



Report on

Operations Under

the European Bank

for Reconstruction

and Development

Agreement Act

1998



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INTRODUCTION

The European Bank for Reconstruction and Development (referred to in this document as the EBRD or the Bank) was established in 1991. Its aim is to foster the transition towards open, market-oriented economies in Central and Eastern Europe, as well as in the successor republics of the Soviet Union, and to promote private and entrepreneurial initiative in countries in this region that are committed to the fundamental principles of multi-party democracy, pluralism and a market economy (see Annex 4 for a list of the EBRD's 26 countries of operation).

The EBRD functions as a development bank, much in the same way that the World Bank and other regional development banks operate. The EBRD, however, is distinctive in three areas. First, its overriding focus is on the private sector and support for the transition from central planning to stable market economies. Its Charter stipulates that not less than 60 per cent of its financing commitments should be directed either to private sector enterprises or to state-owned enterprises implementing a program to achieve private ownership and control. Second, the EBRD's mandate gives it a particular focus on the promotion of democratic institutions and human rights in its countries of operation. Finally, the EBRD is explicitly committed to ensuring the environmental sustainability of all its projects.

The Bank seeks to help its 26 countries of operation to implement structural and sectoral economic reforms, taking into account the particular needs of countries at different stages in the transition process. In particular, its private sector activities focus mainly on enterprise restructuring, including the strengthening of financial institutions, and the development of infrastructure needed to support the private sector. The EBRD has 60 members (58 countries, the European Union and the European Investment Bank – see Annex 4 for a list of the members).

Canada is the eighth largest shareholder, following the other Group of Seven (G-7) countries and the Russian Federation. Our formal participation is authorized under the *European Bank for Reconstruction and Development Agreement Act*, which was promulgated in February 1991. Article 7 of the Act states that:

“The Minister [of Finance] shall cause to be laid before each House of Parliament by March 31 of each year, or if that House is not then sitting, on any of the thirty days next thereafter that it is sitting, a report of operations for the previous calendar year, containing a general summary of all actions taken under the authority of this Act, including their sustainable development aspects within the meaning of Article 2 of the Agreement, and their human rights aspects.”

This report responds to this requirement and reviews the activities and operations of the Bank for the year 1998.

ROLE AND MANDATE OF THE EBRD

The EBRD:

- fosters the transition of former centrally planned economies of Central and Eastern Europe and the Commonwealth of Independent States towards market-oriented economies;
- promotes private entrepreneurial initiative (targets at least 60 per cent of its resources to private sector projects with the balance in support of commercially viable state sector projects that promote private sector development);
- operates only in countries committed to applying the principles of multi-party democracy, pluralism and market economics;
- promotes environmentally sound and sustainable development;
- operates on a self-financing basis.

The EBRD's operations to advance the transition to a market economy are guided by three principles: maximizing transition impact, additionality and sound banking. Financing is provided for projects that expand and improve markets, help build the institutions necessary for underpinning the market economy, and demonstrate and promote market-oriented skills and sound business practices. EBRD financing must also be additional to other sources of financing, and not displace it, further ensuring the Bank contributes to the transition process. Finally, Bank projects must be sound from a banking perspective, thus demonstrating to private investors that the region offers sound returns. Adherence to the sound banking principle also helps ensure the financial viability of the EBRD and hence its attractiveness as a co-investment partner for the private sector.

In promoting economic transition in its countries of operation, the Bank acts as a catalyst for increased flows of financing to the private sector. The capital requirements of these countries cannot be fully met by official multilateral and bilateral sources of financing, and many foreign private investors remain hesitant to invest in the region. By providing an umbrella under which wider funding for private sector investment can be assembled, the EBRD plays a catalytic role in mobilizing capital. In 1998, for every ECU the EBRD invested, it mobilized an additional 3.2 ECU from the private sector and multilateral and bilateral agencies.¹

¹ The European Currency Unit, or ECU, is a weighted basket of 12 European currencies. On December 31, 1998, one ECU purchased 1.7943 Canadian dollars.

Indeed, the projects of the Bank serve a dual purpose. They are intended not only to directly support the transition from a command to a market economy in countries of operation, but also to create a demonstration effect to attract foreign and domestic investors. Like the International Finance Corporation, the Bank is required to operate on a strictly commercial basis and to attract companies to invest in countries through financially viable projects, not through subsidies.

KEY DEVELOPMENTS IN 1998

In 1998, the EBRD faced its most serious operational challenge in its seven-year history. Falling investor confidence in emerging markets worldwide in the wake of events in East Asia, combined with incomplete macroeconomic and structural reform efforts in Russia, precipitated a financial crisis in Russia in August 1998. Russia's already fragile banking system was seriously affected and the impact reverberated through some of the other transition economies. The financial and economic pressures arising from this crisis led to the largest reform setbacks in Russia since the collapse of communism in 1991 and to significant reform reversals in several other transition economies (mainly members of the Commonwealth of Independent States (CIS)).

The suddenness and depth of the Russian financial crisis proved a stress test for reform and restructuring across all of the EBRD's countries of operation. Significantly, those countries (principally in Central and Eastern Europe) that have been most committed to reform and have moved the furthest in creating strong state and corporate institutions proved best able to weather the financial turbulence. The following table classifies transition countries according to a number of transition indicators.

Progress in Transition in Central and Eastern Europe, the Baltic States and the CIS¹

Countries	Population (millions, 1997)	Private sector share of GDP in %, mid-1998	Enterprises			Market and trade			Financial institutions	
			Large-scale privatization	Small-scale privatization	Governance and enterprise restructuring	Price liberalization	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalization	Securities markets and non-bank financial institutions
Albania	3.2	75	2	4	2	3	4	2	2	2-
Armenia	3.7	60	3	3	2	3	4	2	2	2+
Azerbaijan	7.6	45	2	3	2	3	3	1	2	2-
Belarus	10.2	20	1	2	1	2	1	2	1	2
Bosnia and Herzegovina	4.1	35	2	2	2-	3	2	1	2	1
Bulgaria	8.3	50	3	3	2+	3	4	2	3-	2
Croatia	4.5	55	3	4+	3-	3	4	2	3-	2+
Czech Republic	10.3	75	4	4+	3	3	4+	3	3	2+
Estonia	1.5	70	4	4+	3	3	4	3-	3+	3
FYR Macedonia	2.0	55	3	4	2	3	4	1	3	2-
Georgia	5.4	60	3+	4	2	3	4	2	2+	1
Hungary	10.1	80	4	4+	3+	3+	4+	3	4	3+
Kazakhstan	15.7	55	3	4	2	3	4	2	2+	2
Kyrgyzstan	4.6	60	3	4	2	3	4	2	3-	2
Latvia	2.5	60	3	4	3-	3	4	3-	3-	2+
Lithuania	3.7	70	3	4	3-	3	4	2+	3	2+
Moldova	4.3	45	3	3+	2	3	4	2	2+	2
Poland	38.7	65	3+	4+	3	3+	4+	3	3+	3+
Romania	22.5	60	3-	3+	2	3	4	2	2+	2
Russian Federation	147.2	70	3+	4	2	3-	2+	2+	2	2-
Slovak Republic	5.4	75	4	4+	3-	3	4+	3	3-	2+
Slovenia	2.0	55	3+	4+	3-	3	4+	2	3	3
Tajikistan	6.1	30	2	2+	2-	3	3-	1	1	1
Turkmenistan	4.7	25	2-	2	2-	2	1	1	1	1
Ukraine	50.9	55	2+	3+	2	3	3-	2	2	2
Uzbekistan	23.6	45	3-	3	2	2	2-	2	2-	2

Source: Transition Report (EBRD, November 1998)

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

Most advanced industrial economies would qualify for the 4+ rating for almost all the transition indicators.

Highlights of Macroeconomic Performance

- Due to the impact of the Russian crisis, real GDP declined by an estimated 1 per cent in the EBRD's region of operation in 1998. However, this masks significant variations across countries. In the CIS countries, output fell by an estimated 3.6 per cent; in contrast, Central and Eastern Europe and the Baltic States grew an estimated 2.8 per cent.
- Inflation has continued to fall in most countries, helped by low commodity prices and the tightening of domestic liquidity following capital outflows from the region during the second half of the year. However, in a number of other countries inflation has picked up substantially, most notably in Russia, due to significant exchange rate depreciation.
- Current account deficits widened in the region in 1998. Fifteen countries recorded deficits above 7 per cent of GDP compared with nine in 1997.

Russia

The origins of the Russian crisis lay in the country's incomplete macroeconomic stabilization and slow pace of structural reform (especially at the enterprise level). Since 1995, the Russian government had used domestic Treasury bills and international capital market borrowing to finance fiscal deficits. With the persistence of the emerging markets financial crisis since mid-1997, Russia also had to contend with rising borrowing costs and falling commodity prices. As the stock of debt grew, without progress in reducing government deficits, domestic and foreign holders of Russian debt instruments lost confidence. In response to the escalating cost of debt financing and pressure on the ruble, on August 17, 1998, the Russian government suspended payments on its ruble-denominated debt obligations, announced a moratorium on foreign debt payments and effectively devalued the ruble. (It depreciated 60 per cent against the US dollar in the wake of the crisis, and by the end of December 1998 had depreciated 70 per cent relative to its pre-crisis level.) In the wake of the crisis, the President dismissed the reform-oriented government of the Russian Federation.

Heavily exposed to the Russian government and with considerable unhedged foreign exchange liabilities, Russian commercial banks were severely affected by the default and devaluation; many collapsed. The new Russian government, under Prime Minister Yevgeny Primakov, has begun to build some political consensus but has not been able to elaborate an effective recovery program. As a result, the International Monetary Fund has suspended financial assistance to Russia though it continues to dialogue with the government. The lack of an effective recovery program continues to undermine the restoration of investor confidence.

Central and Eastern Europe

In contrast to Russia, several central and eastern European (CEE) countries continued to enjoy relatively robust economic growth in 1998; average real growth for these countries has been above 3.5 per cent since 1994. In 1998, the Slovak Republic and Slovenia joined Poland among the CEE countries where income levels exceeded those of a decade ago. Economic growth in 1998 for the region, though lower than in 1997, was still positive at an estimated 2.8 per cent. However, there was a noticeable weakening in the regional growth rate in the second half of the year.

In 1998, CEE economic growth rates significantly exceeded those of the CIS region. This was due in part to the CEE's relatively low trade dependence on Russia and its ability to withstand the emerging markets financial crisis better than CIS countries. This stronger macroeconomic position has been fostered by significant gains in competitiveness through successful enterprise restructuring and by the creation of strong market-supporting institutions (fiscal, legal, financial and social) in many CEE countries. Poland and Hungary in particular advanced significantly in the transition process (see the table on page 8) and were well poised for long-term sustained economic growth.

Accession to the European Union

The main challenge for the more advanced CEE countries in 1998 was working towards meeting the requirements for accession to the European Union (EU). In March 1998, the EU began initial accession negotiations with five (the Czech Republic, Estonia, Hungary, Poland and Slovenia) of the ten "accession countries" identified in December 1997 at the EU's Intergovernmental Council meeting as candidates for early membership.¹

In the same month the EBRD, European Commission and World Bank signed a Memorandum of Understanding setting out the basic principles for collaboration in supporting projects that will assist all accession countries in meeting the requirements of EU accession. In particular, all 10 accession countries face specific requirements for investment in infrastructure to meet the requirements of the EU's *Acquis Communautaire*. The EBRD will be active in supporting projects where its mandate and EU accession requirements overlap.

¹ The ten accession countries are Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The EU has negotiated accession partnerships with all 10 countries.

The Non-Russian CIS

Given its considerable trade dependence on Russia, the CIS region was profoundly affected by the Russian financial crisis. Growth slowed in seven of the eleven CIS countries (excluding Russia), with those countries trading most heavily with Russia experiencing some of the most significant slowdowns. For instance, in Moldova, where 63 per cent of merchandise exports are destined for Russia, the economy is estimated to have contracted 2 per cent in 1998, after growing modestly in 1997. In contrast, in Tajikistan, where only 8 per cent of exports are destined for Russia, GDP grew an estimated 3 per cent, up from 1.7 per cent in 1997. Many CIS countries with large natural resource sectors were already suffering from the global recession in commodity markets (especially oil and metals).

Ukraine shared many of the underlying structural weaknesses of its Russian neighbour and suffered similarly strong pressure on its currency, leading to a sharp depreciation against the US dollar in September 1998. The Ukrainian government was then forced to reschedule its domestic debt obligations. The Ukrainian economy contracted an estimated 1.5 per cent in 1998.

CIS countries continued to lag considerably behind CEE countries in implementing structural reforms (see the table on page 8). Fearing the employment repercussions and under pressure from vested interests, governments throughout the CIS region were unable or unwilling to advance corporate restructuring. Enterprises were kept afloat by arrears on inter-enterprise payments and taxes. The fiscal position of many countries in the region was also undermined by low tax collection. This in turn constrained investment in health and education, and in social programs for the poor.

Not all CIS countries, however, were equally affected. Those that had previously delayed reforms because of internal civil unrest or war, such as Armenia, Azerbaijan, Georgia and Tajikistan, began to make up lost ground in 1998 by adopting and initiating long-delayed reform programs to foster transition. Armenia, Azerbaijan and Tajikistan, as well as Kazakhstan, were able to sustain relatively stable exchange rates in the wake of the Russian crisis and, as a result, some of these economies experienced some disinflation. All of these countries were able to maintain positive growth in 1998, although in the cases of Kazakhstan and Georgia, the rate of growth slowed somewhat.

Impact of the Russian/Emerging Markets Crisis on the EBRD

The impact of the Russian crisis on the EBRD was direct and deep. As of December 31, 1998, 25.5 per cent of the EBRD's disbursed loan and equity portfolio was in Russia. Furthermore, nearly one-third of this exposure was to the Russian financial sector. The EBRD recorded its first annual loss since 1992 – ECU 261.2 million (C\$468.3 million) – as it increased its provisions following an extensive review of the effect of the Russian crisis on the EBRD's

projects in Russia and other countries, particularly in the banking sector.² However, the strong capitalization of the Bank has allowed it to absorb the loss without threatening its financial viability.

The EBRD, as a regional development bank, however, has an inherently more risky portfolio than the World Bank or the International Finance Corporation because the EBRD's portfolio does not have as diversified a geographic distribution.

The EBRD responded to the Russian financial crisis by first taking steps to safeguard its existing investments and second, by moving to gradually rebuild investor confidence in the region. EBRD banking resources were significantly redirected from developing new projects to monitoring projects that saw a deterioration in their creditworthiness. This often included a hands-on approach by EBRD bankers in working with company management to overcome financial problems.

There was also a significant impact on the geographic focus of the EBRD's operations. In 1997 and early 1998, the EBRD came under strong criticism from some shareholders for not meeting its notional target of 30 per cent of new operational commitments in advanced transition economies. By the end of the 1998, however, the share of new commitments in advanced transition economies had risen to 40 per cent, while Russia's share had fallen to 23 per cent (from a business plan target of 30 per cent) and the share for early/intermediate countries had fallen to 37 per cent (from a target of 40 per cent). This shift reflected, in part, the greater difficulty some advanced transition economies had in accessing commercial financing, as well as a deterioration of the investment climate in Russia and early and intermediate transition countries. It also marked the beginning of a conscious effort on the part of the EBRD to rebalance its portfolio to offset the growing risks of Russian and CIS exposure.

Lessons Learned

An important lesson from the crisis is that the transition process will take longer than initially thought. The Russian financial crisis has vividly confirmed that transition countries that have moved forward most aggressively with structural reforms have been better able to weather the financial crisis than those countries where progress on restructuring has been slow and uneven. In particular, the crisis has demonstrated the importance of sound bankruptcy practices, transparent and effective tax regimes, strong regulatory and financial institutions, and effective legal frameworks that set good governance

² Provisions are subtracted from operating income along with other expenses. For private sector projects, the bulk of the EBRD portfolio, provisioning follows a risk-based approach. Management continually reviews the portfolio to ensure that the currency value of loans and investments reflects management's best estimate of the recoverability of Bank assets.

standards and inhibit corruption. These are the fundamental prerequisites for building investor confidence and will take more time to develop in many transition countries than initially expected.

The crisis has underlined that the state has a pre-eminent role to play in building and consolidating the institutional and social basis for a healthy market economy. The state must have the capacity to enforce laws, collect taxes, regulate financial markets, promote enterprise restructuring and ensure effective corporate governance. However, in many countries, the way privatization was undertaken has created strong vested interests that compete with the state and limit its ability to undertake the most basic of functions, such as tax collection and law enforcement. This in turn further weakens the state, fuels corruption and stalls transition, particularly in such important areas as enterprise restructuring.

In addition, the crisis has underlined the significant social strains of the transition process, which were largely underestimated at the start of the process. The heavy industrial and environmental legacy of the central planning regime in many countries means that the transition process will entail heavy social costs in terms of unemployment and a low level of government services into the medium term. Therefore, many governments in the region face a significant challenge in building the social consensus essential for a successful transition.

The EBRD has traditionally been an active supporter of privatization efforts throughout the region and has provided support to locally owned privatized firms. However, in the wake of the Russian financial crisis, the Bank will participate in enterprise restructuring only with strong strategic partners with a proven track record in achieving change to ensure the risks and costs associated with such projects are minimized for the Bank.

Several years of experience in the region has shown that large state-owned firms that have been privatized through special management buyouts that preserve the control of planning-era management do not perform as well as newly established private firms (locally owned or majority foreign-owned). The pressures of the Russian and emerging markets financial crises have only reconfirmed this conclusion, as large enterprise owners with close contacts with state agencies have intensified their lobbying for the continuation of direct and indirect government support for their failing companies.

In 1998, in the wake of the Russian crisis, the management and the Board of Directors of the Bank started a review of the EBRD's operational priorities. The new operational priorities will be reviewed by the Bank's Governors at the Annual General Meeting in April 1999.

1998 FINANCIAL PICTURE

Financial Highlights

- The Bank suffered losses of ECU 261.2 million (C\$468.3 million). This was mainly due to increased provisioning as a result of the Russian crisis.
- Provisioning charges totalled ECU 553.1 million (C\$992.4 million) in 1998, more than three times their 1997 level.
- 1998 losses masked strong income growth. Operating income rose by 30 per cent to ECU 450.5 million (C\$808.3 million) primarily due to the excellent returns from the sales of selected equity investments and strong growth in Treasury income; operating profit grew to ECU 291.8 million, more than 50 per cent higher than in 1997.
- Despite the difficult operating environment, the Bank signed new commitments of ECU 2.37 billion (C\$4.25 billion), virtually in line with its business plan. This provided funding to 96 projects in 24 countries of operation. The share of commitments going to Russia and to early and intermediate countries was lower than planned, as the Russian crisis curtailed business opportunities in these countries in the latter half of the year.
- The EBRD's ability to mobilize additional financing increased in 1998. The Bank mobilized 3.2 ECU in additional financing for every ECU that it invested in 1998, compared to an average of 2.6 ECU since operations began in 1991.
- Equity investments represented 33 per cent of new commitments, well above the 22 per cent target in the business plan, as the Bank participated in a number of privatizations in advanced transition countries.
- Administrative expenses were well within budget, with no real increase recorded for the fifth consecutive year.

In 1998, the EBRD suffered its first loss since 1992, reflecting the need to provision against the increased risk of its portfolio. Provisioning charges totalled ECU 553.1 million in 1998, more than triple their 1997 level. This is largely due to the Russian crisis.

At the same time, it is important to note that the Bank did not write off any of its assets in 1998 as a result of the crisis (two write-offs did occur but were unrelated to events in the last quarter of 1998). Indeed, the portfolio has so far stood up quite well to the crisis. Although there have been some arrears on loans, they have been largely technical in nature, reflecting the difficulties businesses have had in accessing foreign currency to pay their obligations to the EBRD, rather than problems of insolvency and hence non-recoverability. It is also noteworthy that the EBRD was exempted from the moratorium on foreign debt payments introduced by the Russian government in August 1998.

Administrative Efficiency and Cost-Effectiveness

The EBRD's general administrative expenses, expressed in pounds sterling, were well within budget and slightly lower than those for 1997, reflecting continuing budgetary discipline and cost controls. As a result of the strength of sterling during 1998, however, the Bank's general administrative expenses, when expressed in ECU, were 6.1 million ECU (C\$10.9 million) above the level of last year.

The Bank's efforts at productivity enhancement have been commendable. In 1998, productivity continued to increase as both commitments and projects under implementation rose sharply while costs remained flat. A simplified approval process and streamlined documentation for projects involving fewer resources were adopted in 1998 as part of the continuing commitment to zero-base budgeting.

PRIORITIES IN 1998

Private Sector Development

Canada has been a strong supporter of the private sector work of the Bank, recognizing that a strong private sector is key for the successful transition to a market economy. Of the projects signed in 1998, about 80 per cent were private sector operations, broadly consistent with 1997 and well above the 62 per cent ratio in 1994.

Of particular importance over the past year has been the Bank's continuing effort to promote small- and medium-sized enterprises (SMEs). Much of the Bank's support for SMEs is provided through financial intermediaries, as the relatively small size of individual SMEs means direct financing by the EBRD would impose high administrative costs on the Bank. At the end of 1998, the EBRD had provided close to ECU 2 billion (C\$2.8 billion) to local banks principally to on-lend to SMEs. Lending to these enterprises represented 24 per cent of commitments. By enhancing the financing available to SMEs, the Bank has helped to nurture entrepreneurship and create employment.

The Private Sector Focus of the Bank

The EBRD Agreement requires that the Bank achieve at least a 60/40 ratio (the so-called "portfolio ratio") in its private/public sector activities, both globally and in individual countries.

The global portfolio ratio was satisfied in 1998, with 68 per cent of the Bank's cumulative outstanding commitments linked to private sector activities. Progress in reaching the individual country ratios, however, was mixed. At the end of 1998, the ratio was attained in only 8 of the Bank's 26 countries of operation.

The deadline for meeting the portfolio ratio requirement in individual countries of operation (i.e., five years after the approval of the Bank's first operation in that country) is nearing in a number of countries. The shortfall has been most evident in lower transition economies, where privatization has developed relatively slowly and where the Bank has often been active in developing public infrastructure critical to the development of a strong private sector. Many lower and intermediate transition economies still have relatively small and immature private sectors.

Nevertheless, the private sector share remains below 60 per cent in a number of high transition economies (primarily in the Baltics) where the private sector is dominated by companies that are often too small to be the focus of direct EBRD operations. For these countries, the Bank has established a plan of action as part of its country strategy. In most of these countries, progress was made in 1998 towards meeting the target ratio.

Activities in the Financial Sector

In 1998, notwithstanding the Russian financial crisis, the EBRD signed 72 more financial sector operations valued at ECU 867 million (C\$1.6 billion), bringing total EBRD exposure to the financial sector region-wide to ECU 3.5 billion (C\$6.3 billion). By the end of 1998, the EBRD held an equity stake in 51 banks in 22 transition countries. In most cases where the EBRD holds an equity stake in a local financial institution, it is represented on the supervisory board of the institution where it promotes management accountability, good corporate governance, sound banking practices and proper environmental reviews/procedures.

The EBRD signed its first financial sector project in Azerbaijan in 1998, and a second SME line of credit was concluded for Ukraine with disbursement for the credit line pending ratification by the Ukrainian Parliament. The Canadian International Development Agency (CIDA) is providing C\$3 million in bilateral technical assistance funding in support of the EBRD's second SME financing facility for Ukraine. The funds will be used to finance technical assistance for Ukrainian commercial banks by qualified Canadian organizations.

The EBRD has been active in developing non-bank financial institutions, particularly investment funds. EBRD support for private equity funds in the region is growing. By the end of 1998, total capital mobilized for funds in which the EBRD participated was ECU 2.7 billion (C\$4.8 billion). These equity funds have invested in over 500 companies throughout the region and have contributed to mobilizing total financing of ECU 4.6 billion (C\$8.3 billion) for companies in the region. Among the funds supported by the EBRD are 28 post-privatization and regional venture funds. These funds make significant use of technical assistance provided by bilateral donors to assist companies in the privatization and immediate post-privatization periods.

Investments in and loans to local financial institutions are the main avenues for the EBRD to provide financing to SMEs. The Russia Small Business Fund has been an important vehicle for financial sector and SME development.

The Russia Small Business Fund

Established by the EBRD as a pilot project in 1993, following a request by the G-7, the Russia Small Business Fund (RSBF) is a US\$300-million fund financed jointly by the EBRD, the G-7, the EU and Switzerland, for the promotion of small- and micro-enterprise lending in Russia. Canada, through CIDA, contributed US\$8.1 million (C\$11.3 million) to the program. The Fund operates by lending to local banks that then on-lend to local SMEs. The RSBF also has a technical assistance facility whereby partner Russian commercial banks receive assistance from western experts.

By 1998, the RSBF was operating through 13 Russian banks in 23 regions and numerous small towns across Russia, and its consistently very low arrears levels made it one of the EBRD's most successful projects. Over 23,000 loans had been made for a total of US\$315 million. The RSBF model has been replicated by the EBRD in Moldova, Bosnia-Herzegovina, Kazakhstan and, most recently, within the Ukraine SME line of credit.

The Russian financial crisis in 1998, however, constrained most of the Russian banks participating in the Fund. To preserve the important work of the RSBF in supporting SME development, the EBRD has taken a two-pronged approach. First, in conjunction with strategic foreign investors, it has begun to examine creating a new bank to which the existing RSBF portfolio of insolvent partner banks would be transferred. Second, the EBRD would continue to work, even on a limited basis, with those partner banks that have been co-operating with it through the crisis and which are potentially solvent.

Environment

Despite the challenges faced by the Bank in responding to the financial crises in 1998, support for the environment, as part of the Bank's mandate to ensure sustainable long-term development in member countries, remained a key priority. The Bank is directed by its statutes to "promote in the full range of its activities environmentally sound and sustainable development." The EBRD applies environmental due diligence to all its investment and technical co-operation operations.

Countries at more advanced stages of transition, especially those seeking accession to the EU, are now channeling more resources into investments to improve environmental conditions. In addition, increased attention is being given to improving the provision of essential municipal services, such as district heating, water supply and urban transport, as the availability and quality of these services are critical to underpinning economic development.

In 1998, 11 environmental projects were signed with a total EBRD commitment of more than ECU 196 million (C\$351.7 million). Forty-three environmental analyses, including five environmental impact assessments and twenty-five environmental audits, were conducted on projects approved by the Board of Directors in 1998.

Municipal and Environmental Infrastructure Policy

The adequate provision of basic public infrastructure and services is essential for the economic transition process. Poor quality and under-supply of municipal services, together with energy inefficiencies, have often limited productivity. The EBRD is pioneering operations in this area by financing projects with municipal governments. In June 1998, the Bank approved an operations policy for municipal and environmental infrastructure that emphasizes private sector involvement as well as the development of appropriate regulatory structures and energy efficiency.

The EBRD and Nuclear Safety

Canada and other G-7 countries have been working closely with the EBRD to improve nuclear safety in CEE countries and the former Soviet Union. To facilitate this work Canada has generously contributed to the Nuclear Safety Account (NSA), which the EBRD administers on behalf of the G-7 countries and other contributors. The NSA is used primarily for making essential safety improvements to older generation Soviet-built reactors as part of a comprehensive program for their early decommissioning. As of December 31, 1998, pledges to the NSA totalled ECU 289 million (C\$518.6 million). Canada has contributed C\$19.5 million.

On the G-7's behalf, the Bank has agreed to administer the US\$760-million Chernobyl Shelter Fund for securing the sarcophagus around the destroyed (by nuclear accident) Unit VI reactor in Ukraine. The G-7 nations and the European Union have pledged US\$391 million, of which Canada has pledged a contribution of US\$20 million.

Canada also supports the use of the EBRD's own resources to finance the completion of Soviet-designed nuclear power plants up to Western safety standards. The EBRD applies strict conditions to this support. The completion of these plants must be a commercially viable and "least cost" solution to the country's future electricity requirements; the completed plants must fully comply with Western nuclear safety standards; and any resulting increase in nuclear power in upgraded facilities must be offset by the closure of other unsafe nuclear plants.

Addressing Corruption and Poor Governance

The transition countries, like most emerging economies, face significant challenges in improving transparency and governance. The EBRD's mandate assigns it an important role in addressing governance issues by permitting it to operate only in countries committed to applying the principles of multi-party democracy and pluralism. These principles, when effectively implemented, contribute to transparency in government policy making, act as a check on corruption and ensure an effective state. To underline their importance, the Bank has curtailed financing of public sector projects in countries where the government's commitment to the principles of multi-party democracy is weak. Canada fully supports this approach.

The EBRD seeks to improve governance and transparency largely through the projects it undertakes. Equity investments have been an important tool in this regard. The Bank's participation on the boards of directors of companies in which it invests has been instrumental in improving the transparency of their accounting and business practices and the respect of minority shareholder rights. It is hoped that the success of these companies will have important demonstration effects in the region. In addition, all Bank counterparties are examined to ensure they meet the highest standards of business practice.

In this regard, Canada was instrumental in tightening the Bank's public sector procurement rules against corrupt practices. The new rules underline for all doing business with the EBRD the standards of ethics and conduct required during the procurement and execution of EBRD-financed projects. In 1998, concerns expressed by many Directors about Bank co-investment with companies resident in offshore tax havens led to a review of this issue.

The Bank also attempts to influence the investment climate in its countries of operation through policy dialogue with government. An important high-level venue for this dialogue is the Foreign Investment Advisory Councils. They bring together government ministers, political leaders from the Bank's countries of operation, representatives of the international business community and high-ranking EBRD officials twice yearly to discuss how to improve the investment climate in the countries.

INSTITUTIONAL DEVELOPMENTS

Changes in Presidency

In January 1998, Jacques de Larosière stepped down as President of the EBRD. The Bank's Governors elected Horst Köhler President effective September 1. Mr. Köhler joined the EBRD from the Association of German Savings Banks, where he served as President. This followed a distinguished career at the German Federal Finance Ministry where, from 1990 to 1993, he played a critical role in building western support for the transition process in Central and Eastern Europe.

President Köhler continues to uphold the project-centered private sector focus of the Bank. In addition, he has underlined that the Bank must strive harder to influence specific improvements in the institutions, the legislation and the key variables in the investment climate of its countries of operation. President Köhler has met numerous times with the heads of the World Bank, the International Monetary Fund and other regional development banks to intensify co-operation between institutions and build on their complementarities.

Introduction of the Euro

With the adoption of the Euro as the official currency of the European Monetary Union on January 1, 1999, the EBRD changed its reporting currency from the ECU to the Euro. This required modifications to the EBRD's processing and accounting systems. The Euro will enter into circulation on January 1, 2002. For the transition period, the EBRD has adopted a set of guiding principles for all relevant transactions and relationships with borrowers and counterparties with a view to maximizing flexibility for clients.

Year 2000 Compliance

In January 1998, EBRD management created a committee to develop a Bank-wide action plan for year 2000 (Y2K) compliance. All information technology systems in the EBRD have now been assessed and corrected to ensure that they are Y2K compliant. Testing is expected to be completed in March 1999. In addition, the Bank now includes Y2K resolutions in all its standard loan agreements.

Financial institutions face special challenges, however, in meeting the challenges of Y2K because of their numerous links with external parties – other financial institutions, exchanges, clearing houses and clients. Failure of these parties to be Y2K compliant can have financial implications for a fully compliant financial institution. To address this issue, the EBRD has identified potential high-risk clients and is working with them to reduce the risks.

MANAGING CANADA'S INTERESTS

The highest authority in the Bank is the Board of Governors. Member countries are represented by a Governor and an Alternate Governor. The Honourable Paul Martin, Minister of Finance, is the Canadian Governor and Mr. Donald Campbell, Deputy Minister of Foreign Affairs, is the Alternate Governor.

The Board of Directors is responsible for the general operations of the Bank. The Board is composed of 23 members, of which four are non-European members. Canada is the third largest non-European shareholder, after the United States and Japan, and by virtue of its share has the right to elect its own Director. Canada also represents Morocco at the Bank. The Canadian Director is Mr. Patrice Muller. Mr. Tom MacDonald, Minister (Economic/Commercial) in the Canadian High Commission in London, is the non-resident Alternate Director who represents Canada in the absence of the Canadian Director.

Within the Canadian Government, responsibility for oversight of the EBRD's activities resides with the International Finance and Economic Analysis Division of the Department of Finance. In consultation with the Department of Foreign Affairs and International Trade (DFAIT) and CIDA, the Department of Finance regularly reviews the Bank's policy papers and proposed country strategies, and provides advice to the Canadian Director.

Canada continued to advocate increased EBRD activity in Ukraine and other countries in lower or intermediate stages of transition, provided the increased risk was balanced against lower risk projects elsewhere in the portfolio. Canada has supported the development within the Bank of a "wholesale" approach to activities, under which the Bank channels financing to SMEs

through lines of credit or equity investments in local banks and other financial intermediaries in its countries of operation. In light of the Russian crisis, Canada has encouraged the EBRD to pay greater attention to systemic risks in the financial sector and to improve co-ordination with other institutions, particularly the World Bank, in addressing issues of regulation and supervision.

Canada's Voting Record

Canada and other shareholders typically raise concerns and questions about specific Bank operations before they get to the Board. As a result, decisions at the Board are generally taken by consensus without a formal vote. Nevertheless, the Canadian Director voted against:

- a loan to Chernogorneft, a large privately owned Russian oil company, because of a longstanding commercial dispute between that company and a Canadian investor; and
- the financing of two steel projects in the FYR of Macedonia and Moldova because they were viewed as unlikely to be financially viable without significant displacement of production in other countries.

Canada has continued to underline the importance of the project-centered private sector focus of the EBRD. It has also argued that the Bank cannot relax its efforts to expand the share of its private sector operations. Recent events have, however, underlined the importance of the state and its institutions in private sector development. Canada has argued that the Bank must do more to influence the investment climate in its countries of operation through the demonstration effects of its projects, through its relationship with client governments and through consultation with other international financial institutions operating in the region. The Canadian Director has frequently spoken in the Board on the importance of the Bank's charter requirement that member countries be committed to market reform and multi-party democracy.

With respect to its own contributions to the EBRD, Canada continued to play a leading role in the adoption of zero real growth budgets for 1998. The Canadian Director chaired the EBRD Board's Budget and Administrative Affairs Committee, which sets the administrative budget levels and deliberates on the annual targets for the volume of financing operations.

CANADIAN COMMERCIAL INTERESTS

The EBRD offers a wide variety of opportunities for Canadian businesses. One of the tasks of the Canadian Office is to make Canadian business people aware of investment opportunities, explain how the Bank's contracting works and ensure that all contracts are awarded in a transparent and fair manner.

To achieve these objectives, the Canadian office provides market information and intelligence to Canadian firms, advises Canadian project sponsors on EBRD financing options, develops commercial co-financing opportunities with the Export Development Corporation and Canadian financial institutions, identifies and sources EBRD procurement opportunities with DFAIT and Industry Canada, and promotes Canadian technical co-operation activities and official co-financing between the EBRD and CIDA.

In 1998, two Canadian-sponsored projects were signed and additional financing was approved for a third project, representing EBRD financial commitments of US\$47.4 million. (The aggregate size of the three projects is US\$243.4 million.) A description of each of the Canadian-sponsored projects is given in Annex 2.

Canadians are also well represented on EBRD staff. At the end of 1998, Canadians accounted for 5.3 per cent of the Bank's professional positions, above Canada's 3.4-per-cent share of the institution's capital. It is noteworthy that a Canadian heads the Bank's resident office in Kyiv and that Canadians are the deputy heads of the Poland/Czech and Slovak Republic/Baltics Team as well as the Bank's resident office in Kazakhstan.

Promoting Canada's Interests

Members of the Canadian office made six visits to Canada in 1998 to meet with business people, conduct seminars, speak at conferences and consult with government officials.

In addition, a Director's Assistant promoted the Canadian Office and the EBRD as instruments for advancing Canadian commercial interests to a Canadian trade mission travelling in the Baltic region.

CHALLENGES AHEAD

Most of the countries of the region have made significant progress in economic and political transition since the early 1990s. Throughout this process the EBRD has, both directly and through the demonstration effects of its projects, helped to advance the transition process. The Bank has been important in catalyzing private sector investment in the region and has been a strong force in promoting entrepreneurship, particularly through its support for SMEs.

The Russian crisis has served as a litmus test of the transition process, highlighting the challenges for the future. It has underlined the importance of an effective institutional framework for a well-functioning market economy. It has shown that those countries with strong institutions and good regulatory frameworks should be in a good position to continue to make progress in the transition process in the coming year. Those with weak underlying fundamentals, however, will remain extremely vulnerable to external shocks.

The countries in the region will be put to the test further in 1999 with the prospects for economic recovery in Russia, at this point, tenuous at best. Russian output continued to fall in early 1999 and although inflation has moderated somewhat, it remains at double-digit levels and well above its pre-crisis level. Those countries with the strongest links to Russia, particularly the CIS, continue to be threatened and will need to show an even stronger commitment to reforms to weather these difficulties.

Good governance will continue to play a critical role in these countries. Good corporate governance is one aspect of this. The state, however, also has a strong role to play in supporting an enabling investment climate, by promoting sound institutions, administering tax collection and improving legal and regulatory frameworks. It must also ensure that appropriate new legislation is not only developed, but is properly implemented.

In assisting its member countries in 1999, the EBRD in turn will face the challenge of managing its portfolio in an increasingly uncertain and risky environment. The Bank will need to pay increased attention to balancing its portfolio across countries, products and risk categories. The EBRD's medium-term strategy for 1999-2002 will be critical in ensuring the Bank has sufficient flexibility to meet new challenges in the coming years and in providing strong direction to the Bank in fulfilling its mandate.

A clear lesson from the crisis is that transition in the region is a complex and difficult process that will take longer than many initially expected. The primary responsibility for shaping a response to the challenges of transition lies with the countries themselves. The international financial institutions, however, particularly the EBRD, have an important supporting role to play.

Contacting the Office of the Director for Canada

The Canadian Director's Office at the EBRD may be reached at:

Office of the Director for Canada and Morocco
European Bank for Reconstruction and Development
One Exchange Square, Room 8.15
London, EC2A 2JN
United Kingdom

Mr. Patrice Muller, Director	Tel: 44-171-338-6457
Mr. Tom MacDonald, Alternate Director ¹	Tel: 44-171-338-6507
Ms. Josée Berthiaume, Director's Assistant ²	Tel: 44-171-338-6458
Mr. John Kur, Director's Assistant ³	Tel: 44-171-338-6509
Mrs. Diana Price, Executive Secretary	Tel: 44-171-338-6507
	Fax: 44-171-338-6062
	Internet address: PriceD@ebrd.com

¹ Resident at the Canadian High Commission in London.

² Responsible for policy matters.

³ Responsible for business development and investor liaison.

For More Information on the EBRD

The Bank releases considerable information on its various activities. Bank publications include information guides (e.g., *Financing With the EBRD*), special reports (e.g., *The Annual Report, Transition Report*), country strategies and assorted fact sheets.

Information can also be obtained on the Bank's Internet site:

<http://www.ebrd.com/>

Requests for information can be addressed to:

Publications Desk
European Bank for Reconstruction and Development
One Exchange Square
London, EC2A 2JN
United Kingdom
(Fax: 44-171-338-7544)

ANNEX 1

THE BANK'S FINANCIAL ACTIVITIES

The Bank's financial activities are divided into ordinary and special operations depending on the source of funds. Ordinary operations, which are financed from the ordinary capital resources of the Bank, comprise subscribed capital, market borrowings and income from loans and investments. Special operations are those financed by "Special Funds" for specially designated purposes that are typically outside the Bank's regular activities. Unlike other regional development banks, however, the EBRD does not operate a concessional or "soft" loan window.

Ordinary Capital Resources

At the end of 1998, the total authorized capital of the Bank was ECU 20 billion (about C\$35 billion). Canada has subscribed to 3.4 per cent – or ECU 680 million (about C\$1.2 billion) – of the Bank's authorized capital. Canadian contributions to the Bank's capital are made in US dollars (at a pre-determined ECU/US\$ exchange rate).

In 1998, Canada made its first purchase of shares under the first capital increase (which came into effect April 3, 1997 and doubled the initial ECU 10-billion capital base). Under the first capital increase, 77.5 per cent of our share is "callable" – i.e., the Bank can request these resources in the unlikely event that it requires them to meet its financial obligations to bondholders; the balance, or 22.5 per cent, is "paid-in." Payments will be made in eight equal annual instalments of US\$12,145,331.25 (40 per cent in cash and 60 per cent in non-interest-bearing demand notes encashed over five years). Under the initial capital, 30 per cent was paid-in over five years (split evenly between cash and notes encashed over a three-year period) and 70 per cent callable. Canada completed payments for the initial capital in April 1997. The table below details Canadian payments to the Bank in US dollars.

Canada's contributions to the capital of the Bank are non-budgetary expenditures because our shares in the Bank are considered an asset. Nonetheless, Canada's contributions to the Bank do increase the government's borrowing requirements.

Canadian Payments to the EBRD

Year	Notes	Cash	Encashment of notes	Total cash outlay
(in US dollars)				
1991	11,903,502	11,903,502	11,903,502	23,807,004
1992	11,903,502	11,903,502	3,967,834	15,871,336
1993	11,903,502	11,903,502	7,935,668	19,839,170
1994	11,903,502	11,903,502	11,903,502	23,807,004
1995	11,903,502	11,903,502	11,903,502	23,807,004
1996	-	-	7,935,668	7,935,668
1997	-	-	3,967,334	3,967,334
1998	7,287,198	4,858,132	1,457,439	6,315,572
Total	66,804,708	64,375,642	60,974,449	125,350,092

Market Borrowings

At the end of 1998, cumulative borrowings by the Bank totalled ECU 9.7 billion (C\$17.4 billion) with an average maturity of 7.1 years at an average cost of funds of LIBOR minus 37 basis points. Funds have been swapped into floating rate instruments, primarily in US dollars, ECU and deutschmarks.

Standard & Poor's has assigned the Bank an AAA long-term and A-1+ short-term credit rating. Moody's Investors Service has similarly rated the EBRD long-term bonds triple-A.

Special Operations

The EBRD administers a number of bilateral and multilateral concessional funds. Canada has contributed to the following Special Funds:

The Canada Technical Co-operation Fund – The main purpose of this fund is to provide financing to hire Canadian consultants for EBRD projects. Canada has contributed C\$7.66 million since the Fund was established in 1992.

Nuclear Safety Account (NSA) – This facility was established to help finance the closure of the Chernobyl nuclear power plant and to improve safety conditions at nuclear power plants in countries of operation until the plants can be closed. The NSA complements other bilateral and multilateral nuclear safety technical assistance and functions in parallel with multilateral efforts to achieve broader energy sector reform in the region. Canada has contributed C\$19.5 million to the total fund of ECU 289 million (C\$518.6 million). The NSA was established in 1993.

Chernobyl Shelter Fund – The main purpose of this fund is to secure the sarcophagus around the destroyed Unit VI nuclear reactor in Ukraine. The total estimated cost of this eight-year project is US\$758 million and US\$391 million has been pledged so far. Canada has pledged a contribution of US\$20 million to be paid over six years starting in 1998.

Russia Small Business Fund (RSBF) – The purpose of this fund is to establish a facility for small business finance and micro-lending in various regions of Russia. Canada has contributed US\$8.1 million toward the US\$300-million fund, including a new contribution of US\$2 million in 1998 for investments in northern Russia in response to the success of the Fund. The RSBF was established in 1993 as a pilot project and became permanent in 1995.

ANNEX 2**EBRD – CANADIAN-SPONSORED PROJECT ACTIVITY IN 1998**

Approval/ signing date	Canadian company	Project country	Project name	Type of financing	Total EBRD commitment (ECU million)	Total project cost US\$ million
February (signed)	Consumers Packaging Inc.	Ukraine	AD Zarya Glass	Equity	12.4	48.8
November (signed)	Saskatchewan Wheat Pool Strait Crossing Inc. and Dessaport International	Poland	Europort Gdansk Grain Terminal	Senior debt ¹	25.0	86.6
November (approved)	Telesystem International Wireless Corporation	Romania	Mobifon GSM Phase II Financing	Senior debt ²	10.0	108.0
Total					47.4	243.4

¹ The EBRD provided US\$25 million in senior debt from its own account in addition to US\$25.5 million in syndicated loans and US\$14.5 million in parallel loans, of which Export Development Corporation (EDC) provided US\$7 million. The Royal Bank of Canada underwrote US\$32.5 million of the financing and took a final participation of US\$7.5 million.

² For the project's Phase I Financing, the EBRD signed a senior loan of US\$85 million and a subordinated loan of US\$10 million with Mobifon on September 23, 1997. EDC also provided a parallel loan of US\$25 million. For the project's Phase II Financing, the EBRD provided US\$10 million in senior debt from its own account in addition to US\$10 million in syndicated loans. EDC provided a further US\$10 million in parallel co-financing in Phase II.

ANNEX 3

DOING BUSINESS WITH THE EBRD

General inquiries about working with the EBRD should be directed to the Office of the Director for Canada or to the Bank's **Communications Department** in London – (tel: 44-171-338-6096; fax: 44-171-448-6690).

Canadian Project Sponsors: Canadian companies interested in potentially sponsoring a project with the EBRD are requested to direct initial inquiries either to **Project Inquiries** in London (tel: 44-171-338-6282 or 44-171-338-6252; fax: 44-171-338-6102) in London or to the Bank's Resident Office in the country of operation. Summaries of EBRD private sector operations can be obtained on the Bank's Internet site: <http://www.ebrd.com/> .

Canadian Suppliers of Goods and Works: In its monthly newsletter, *Procurement Opportunities*, the EBRD makes available information on all stages of public sector project development, from the point a project has been identified by the Bank through to its approval. Procurement and co-financing notices, as well as and contract awards information, isare also published in the newsletter. *Procurement Opportunities* can be accessed on the Bank's Internet site (assee addressed above), and a hard-copy subscription can be obtained for £85 from:

EBRD Subscription Department (*Procurement Opportunities*)
82-84 Peckham Rye
London SE15 4HB
United Kingdom
Tel: 44-171-639-0333
Fax: 44-171-358-9568

Canadian Consultants: The EBRD's *Procurement Opportunities* newsletter contains technical co-operation notifications, and invitations for expressions of interest for consultancy services, pertaining to both public and private sector projects. The EBRD also makes use of the World Bank's electronic DACON (Data on Consultants) Registration System. Although it is not required for consultants to register with DACON to be eligible for EBRD assignments, it is nonetheless advisable as a useful marketing tool. Requests for DACON registration packages should be sent directly to:

DACON Information Centre
World Bank
1818 H Street
Washington, DC 20433 USA

Individual Canadians: The EBRD maintains a recruitment section on its Internet site, which provides information on specific employment competitions at the Bank as they become available. In general, applications for employment for both permanent positions and summer jobs should be sent to:

Mr. Franco Furno, Director of Personnel
Personnel Department
European Bank for Reconstruction and Development
One Exchange Square
London, EC2A 2JN
United Kingdom

ANNEX 4**EBRD MEMBERSHIP – AS AT DECEMBER 31, 1998**

	Share of the Bank's capital		Share of the Bank's capital
	(%)		(%)
European Members		Countries of Operation	
Austria	2.28	Albania	0.10
Belgium	2.28	Armenia	0.05
Cyprus	0.10	Azerbaijan	0.05
Denmark	1.20	Belarus	0.20
Finland	1.25	Bosnia and Herzegovina	0.17
France	8.52	Bulgaria	0.79
Germany	8.52	Croatia	0.36
Greece	0.65	Czech Republic	0.85
Iceland	0.10	Estonia	0.10
Ireland	0.30	FYR of Macedonia	0.07
Israel	0.65	Georgia	0.10
Italy	8.52	Hungary	0.79
Liechtenstein	0.02	Kazakhstan	0.23
Luxembourg	0.20	Kyrgyzstan	0.10
Malta	0.01	Latvia	0.10
Netherlands	2.48	Lithuania	0.10
Norway	1.25	Moldova	0.10
Portugal	0.42	Poland	1.28
Spain	1.70	Romania	0.48
Sweden	2.28	Russian Federation	4.00
Switzerland	2.28	Slovak Republic	0.43
Turkey	1.15	Slovenia	0.21
United Kingdom	8.52	Tajikistan	0.10
European Union	3.00	Turkmenistan	0.01
European Investment Bank	3.00	Ukraine	0.80
		Uzbekistan	0.21
Non-European Members			
Australia	0.50		
Canada	3.40		
Egypt	0.10		
Japan	8.52		
Korea	1.00		
Mexico	0.15		
Morocco	0.05		
New Zealand	0.05		
United States	10.00		