Guarantee covers only specific political risks. Under risk-sharing, the EIB is expected to obtain third party guarantees or other security to cover the commercial risk with an aim of having 30% of the portfolio established under the current mandate secured this way. For these loans, only defined political risks (currency non-transfer, expropriation, war or civil disturbance, denial of justice upon breach of contract) are covered under the Community Guarantee.

The risk-sharing scheme has helped to mobilise commercial bank guarantees for loans in emerging markets, especially in Asian and Latin American (ALA) countries. Table 4 below shows that the Bank had achieved at the end of December 2005 16.7% in terms of risk-sharing loans as a proportion of total loans signed under the mandate overall. The proportions differ greatly between the various regional headings of the mandate. The target of 30% for mandate operations has already been substantially exceeded in ALA, but is unlikely to be attained individually in SEN, MED or RSA. Most of the lending operations in the New Member States before accession, however, were carried out without EU guarantee under the Pre-Accession Facility, adopted by the Bank after the Decision came into force.

Table 4: Risk-sharing achieved as at 31<sup>st</sup> December 2005

Mandate		Signatures			
Region	Ceiling EUR million	Total EUR million	Risk Sharing EUR million	Risk Sharing % achieved on mandate alone	Risk Sharing % achieved on mandate and non-mandate
SEN	9 185	7 817	830	10.6	65.3
MED	6 520	6 272	601	9.6	14.6
ALA	2 480	1 942	1 463	75.3	80.4
RSA	825	757	80	10.6	10.6
TERRA	600	600			
Turkey SAP	450	450			
<b>EU Mandate Total</b>	<b>20 060</b>	<b>17 838</b>	<b>2 974</b>	<b>16.7</b>	<b>52.1</b>
Pre-Accession Facility II	14 000	12 304	12 304		
Med Partnership Facility	1 000	364	364		
Article 18 project*		500	500		
<b>Outside Mandate Total</b>	<b>15 000</b>	<b>13 168</b>	<b>13 168</b>		
<b>Overall Total</b>	<b>35 060</b>	<b>31 006</b>	<b>16 142</b>		

\* Beijing Airport Project

There are large regional variations in risk-sharing within the framework of the mandate 2000-2007

The reasons for the variations in risk-sharing under the regional sub-mandates are as follows:

– Firstly, most projects under mandate in South Eastern Neighbours are in the public sector and therefore outside the scope of risk-sharing. The projects in the private sector, i.e. many loans with commercial guarantees, were signed under the Pre-Accession Facility – under EIB’s own risk - outside the framework of the mandate.

– Secondly, the current rather low level of risk-sharing in the Mediterranean region essentially reflects the difficulty for local promoters to gain access to external (including European) banks willing to provide a guarantee acceptable to the EIB under its risk guidelines. On the other hand, local commercial banks and industrial companies are said not to comply with the EIB’s criteria for risk-sharing. Accordingly most of the loans signed up until now have been signed with governments or public entities. However, the overall volume of direct and indirect support to the private sector has significantly increased since the establishment of the Facility for Euro-Mediterranean Investment and Partnership (FEMIP). In addition, the introduction of new instruments such as the “Special FEMIP Envelope” (SFE), which allows FEMIP to undertake selected investments of a greater risk profile, will favour the further development of risk-sharing operations. This envelope is aimed at reinforcing the EIB’s support for the private sector. In 2005, two operations were signed for €80 million.

– Thirdly, in contrast, the ALA mandate supported mostly projects linked to European Foreign Direct Investment (FDI) in ALA or projects implying transfers of technology and know-how from Europe, with a high proportion of projects in the industrial and service sectors as well as utilities involving EU companies. As a result, most projects financed are carried out by strong and creditworthy private sector promoters making it possible to mobilize non-sovereign guarantees, mostly from European commercial banks; hence, the particularly high percentage of operations that availed themselves of the risk-sharing scheme.

It should be stressed however, that from another perspective, one reason why the borrowing firms are so creditworthy is because they are European, which is linked to the Mutual Interest Provision for ALA; this is positive from the guarantee perspective, but poses a great deal of other problems such as discriminating against local firms, providing a type of “tied aid” etc (see Friends of the Earth International, et al 2006; DFID 2006). If the Mutual Interest provision is abolished or very strongly modified and the EIB, encouraged strongly by its shareholders to take more risks (for projects with a good rate of return), the EIB could lend far more to local enterprises in the developing economies, which could significantly increase its development impact.

The EIB has made two risk-sharing operations in South Africa to date. Lending for public-sector projects has so far been supported either by State guarantees or by appropriate project-specific covenants. As for private-sector projects, representing 55% of total lending in South Africa to date under the current mandate, most of them are guaranteed by first-class local banks, whose international rating is at the same level as, and indeed constrained by, the sovereign rating of the Republic of South Africa.

### 3) The EIB's instruments

The EIB's operations under the mandate have been conducted mainly using the following instruments:

*Standard senior loan:* this is the EIB's main product in all regions, with stringent guarantee requirements, as per its Statute. Of particular value are the long maturities of up to 25 years for the financing of infrastructure projects unavailable in local markets.

The vast majority of EIB interventions in the Mediterranean Partner Countries (MPCs), the Western Balkans and ALA have been based on such loans.

*Global loans:* In addition to its standard senior loans and for smaller scale projects with an investment cost of less than €25 million equivalent, the Bank channels long term loans (generally 6-8 years) to small and medium sized enterprises (SMEs), or to local authorities for infrastructure investments, through local intermediary banks and leasing institutions which assume the project risk.

*Special FEMIP Envelope (SFE):* As mentioned above, to support more effectively the private sector needs in the MPCs the SFE was established in 2003 to finance selected private sector operations with a higher risk-profile. In these cases, the Bank accepts on its books relatively higher commercial risks, not covered by a highly rated third party outside the MPCs. The SFE can be used for both standard senior loans and global loans, but so far EIB activity has taken only the form of global loans.

It has been reported (in the EIB's own publication, *Investment Capital in Mediterranean Countries*, 2005) that under FEMIP the exchange rate risk is generally borne by the European Union. If this is the case, this could be a cause for concern as it could imply very large and open-ended contingent liabilities for shareholders. More detailed analysis seems required (see also below).

However, within FEMIP financing, one of the modalities described are participation loans, where the remuneration is linked to the performance of the borrowing firms. This type of quasi-equity (risk-sharing) instrument seems very innovative and – if successful – could be extended to other regions. It could also provide a precedent for GDP-linked bonds, which operate under a similar principle but at a macro-economic level.

EIB activity under mandate has been complemented by EU budgetary resources, managed by the EIB:

*Interest subsidies:* In the context of its objectives relating to the environment in the Mediterranean Partner Countries, the European Commission subsidizes FEMIP interest rates for environmental projects, thereby enhancing the economic and financial impact of projects. Such subsidies have provided an incentive to MPCs to take appropriate action towards the protection and rehabilitation of the environment, leading to a substantial increase in EIB lending levels in the region's environmental sector. Through project conditionality, they have further offered the leverage to encourage gradual policy reform.

*Technical assistance:* In the Mediterranean, loan operations for environmental projects have been supplemented by interest subsidies and limited grants for technical assistance. More generally, the EIB takes useful initiatives, like helping the establishment, with the Commission, of a European Private Public Partnership for Infrastructure Expertise Centre (EPEC) to disseminate experiences of PPP across Europe. This Centre could also be used for this purpose in developing countries.

*Risk capital:* Provided in the form of equity and/or quasi-equity financing to strengthen private companies' capital structures and act as a catalyst for joint venture projects. The EIB can also participate in selected venture capital / private equity funds, support micro-finance and help develop the local financial sector. In the Mediterranean, the EIB has also been able to use risk capital from the Community's budget to extend credit and capital investment lines to banks and also to directly invest in private equity funds. In South Africa, the Commission – in consultation with the South African authorities – asked the EIB in 2001 to manage part (€ 50 million) of its grant-aid programme in the form of a risk-capital financing facility to assist emerging entrepreneurs from the historically-disadvantaged persons ("HDPs") communities, in particular through the provision of equity capital. According to the 2006 Report from the Commission to the European Parliament and the Council, op cit, the results of this scheme, channeled principally through the Industrial Development Corporation of South Africa, have been very encouraging.

In general, a particular effort has been made to develop EIB funding in local currencies, notably in Hungary, Poland, the Czech Republic and South Africa. The EIB's AAA credit rating, together with a relatively well-advanced local currency markets, have enabled the Bank to issue Euro-local currency bonds permitting it to denominate its loans to local borrowers in the local currency. This has proved to be particularly useful for projects serving the local market - typically utilities with local currency revenues – that borrow from the EIB for long maturities and are thus able to avoid any foreign exchange risk.

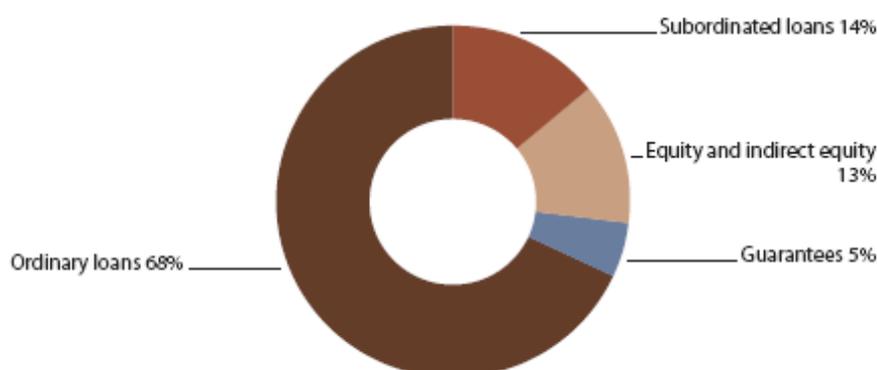
The EIB pioneered issuance of debt in local currencies by international actors in new EU Member States and Acceding ones and has become one of the largest non-government issuers in the region. This was greatly valued in countries like the Czech Republic (interview material). In 2005, the EIB raised a total of €1,500 million equivalent in local currencies, including the Turkish lira. The EIB prides itself (EIB, Annual Report 2005) in issuing the largest Turkish lira bond in the international market and building the first-ever yield curve in Turkish lira going out to 10 years. The EIB has more recently started to contribute to local capital market development in certain African countries with a leadership role in raising funds in South African rand. It launched a synthetic Botswana pula bond, the first to be linked to this currency.

In view of increasing hedging exposure for transactions in several ALA countries, the EIB started issuing bonds denominated in local currencies of the ALA countries with the launch of transactions in Mexican pesos for almost €200m. Since 2004, there have been a number of innovative issues via synthetic issues in Brazilian reals and Russian roubles. Those synthetic transactions may help develop those countries' derivatives markets which could be very positive. However, these synthetic instruments may pose new macro-economic risks for the countries that need to be evaluated carefully (Dodd and Griffith-Jones, 2006 and below).

A further risk-taking instrument of the EIB is the Investment Facility (IF) designed to particularly support the development of the private sector in the ACP countries, as well as develop the financial sector and support commercially viable public enterprises. The IF is a €2.2 billion revolving fund, offering loans (including ordinary, senior and local currency), equity and quasi-equity and guarantees. As a revolving fund, it is intended to become self-sustaining. This is complemented by €1.7 billion own resource lending by the EIB.

The IF, launched in 2003, has a commitment to lend on commercial terms – to avoid crowding out private funds – with subsidies in only a few cases. Until end 2005, it had disbursed €830 million for about 50 projects. The distribution by type of instruments of the IF can be seen in the graph below.

## Breakdown by type of financial instrument (01/04/2003 - 31/12/2005)



The IF's strategy is to seek to progressively develop and manage a portfolio of equity investments that includes a mix of both direct and indirect investments as well as both large, stable companies and some more innovative and higher-risk investments, the latter being very important to the long-term development of the private sector in the ACPs. The IF is investing both directly in companies and indirectly through suitable intermediaries such as private equity funds. By the end of 2005, equity investments accounted for 13% of the IF portfolio, ranging from a direct investment in a new high-end Club Méditerranée beach resort hotel in Mauritius to a new investment fund dedicated to micro-finance institutions located predominantly in Africa's low-income countries (La Fayette Investments).

Quasi-equity and subordinated loans accounted for some 14% of the IF portfolio at the end of 2005, very much used by the Bank under Lomé. They remain useful instruments which the IF can deploy to achieve the catalytic objective of enabling other lenders such as commercial banks to support investment projects with debt financing, particularly in cases where a project sponsor has limited capacity to raise sufficient new ordinary equity.

There seems to be some progress in developing Guarantee instruments, which constitute an obvious alternative to direct lending in a number of ACP countries where there is a lack of capacity to take on risk or maturity transformation. Thus, they can have a major economic benefit in bridging a confidence gap that could otherwise lead promoters/ operators to forgo or abandon long term investments. Guarantees help to channel external funding to these countries and to mobilize domestic savings on a long-term basis, thus strengthening the local capital markets. By the end of 2005, guarantees accounted for 5% of the IF portfolio which seems positive. Reportedly, it is only through the IF that the EIB grants guarantees in its external lending.

An interesting EIB guarantee is the 25 million guarantee granted in 2004 to the West African Development Bank (BOAD), which was combined with a €25 million global loan and a €4.5 million participation in a capital increase. The guarantee facility consists of a partial guarantee of BOAD's loans to enterprises and a partial counter-guarantee for BOAD's own guarantees on an enterprise's bond issues or other securities (source: EIB website).

It would seem very valuable that, if these types of schemes were successful, greater use would be made by the EIB of guarantees within the ACP countries – especially within the IF – and that the EIB could draw both on its experience in the EU and in the ACP countries to offer guarantees in other developing countries (see below).

The IF's ability, in certain circumstances, to provide local currency financing is a major value added in meeting the requirements of SMEs and other companies with very little, if any, foreign exchange revenues. Local currency loans, whereby the IF provides loans in the currency of the recipient country and takes on the foreign exchange risk of the operation, accounted for nearly 9% of the IF portfolio at the end of 2005. In return for assuming the foreign exchange risk and to avoid market distortions, the IF receives a premium based on the difference between interest rates in the local market and the euro market.

This does imply a potential high level of contingent liability for the IF should major devaluations occur in a number of ACP countries at the same time. It may be interesting to study more carefully whether assuming the whole foreign exchange risk is the best and the most cost efficient way for the IF to offer comfort to the private sector in those countries.

Various forms of “senior” and “junior” debt and risk-sharing financing instruments are available through the IF. These allow flexibility in setting terms and conditions, which can be adapted to the nature of a project. This can be done, for example, by varying the EIB's remuneration depending on the performance of a project. The EIB's own resources offer long-term, senior debt on very favourable financing conditions for larger operations in the financial sector and for those with lower risk. The EIB bases its lending conditions for the Investment Facility, and for lending from its own funds, on its “AAA” credit rating. It can pass on these advantages as it operates on a non-profit basis. The difference is that with the Investment Facility the bank accepts more risk and sets the pricing for lending accordingly. When lending from its own resources the bank takes a low level of risk, which it mitigates by guarantee and security arrangements.

Potentially, the IF is a highly innovative instrument. However, there are initial reports that there is a high degree of risk aversion in the credit risk guidelines established for the IF which may have diminished its development impact.

There seem to be interesting exceptions however, in terms of development of innovative instruments for the ACP countries. One example is the proposed loan to the Lumwana copper project in Zambia, where interest servicing would be linked to the copper price, which is very good in terms of sharing the risk of future changes in the copper price between borrowers and lenders (see below for other risk sharing instruments, based on similar principles)

The EIB has been preparing new IF credit risk policy guidelines. It is important in such guidelines that an appropriate trade-off is struck between maintaining the real value of the revolving fund to keep the IF financially sustainable and taking more risks, where this will have clear development impact given the relatively complex and sometimes difficult investment climate in many ACP countries. However, a more careful analysis may be required of the IF possibly taking too much exchange rate risk, which could imply too much contingent liability.

#### **4. Recommendations for Improvement**

It seems that some progress has been made in designing instruments that imply greater risk-taking at the EIB in its operations in developing countries. Furthermore, the Investment Facility has developed guarantees. However, progress has been rather limited and much more could be done. It is surprising that, reportedly, except for the Investment Facility in the ACP countries, the EIB does not offer guarantees at all in developing countries, this is especially surprising given the experience which the EIB has in offering guarantees within the European Union and specifically with instruments like the EIF (European Investment Fund) in which the EIB plays a central role, from which very valuable lessons can be drawn for EIB guarantees in developing countries; the possibility could also be evaluated of the EIB helping establish EIF-like instruments in developing country regions. (In the past, both Argentinean and Brazilian senior officials were very interested in the possibility of a Mercosur EIF; there is also a UNESCAP proposal for the establishment of an AIF (Asian Investment Fund) to help fund infrastructure).

At a broad level, it is important to stress the large untapped potential for greater involvement of private markets, both international and especially domestic, in development. Where these markets have temporary imperfections, the role of MDBs to help overcome these imperfections, can be crucial. A similar case can be made that on occasions there are temporary “government failures”. In some cases leadership in first-time transactions, creating the confidence and the conditions for subsequent transactions can be crucial. The EIB has done this in the case of local currency paper in Central and Eastern Europe. The IFC Municipal Fund reports successful demonstration transactions in countries like South Africa. The EIB could do far more of introducing innovations, for example, via the far wider introduction of local currency paper and via the introduction of better risk sharing via guarantees or by introducing GDP-linked bonds, as discussed below. More resources need to be made available for large initial transaction costs associated with first transactions when introducing them implies important externalities.

This also relates to doing transactions which have “learning by doing” externalities. For example, even in country environments lacking the requisite regulatory and legal frameworks, innovative transactions can show the imperative for changes and thus create the demand and dynamic for focused reforms at the country level.

Naturally, where market imperfections are more permanent (or at least more long term), as in the case of missing markets in poor countries, the case for more conventional loans from MDBs remains strong. The distinction between more temporary and more permanent market failures, and the need for different policy responses, was made recently by Joseph Stiglitz<sup>11</sup>. This seems to provide a useful analytical framework for designing policy instruments and actions by MDBs. However, there is a vast area for MDBs to help channel private flows, both international and private, to worthwhile investment projects.

More specifically:

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<sup>11</sup> Presentation at Manchester Conference on Financial Regulation:  
<http://www0.gsb.columbia.edu/ipd/programs/item.cfm?prid=133&iyid=5&itid=812>

- i. It would seem very desirable for the EIB to reduce its requirement for counter-guarantees from fairly creditworthy borrowers investing in projects with a good rate of return. In this sense, it seems useful to relax the EIB's credit policy to accept greater risk. A more careful analysis of the private sector arms of institutions like IFC may provide interesting lessons. Furthermore, the "zero loss" mentality at the EIB needs changing. The EIB, with its very strong capital base (and with the potential for setting aside reserve funds for more risky activities) can afford to take greater risks, both in lending to sub-sovereigns and in guaranteeing or lending directly to the private sector. This does not mean a "license to lose money", but a change of balance from excessive prudence to carefully assessed greater risk taking in its lending to developing countries.
- ii. It seems very desirable for the EIF to move into risk mitigation activity, for example, by providing guarantees. A move towards more risk mitigation has been suggested by several reports on MDBs as desirable (see above). Guarantees can be, where appropriate, a vital mechanism to ensure that private financing becomes available (in areas such as infrastructure project finance and loans to SMEs) which would otherwise not be feasible due to credit rationing. They have become fairly important as an IFI instrument; in recent years guarantees are estimated to have been equivalent to almost 10% of IFI combined programmes (Winpenny, 2005).

In deciding and designing guarantees it is important that these are tailor made with existing market or government imperfections, to avoid two distortions:

- i. Ensure that private investors choose good projects and run them efficiently thus avoiding adverse selection. Excessive guarantees could provide incentives for potentially more profitable projects, with very high risk of failure. Furthermore, the design of the guarantee needs to encourage the investor to maximize its success.
- ii. It is necessary for guarantees to avoid excessive contingency liabilities both for international institutions and host governments (Griffith-Jones and Fuzzo de Lima, 2005)<sup>12</sup>

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<sup>12</sup> For a very balanced discussion of guarantees, also see Winpenny (2005). Interesting and highly enthusiastic support for guarantees can be found in WEF (2005) and Sheppard (2005).

It would seem that the type of risk which the EIB would be best qualified to guarantee against – given its expertise with the EIF and experience with governments – is regulatory and contractual risk in appropriate cases. It is noteworthy that most MDBs now offer products in this area including the World Bank Partial Risk Guarantee (PRG) – see table below. However, take up has been relatively limited to date. This may change as a result of the very welcome 2005 announcement that the guarantee would no longer count 100% against the World Bank’s country limit but would count just 25% of their value against those limits. Similar changes could be introduced in the case of the EIB, once it starts issuing guarantees.

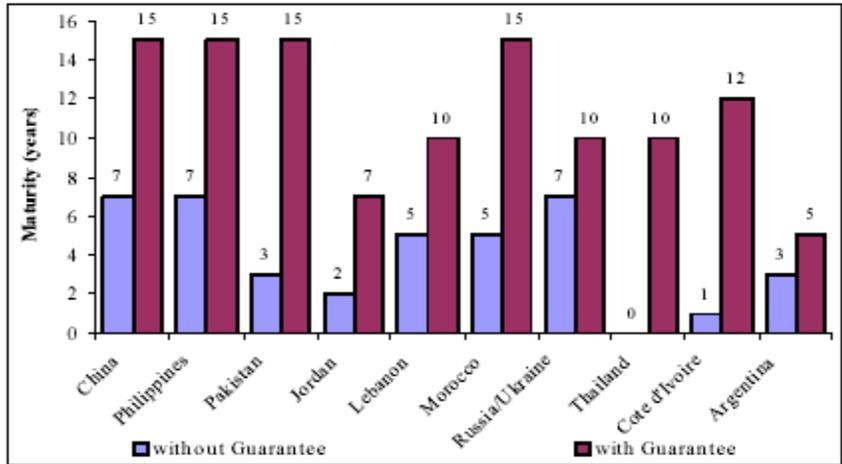
Table 5:

Infrastructure Risks and Relevant Risk Mitigation Instruments (RMIs)		
Type of risk	Available RMI	Example
Political, foreign exchange availability	Political risk cover – either specific, part of comprehensive cover, or in a credit guarantee; preferred creditor status	MIGA political risk cover; participations (e.g., B loans)
Credit	PCGs	IFC PCGs; USAID DCA Partial Loan Guarantees
Devaluation	None as such. Local currency guarantees and devaluation liquidity schemes are relevant.	IFC local currency PCG; OPIC Foreign Exchange Liquidity Facility; Guarantco
Commercial	None specifically, but PCGs include this risk among others.	
Project profile	PCGs can lengthen loan tenors to match cash flows.	PCGs
Rate of return	Breach of contract cover can protect tariff covenants; devaluation liquidity schemes protect cash flow following devaluations.	MIGA Breach of Contract cover
Sub-sovereign	Certain RMIs can be offered without a sovereign counter-guarantee (SG); others need SG. Relevant RMI depends on type of risk to be covered.	The following do not need SG: IFC PCG; MIGA PRI; Private sector guarantees from IDB, ADB, AfDB, etc. The following do need SG: IBRD PRG; IBRD PCG; Public sector lending of IDB, ADB.
Contractual and regulatory	Breach of contract cover	World Bank Partial Risk Guarantee; MIGA Breach of Contract cover

Source: Winpenny 2005

The second type of risk that can be covered by guarantees is credit risk. To avoid moral hazard, it is important that such guarantees are partial and clearly defined. One particularly helpful use of such guarantees is to cover against non-payment of the part of the debt service that has a longer maturity than is available normally from commercial lenders. According to the World Bank, the extension of maturities of debt instruments can be up to twelve times what it would have been without guarantees (see Figure 4)

Figure 4: Difference in maturities in infrastructure projects in developing countries



Source: World Bank (2001)

The third type of risk that private investors and lenders are understandably very keen to get guarantees on is devaluation risk, especially after so many major debt and currency crises in the 1980's and 1990's. As partly discussed above in relation to the IF, open-ended public guarantees against devaluation can impose excessive contingent liabilities on an institution like the EIB and indeed on host governments (where counter-guarantees are required). Recent history has taught us how costly such guarantees granted ex-ante or sometimes ex-post can be.

One way forward is to design partial exchange rate guarantees via, for example, liquidity facilities. These imply temporary loans drawn after a large devaluation (of a pre-determined scale) that results in the inability of the project to repay its debt. As soon as the project becomes again profitable the loan is paid back to the guarantor. To restrict excessive contingent liability and sharing of risks, both the maximum scale of the loan and its duration can be pre-established. Reportedly, the only example of this kind of scheme is the USOP/C revolving facility for supporting the AES Tiete power project in Brazil. It is interesting that the Camdessus World Panel on Financing Water Infrastructure recommended such a Liquidity Facility, with positive features, such as stressing the need for “affordable” water surcharges and defining a threshold above which the Liquidity Facility would intervene (Winpenny op cit). This would presumably both aim to protect the poor from excessive burdens and limit contingent liabilities for the international public body (for example the EIB) by sharing part of the devaluation risk with the private lender. Indeed, the Liquidity Facility could be constructed so that the private investor would bear a proportion of the risk if a devaluation larger than x% occurred; this would limit moral hazard and large contingency liabilities. Such liquidity facilities have an element of valuable counter-cyclicality, as the project continues to operate in the face of a large devaluation, which are often accompanied by declines of growth in developing economies and sharp credit rationing (Griffith-Jones and Lima, 2005).

However, the most desirable modality for dealing with foreign exchange risk is promoting local currency financing. This directly overcomes the problem of currency mismatching for projects or companies that borrow in foreign currency and have revenues in local currency; this has been an extremely important cause of debt and currency crises, as well as causing major disruptions (and even bankruptcies) to companies and projects. Where such financing is not available (or is too expensive or too-short-term) MDBs or RDBs can help to develop such a market.

One mechanism to do this is through guarantees, for local currency debt, to be sold either to domestic or even foreign investors. Recently there are some experiences where a partial guarantee by a RDB has been able to upgrade a project to investment grade, allowing local institutional investors to buy this paper. One example is the road to the airport in Santiago de Chile. This project borrowed \$260 million with a 100% guarantee of principal and interest from the IADB, 75% of which was passed on to a monoline insurer. As this raised the project to investment grade, Chilean pension funds were able to buy it<sup>13</sup>.

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<sup>13</sup> Interview material

The involvement of a monoline insurer in this case is of more general interest. A large proportion of municipal debt in the US used, for example, to fund large infrastructure projects, is insured by monolines; by upgrading the risk to investment grade it facilitates low-cost, long term borrowings from institutional investors. The combination of the EIB and the monoline insurers guarantees to facilitate low cost local currency borrowing may be a promising avenue to explore, especially for middle-income countries.

The alternative path, which the EIB has successfully followed in Central and Eastern Europe, as well as beginning to do so in other regions, is to lend directly in local currencies. Where this can be funded by issuing debt in the same currency, this eliminated foreign exchange risk for the EIB. As pointed out above, such issuing of paper in local currencies also has the important virtue of developing local capital markets, particularly effective where there is local long term savings, but financial mechanisms are not available to channel it to productive projects. The development of domestic capital markets creates a more stable source of local funding for both the private and public sectors thereby mitigating the problems of pro-cyclicality and sudden stops in private capital flows described above.

It would seem very desirable for the EIB to expand further its activity of lending and borrowing in local currencies both in the countries where it has already done so, but particularly in other countries. It can build upon its experience and help develop a valuable instrument.

A step further could be taken, which would make local currency investments more attractive to international investors. Once the EIB has a somewhat larger portfolio of local currency debt, it could create a diversified portfolio of this debt across a variety of developing countries to generate a return to risk that is sufficiently high to be competitive in international capital markets, due to the considerable benefits of diversification (see Dodd and Spiegel, 2004 and Eichengreen and Hausmann 2003). Such a portfolio could be securitized and sold to international investors.

The EIB would be in the unique position within the MDB/RDB system to even consider including some developed country paper in such a basket. This option is not available to other multilaterals like the World Bank, which only lends to developing economies, though the World Bank could capture important benefits of diversification by combining paper from a variety of developing economies. Such a basket would not only raise the average rating of this paper, but perhaps, more importantly, would include additional major benefits of diversification. Indeed, empirical research has clearly shown that, for a number of variables and time periods, the correlation between developed and developing countries is significantly lower than that within developed countries (Griffith-Jones, Segoviano and Spratt, 2004). Therefore, such a basket could capture these additional benefits of diversification.

Clearly such a proposal requires further study; however, it shows how the special characteristic of the EIB (unique amongst the MDBs in lending to both developed and developing countries) could be used as a base for developing innovative financial instruments that could be very valuable for developing economies.

#### **IV New instruments (GDP-linked bonds) and new demands (global public goods)**

##### **1. GDP-linked bonds**

Besides issuing and developing further instruments already in existence, such as local currency lending, the EIB could go one step beyond and pioneer new instruments as it did in the past with local currency paper. This should be done in cases where there is a strong case and a growing consensus that such instruments can play an important role in supporting development. One such example seems to be GDP-linked bonds. The servicing of these GDP-linked bonds would be higher in times of rapid growth and lower when growth was slow or negative.

There has been increasing interest in creating bonds linked to the growth of a countries' gross domestic product. At the spring meetings of the International Monetary Fund and the World Bank, both potential issuers and investors expressed a clear appetite for such bonds (see United Nations, 2006 on [www.stephanygi.com](http://www.stephanygi.com) or IMF website, for meeting report).

GDP-linked bonds would have important advantages when compared with conventional foreign debt for borrowers and investors, as well as significant externalities for the international financial system. For borrowers, issuing such bonds would help stabilise public spending throughout the cycle as governments would service more debt when they could better afford to, and less in more difficult times. It would also significantly reduce the likelihood of costly and disruptive defaults and debt crises. Such crises are particularly damaging for the poor. Defaulting on debt is a last-resort that governments find highly undesirable and costly to the country's international reputation. Indeed, as argued by senior policy-makers, it is the lack of insurance mechanisms like GDP-linked bonds that makes debt crises more likely. A temporary reduction of a country's debt service when the economy deteriorates would facilitate more rapid recovery. This would open space for higher government spending in bad times, thus reducing the need for damaging cuts in social spending. On the other hand, in boom times, higher servicing of debt by governments would curb excessively expansionary fiscal policy in times of rapid growth.

For investors, defaults are costly as they result in expensive renegotiation and sometimes in very large losses. As GDP-linked bonds would help reduce the probability of default, effective total payments may in fact be higher than with conventional bonds. Furthermore, GDP-linked bonds would give investors the opportunity of taking a position on a range of countries' growth rates, offering a valuable diversification opportunity. If GDP-linked bonds became widespread across countries, investors could take a position on growth worldwide – the ultimate risk diversification (see Griffith-Jones and Shiller, 2006).

For international institutions, and the countries that fund them, there would be benefits from the decreased likelihood of debt crises as this would reduce the need for costly rescue packages. Reduced risk of crisis contagion would also benefit other developing countries. These externalities and the fact that, as discussed above in section II, financial innovations are difficult to introduce, seem to clearly justify some initial public action (for example, from the EIB as well as other MDBs) to help jump-start and develop this market instrument. This role of “market maker” by MDBs for innovative instruments that better distribute risk is increasingly important.

The EIB could, for instance, make loans whose servicing would be linked to the growth rate of GDP. The loans could then be grouped – and if appropriate – securitized and sold to the financial markets. Another possible way through which the EIB could act as “market maker” would be for a country (or several countries simultaneously) to issue GDP-linked bonds and sell them via a private placement to the EIB. The EIB could either keep such paper on its books or – if appropriate – sell it on. Reportedly, private placements have been used in the past to introduce similar innovative mechanisms, for example, the “baby IFF”.

GDP-linked bonds should be a core element of government financing both for developed and creditworthy developing countries. Developed countries are the best equipped to issue GDP-linked bonds immediately, because of the relatively high trust that is placed in their capital markets and in their GDP accounting. Their doing so would have a valuable demonstration effect around the world. European countries, especially those like Italy and Sweden with pensions indexed to GDP growth, could find such bonds particularly relevant for their own economies.

The history of financial innovation is essentially one of learning by doing. Inflation-indexed bonds met initial skepticism, relating to problems such as precise measurement of inflation. In fact, once these bonds started to be issued, inflation statistics improved further. Inflation-indexed bonds are now widely accepted across the world; in the UK, they represent around a quarter of government debt. A similar evolution can be envisaged for GDP-linked bonds.

Introducing GDP-linked bonds would create a market for the economies themselves. The widespread impression that the stock market of a country is a market for the entire economy is mistaken. Stock markets are claims on net corporate profits that can constitute as little as 10 per cent of GDP.

The moment is particularly favorable (Griffith-Jones and Sharma, 2005). Investor appetite for emerging countries' risk continues to be strong. Investors' experience with Argentine GDP-warrants, issued as part of their debt restructuring, has been very positive; their price has been rising significantly. However, markets and issuers may be slow to move forward on their own to develop GDP-linked bonds in normal times, due to externalities and collective action problems, as well as initial lack of liquidity of such instruments. Several developing country policy-makers have at meetings and seminars expressed a clear preference for MDBs and RDBs to play an important initial role. Any country whose growth slows significantly would be thankful afterwards that they have the insurance such bonds represent. Recent instability is showing yet again the value of insurance against economic fluctuations and a possible – or probable – slowdown in the world economy.

As in the case of local currency paper, the EIB seems to have a particular advantage for potentially lending in a GDP-linked modality to different categories of countries (high, middle and low income ones) and then securitizing a basket of such loans which would have very broad diversification benefits for potential investors. Furthermore, the EIB's strong capital base could allow some variability in time in the stream of debt servicing, should the EIB keep these GDP loans permanently, or more probably temporarily, on its books.

It is likely that the creation of GDP-linked loans would require close collaboration with other MDBs (and especially with the World Bank) as well as with the IMF. Indeed, the IMF and the World Bank (through SDSS and GDSS, the statistical code and standard) could – where necessary – help improve or even monitor GDP growth statistics. The United Nations (UNDESA and UNDP) have been studying this instrument.

If currency mismatches in developing countries were reduced by their issuance of local currency paper for domestic investors, and if external debt servicing were linked to those countries' growth, the risk of debt crises would be significantly reduced for most developing economies. The option of GDP-linked debt being issued in local currency and sold to both domestic and foreign investors will be especially valuable to developing economies but may be less attractive to foreign investors. The welfare benefits for poor people in developing countries would be particularly large, given the strong evidence that volatility of growth in general and debt crisis in particular, are especially damaging for poverty reduction. However, developed economies would also benefit if they issued this type of debt.

## **2. EIB's current instruments in relation to global public goods (focusing on climate change)**

From the available literature, climate change is the only global public goods tackled through specific instruments by the EIB. Others in the environmental sphere<sup>14</sup>, while they can qualify for project-based lending as part of the four EIB 'environment' categories, are argued to be **taken into account through environmental assessment procedures**. Consideration of some global environmental public goods, such as the control of persistent organic pollutants or ozone depleting substances will be tackled in the borrower country in accordance with commitments under international environmental agreements.

The EIB also applies principles and practices based on the **common EU approach of MFIs to environmental issues** (known as the European Principles for the Environment<sup>15</sup>) throughout the project cycle<sup>16</sup>. The EIB has nevertheless received criticism for its environmental safeguards, particularly from the use of environment assessment procedures of the borrower nation, which may be less stringent than the relevant EU Directives.

Incorporating **climate change** is mentioned in much recent EIB literature as a key future challenge for its lending portfolio. It has made significant progress in developing specific

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<sup>14</sup> For example transboundary air and water quality, or biodiversity considerations.

<sup>15</sup> [www2.eib.org/epe](http://www2.eib.org/epe)

<sup>16</sup> According to the Bank's response to "EIB in the South, in whose interest?" Doc 06/231 June 2006.

instruments to address climate change mitigation, although their creation is too recent to assess their individual effectiveness.

The EIB currently has **three dedicated instruments** to address climate change mitigation: The €1bn **Climate Change Financing Facility** finances projects that enable greenhouse gas reduction in the EU (including under the EU Emissions Trading Scheme) and outside the EU (including Clean Development Mechanism (CDM) and Joint Implementation (JI) instruments of the Kyoto Protocol), for which advance funding for consulting and registration are available through the €5 million **Climate Change Technical Assistance Facility (CCTAF)**.

The recently established **Multilateral Carbon Credit Fund (MCCF)**, a joint initiative with EBRD, focuses on purchasing carbon credits (JI and CDM) from projects financed by the EBRD and/or EIB in the territories of the member states of both banks, with a focus on European and Euro-Asian Countries in Transition. It will also facilitate green investment schemes for sovereign participants. It has a projected budget of €50-150 million and its costs are funded by participating Member States, who purchase the resulting carbon credits.

The main emphasis to date on climate change (mitigation and adaptation) has been through creation of these specific instruments. These instruments are significant and have potential for expansion, although they are difficult to assess at this stage. Nevertheless, the use of instruments necessarily limits the scale of climate change related lending from the EIB and the focus is heavily weighted towards mitigation actions. A wider assessment of climate change **mitigation and adaptation potentials of projects** and efforts to target developing countries may therefore be necessary and/or desirable across its portfolio. This may help to ensure that UK's and DFID's international policies on climate change mitigation do not run contrary to lending by institutions in which it is a stakeholder, such as EIB, through carbon-based projects in the energy sector and elsewhere. This is particularly pertinent given that this contradiction has recently been flagged by the House of Commons Environment Audit Committee report on Trade, Energy and Environment as a major contradiction of DFID policy<sup>17</sup>.

### **Comments / Suggestions**

#### **i. Project eligibility and lending targets for global environmental public goods**

In a relatively simple move, the EIB could **widen project eligibility to cover global public good issues** such as greenhouse gases mitigation in developing countries. This may also require an assessment of staff capacity to deal with lending around such matters. The EIB could also

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<sup>17</sup> [www.parliament.uk/parliamentary\\_committees/environmental\\_audit\\_committee/eac\\_26\\_07\\_06.cfm](http://www.parliament.uk/parliamentary_committees/environmental_audit_committee/eac_26_07_06.cfm)

consider committing itself to **lending targets for renewable energy projects**. Such targets could be set either as a percentage of total lending or as a percentage of the total energy portfolio, and individually determined for different regions according to opportunity and demand.

**ii. Targeting developing countries in climate change instruments**

Currently, climate change instruments will tend to favour more economically advanced nations (such as Countries in Transition) with a comparative advantage in producing emissions reductions and the capacity to administer and monitor carbon credits. The EIB may therefore need to consider how these instruments might **target developing countries with lower comparative advantage and administrative capacity**, including emissions reduction projects that do not generate formal credits. It would also need to expand its lending instruments and lending volumes to developing countries to support these changes.

**iii. Expanding the role of adaptation**

Currently, climate change efforts are mainly focused on mitigation of greenhouse gases. Increasingly however, project lending will need to incorporate and incentivise adaptation to climate change. This may be achieved to some extent by **prioritising adaptation** in existing climate change instruments but it may also require incorporation of more **formal screening** in the interests of both effectiveness and transparency. Such screening would need to be sensitive to achieving a balance between administrative efficiency and defensible risk management, and ideally be incorporated into existing assessment frameworks such as the DIAF (see below).

**iv. Climate change indicators for and extension of the DIAF**

The EIB claims to routinely screen all projects for their potential to mitigate climate change and generate carbon credits, as well as the adaptability of projects with assets at risk from climate change impacts. It internalises the economic value of likely greenhouse gas emission reductions in the economic analysis of the project where significant and practical. However, there is currently no documentation regarding the transparency or systematic nature of these procedures. Specific climate change instruments are focused primarily on creation of formal carbon credits, particularly in Countries in Transition, and are relatively independent of other considerations and procedures related to development and developing countries.

The EIB may therefore wish to **develop climate change indicators** (defined in light of similar processes in other development and lending institutions, particularly the Commission), and **integrate such indicators into its Development Impact Assessment Framework**. Assessment

of climate change factors through these indicators could include some or all of the following areas:

- **Mitigation:** What are the greenhouse gas emission consequences resulting from the investment, and how they might be mitigated?
- **Climate risk management:** What are the risks to the investment of current and future climatic impacts, and how might these risks be managed or reduced?
- **Vulnerability and adaptation:** What is the existing vulnerability to climate change of the target beneficiaries, and what is the potential contribution to adaptation / vulnerability reduction of the investment?
- **Avoiding ‘maladaptation’:** How to ensure that vulnerability won’t be inadvertently increased by the project?

Such integration would enable the EIB to chart its progress on mitigation elements outside its specific instruments, promote improved climate-resilience of investments generally, and enable consideration of climate change aspects within the evaluation process. Consideration of climate change aspects adds to ongoing efforts in the EIB to **broaden decision-making** and impact analysis tools beyond predominant ERR calculations. Integration with the DIAF promotes coherence with other development aspects of lending, and could be made consistent with emerging policy development and related commitments of OECD countries to screen their development investments for climate risks<sup>18</sup>.

In order for such a move to have a more comprehensive impact, the amended DIAF would need to be applied **beyond the Investment Facility alone**, as is currently practiced. This would support previous European Parliament recommendations to extend the DIAF criteria to cover all projects supported by the EIB in developing countries<sup>19</sup>.

#### v. **Creating climate change criteria for subsidised loans and guarantees**

Currently, the EIB provides subsidies (of up to 3%) on loan interest to low-income developing countries. The subsidies are drawn from budgetary resources provided by the European Development Fund (EDF). Under the Cotonou Agreement, a subsidized interest rate on ordinary

<sup>18</sup> Declaration on Integrating Climate Change Adaptation into Development Co-operation. OECD DAC/EPC. 4<sup>th</sup> April 2006. Available at: [www.oecd.org/dataoecd/44/29/36426943.pdf](http://www.oecd.org/dataoecd/44/29/36426943.pdf)

<sup>19</sup> Extension of the DIAF to all developing country lending was supported by the European Parliament Committee on Development Report on the impact of the lending activities of the European Community in developing countries. (2004/2213(INI)) 09/06/05.

loans from the Bank's own resources or the Investment Facility may be subsidised for either infrastructure projects in least developed or post-conflict ACP countries, to assist with restructuring and/or to facilitate private-sector input into the sector; or for projects (in the public or private sector) with **substantial social or environmental benefits**.

The total value of subsidized loans has been declining in recent years. There may be the potential to use a similar such subsidy as a means of contributing to an **incentive structure for projects to consider both mitigation and adaptation** aspects of climate change. Specific criteria would need to be developed in line with other lending agencies to qualify projects contributing to greenhouse gas emissions reductions or adaptation.

## **V Suggested new roles and instruments for EIB in the next decades; by way of conclusion**

There is a clear need for MDBs and RDBs, both to continue performing their existing roles (where these continue to be relevant) and to perform new roles, reflecting new or unmet challenges.

From a broad perspective, there is growing consensus that MDBs and RDBs should: a) continue lending where capital and loan markets are incomplete, and especially where they are missing. This includes lending to low-income countries; it also implies lending, even in middle-income countries for sectors where private financing is not available for good projects, with infrastructure providing a particularly relevant example where needs are very large. Investing in infrastructure – especially in certain aspects, such as rural and feeder roads, as well as water and sanitation – has for low-income groups, clearly pro-poor effects. Given the strong expertise of the EIB in infrastructure, this seems an area where it could usefully expand its role in financing infrastructure in developing economies. This may require increased expertise of EIB staff in such investment in developing economies. One complimentary possibility is for greater collaboration with other regional development banks, or even with national development banks (possibly via their increasingly active regional associations). It may also be desirable to define regions and/or sectors within infrastructure that the EIB could best specialise in, with regional projects (as discussed below) a clearly good candidate for the EIB, given its expertise and mandate. b) Supporting the provision of global and regional global public goods. Facilities to combat global warming provide an excellent example of the former where the EIB, jointly with other MDBs, can play an increasingly important role. New instruments need to be developed to perform this role better. Supporting regional infrastructure – an often neglected sector in developing economies is a good example of a regional public good, where the EIB, with its long and relevant history in this area within Europe, could transfer further both resources and expertise to developing economies.

The growing reality and perception of the volatility of private flows, and their development costs, have assigned two new central roles to MDBs and RDBs to mitigate this volatility and their undesirable effects. Benefits of private flows would be enhanced and their potential costs

reduced. These new roads: c) provide (partial) counter-cyclical financing for middle-income countries in times of capital flows drought and d) increasingly important, help develop innovative market instruments that better share risks through time between borrowers and creditors; this would give a new role to MDBs as “market makers”. It is interesting that senior policy-makers of developing countries, as well as market participants, highlight the importance of MDB support in these two roles.

As regards regions in which the EIB should specialise in, it may be desirable in the long term that a higher proportion of its external lending goes to developing economies, both low and middle income countries, especially in sectors where profitable projects cannot be financed by the private sector. This could enhance the EIB’s contribution to development and poverty reduction. However, in the short to medium-term, the need for gradual change, unmet needs in neighbouring countries and geo-political considerations seem to justify continuation of current greater emphasis in lending to neighbouring countries.

At present and for the last two years, conditions for private capital flows to emerging economies have been extremely favourable in terms of levels of flows, their cost and maturity etc. This seems to make the need for counter-cyclical MDB lending and for innovative instruments temporarily less clear. However, historical experience and remaining old as well as new vulnerabilities make it unfortunately very likely that current conditions are highly exceptional and that it is very possible that such favourable conditions will deteriorate. Now sources of vulnerability relate to the persistence of major imbalances in the global economy, as well as the existence of new instruments, such as derivatives. Furthermore, even in current highly favourable circumstances, lending and investing is highly favourable concentrated and many low-income and low-middle income borrowers are excluded (ten countries account for 70% of emerging market sovereign bond issues). The EIB is widely perceived as being very efficient due to the speed and low cost of its’ loans. The latter is partly due to its privileged capital backing, but is also due to its expertise in accessing capital markets which it does on a very large scale. It therefore, can use this access to provide fairly cheap and long-term funds to developing economies which implies important value added. This combines with the EIB’s significant engineering expertise in long-term projects, especially for infrastructure. This implies a positive signalling effect as other financiers respect this established reputation of the EIB. It seems important that these skills and externalities are also applied (and suitably adapted) in its external mandate; this will allow external borrowers and especially developing countries, to benefit from them.

As discussed above, the EIB has a particularly strong position with very high capital (augmented by its profits); it already has strong guarantees from the Commission.

This strong position implies that the EIB's banking practice (and Statutes, where necessary) should be modified from its current rather conservative approach so it could take more risk by, for example, lending to fairly creditworthy customers for profitable projects, even if those cannot get a counter-guarantee. This would facilitate in particular lending to the emerging private sector in lower middle income and low-income countries.

The EIB should move into risk mitigation actively by providing guarantees building on its positive experience within Europe and with the Investment Facility. In fact, it seems an anomaly that in its external mandate, the EIB can at present only grant guarantees through the Investment Facility whereas for other IFIs guarantees are estimated to reach almost 10% of their programmes. The fact that the Commission proposes to extend its own guarantee coverage for the EIB to cover guarantees the EIB would grant (as described above) should hopefully facilitate more widespread use by the EIB of guarantees to help capitalise private flows.

It is important that EIB guarantees are well designed to avoid moral hazard and excessive contingency liabilities. Careful design and clear definition of risks to be covered is important. The EIB can draw on its own previous experience, on that of other MDBs as well as with the European Investment Fund, in which the EIB has played a major role.

Indeed, developing country policy-makers (both from Mercosur for which several reports were written and more recently from Asia) as reflected in a UNESCAP in emulating an EIF in their regions. It may be valuable for the EIB to provide technical assistance, and even consider providing some seed capital, for the establishment of such funds especially in the region of integrated infrastructure, where gaps are large and potential growth impact so great.

An instrument which the EIB has developed successfully in certain regions is lending in local currencies. It seems highly desirable that it extends its activities to other countries given that local currency debt implies no currency mismatches for the debtor and therefore reduces the risk of debt crises. Where feasible, this should be funded by debt the EIB issues in the same currency. This both eliminates foreign exchange risk for the EIB and helps the development of local capital markets. The EIB could take a step further and create a diversified portfolio of local currency

debt of a variety of developing countries and possibly even of some developed countries (Which only the EIB could do amongst MDBs). Such a diversified portfolio could be securitised and sold to institutional investors who could find the benefits of diversification it offers considerable. Such a proposal seems to deserve further study.

The EIB could also take one step further and innovate by pioneering other new instruments as it did previously with local currency paper. There seems to be a strong case for GDP-linked bonds by both developed and especially developing countries. Such instruments would help stabilise government spending through the cycle, helping to smooth growth and diminish the likelihood of developmentally and financially costly debt crises. For investors, there are also important attractions, such as being able to take a position on a range of countries' growth rates. International institutions and creditor governments would benefit from decreased likelihood of debt crises and smaller need for expensive rescue packages.

Though there is increased recognition by issuers and investors of the advantages which GDP-linked bonds could offer, there seems to be a typical "first mover" problem. Individual governments, though seeing the insurance advantages, seem shy about being the first to issue GDP-linked bonds, fearing initial transaction costs and having to pay a novelty premium, they express a strong preference for MDBS or RDBs to act as "market-makers". The EIB could do this by making loans linked to the growth of GDP; such loans could then be grouped, securitised and sold to financial markets.

As in the case of local currency paper, the EIB would have a special advantage, in that such a basket of GDP-linked bonds could, uniquely include high, middle and possible low, income countries. This would have large diversification benefits for potential investors. It would also help not just middle income, but also possibly, low-income countries to have access to the valuable type of insurance that GDP-linked bonds could offer. Further study is required to define the most appropriate modality in which the EIB could support the development of this instrument. Collaboration with the World Bank and IMF could be valuable as well as with the United Nations.

The EIB currently has three dedicated instruments to address climate change mitigation: the Climate Change Financing Facility which finances projects that enable greenhouse gas reduction both in and outside the EU; the Climate Change Technical Assistance Facility which assists with consultation and registration; and the Multilateral Carbon Credit Fund which focuses on

purchasing carbon credits from projects financed by the EBRD and/or EIB, with a focus on European and Euro-Asian Countries.

Wider assessment is needed of climate change mitigation and adaptation potentials of all projects (and not just those using the above instruments) financed by the EIB in developing countries, to ensure that the UK's and DFID's international policies on climate change mitigation do not run contrary to lending by institutions such as the EIB.

Suggestions for further possible action by the EIB include:

- \* Widen project eligibility to cover global public good issues such as greenhouse gases mitigation in developing countries
- \* Commit itself to lending targets for renewable energy projects
- \* Further assist developing countries with lower comparative advantage and administrative capacity in emissions reduction projects (instead of focussing mainly on more economically advanced nations)
- \* Incorporate and give incentives for adaptation to climate change (instead of focusing mainly on mitigation)
- \* Develop transparent climate change indicators and integrate such indicators into its Development Impact Assessment Framework. This DIAF criteria should cover all projects supported by the EIB in developing countries.
- \* Expand and adapt subsidised loans to create an incentive structure for projects considering both mitigation and adaptation aspects of climate change.

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## **Annex 1**

### **DEMAND DRIVERS FOR IFI BORROWING (SHORT TO MEDIUM TERM)**

- Investor risk appetite and liquidity: Central to the benign market conditions for private sector borrowing and capital raising since 2002 has been the high liquidity conditions for global investors driven by low interest rate environments and fiscal surpluses flowing into the US from Asia. The liquidity conditions have driven a search for yield and an extension of risk appetite into higher risk and more volatile instruments. For example maturities have increased and credit ratings extended even as credit spreads have reached historical lows
- Private flows are heavily pro-cyclical. The benign economic conditions since 2002 favoured by investors have lead to strong pro-cyclical private capital flows in both bank lending and bond and equity markets.



## Annex 2

### OVERVIEW OF THE BANK'S OPERATIONS OUTSIDE THE EU UNDER THE MANDATE

#### 1.1 Summary of operations

This Annex gives a summary and general assessment of all loans signed as of 31 December 2005, together with a regional and sectoral breakdown of loans. The results are presented separately for SEN

Table 1 below shows that loan signatures as of 31 December 2005 (i.e. with little more than one year of the duration of the lending mandates to run) have reached 89% of the overall lending ceiling of €20,060 million. Until the end of the mandate period, the EIB expects to utilize all the mandates fully.

Table 1: Loans signed as at 31 December 2005

<b>Mandate</b>		<b>Signatures</b>			
<b>Region</b>	<b>Ceiling EUR m</b>	<b>Total EUR m</b>	<b>% of ceiling</b>	<b>Number of loans</b>	<b>Average loan size EUR m</b>
SEN	9 185	7 817	85	120	65
MED	6 520	6 272 <sup>11</sup>	96	89	70
ALA	2 480	1 942	78	43	45
RSA	825	757	92	14	54
TERRA	600	600	100	5	120
Turkey SAP	450	450	100	5	90
<b>Total</b>	<b>20 060</b>	<b>17 838</b>	<b>89</b>	<b>276</b>	<b>65</b>

The sectoral breakdown in Table 2 below shows that the Communications sector (Transport and Telecoms) accounted for 35% of total lending. Over half of the loans in this sector were granted in the SEN region, with Romania, Bulgaria and Turkey receiving the biggest amounts for the rehabilitation and upgrading of roads and railways, and the construction of motorways.

The Water and Miscellaneous sector (including areas such as urban rehabilitation) sector absorbed 20% of total lending, with lending distributed evenly between the SEN and Mediterranean regions. Algeria, Morocco and Romania have been major beneficiaries of EIB lending in this sector.

The Energy sector accounted for 19% of loans granted during the period under review. A major part of this went to the following Mediterranean countries – Egypt, Morocco and Tunisia:

Table 2: Sectoral breakdown of loans signed at 31 December 2005

Region	Energy		Communi- cations		Water & Miscell.		Industry & Services		Global loans		Total	
	EUR m	%	EUR m	%	EUR m	%	EUR m	%	EUR m	%	EUR m	%
SEN	496	6	3 973	51	1 603	21	354	5	1 391	18	<b>7 817</b>	100
MED	2 149	34	1 669	27	1 250	20	394	6	810	13	<b>6 272</b>	100
ALA	547	28	340	18	20	1	686	35	349	18	<b>1 942</b>	100
RSA	52	7	100	13	245	32	0	0	360	48	<b>757</b>	100
TERRA	0	0	0	0	450	75	75	13	75	13	<b>600</b>	100
Turkey SAP	90	20	120	27	40	9	0	0	200	44	<b>450</b>	100
<b>TOTAL</b>	<b>3 334</b>	<b>19</b>	<b>6 202</b>	<b>35</b>	<b>3 608</b>	<b>20</b>	<b>1 509</b>	<b>8</b>	<b>3 185</b>	<b>18</b>	<b>17 838</b>	<b>100</b>