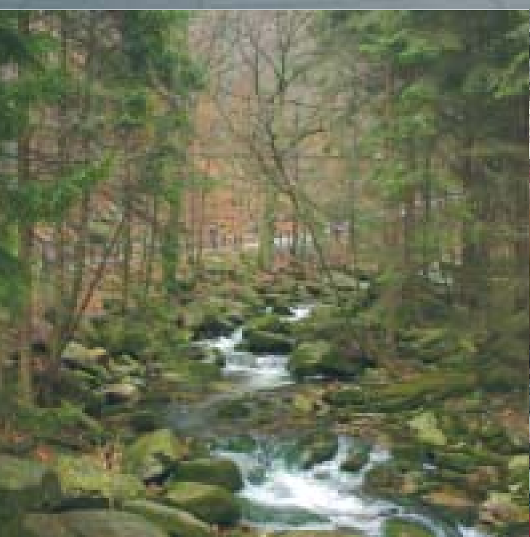
Europe



Introduction

Economic Overview

Since 1989, many Eastern European, CIS and Balkan countries have been in the process of transition from planned to market economies. Over the past decade and a half, these countries have made tremendous progress in integrating with the world economy. Even though these countries have been impacted by the global and EU economic slowdown, the growth rates of economies in Eastern Europe still ranged between 3.6 percent and 6.3 percent in 2003, with the region's resilience reflecting the strength of finance, infrastructure, and taxation reforms.

Eight Eastern European countries are presently candidates for accession to the EU in 2004. For these prospective members, entry represents largely unhindered access to a market of 500 million consumers. In the past few years, trade between Eastern Europe and the EU has increased rapidly, accounting for as much as 60 to 70 percent of the total trade of many countries; and 10 years of foreign direct investment in this region has changed the corporate and banking sectors of many of the countries beyond recognition.

While significant advances have been made, the economic development of Eastern Europe continues to lag that of EU member states by a considerable margin. In addition, the industrial structures of Eastern Europe continue to be very different from those seen in the West. To pass initial screenings for EU entry, these countries have had to stage a series of fiscal adjustment measures, the appropriateness to the conditions in each country of which remains to be determined. Moreover, all EU candidate countries will be required after admission to adhere to high EU standards in terms of wages, tax receipts and environmental protection. This requirement could ultimately cause these countries to lose their competitiveness relative to developing countries in Asia and elsewhere.

According to the ***United Nations' Economic Survey of Europe 2003***, the poor performance of EU economies in recent years has made it difficult for Eastern Europe to increase exports as fast as it might otherwise. Therefore, recent economic growth in the region has been driven primarily by domestic demand - driven by a rise in general income levels and heavy government spending. These developments raise questions about the sustainability of the region's economy into the future. Increasing purchasing power can be expected to continue sustaining economic growth for awhile and Eastern European consumers today continue to share a generally bullish outlook. However, unless export markets to Western Europe begin to expand significantly, accumulating financial deficits could cause economic growth in Eastern Europe to stall. Improved competitiveness and diversification of economic competencies among regional economies must happen in order to keep exports growing.

Social Overview

In order to compensate for decades of stunted economic development under communism, Eastern European countries have aggressively pursued strategies targeting economic growth. Hastily developed and implemented reform policies have caused imbalances in social development and, in part due to the rapid privatization of state-run enterprises during their transformation to market-oriented economies, countries in the region now face high levels of unemployment. Roughly eight million Eastern Europeans are now unemployed, with the jobless rate in most countries approaching 15 percent. The reduction or cancellation of past social welfare policies has further exacerbated current unemployment problems by removing the social safety net for those out of work. As a result, Eastern

Europe has seen a dramatic rise in social problems across the board.

Challenges and Opportunities

After the shock of the past dozen or so years, the social and economic states of these nations have gradually stabilized and in many cases are showing signs of improvement. Experts anticipate that the region will enjoy strong economic growth in 2004. During the communist era, countries already established a solid foundation in labor training and industrial production. As a result, these nations have the ability and opportunity to stage faster growth than other developing countries.

In most countries in the region, the rate of illiteracy among adults is under one percent. The UN lists the Czech Republic, Poland, Estonia and Latvia as nations with a high level of workforce development, where high school matriculation is over 80 percent. However, against this is an unemployment rate for the region that fluctuates between 10 and 15 percent. How to create jobs and raise participation in the workforce is an enormous challenge, which will be a critical factor in ensuring the success of continued economic development.

While nations began to privatize state-run enterprises in the 1990s and significant achievements have been made, the region still lacks a healthy financial system, which, in turn, hinders development of a robust private sector. According to the World Bank, countries in the region need to strengthen management of financial markets and ensure smoother avenues for financing in order to guarantee economic development. Transparency and the strengthening of corporate and institutional governance are key factors to securing sustainable growth and attracting foreign direct investment in Eastern Europe and the Balkans.

Regional Strategic Goals

SMEs have a crucial role in economic transition process. Already SMEs make up the vast majority of private businesses operating in the region; and, because of their size and adaptability, they are likely to be the largest source of employment generation. As in more mature market economies, a vibrant SME sector will also be a key source of innovation, entrepreneurship, and productivity growth. For these reasons, improving the business environment for SME development is a key ICDF objective within the region.

Implementation of Development Cooperation

Supporting the Development of SMEs

Countries in the region display varying levels of SME development. In countries with relatively strong economies, such as Estonia, SMEs account for over 90 percent of all companies. Conversely, SMEs make up only 50 percent of all companies in Russia. However, SMEs face numerous challenges including a lack of access to credit and equity finance. This funding shortages stem from the weaknesses of banking institutions in the region, the absence of capital markets, and the weak legal framework for credit and collateral. Supportive action from the international community is needed to address these weaknesses in the institutional infrastructure and in the incentives of financial intermediaries.

In an effort to promote vibrant development of SMEs to support economic growth, the ICDF stages re-lending programs, which both strengthen the function of financial institutions and solve the problem of insufficient capital for SMEs required for sustained operations. Well-run financial institutions can use these deposit / loan operations to create a monetary multiplier effect, boosting economic activity.

Providing Micro-Credit for Start-Up Companies

Micro-loans commonly serve as the basis of creating companies in developing nations. The loans are disbursed to micro-sized companies to enable them to have a source of capital despite a lack of collateral. The

ICDF provides financing to fund programs that offer loans to micro-sized firms. This strategy enables these companies to enjoy reliable financial services and provides a channel for vulnerable groups to gain access to formal credit. The programs also assist the underprivileged to purchase production equipment, thus promoting economic development.

Facilitating the Privatization of State-Owned Enterprises

Private companies usually operate more efficiently and flexibly than state-owned firms. As a result, private enterprise has played a vital role in the economic development of capitalist nations. Since abandoning communism in the 1990s, the countries in Central and Eastern Europe have worked to expand private sector production and promoted the privatization of state-owned firms. These efforts, however, have met with some difficulties. In order to hasten private sector development and improve the economic and fiscal systems of these countries, the ICDF has established a special investment fund aimed at aiding development of private enterprises with significant potential. The fund also provides capital to privatized state-owned firms to alleviate their difficulties in obtaining operational capital.

ICDF Projects in the Region

Belarus

- **SME Re-lending Project**

  This project is providing financing with the EBRD to the National Bank of Belarus, who then re-lends it to five other participating banks. The funds are then disbursed to SMEs throughout the country.

Bulgaria

- **MSME Credit Project**

  This project is providing financing to ProCredit Bank for re-lending to MSMEs. Overall, the project hopes to strengthen the banking system and accelerate private sector development.

Lithuania

- **EBRD Financial Intermediary Investment Special Fund–Drobe Privatization Project**

  In conjunction with the EBRD and the IFC, the ICDF is providing investment and financing through the FIISF to the Drobe Wool Company for production machinery and equipment upgrades.

FYR Macedonia

- **Skopje Export Processing Zone Development Project**

  The ICDF is investing and providing financing for the Skopje Development and Management Co. to develop a 30-hectare export processing zone (FEZ).

Poland

- **SME Re-lending Project**

  The ICDF is providing a US$20 million loan to Poland's Industrial Development Bureau, which selects qualified financial institutions to loan the funds to SMEs. The project is also providing technical assistance to improve management capabilities.