



Western CIS and the Caucasus



Strong domestic demand contributed to another year of high growth in 2005. The EBRD doubled its investment in Ukraine and devoted an increasing share of its financing to the rest of the region, which includes four of the poorest countries where the Bank operates.

◀ Production at the Gostomel glass factory in Kiev is set to increase following the construction of a new furnace backed by EBRD financing.

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Armenia led the way in terms of reforms in 2005.

Investment climate

Growth in the western region of the Commonwealth of Independent States (Belarus, Moldova and Ukraine) and the Caucasus (Armenia, Azerbaijan and Georgia) remained robust in 2005 on the back of strong domestic demand. However, growth declined slightly from 2004 levels in some countries.

The most significant slow-down was in Ukraine, where growth fell from 12.1 per cent in 2004 to 2.4 per cent in 2005. This was due to a sharp decline in external demand for steel and other metals and a reduction in investment because of continuing uncertainty over the business and political environment. Under the new leadership elected at the end of 2004, Ukraine has built on the previous government's reforms and affirmed its commitment to democratic and market reform and European integration. It has reached several milestones on the way towards membership of the World Trade Organization (WTO).

In the banking sector, Ukraine repealed the burdensome regulations that had required all investments to be made only in local currency and through local bank accounts. An improved regulatory framework has led to increased foreign investment and growth in lending to the private sector. The transparent re-sale of the Kryvorizhstal steelworks has set a new standard for the privatisation of state-owned assets and has eased concerns about the investment climate. Despite these achievements, progress in other reform areas has been slower than expected.

Rapid growth was achieved in the Caucasus in 2005 – most notably in Azerbaijan, which saw a doubling of its growth rate from 10.2 per cent in 2004 to 20 per cent in 2005 following an increase in oil production and higher oil prices. Armenia's strong growth (13.9 per cent in 2005) continued to be underpinned by a boom in construction and in the

services sector and a good harvest. Georgia's growth of 7.5 per cent reflects particularly strong improvements in the industrial sector following recent privatisations. Growth also remained robust in Belarus and Moldova.

The rate of inflation remained high (averaging at 10 per cent) across the region, except in Armenia where it stood at 0.6 per cent. Reducing inflation will require prudent management of the revenue gained from oil exports. In addition, rapid credit growth has created a challenge for monetary policy and banking supervision in many countries. In Belarus, inflation declined considerably to 10.6 per cent and is now comparable with other countries in the region. This was achieved through the tightening of monetary policy and exchange rate stability but price controls on basic goods and utility services have also played a role.

Armenia led the way in terms of reforms in 2005, making further progress in large-scale privatisation and banking reform and strengthening its competition policy. It established a new deposit insurance fund with mandatory contributions from local banks and passed legislation providing for mandatory disclosure of financial transactions over a specified threshold, with a view to combating money laundering. However, opposition parties and independent observers denounced the results of a national referendum on key constitutional reforms in November 2005, raising concerns about the prospects for transparency and fairness in forthcoming parliamentary and presidential elections.

Georgia made significant progress in the transition process in 2005. The election of a democratic and market-oriented government at the end of 2003 has yielded a number of reforms over the past two years. The government has made improvements in large-scale privatisation, enterprise restructuring and governance, including new legislation on secured



transactions. In Azerbaijan, progress in transition has been slower. However, the country recently accepted the International Monetary Fund's Article VIII obligations and has taken some steps towards meeting the membership requirements of the WTO. It has also established a special commission for dealing with corruption.

In the run-up to national elections in Moldova in 2005 the government reduced its interference in the economy and introduced important reforms in governance and enterprise restructuring. As in Georgia and Ukraine, Moldova has emerged from a political crossroads with a stronger commitment to democratic and market reform and global integration.

In contrast, Belarus has shown little indication of moving towards greater political pluralism and democratic rights. Only limited progress was achieved in structural reforms, and a large reform agenda remains to be addressed.

Much still needs to be done across western CIS and the Caucasus to improve the climate for doing business. The 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS) shows improvements in some areas but a deterioration in others. For example, enterprises in Belarus reported that the business environment had improved over the past three years but this was from a very low base and state intervention still occurs regularly.

In contrast, obstacles to doing business have increased in Armenia and Azerbaijan over the past three years according to the firms surveyed. In both countries, firms reported that they are required to pay an increasing level of bribery, and senior managers are having to spend more time dealing with public officials on regulatory issues.

EBRD investment

EBRD investments in the western CIS and the Caucasus totalled €931 million in 2005, an increase of €332 million on the previous year's total. This region is attracting an increasing share of EBRD investments as the Bank continues to shift the focus of its financing further east. The six countries in this grouping received 22 per cent of the Bank's total investments in 2005, up from 14 per cent in 2004. The number of EBRD projects signed during the year almost doubled, rising from 18 in 2004 to 34 in 2005. Since the EBRD started its operations in 1991, it has invested a total of €3.7 billion in this region.

Four of the countries in the grouping (Armenia, Azerbaijan, Georgia and Moldova) form part of the Bank's Early Transition Countries (ETC) Initiative, which aims to support the poorest countries where the Bank operates (see page 14). The initiative is supported by the ETC Fund, a multi-donor facility which operates in parallel with other assistance in the region, including by the European Community and the United States. All four ETCs benefited from an increase in EBRD financing in 2005.

The largest recipient of finance was Ukraine (€529 million), which saw a doubling of EBRD investment in 2005. The main areas of EBRD support were transport, agribusiness, banking, investment funds, energy and municipal infrastructure. For example, the EBRD financed the next stage of the road construction project that will link Kiev to Ukraine's western border and financed a new high-voltage electricity transmission line that will improve electricity supply in the Odessa region. The Bank also invested in two private equity funds that will provide much-needed equity capital to medium-sized businesses and financed the development of a chain of petrol stations.

Success story

Funding new ventures in Ukraine

If you have ever bought any pharmaceuticals in Ukraine, the chances are they were delivered by Laona, a local distribution company started by four friends at Kiev University. When supply chains broke down in the early 1990s, the friends funded their studies by delivering drugs to pharmacies in cardboard boxes.

They did so well that within two years they had started Alba Ukraine, a wholesale distribution company. One of the few drugs companies to survive the 1998 currency crisis, it expanded across the country and set up 12 affiliates. By 2000 it had become the largest wholesale distributor in Ukraine.

To maintain its market lead and to continue its expansion, the company decided in 2002 that it needed financing. And that is where the EBRD and Euroventures Ukraine come in.

Euroventures Ukraine is about to receive €21 million of financing in the form of subscribed capital from the EBRD, one-third of the fund's projected total size. This is the successor to the Euroventures Ukraine Post Privatisation Fund, which was sponsored by the EBRD. The aim of these funds is to provide capital to local private companies to help finance the expansion of their businesses (and, obviously, to provide positive returns for the funds' investors).



In the case of Laona, the new equity allowed it to finish construction of a state-of-the-art new warehouse, to launch a new production line, to improve storage and to upgrade customer services. And the fund's involvement did not stop at giving out the money – with a fund manager on the board of directors, it actively takes part in running the company to international standards. By the end of 2006, Laona is hoping to have a 15 per cent market share and sales of €169 million.

“Working with Euroventures Ukraine is invaluable for us in terms of learning skills that within a short period of time allowed us to create new competitive advantages and to enhance our existing ones,” said Vladimir Dzhuz, one of the founders and now Deputy Head of the Supervisory Council at Laona.

Another fund beneficiary is Anthousa, a chain of supermarkets owned by Furshet, the first of whose stores opened during the currency crisis of 1998. Furshet is now a home-grown empire, not only selling food and household goods at 47 stores around the

country but also producing vegetables, ravioli, jams and confectionery under its own label. It runs its own bakeries and even has an online home delivery service. In 2004 it made an estimated €203 million, making it the second-largest supermarket chain in Ukraine.

This growth was partly supported by €2 million of new capital provided in 2002 by the Euroventures Ukraine Fund. Some 9,000 new jobs have been created in the company since the fund's investment.

The new fund aims to diversify its investor base. The hands-on approach of the fund manager and the high-level expertise of team members will help to create sustainable private businesses and thereby attract foreign investment, setting an example to fledgling businesses countrywide and in neighbouring areas.

Tackling energy efficiency

It was a very cold start to the year in Ukraine, underlining if it were necessary the country's chronic energy efficiency problems. The Ukrainian economy uses almost seven times the amount of energy used in western Europe per unit of gross domestic product. Unsurprisingly, this puts a big strain on the economy and, of course, on the environment.

High energy usage is partly due to the cold climate and the needs of Ukraine's heavy industry but there is also a legacy of enormous reliance on inefficient Soviet-era energy systems in all homes, hospitals, schools and factories. Although costs have risen in recent years, power is still subsidised so people are unaware of the amount of valuable energy they are using.

“Ukraine could reduce by half the 70 per cent of its gas supply it now imports mainly from Russia and Turkmenistan,” said Vasyl Bogatyr of the Ukrainian Energy Service Company (UkrESCO), a majority state-owned joint-stock company established in 1998 as a joint initiative between the EBRD and the EU. “But it would take tens of billions of dollars to plug all the holes.”

In 2005 the EBRD pledged to support energy efficiency in Ukraine with a €9 million loan for UkrESCO to fund further environmentally friendly energy efficiency projects designed and implemented by the company. So far, UkrESCO has put 19 energy-saving projects in place, ranging from the installation of new co-generation systems to the refurbishment of boiler houses.



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The EBRD stepped up its efforts to establish a framework for direct lending to municipalities in Ukraine and signed the Bank's first investment in the municipal sector without a state guarantee to improve water services for the city of Dnipropetrovsk. The Bank provided further financing to UkrESCO for energy efficiency projects (see page 57) and restarted discussions with the new Ukrainian government, within the framework of the Energy Task Force and the Working Group on Transport, to help the country with reforms in the power and transport sectors.

In Belarus the EBRD strictly limits its activities to supporting the emerging private sector and does not finance state projects. This is due to the government's limited progress towards implementing democratic and market reforms in accordance with Article 1 of the Bank's Founding Agreement. During 2005 the Bank signed four private sector projects totalling €32 million. These included support for the entry of a regional retail operator into the rapidly growing DIY market in Minsk and support for the expansion of a locally owned brewery, Olivaria, that has operated since pre-Soviet times.

In Moldova the EBRD signed a record number of projects in 2005, in keeping with the ETC Initiative, which commits the Bank to supporting a large number of small projects. The eight projects signed in 2005 totalled €21 million. These included an equity investment in an agribusiness company and greater support for micro enterprises through a loan to the Rural Finance Corporation.

In the Caucasus, EBRD investment increased from €296 million in 2004 to €350 million in 2005. A large proportion of this was devoted to Azerbaijan, which received €245 million of EBRD finance. Support for the upgrading of the Baku-Samur road project, development of the Shah Deniz gas and oil field and construction of the South Caucasus gas pipeline provided the bulk of this business volume.

However, in line with the new strategy for Azerbaijan, the EBRD significantly increased the number and range of projects undertaken, using instruments available under the ETC Initiative and supporting the diversification of the economy. Co-financing facilities were negotiated with two local banks for the financing of medium-sized domestic enterprises, and the financing of micro enterprises was accelerated by increasing the number of banks and other specialist institutions that on-lend EBRD finance.

In Armenia the EBRD signed projects totalling €18 million, resulting in a substantial broadening of the Bank's portfolio in this country. Small loans were provided to locally owned renewable energy and gold mining companies. In addition, three equity investments were made under the Direct Investment Facility in local industries and financial service companies. Co-financing facilities were put in place with two domestic banks.

In Georgia an increase in EBRD investment was prompted by significant improvements in the business climate following the 2003 "rose revolution". Total EBRD financing of €87 million was provided through seven projects. Three of these were equity investments in local agribusiness companies. Of particular note was an EBRD loan (combined with grant financing) in support of a public transport project in Tbilisi.

The EBRD continued to help small businesses in the western CIS and the Caucasus through the TurnAround Management (TAM) and Business Advisory Services (BAS) Programmes (see page 29). In 2005, 16 TAM projects were started, funded by the ETC Fund and bilateral donors. A total of 320 BAS projects were started, also funded by the ETC Fund. A new BAS office was opened in Moldova. The two programmes continued to assist rural regions and introduced a new "cross-border" programme in the

EBRD investments in 2005

€931
million

Share of the Bank's total investments in 2005

22%

Total EBRD investments since 1991

€3.7
billion

Caucasus and a “women in business” initiative. TAM/BAS activities have led to EBRD investment of €78 million since 1991.

Looking ahead

In Ukraine the EBRD adopted a new country strategy in 2005, with the aim of increasing investment in infrastructure, transport and energy efficiency projects. The level of EBRD investment will depend on how successfully Ukraine commits to improving business conditions and undertaking reforms, such as establishing a consistent tax regime and a truly independent judiciary. The Bank will seek to enhance business practices in the companies receiving EBRD finance and will look for ways to develop local currency financing based on the approach used in other countries in the region.

In Belarus the EBRD will continue to focus on developing the private sector and on providing finance to micro and small enterprises through a growing number of privately owned banks. The Bank will also seek to establish a specialist microfinance institution that could reach out to entrepreneurs throughout the country.

In 2005 the EBRD adopted a new country strategy for Moldova, which remains the poorest country in Europe. The strategy establishes a number of challenges that need to be addressed. Moldova has to reduce government interference, strengthen its regulatory authorities and streamline its legal framework. The EBRD will seek to support micro, small and medium-sized enterprises by increasing the number of credit lines provided to local banks for on-lending. The Bank will continue to support businesses across all sectors. In particular, we aim to invest in private infrastructure projects to redress the balance between the capital city and the regions, especially in rural areas.

In its new strategy for Azerbaijan, launched in 2005, the EBRD acknowledged that the country faces substantial challenges despite the real progress achieved over the past couple of years. The EBRD intends to build on its large-scale investments in the energy sector and to support the country's economic diversification beyond oil and gas. The EBRD will help to improve competitiveness in the banking sector and will target improvements in infrastructure.

In all three Caucasus countries the EBRD will seek improvements in the investment climate through dialogue with the relevant governments. Investment priorities for Georgia include further support for municipal projects while in Armenia the Bank aims to strengthen the financial sector and to increase support for small businesses.