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REPORT FROM THE COMMISSION TO THE COUNCIL

A new Euro-Mediterranean Bank

EXECUTIVE SUMMARY

The Laeken European Council of 14-15 December 2001 has invited the Commission to examine the setting up of a Euro-Mediterranean Development Bank. At this stage, the Commission has reached the following conclusions.

- (1) Against the region's sustained demographic growth and considerable development needs, the disappointing economic performance over the last decade of our Mediterranean partners and the recent worsening of the situation since September 2001 constitute a *challenge* for partner countries as well as for the EU and call for urgent responses.
- (2) The most urgent need for a new start to the region's development is a shift towards a strong *private sector driven* economy. The region's major development finance needs are both in the form of sustained quantitative capital inflows and encouraging additional flows towards the private sector development, in particular SMEs. This can take place only if the appropriate legal and institutional framework and an increased private sector culture is in place in partner countries.
- (3) *Ownership* is a cornerstone of comprehensive development policies and *partnership* a key feature of the Barcelona process; Mediterranean partner countries should therefore become full partners and members of any new institutional setting promoting the region's development.
- (4) Given the political and economic importance of Mediterranean partner countries for the European Union, and the Union's overwhelming role in the official development assistance to the region, the *European character* of any enhanced or new institutional setting of development finance is essential. The EC, Member States and the EIB should together retain the control of the relevant institutional setting.
- (5) Financial instruments directly addressed at developing the private sector and the domestic financial sector can be financed by a fund or by a banking institution. A fund would uniquely rely on donor's *budgetary* contributions and not provide *any leverage* on capital raised. Furthermore it would be difficult to ensure *ownership* by the partner countries. A banking institution would allow for a high leverage on capital raised, ensure ownership of the partner countries and provide a wide and flexible range of instruments, including loans and equity investments.
- (6) The suggested approach is to create a *banking institution*, subsidiary of the European Investment Bank, which would build on, encompass and enhance the EIB's current activity in the region. Its main role would be to foster the development of private sector and help finance infrastructures, especially in sectors, which are being liberalised. It would build upon the Community's existing lending instruments by incorporating the EIB's loan portfolio in the Mediterranean partner countries.
- (7) The main contributors to the setting up of the institution are expected to be EU shareholders: the Member States, the European Community and the EIB. A final choice will have to be made following a dialogue with partner countries. At this stage however, and taking into consideration the respective merits of each option, an EIB majority-owned subsidiary would be the simplest and most rapid way to enhance the EU's financial support to identified financing needs.

- (8) While giving some indications, the present report has kept a number of features of the new envisaged institution *open* for further examination : its exact amount of capital, the respective shareholding of the founding members in the capital, the eventual geographic coverage of operations, the future of the EC budget guarantee on loans in the region, the methods to ensure ownership by the Partner Countries in both the setting up and running of the new institution, and the coordination mechanisms to ensure that it is fully integrated into the Barcelona Process.

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1. INTRODUCTION

The *Euro-Mediterranean Partnership* was launched at the 1995 Barcelona Conference between the EU and its twelve Mediterranean partners reflecting the realisation that the South and East Mediterranean is an area of vital strategic importance. The "Barcelona process" sets out to create a common Euro-Mediterranean area of peace and stability, shared prosperity, and social, cultural and human partnership.

Meanwhile the search for peace, stability and shared prosperity has become more important than ever. The events of 11 September 2001 have revealed the vulnerability of the economies of our Mediterranean partners. At the same time, the enlargement process is proceeding rapidly, highlighting the need to keep a good balance in the Union's external relations.

It is therefore time to consider how to build on the successes on the past and to take the Partnership a step further in line with the Commission's Communication to prepare the forthcoming Euro-Mediterranean Foreign Ministers' meeting in Valencia (22-23 April)¹. In response to the Laeken Council invitation to the Commission and the Council to examine the setting up of a Euro-Mediterranean Development Bank, this report examines the creation of a Euro-Mediterranean Bank (EMB) and its practical implications. The main role of the institution, which would encompass and enhance the work that the EIB is already doing in the region would be to foster the development of private sector based market economies and help finance infrastructures in sectors, which are being liberalised. The EMB would build on the Community's existing instruments by incorporating the EIB's loan portfolio in the Mediterranean partner countries. It would provide loans and equity and help to foster the development of the private sector in partner countries.

This new banking institution would, in the spirit of the Barcelona Process, be both European and Mediterranean in character: its members or owners would consist of our Mediterranean partner countries together with the European Union (Member States, European Community, EIB). It would however have an open structure so that membership could be widened, if appropriate.

2. EXISTING FRAMEWORK OF EURO-MEDITERRANEAN ECONOMIC RELATIONSHIP

2.1 Background

The economic and financial partnership is one of the *three pillars* of the Barcelona process. Its main objective is creating an area of shared prosperity. When adopting the Barcelona Declaration, the partners set themselves the following long-term objectives for the economic and financial partnership:

- *Accelerating the pace* of sustainable socio-economic development;
- Improving the living conditions of their populations, increasing the employment level and reducing the development gap in the Euro-MED region;
- Encouraging *regional co-operation* and integration.

¹ SEC(2002)159 final of 13 February 2002.

With a view to achieving these objectives partners agreed that the Partnership would be based upon:

- The progressive establishment of a *free-trade area*;
- The implementation of appropriate *economic co-operation* and concerted action in the relevant areas;
- A substantial increase in the European Union's financial assistance to its partners.

2.2 The economic and financial partnership: assessment and prospects.

More than six years after launching the Barcelona Process, important progress has been made in key areas, but in others expectations have not been met. The development gap between the Union and the Mediterranean partners has not been narrowed. Much progress has been made in the conclusion of Association Agreements, but the ratification process has been too slow. Nevertheless, the creation of a *Euro-MED free trade area has become an irreversible process*. Moreover, the Agadir initiative (i.e. the establishment of free trade between Morocco, Tunisia, Egypt and Jordan, with possibilities of others joining later) ensures that free trade among Mediterranean partners will become a reality and this is a necessary complement to the liberalisation of trade between the Union and Mediterranean partner countries.

The fundamental issue for our Barcelona partners is how to *reach a high level of economic growth* that does not jeopardise internal and external balance, and that at the same time creates sufficient jobs and respects the environment. Job creation must be the number one priority, not only to reduce the current high levels of unemployment, but also because it is estimated that 45 million new entrants will enter the job market in the next decade. Addressing this huge challenge involves notably trade liberalisation, freer capital movements including higher volumes of foreign direct investment, financial sector reform, fiscal and budgetary reform, reform of the labour market, a modernised social safety net, eliminating red-tape, institutional reform and legislative and regulatory reform. It also requires that due consideration is given to pursuing equilibrium between increased economic activity arising from trade liberalisation and the need to protect the environment in an area which is widely recognised as highly fragile from an environmental point of view. It is in these areas that the Commission, with partner countries, is developing major initiatives in the context of MEDA II, so as to assist countries in preparing the implementation of the Association Agreements.

Meetings periodically taking place at the level of Ministers, officials and experts have become an established feature of the Barcelona Process. Such meetings have created platforms for making recommendations and for exchanging information and best practice. As regards the financial and economic partnership a *regular economic dialogue* has been established at both the regional and the bilateral level. A first meeting of the reinforced regional economic dialogue at the level of high officials was held in November last year.

The World Bank and the IMF have been associated with these meetings, in particular with the dialogue at the regional level. The International Financial Institutions strongly support the Association Agreements. They recognise the catalytic role of the agreements in support of reforms. There is regular co-ordination with the IFIs, both at senior official level and at the level of task managers. This has allowed the Commission to ensure a *high degree of co-ordination* with other key players. The European Investment Bank has also been associated in this process.

The FEMISE network is also a key forum of the Economic and Financial Partnership. It includes more than 95 members, mostly economic research institutes, coming from the 27 partners of the Barcelona Process. The principal goal of the FEMISE network is to *advance economic research on the priority subjects* of the Euro-Mediterranean Partnership. FEMISE has proved to be a unique and valuable network, highly complementary to the work done at the level of Ministers and officials. It also makes an important contribution to strengthening economic research capacity in Mediterranean partners.

With the prospect of the entry into force of more Association Agreements, more partners will face a dual challenge: *liberalising trade* with Europe as agreed in the Association Agreements and *preparing their domestic economy* to meet this challenge. The Barcelona economic and financial partnership accompanies this process. It provides the countries with the necessary expertise, resources and a platform of dialogue, complementing their own efforts.

While the MEDA instrument can be mobilised to help to address a wide range of issues, it remains predominantly a Community-to-government instrument, aiming only indirectly at private sector development. The EIB has helped the countries predominantly in providing support for much needed infrastructure. This suggests that *a more pro-active approach* in support of private sector development could be a useful complement, especially at a time when more and more sectors will be exposed to direct competition from Europe. For that reason the Commission has proposed, in the context of the preparation of the Euro-Mediterranean Foreign Ministers Meeting to be held 22 and 23 April in Valencia, that a decision on an EMB should form part of the Valencia Action Plan ².

3. THE EU'S FINANCIAL SUPPORT TO THE REGION

3.1. Meda assistance

The MEDA ³ programme tackles both bilateral and regional relationships in the Euro-Mediterranean partnership in a complementary manner:

- at *bilateral level*, priority is given to projects identified in the National Indicative Programmes (NIP) which concern 8 countries: Algeria, Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia, and Turkey ;
- at *regional level*, the objective is to support projects and regional activities carried out by several Mediterranean partners. All the 12 Mediterranean partners are eligible for funds under the MEDA Regional Indicative Programme.

Helping partner countries to prepare for the implementation of the Euro-Mediterranean *Association Agreements* is a key orientation of the MEDA Programme. The MEDA Programme is the *main financial instrument* supporting the economic and structural reforms of the beneficiary countries. Between 1995 and 1999, grants worth over € 4.4 billion were committed. The MEDA II programme (2000-2006) benefits from an overall funding of € 5.35 billion. The first table attached (Annex 1) summarises commitments over the period 1995-2001. Amounts committed under MEDA in favour of *private sector development* have been *substantial, amounting to €709 mln or about 18 percent of total bilateral MEDA support*

² Communication from the Commission to the Council and the European Parliament to prepare the Meeting of Euro-Mediterranean Foreign Ministers, Valencia, 22-23 April 2002; SEC(2002), 159 final

³ Council Regulation (EC) N° 1488/96 of 23 July 1996, OJ L 189, 30.7.1996, p 7, as amended by Council Regulation (EC) N° 2698/2000 of 27 November 2000, OJ L 311, 12.12.2000 p 1.

during the period 1995 to 2001. (see annex 2) This includes support for projects in the areas of financial sector development, small- and medium scale enterprises, privatisation and trade matters. Moreover, MEDA contributes **indirectly** to a better functioning private sector. This concerns not only support in a bilateral context for a better regulatory and legal framework, but also various initiatives at the regional level. The latter includes for example the Euro-MED Market programme (€9.9 mln) and the Euro-MED Innovation, Technology and Quality Programme (€15 mln). These programmes aim at helping to establish the right conditions for partners' operators to reap the full benefits of the Euro-MED Free trade area⁴.

3.2. EIB finance

Over the last five years, an average annual lending volume of some € 1 billion has made the EIB *an important player* in the region, in which it now has a total portfolio of operations of about € 9 billion.

The first EIB Euro-Med Lending Mandate providing for loans up to € 2.3 billion was fully committed by the Bank over the period 1997-1999. Under the new Euro-Med Lending Mandate (II), the EIB - covered by a Community guarantee - is to lend up to € 6.4 billion during the period 2000-2006. In addition to this mandate, the Bank has established in September 2001 a Mediterranean Partnership Facility of € 1 billion on its own risk (without the Community Guarantee) for large cross-regional projects in the fields of transport, energy and environment (expiry 2004).

In 2001, EIB lending in the Mediterranean partner countries rose to € 1.5 billion, against € 1.2 billion in 2000. Overall, in spite of efforts to develop its long term loans and risk capital operations made available with the local banking and financial sector, the bulk (about 70%) of the bank's commitments remains on infrastructure projects.

The EIB and MEDA already interact in a number of areas. *Loans with risk sharing features*, aimed at private sector development, are financed under the MEDA programme and managed by the EIB. A new risk capital facility of € 100 million was created in 2001 under the MEDA programme, to be run by the EIB. In particular cases, for environmental protection, the EIB has the possibility to provide *loans with interest rate subsidies* from the MEDA budget.

The quality of the bank's projects is an essential element in ensuring the sustainability and competitiveness of its present lending conditions. However, while other institutions like the EBRD or the World Bank need a high gearing ratio of operations-to-capital of one-to-one, which ensures their financial standing and their AAA rating, the EIB owing to the guarantee from the Community Budget on lending envelopes approved by the Council can operate in third countries with the same gearing as within the European Union, i.e. a 2.5:1 operations-to-capital ratio, without jeopardising its financial standing. This has up to now contributed to the possibility for the EIB to charge lower interest rates than other multilateral development banks. When it operates outside the Community guaranteed envelopes, the policy of the EIB is to seek commercial guarantees at market terms.

3.3. Overall flows of financial support

In 2000, the *World Bank* committed € 2.5 billion overall in favour of the Mediterranean Partner countries, out of which € 1.9 billion was in favour of Turkey. In Maghreb and

⁴ Preparing for the Euro-Mediterranean Free Trade Area: Elements for Regional Industrial Co-operation 2002-2006; SEC (2002) 130 final

Mashreq countries the World Bank committed € 605.6, against €638.6 million in the case of the EIB. The bulk of the *African Development Bank's* commitments were in Maghreb countries (€ 291.2 million) with an additional € 41.6 million in favour of Egypt.

Total EU commitments, including bilateral financial support from Member States represented € 3.3 billion. The EU is *overall the main contributor* of financial assistance to the Mediterranean partner countries. (See Annex 3).

4. CONTEXT FOR AN ENHANCED ECONOMIC DEVELOPMENT OF MEDITERRANEAN PARTNER COUNTRIES

Improved Economic Performance but Insufficient Growth

The region's economic record in recent years has been mixed. Most partners have made much progress in the area of economic stabilisation. As a result key indicators such as inflation, public sector deficits, current account deficits have developed rather favourably, although exceptions exist. Growth performance has however been disappointingly low in recent years, even though international demand has been growing rapidly, and below the levels of countries that have pursued and sustained structural reform agendas and have integrated with the world economy. This is linked to a hesitant attitude of many partners towards much needed economic and social reforms. A major factor in the region's poor growth record is its slow progress in opening up to trade and investment. There are also indications that with the current weakening of the world economy and the impact of 11 September events a growing number of countries will be confronted with deterioration in these key indicators.

Average annual GDP growth over the period 1990-2000 was 2% in the Maghreb⁵ and 3.6% in the Mashreq⁶. However it is estimated that for the whole Middle East and North Africa⁷ countries, growth needs to be at least 7% per annum to absorb the growing labour force.

Overall the *current level of growth is far below that needed to ensure sustainable development and a reduction in poverty*, and there is a risk that the socio-economic balance could be disrupted. In the Maghreb, over the last decade real growth was even slightly less than population growth leading to a small decline in per capita GDP. Unemployment has been rising over the last decade and is now very high at broadly 19% in the Maghreb and 17% in the Mashreq. Labour force growth is currently 3% per annum in the Maghreb and Egypt needs to find jobs for over half a million young people each year.

The Role of Investment and Finance, and Investment Needs

Investment has a crucial role in helping Mediterranean countries attain the growth levels necessary for sustainable development. Domestic and foreign sources of investment need to be *increased* and external official assistance can support reform efforts needed to facilitate the process of structural adjustment. *Such reforms and adjustment are crucial* for attracting private investment and promoting private sector development.

Well-functioning *infrastructure services* are needed to support industry and are critical for rapid domestic private sector led growth and for connecting domestic private sector actors to business partners in the rest of the world. Efficient financial intermediation is very important

⁵ Including Libya and Mauritania

⁶ Excluding Israel

⁷ Estimates exclude Israel and Turkey.

in improving savings rates and allowing financial systems to play a catalytic role in economic development, including channelling resources to their most productive uses. Strong and broad domestic banking and financial sectors are crucial in this respect.

A number of the *investment needs* in the region are typical for low/middle income countries. Most countries suffer from both quantitative and qualitative shortfalls in physical infrastructure at the domestic and regional levels. In fact, most countries in the region fall below the lower middle income country average for units of electricity produced, kilometres of paved roads, telephone lines and availability of safe water etc. Many face serious shortfalls in key infrastructure sectors and existing services have become increasingly overburdened by the consequences of rapid population growth, and by new (especially private business) demands.

Regional infrastructure is also lacking. Regional conflicts, divisions and uncertainties have inhibited efficient regional projects in energy, transport and water management. The quality and development of existing infrastructure is insufficient to reduce transactions costs to a level compatible with international competition.

The private sector needs to become the engine of growth in Mediterranean countries. A constraint on the development of the private sector is the limited sources of finance and investment from the domestic financial sector. The large size of government participation in the financial and real sectors is a major contributing factor to the low level of development of the banking sector. *Local banking sectors lack efficiency and competition.* In a number of countries a substantial share of the population does not even have access to the banking sector.

Without well developed capital markets sources of long-term funds are insufficient to promote private sector development and lending largely remains short-term and trade-related. While large corporations are usually able to obtain bank finance because of their track-record, the alternatives, whether in the form of bonds or equity, are not available. The *weakness of legal and judicial systems* (including enforcement of collateral rights) discourages bank lending to small businesses and clients with no borrowing history. While in some countries micro-finance schemes have been introduced, these are insufficient to meet potential demand.

Foreign Direct Investment is a key fuel of investment and growth and privatisation plays a key role in attracting FDI. According to the World Bank, at the end of the 1990s *privatisation revenue* in the region increased significantly, owing to significant operations in Morocco, Egypt and Tunisia, and led to additional inflows of related *FDI* given the high level of foreign participation in these operations. Privatisation revenue however remained modest against the size of the region, on average below € 4 billion per year (broadly 1% of GDP) for Maghreb and Mashreq countries. In addition, non-privatisation FDI remains at low levels. Business surveys show that many private investors are deterred by weak domestic institutions, particularly the legal system, and inefficient administrative procedures.

Given the still large size of the public sector in most countries of the region, privatisation will remain an important potential source of finance for the budget deficits, and of hard currencies inflows, and is key to promoting and facilitating private sector development.

Estimates of the Volume of Investment Needed

Various estimates have been made of the costs of *replacing* old infrastructure systems and the *incremental investment* needed to bring infrastructure up to internationally competitive levels. While these estimates vary depending on assumptions concerning country coverage, growth rates and needs, they are at similar orders of magnitude, broadly \$200-300 billion over the next decade for the MENA⁸ region countries.

It is also possible to make an estimate of the investment needed to raise growth in the region to 7% per annum. This is the estimated required rate of growth to absorb new entrants to the labour force and to stabilise unemployment at current rates. Such a calculation relies on the use of the Incremental Capital Output Ratio (ICOR), a measure associated with the efficiency of investment by comparing the investment ratio with the growth rate.

Using World Bank estimates of ICOR for five countries (Algeria, Egypt, Jordan, Tunisia, Morocco) and estimating the nominal output gap due to growth being less than 7% in 2000 and 2001, and estimate of investment needs can be calculated. Such a calculation implies an investment deficit of US \$ 40-50 billion per year in these five countries based upon recent growth rates. However, it should be noted that ICORs are relatively high in Mediterranean countries, suggesting that investment decisions are inefficient, and this static analysis does not take into account future improvements in efficiency and productivity. Improvements in economic policies and the efficiency of investments, in particular public investments, would considerably lower the latter amounts which rather point to current inefficiencies than to real quantitative needs.

While a large part of necessary investments will remain within the public sector, an increasing share will have to come from the *private sector* both foreign and domestic. The region has missed out on the boom in international private capital flows over the last decade (non-privatisation FDI flows are relatively small) and such flows will have to provide a major source of investment finance in the future.

However, it is not only a question of the quantity of investment, these estimates will be affected by the *quality or efficiency of investment* which is also highly relevant. Higher investment must go hand in hand with structural reforms which help to improve resource allocation, absorptive capacity and private sector development.

How can Finance and Investment in the Mediterranean Region be Increased ?

One of the main obstacles to higher inflows of capital is the very unfavourable perception of *country risks*, mainly political risks, owing to the region's record of open conflicts, tensions and also internal unrest. These political risks contribute to poor and non-existent country ratings by international rating agencies, affecting the cost and access to the international financial markets. Nevertheless, despite the impact of political and security risks on investment, there is much that can be done by the international community and by recipient countries to increase levels of investment by improving the risk profile and absorptive capacity of the region.

At the broadest level the investment climate needs to be improved as stressed in the 2002-2006 Country Strategy papers. The need for an enabling environment for savings and

⁸ The MENA region includes: Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Malta, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, United Arab Emirates, the West Bank and Gaza, and Yemen.

investment, including sound macro-frameworks, strong and reliable financial, legal and administrative institutions, and effective management of public resources in order to help mobilise both domestic and foreign financial resources is vital.

Governments wanting to improve the climate for doing business must eliminate or reduce barriers, and simplify procedures. However, reform is not just about legislation, but about administration also. Focused policy dialogues between governments and the private sector (domestic and foreign) and donors can play an important role.

A good investment climate creates room for entrepreneurs and markets to develop and exploit new opportunities for growth and job creation. Evidence shows that competition, whether it be domestic or foreign (through freer trade), provides incentives for businesses to improve their performance as well as encouraging greater investment.

The development of privately owned banks is also vital. Privately owned banks with profit incentives are more likely to find good customers and provide loans to projects that are most likely to succeed. In addition, improved access of SMEs to financial and business services (venture capital funds and partnerships and micro-credit schemes) is important. Technical support is also needed in terms of managerial skills and other business support services, including access to information.

Liberalising FDI with the aim of attracting significant inflows should be a key component of economic policies of the countries of the region. Foreign direct investment contributes toward financing development in the long term and is especially important for its potential to transfer knowledge, skills, and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship. Transparent, stable, and predictable investment climates, embedded in sound macroeconomic policies and institutions are critical here.

Overall, while peace is essential to reduce the high level of country risks, domestic economic policies will need significant improvements to play a more favourable role in establishing the appropriate conditions for growth and investment, to be driven by the private sector, including the development of a competitive local financial sector. Given the overall poor present competitiveness of the financial sector of most of the region's countries and their considerable investment needs, it can reasonably be expected that the demand for competitive project finance will significantly exceed the local supply.

5. ENHANCING THE EU'S SUPPORT TO THE REGION

5.1. Main features

The rationale for a new Euro-Mediterranean financial support institution and the various possible options have been examined against the above diagnostic on development needs in the region. It has been concluded that:

- i./ given the political and economic importance of Mediterranean partner countries for the European Union, and the Union's overwhelming role in the official development assistance to the region, the *European character* of any enhanced or new institutional setting of development finance is essential;
- ii./ *ownership* is a cornerstone of successful policies of economic development, and *partnership* is a key feature of the Barcelona process; Mediterranean partner

countries should therefore become full partners and members of any new institutional setting promoting the region's development;

- iii./ against the region's sustained demographic growth and considerable development needs, its disappointing economic performance over the last decade constitute a challenge for the EU and call for urgent responses;
- iv./ in view of considerable growth needs, the region's major development finance needs are both in the form of *sustained quantitative capital inflows and encouraging additional flows towards the private sector development*, in particular SMEs, and towards infrastructure, especially in sectors which are being liberalised; this can take place only if the appropriate legal and institutional framework and an increased private sector culture is in place in partner countries;
- v./ new structures and institutions must *build on* the considerable efforts and progress that have already been made and must therefore be *complementary* to existing structures;
- vi./ the forthcoming Free Trade Area will require a comprehensive restructuring of the private sector and new investments in order to meet EU norms in such areas as products standards and environment standards;
- vii./ the assessment of the various options' respective merits should not be restricted to economic criteria but should also include political ones.

5.2. Options

A number of options have been examined, including :

i./ A facility or a fund.

A./ An EIB facility

The first possible option is an EIB lending facility in the region. The EIB current € 6.4 billion lending envelope for 2000-2006 in the region could for this purpose be further increased or renewed earlier than expected. This option is easy to implement and has low operational cost consequences.

This option nevertheless has significant budgetary implications, if it is assumed that the Guarantee from the Community Budget would be maintained. Each additional tranche of € 1 billion lending would require a € 58.5 million provisioning from the Community Guarantee Fund. There is presently a very tight room of manoeuvre under the current rules of the Community Guarantee Fund mechanism, which would need to be reconsidered. An EIB lending facility would furthermore not address a number of the identified needs of the private sector development, in particular the need for equity funds. The desirable shift of operations towards the private sector would thus be made more difficult. This option further does not respond to the identified need for more ownership from Mediterranean Partner countries.

In view of these limitations, and while this option remains open as the easiest way to expand on existing instruments, it is not considered to fully meet identified needs and not examined further at this stage.

B./ A fund A radical reallocation or overhaul of budgetary instruments, with a view in particular to creating a *revolving fund* for private sector investments. A fund:

- could be made rapidly operational;
- could combine several windows such as equity capital or technical assistance.

However a fund:

- would not be able to raise additional resources from the financial markets and would thus not provide *any direct leverage* on capital raised; accordingly this option would generate smaller flows of funds for the region;
- would be relatively less effective and more costly in terms of budgetary resources; there is a precedent for this type of instrument in ACP countries, under the "Cotonou facility", a revolving fund which has been funded with € 2.2 billion from the EDF budget; a fund of a significant size in the Mediterranean (minimum € 500 million, up to € 1 billion) would therefore be a very *costly* instrument for the donors' budgets, for which, as far as the EC budget is concerned, there is not any significant room of manoeuvre under the current Financial Perspective until 2006;
- would remain fully dependent upon donors' budgetary support. Partner countries would not be expected to contribute to a fund. This instrument would not thus meet the *ownership* necessity for the countries of operations;
- financing the private sector development needs in the partner countries would require the *full range* of financial products, particularly loans which a fund would not be able to provide.

Moreover, this solution would not provide with the necessary political visibility.

At this stage therefore the option of a fund with budgetary resources has not been considered further.

ii./ A bank.

A *banking* institution would allow for a wide membership and *ownership* from the partner countries, a significant *leverage* on capital raised, and would provide *the full range of financial products* needed for the development of the private sector in partner countries, including those specially tailored to post conflict situations.

A Euro-Mediterranean Bank (EMB) should focus on areas, which have so far been bottlenecks to the Mediterranean partner countries development and add instruments which have so far been absent or under-utilised. Its core *mandate* should be to foster the development of the private sector, sound and competitive financial intermediaries channelling finance to local SMEs, and projects attracting foreign investments. Support to infrastructure projects would privilege areas where liberalisation policies are being implemented and infrastructure with a trans-regional dimension.

The EMB would provide *loans and equity* investments, either directly or, where possible, through local and regional financial intermediaries. It would thereby also support the development of sound and competitive local private banks and match its hard currency resources with local ones. The high degree of priority for private sector development requires

a corresponding corporate culture of this new subsidiary. The setting up of a risk insurance instrument should be examined as a complementary feature in view of enhancing leverage on new investments, as well as the development of post-conflict instruments. A project related technical assistance window could complement the bank's investments.

The EMB should pursue *sound banking practices*. So as to provide additional rather than diverted finance, its interest rates could progressively be adjusted to reflect its full cost of capital including the risk component associated with the development of private sector activities in partner countries. Concessional finance would only be provided in a selected number of areas, such as environment projects, for which EIB loans already currently benefit from interest rate subsidies financed from the EC budget, or to complement loan finance for well targeted initiatives such as technical assistance or performance fees for developing SME finance through the local banking system. The EMB would aim at maximising the leverage of its interventions and hence actively pursue co-financing policies.

However a number of different options arise as regards the setting up of a regional development bank. Each of these options has advantages and inconvenients which deserve careful consideration.

A./ A fully new regional development bank

A fully new financial institution is attractive from the point of view of visibility and full involvement of the Mediterranean partner countries. However it would be costly and would take time, possibly about two years, to set up and become operational. Provisions would furthermore have to ensure how it builds on existing practices and instruments. The scope for duplication with the EIB's current lending activities in the Mediterranean would be important.

Given these drawbacks this option has not been considered further.

B./ An EIB subsidiary

a/An EIB majority-owned subsidiary

Setting up the new bank within the EIB group would allow for significant synergies and economies of scale which would be reflected in the operating costs of the new institution. Through its majority in the capital of the bank, the EIB would be able to consolidate the new institution in its accounts. A number of management functions such as personnel management, accounting, liabilities management, and legal expertise could to a large extent be shared with the EIB's main activities within the European Union. The core management function of the new subsidiary could, at least in the early years, be focussed on the operations management. This option owing to its low operating costs would allow for the subsidiary's interest lending rates to remain very competitive.

Given the advantages of a bank it is proposed to examine this option further, taking into consideration the already important EIB lending in the region and incorporating this important asset.

b/ An EIB minority-owned subsidiary

An EIB minority-owned subsidiary would represent an intermediary option between a brand new bank and a majority-owned subsidiary. The minority subsidiary option

would have some of the advantages of an EIB majority-owned subsidiary. A certain degree of know-how could be transferred from the EIB, and the new institution could, to some extent, benefit from EIB secondment for a number of its management functions. The lesser degree of integration within the EIB group, in comparison with a majority-owned subsidiary, may as well allow for more flexibility and, subject to the mandate of the new institution, facilitate the shift of its core focus to different activities.

However, there are significant differences with the majority option. The new bank would not be consolidated within the EIB and would have a far less degree of integration within the EIB group. Capital requirements may be different as in the case of a majority-owned subsidiary, notably if its operations-to-capital gearing ratio needs to be set at a different level. Lower economies of scale could translate into higher operating costs – in comparison with the majority option – and influence the new institution's lending rates, which would need to be set at a higher level than in the case of a consolidated subsidiary.

5.3 Features of an EIB subsidiary

An EIB subsidiary, whether minority or majority-owned, would enable a full membership of the partner countries. It would have the mandate described in point 5.2.ii. The EIB's existing lending portfolio in the region, which benefits from the Community guarantee, would be transferred to the new entity, with liabilities of a similar amount. On the revenue side, the new bank would thus benefit from the net revenues generated by the EIB's current loans in the Mediterranean, which would lower net start-up costs in comparison with the setting up of a new stand-alone institution. Non lending existing instruments such as equity or quasi-equity schemes presently managed by the EIB and financed under the MEDA programme could also be merged with the new institution. Incorporating existing instruments would *not only avoid duplication*, it would also be an *efficient and rapid* way of setting up a new institution.

The EMB would be adequately capitalised so as to secure its *financial standing* and to minimise its cost of borrowing. At present, the EIB loans for projects in the area are covered by a blanket guarantee of 65% of the total amount from the Community budget. While the current lending activities in the Mediterranean would continue to be guaranteed from the EC budget, the future of the EC budget guarantees on these loans and their implications on the EC budget and on overall lending levels in the area deserves further study. The EMB's operations-to-capital gearing ratio would reflect the risk associated with its activities. To give an illustration, and taking into account the most recent experience, i.e. the set-up of EBRD, the capital necessary to cover the institution's first four years of operations [2003-2006] could amount to between € 7 billion and € 12 billion. In order to ensure a high leverage of funding and to limit the budget burden of setting up the new institution, 20% or 30% of the EMB's capital would be paid-in (indicative levels). Its remaining resources would be secured from its borrowings on the market. The EMB's initial capital would progressively be increased in line with its effective exposure.

In order to ensure the EMB's *European character*, it is expected that together EU shareholders – Member States, the European Community and the EIB – would subscribe a majority of its capital. *Ownership* by the Mediterranean partner countries of a significant part of the EMB's capital is essential in order to ensure their full participation in the decision making process. At the outset EU members and Mediterranean partner countries would build the core initial group of shareholders. At a later stage, the EMB could, if deemed appropriate by its founding members, envisage to be open to outside shareholders provided, that they

share the Union's political goals in the region. The EMB would have a board of governors at ministerial level and a non-resident board of directors. The board of governors' guidance would ensure consistency with policies developed in the context of the Barcelona process framework. Adequate staffing would reflect the EMB's membership and help fostering a joint banking and financial culture as well as strengthening the sense of ownership.

Possible *sources of funding* of the EMB would reflect its membership: the share capital would need to be secured from the EU Member States, the EC and the partner countries' respective budgets. The EIB's participation would be financed from its own resources. Assuming a Community share tentatively between 5% and 10% of the EMB's capital, the potential *impact on the EC budget* of the first capital subscription under the current Financial Perspective is estimated between € 70 million and € 360 million (indicative levels) ⁹, for which financing remains to be secured. It is probable that an additional capital subscription would be necessary after 2006 under the next Financial Perspective in order to cover growth needs and to secure an enhanced gearing ratio. Some technical studies would need to be commissioned in the founding period and have an estimated cost of € 500.000.

6. Conclusion

1. A final choice will have to be made -following a dialogue with partner countries. At this stage, however, and taking into consideration the respective merits of each option, an EIB subsidiary would be the simplest and most rapid way to enhancing the EU's financial support to identified financing needs. The EMB would be incorporating the EIB's current activities in the region, which would avoid duplication among EU instruments and institutions. It would enable a full ownership from the partner countries. A majority-owned subsidiary would, owing to important economies of scale within the EIB group, allow for the lowest level of operating costs, and is therefore the most cost-efficient option. It is therefore concluded that the best response to identified needs is the setting up of the EMB as an EIB majority-owned subsidiary.

2. Once the basic orientations of this new financial institution have been agreed, an analysis of the necessary practical steps for its implementation should be carried out by the Commission in co-operation with the EIB, Member States and partner countries.

⁹ Low scenario: € 7 bn capital x 5% EC share x 20% paid-in = € 70 million
High scenario: € 12 bn capital x 10% EC share x 30% paid-in = € 360 million

ANNEX 1

MEDA Commitments per country and year 1995-2001 (Mio €)

MEDA	1995	1996	1997	1998	1999	2000	2001	1995-2001
Bilateral								
Morocco	30		235	219	172	140,6	120	916,6
Algeria			41	95	28	30,2	60	254,2
Tunisia	20	120	138	19	131	75,7	90	593,7
Egypt		75	203	397	11	12,7		698,7
Jordan	7	100	10	8	129	15	20	289
Lebanon		10	86		86			182
Syria		13	42		44	38	8	145
West Bank/Gaza	3	20	41	5	42	96,7		207,7
Turkey		33	70	132	140	310,4	147	832,4
Total bilateral	60	371	866	875	783	719,3	445	4119,3
Regional *	113	33	93	46	133	159,8	228,3	806,1
Technical assistance			22	20	21		83,2	146,2
GRAND TOTAL	173	404	981	941	937	879,1	756,5	5071,6

* year 2000 includes Technical Assistance

ANNEX 2

MEDA : soutien au secteur privé

Secteur		Montant CE Meuro	dont AT	dont Fonds de garantie
Financier	En cours	93,77	56,77	37,00
Financier	Pipeline 2002	45,00		
Financier	Total	138,77	56,77	37,00
P.M.E	En cours	483,00	470,30	12,70
P.M.E	Pipeline 2002	111,00		
P.M.E	Total	594,00	470,30	12,70
Privatisation	En cours	116,00	116,00	
Privatisation	Pipeline 2002			
Privatisation	Total	116,00	116,00	
Questions commerciales	En cours	16,09	16,09	
Questions commerciales	Pipeline 2002	20,00		
Privatisation	Total	36,09	16,09	
Total		884,36	659,16	49,70

ANNEX 3

MEDITERRANEAN - Development finance commitments for the year 2000*

	1	2	3	4	5	6	7	8	9	10
	MEDA	EIB	Member States bilateral**	Total EU	World Bank***	AfDB	IFC	EIB + WB + IFC + AfDB	Total EU and multilaterals	EU consolidated ****
Algeria	30,2	143	87,7	260,9	105,2	212,1	0,3	460,6	578,5	326,1
Morocco	140,6	83	130,7	354,3	7,6	0	12,7	103,3	374,6	359,6
Tunisia	75,7	154,8	110,6	341,1	219,2	79,1	0,35	453,45	639,75	411,5
TOTAL MAGHREB	246,5	380,8	329	956,3	332	291,2	13,35	1017,35	1592,85	1097,2
Egypt	12,7	100	16,2	128,9	54,3	41,6	16,8	212,7	241,6	154,6
Israel	0	0	0	0	0	0	0	0	0	0
Jordan	15	69,8	29,3	114,1	38	0	4,8	112,6	156,9	125
Lebanon	0	0	8,47	8,47	148,7	0	6	154,7	163,17	48,07
Palestinian Authority	96,7	13	163	272,7	32,6	0	2,7	48,3	308	281,7
Syria	38	75	45,7	158,7	0	0	1,1	76,1	159,8	159
TOTAL MASHREQ	162,4	257,8	262,67	682,87	273,6	41,6	31,4	604,4	1029,47	768,37
Cyprus	0	0	0	0	0	0	0	0	0	0
Malta	0	0	5,5	5,5	0	0	0	0	5,5	5,5
Turkey	310,4	575	569,9	1455,3	1920,5	0	287	2782,5	3662,8	2020,4
Regional envelope	159,8	0	0	159,8	0	0	43,7	43,7	203,5	171
TOTAL	879,1	1213,6	1167,07	3259,77	2526,1	332,8	375,45	4447,95	6494,12	4062,7
percentage of TOTAL	13,5%	18,7%	18,0%	50,2%	38,9%	5,1%	5,8%	68,5%	100,0%	62,56%

* IMF support is of purely macroeconomic nature and thus not included in the table

** source OECD

*** WB figures are for the year 2000 (up to June 30, 2000)

**** MEDA, EIB and EU Member States' share in the WB, IFC and AfDB

ANNEX 4

Key economic indicators (2000 data)

	GDP bn US\$	(in Population (in million)	GDP/capita (in US\$)	Real GDP growth	Inflation
Algeria	53,8	30,3	1776	2,6	24,5
Morocco	33,4	28,7	1163	0,8	2,5
Tunisia	19,5	9,6	2031	4,7	2,6
Maghreb	106,7	68,6	1555		
Egypt	98,3	63,8	1541	5,1	5,4
Israel	110,3	6,2	17790	5,7	2,0
Jordan	8,3	4,9	1694	3,9	-0,6
Palestinian authort	-	n.a.	n.a.	n.a.	n.a.
Lebanon	16,6	4,3	3860	0,5	0,2
Syria	16,5	16,1	1025	1,4	0,5
Mashreq	250,0	95,3	2623		
Turkey	199,9	65,3	3061	7,2	50,6
Cyprus	8,8	0,8	11536	5,0	4,1
Malta	3,6	0,4	9103	5,0	2,4
Candidates	212,2	66,5	3194		
Total	568,9	230,4	2470		

Sources: WB, UNCTAD

ANNEX 5

FDI inflows					
	FDI figures		Population		Index
	1995-2000 average (in m US\$)	Breakdown	Population in 2000 (in million)	Breakdown	
	(2)	(3)	(4)	(5)	(6)=(3)/(5)
Algeria	5,7	0,1%	30,3	13,1%	1
Morocco	524,7	8,8%	28,7	12,5%	71
Tunisia	485,7	8,2%	9,6	4,2%	196
Maghreb	1016	17,1%	68,6	29,8%	57
Sub-total					
Egypt	916,8	15,4%	63,8	27,7%	56
Israel	2305,0	38,7%	6,2	2,7%	1438
Jordan	193,0	3,2%	4,9	2,1%	152
Palestinian Authority	n.a.		n.a.		n.a.
Lebanon	149,2	2,5%	4,3	1,9%	134
Syria	87,3	1,5%	16,1	7,0%	21
Mashreq Sub-total	3651	61,3%	95	41,4%	148
Turkey	852,8	14,3%	65,3	28,3%	51
Cyprus	64,0	1,1%	0,8	0,3%	326
Malta	369,7	6,2%	0,4	0,2%	3667
Sub-total candidate	1287	21,6%	66	28,8%	75
Total	5954	100,0%	230	100,0%	100

Source: UNCTAD

ANNEX 6

FDI inflows (in millions of US\$)

	1989-1994 average	1995	1996	1997	1998	1999	2000	1995-2000 average	1995-2000/ 1989-1994 increase
Algeria	12,0	5	4	7	5	7	6	5,7	-52,8%
Morocco	352,0	335	357	1079	329	847	201	524,7	49,1%
Tunisia	358,0	378	351	366	670	368	781	485,7	35,7%
Maghreb	722	718	712	1452	1004	1222	988	1016	40,7%
Egypt	741,0	598	636	891	1076	1065	1235	916,8	23,7%
Israel	380,0	1349	1387	1628	1754	2363	5349	2305,0	506,6%
Jordan	6,0	13	16	361	310	158	300	193,0	3116,7%
Palestine	0,0	0	4	0	0	1	0	0,8	
Lebanon	10,0	35	80	150	200	250	180	149,2	1391,7%
Syria	98,0	100	89	80	80	91	84	87,3	-10,9%
Mashreq	1235	2095	2212	3110	3420	3928	7148	3652	195,7%
Turkey	708,0	885	722	805	940	783	982	852,8	20,5%
Cyprus	91,0	82	50	68	56	65	63	64,0	-29,7%
Malta	70,0	132	277	81	267	822	639	369,7	428,1%
Sub-total	869	1099	1049	954	1263	1670	1684	1287	48,0%
Total	2826	3912	3973	5516	5687	6820	9820	5955	110,7%

Source: UNCTAD