'The role of the European Investment Bank' from The Courier ACP-EU

Caption: In this article, the author explains how the European Investment Bank (EIB) contributes, in ACP (African, Caribbean and Pacific) countries, not only to the development of the public sector by financing major infrastructure projects, but also to the development of the private sector. Typically, EIB operations in support of the private sector consist of lines of credit for small and medium enterprises, allocated through local banks. In this way, the EIB participates in a structured process of cooperation and competition in which the public sector and the private sector complement each other.

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The role of the European Investment Bank

by Stephen McCarthy *

'*Long live the private sector*.' Sometimes it seems as if private sector development is a newly discovered development slogan, a new panacea. Would that reality were so simple!

If we take a historical perspective, we see that the private sector has had many centuries to demonstrate its contribution to the development of Africa and the other ACP countries. Yet for most of recorded history, the indigenous African private sector has remained individual in scale and more concerned with trading than with manufacturing. The historical record of the foreign private sector is no more encouraging. True, organised camel caravans have been trading gold and salt across the Sahara for at least a thousand years, but then came the internationalisation of the slave trade. And, during the colonial period itself the record of foreign private sector investment is distinctly ambivalent.

So the newly independent African governments, in line with prevailing ideology at the time and the advice they were receiving from experts, largely discounted the contribution which the private sector could make to development and instead promoted state entrepreneurship, eventually establishing a herd of white elephant parastatals. But, as elephants are wont to do, in their search for food they stripped the land of its resources. The herd has had to be culled.

In the meantime, ideas have matured. We now know finally and, let us hope, definitively, that the private sector and the state have to complement each other. The structured processes of cooperation and competition which go into building a modern private business sector offer the best prospects for wealth creation in a society; but the state, at the local, national and even international level, has to provide the stability and framework within which this process can happen. Property rights in goods and land have to be clear and enforceable; contracts have to be respected and workable and ultimately backed up in the courts; stable legislatures have to provide a framework of rules and taxation; impartial bureaucracies have to administer them and governments have to offer a low inflation, stable economic environment and negotiate appropriate trade agreements.

So the most important requirement for private sector development is to build up healthy and effective state institutions. That is a task primarily for the citizens of the country concerned. Outsiders, such as development agencies and NGOs, may be able to help a bit by offering specific know-how from time to time or by demonstrating how states function elsewhere, but they can certainly not substitute for a process of social change and development which has to take place within the country itself. Moreover social institutions cannot simply be built, like a bridge or a factory. There are no platonic guardians sitting outside societies and pulling the strings of social change — though occasionally of course a single individual, a Nelson Mandela for example, can have a huge impact on a whole society.

However, let us suppose that in a particular ACP country, this critical requirement has been met; the institutions of the state are functioning well or at least moving in the right direction. Then the conditions are right for the private sector to flourish within that society and to make its contribution to human well-being. Private businesses will then need infrastructure and they will need finance. It is under these circumstances that a bank, such as the EIB, which operates broadly along commercial lines but also has public objectives, can make an important contribution.

Let us start with infrastructure by looking at the railway lines on a map of Africa. See how they all originate at the coast and run a few hundred kilometres inland before coming to a halt. Only through Zambia and Angola is it theoretically possible to cross the continent by rail from East to West, and the Angolan line has not operated for many years. Only in Southern Africa is there really an integrated international railway network, encouraging trade by linking countries together. As it happens, this region also boasts one of the best international road networks and is rapidly developing a system of regional power transmission — to which the EIB has so far contributed over ECU 300 million […].

So infrastructure really makes a difference; it is not by chance that many observers see Southern Africa as having more promising prospects than other African regions in the near future. For the rest of sub-Saharan Africa, the requirements for infrastructure development remain huge and largely unsatisfied. Notice how few of the railways on the map have been built since independence.

But the point of looking at the map is to demonstrate how much infrastructure investment is going to be required on the African continent if we want to see sustained economic growth in the future. In the absence of such infrastructure, the coming century may well see development principally occurring along the African coastline, accompanied by population movements from the interior, since industrial production which takes place along the coast will have far greater possibilities of reaching international markets, and being supplied by them, than will enterprises in the interior. To achieve this and to support private sector development itself, overall investment levels will have to rise from about 16% of GDP currently, to 25% or more of GDP maintained over several decades.

Although the other regions of the ACP also have to find ways of overcoming their problems of relative isolation and smallness, their infrastructure problem is different and not so overwhelming. For example, Caribbean countries may find the continued development of service industries, particularly tourism and data processing, more promising than attempting to compete in international markets for manufactured goods. In this case the major infrastructure requirement is likely to be various forms of environmental protection as well as modern high capacity telecommunications.

All of this is nicely speculative. But where is the finance going to come from? Flows of international aid, which for the ACP countries now represents only about 6% of their GDP, will certainly not be sufficient. Moreover, aid is increasingly required for other pressing human needs, rather than for investment in the classic sense.

There are only two other possibilities. The first is to increase the level of domestic savings in the ACPs, and the second is inflows of foreign private capital. The EIB, as a major multilateral investment bank, increasingly sees its role in the ACPs as that of facilitating this process — helping to support the development of domestic financial markets on the one hand and encouraging and intermediating the flow of foreign capital towards these countries on the other.

Mobilising domestic savings for the private sector requires functioning financial markets. In many ACP countries they simply do not exist and in all of them, with the exception of South Africa, some elements of a fully integrated domestic financial sector are missing.

In most ACP countries the domestic financial sector consists of a few banks which take short-term deposits and make short-term loans. Sometimes, the banks are burdened with non-performing debt of old parastatal institutions and other political lending, though that tendency is now diminishing. There is rarely any inter-bank market, and the little medium to long-term lending which might occur would be on rolled-over overdrafts at floating interest rates. Interest rates themselves have gone from being unduly low to excessively high, no doubt necessary for stabilisation policy but not encouraging for investment. There is little competition between the banks and banking sector margins are usually high — but so are the risks, as discussed below. Some countries have stock markets but they are illiquid and add little to the mobilisation of domestic savings. No private company issues long-term bonds; there is too much uncertainty over future interest and inflation rates and secondary markets do not exist. Institutions which might have access to long-term savings, such as insurance companies and pension funds, almost invariably invest their resources in government paper (sometimes they are obliged to do so), or in real estate. The formal banking sector rarely reaches beyond urban businesses; it does not therefore offer finance for SMEs or savings vehicles for rural people — still less micro-finance lending. Private banks are very risk averse, just as public banks have often been extremely imprudent, but both have had to operate in a climate of generally high inflation, macro-economic instability and unpredictable government policy — not to mention very small markets which makes running a financial system very expensive.

Anybody who has ever worked with the financial sector in the ACP countries will recognise this picture.

They will also know that in many cases the situation has improved over the last decade, in small cumulative ways. But clearly there is need for further deepening and strengthening of domestic financial systems, before they can become dynamic sources of finance for the private sector.

A key feature of the EIB's approach is to operate as much as possible with and through the domestic financial institutions in the ACP countries, thereby steadily strengthening them and building up their administrative and financial capacities. Typically, EIB operations in support of the private sector consist of lines of credit for small and medium enterprises, through a local bank or through the banking system. Thus in the first five years of Lomé IV alone, the EIB set up 65 such operations in 41 ACP countries. Altogether over the last 20 years the Bank has financed more than 1 900 SME projects in this way. Moreover, the trend is accelerating. In fact the Bank is now financing a new SME investment, in one ACP country or another, almost every working day of the year.

The advantage of this approach is that it puts decision-making where it belongs — in the ACP country concerned. The essence of private sector development is that it springs from the aspirations, ideas and enthusiasms of countless individuals, perceiving opportunities in their local context and acting on them. It is quite mistaken to think that this process can be steered at a distance from say Luxembourg or Brussels.

Hence, when the EIB makes a line of credit to a local bank or development finance institution (DFI) it expects the local bank to identify, appraise, choose and monitor the projects to be financed. The Bank exercises a supervisory role in the process; but only rarely does it have to intervene on specific project decisions.

The intermediary then usually on-lends the resources from the EIB in the form of medium and long term loans at fixed interest rates which reflect market conditions. But there are many other possibilities, for example to use risk capital resources to provide equity to a particular project. In short, the objective is to build in a pragmatic way on whatever exists and seems viable in the financial system. Thus the EIB provides finance, but it also encourages the local bank or other financial institution to develop the scope of its own operations, for example by offering long-term loans, building up a capacity for project-based financing, and so on.

Of course, under the present and all previous Lomé Conventions, EIB loans in the ACP countries, whether from risk capital or the Bank's own resources, have carried a concessional interest rate. It is important that this concessionality should not be allowed to distort the financial markets, particularly at the level of the borrower. So for several years now the ElB's policy has been that the interest subsidy should always be stripped out, either at the level of the state or by the financial intermediary, which would then use it for capacity-building or some other social objective.

Turning to foreign private capital flows, here the bad news is well known. These have increased enormously on a global scale but Africa is taking only a small share and this goes to just a few countries, notably South Africa. Moreover, global flows of private capital are extremely variable from one year to the next.

But although Africa's share of private financial flows is small, in no sense is there some absolute shortage of private finance available to invest in Africa. There may be problems of financial intermediation and there are certainly problems of risk management, which we come to below, but there is not simply a limited supply of investible resources which happens to have gone everywhere else but Africa. Indeed, Africa's own flight capital is estimated to be of the same order of magnitude as the continent's external debt. This is witness to the rationality of African investors who have preferred to invest where the risks appeared less and the returns more secure.

Foreign investors, even more so, still perceive Africa as a high risk area. Although economic policies and attitudes to foreign investors have recently changed in many countries, there is still the fear of policy reversal. In addition reliable information on the business environment in a particular African country is difficult and expensive to obtain — just putting the investment code on the Internet is hardly a solution. The case of Namibia comes to mind — a country with a business friendly environment, superb infrastructure by

African standards, but only a small domestic market and, until recently, little inward investment except in the well-established mining sector.

In fact, as with domestic investment, the picture in Africa is not quite as bleak as it seems. Although starting from a very low base, in recent years, foreign private capital flows to Africa have been growing faster than in any other region of the world. In some African states such flows are already comparable, as a proportion of GDP, to countries in Asia and Latin America.

As a bank which works directly with the private sector throughout the region, the EIB is probably more aware than others of this shifting sentiment towards Africa. True, it does not occur right across the continent and the interest is so far heavily focused on the mining sector, but investor confidence has certainly improved over the last couple of years.

For this type of investment the contribution of the EIB, apart from the important one of providing finance itself, is to reduce the risk and the perception of risk for the investor concerned and to increase his comfort level. The investors are often already clients of the EIB in Europe or elsewhere. They know that the ElB's presence in a particular project, the quality of its technical appraisal, its particular knowledge of the country concerned, and not least that the EIB is an institution of the EU, can all contribute to reduction of risk and hence to the success of the project. And if risks can be reduced then private capital flows will increase.

The future

Looking forward to the year 2000 and beyond so far as the EIB is concerned, there is no shortage of good viable investment projects in the ACP countries, coming from both domestic and foreign investors, and no problem in fully using the resources which it is mandated to manage under the Lomé Convention. The Bank will remain committed to the approach which it has built up over the last 20 years in the ACP countries. As explained above the key elements of this are:

— In the case of smaller investments and enterprises, to work through local financial intermediaries in the country concerned. This approach puts ownership and responsibility where they really belong. In so doing it builds up local administrative capacity; these EIB global loan operations are not dependent on an army of technical assistants.

— For major investment projects, whether for foreign private investors or the necessary public infrastructure, to continue to provide a quick, responsive service from its headquarters in Luxembourg.

But with the improving prospects for private sector development throughout the ACP countries, it is clear that a new challenge is emerging — to mobilise new sources of finance both from domestic savings and foreign private capital. Increasingly the task for the Bank is not just to finance projects, but to ensure that it uses the available resources, its experience and its technical expertise, as a means of mobilising and gearing up these additional financial flows. In view of the enormous outstanding investment requirements, and the limited availability of official aid from development agencies, this is an imperative for the future. The international standing of the EIB, and its global presence as a borrower in most of the world's financial markets and a lender in many of them, will be important strategic assets in this task.

S. M.

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