REPORT

IS THERE A NEED FOR A BALTIC SEA INVESTMENT BANK?

Rethinking the Role of International Financial Institutions in the Baltic Sea Region

Baltic Development Forum

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Is There a Need for a Baltic Sea Investment Bank?

Rethinking the Role of International Financial Institutions in the Baltic Sea Region

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Foreword

The independent foundation Baltic Development Forum, Copenhagen (Denmark), took the initiative to investigate the need for setting up a new financial institution in the Baltic Sea Region to counter the financial underdevelopment in the region.

We were asked to address this question in a report prepared for the second Baltic Development Forum Summit in Malmö (Sweden) 17 – 19 September 2000. The report is to serve as a background paper for the session: ”Do we need a Baltic Sea Investment Bank?”

The first draft of the report was discussed at a round table meeting in Stockholm 3 August 2000. The round table participants were:

Juha Ahtola, Nordic Baltic Holding
Director of Investment Operations Morten Christiansen, The Industrialization Fund for Developing Countries
Chief Economist, Olle Djerf Nordic Baltic Holding
Senior Vice President, Peter Forsblad Nordic Baltic Holding
Executive Vice President Erkki Karmila, Nordic Investment Bank
Director, Transition Strategy Hans Peter Lankes, EBRD
Director Lars Tybjerg, Ministry of Economy (DK)

Director Anne Dorte Riggelsen, Baltic Development Forum
Analyst Henrik Casper, Baltic Development Forum

The valuable contributions from the round table meeting have been incorporated in the final draft and they have been an important addendum to the final report.

The analyses are the sole responsibility of the authors.

The report is sponsored by Nordic Baltic Holding.

Stockholm, August 2000

Director Erik Berglöf, SITE, Stockholm School of Economics, Stockholm
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Executive Summary

The transition countries in the Baltic region are facing a growth and development challenge in catching up with their Western neighbors. To what extent does access to finance constrain their development? What can be done to relieve such constraints? Are existing international financial institutions doing enough to support the countries in meeting their challenge? Or is there a need for a new institution, a Baltic Sea Investment Bank?

Investing in the three Baltic countries and Poland is perceived as less risky than in Russia but much riskier than in EU countries. The high risk premium especially constrains the development of new and innovative sectors essential for growth and integration. Bringing down this premium is the key problem in unleashing the development potential in these countries. The risk has several sources, but political risk, macroeconomic instability, limited microeconomic information and legal uncertainty are the most important. The first two issues are largely resolved. The European Union has been successful in reducing local political risk, promoting reform through a top-down approach with strong conditionality. The Baltic governments have also shown credible commitment to stability, and the fragility of domestic financial institutions has been gradually addressed.

The main residual risk premium in the Baltic countries and Poland comes from weak enforcement of laws and lack of transparency. The problem is not a shortage of capital, but poor governance leading to misallocation and a poor composition of finance. Even in developed economies, financial constraints arise from poor information structures or difficulties in controlling the use of funds by insiders, but the problem is more serious in the transition countries. Standard, sophisticated legal codes have been introduced, but these laws have not been fully tested and enforced. Business practices still have to fully adopt the use of legal proceedings, and they are too reliant on either informal solutions or "state" intervention. There is still not sufficient experience and ability to use the rules created for promoting an environment supporting decentralized and entrepreneurial activity. Limited public information hinders access to financial markets and also undermines proper legal enforcement in a vicious circle. There are still long delays and ambiguity in enforcement, and current economic practices often bypass formal mechanisms. This results in potential illegality, lack of transparency and vulnerability to corrupt practices.

This "institutional gap" creates significant financial constraints, in particular for new and smaller companies with limited access to connected lending and other informal enforcement mechanisms. What can be done to fill this gap? The record of national development banks is not encouraging. These institutions saw a massive expansion in the sixties, stagnated in the late seventies and have largely run down or closed. State ownership of banks tends to politicise resource allocation, and the state is poor at enforcing financial obligations. Large institutions tend naturally to focus on larger firms. Centralized allocation systems such as state development banks also often outlive their usefulness. Predictably, the creation of development banks has almost invariably lead to disasters, with lending directed by political, often regional, interests, leading to very low repayment rates and losses rarely less than two third of assets. These banks build little expertise in credit analysis, and as they lack a retail basis their ties to the local economy are weak. In conclusion, evidence shows that

state development banks fail to promote growth and lead to financial underdevelopment, and lower productivity growth.

Creating such an institution would also replicate the top-down approach dominant in the region, applied by the EU and the IMF). The European Union has been able to induce significant change through strong conditionality, which has supported the operational ability of the large IFIs. The presence of the EBRD, IBRD, EIB and NIB ensure sufficient funding for large-scale infrastructure and commercial investment. At least the first two have also directed conventional funding on a significant scale at entrepreneurial and smaller firms.

It is thus difficult to argue that there is scarcity of traditional bank lending in the region. Rather, there is a lack of "entrepreneurial" finance. In countries at a late stage of transition, this reflects the institutional “gap” between the formal rules of a market economy and their concrete use. Any large institution created to address this gap directly would substitute itself for the missing mechanism rather than promote its growth. What is needed is a more bottom-up approach reinforcing grass-root initiatives to improve access to legal remedy for business, increase public knowledge on new rules and accountability for new institutions, build up an implementation record, and create dedicated service institutions with the necessary expertise to guide firms through this process.

The report discusses the prospects for an agency, a “Venture Catalyst”, which would help new private initiatives to activate the new institutions needed to support market transaction (such as regulators, courts, arbitrators, independent evaluators, enforcing agencies etc). This agency would have a charter clearly delimiting its life span as a state-sponsored development entity, and would pursue a portfolio of service and investment activities. Its focus should be on advice at least as much as on investment. Areas of service activity could include legal advise, consulting, market research and trade promotion. Its portfolio of activities would include helping to set up venture capital funds and contribute to the creation of exit markets, such as via the building of a credit rating institution. Another critical task should be a policy of assisting companies to “test” existing legal institutions, e.g., by bringing lawsuits, demanding disclosure or market access, or pursuing bankruptcy procedures. Along the advising function, agency efforts should be directed at promoting various bottom-up initiatives promoting entrepreneurial and civil society activities. Constituencies must be built for greater transparency and improved implementation and enforcement of existing laws.

Most importantly, the institution should bring together private and public interests and should from the start be destined for ultimate privatization, as a whole or in parts, to motivate top quality personnel. Personnel and management could have an explicit title to some shares after a vesting period.

In designing the charter for such a temporary agency, based on a bottom-up approach and with a decentralized structure, the fundamental question are these: What in the charters of existing international financial institutions constrains them from filling the “institutional” gap. In what significant way would the new agency be different? Is it easier, and cheaper, to change the charters of existing institutions rather than to create a completely new entity?

1. Introduction

The Baltic region is one of the potential high-growth regions in Europe. The collapse of the Soviet Union and the end of the Cold War promised to unleash entrepreneurial activity and spur economic and social development in these and the other transition countries. Some of these hopes have been realized, but there is far to go in bringing these economies in line with their western neighbors. Trade patterns are still distorted and institutional development is uneven. Investing in the three Baltic countries and Poland is perceived as safer than in Russia, but still much riskier than in countries of the European Union. Yet investment is precisely what the transition countries in the Baltic region need if they are to meet the challenge of closing the income gap with the countries of the European Union. With more funds, many argue, the growth process could be sped up. But more money, whether from domestic sources or from abroad, will not be sufficient. Resources must be allocated across projects, and their use must be monitored. Existing institutions that might take on these tasks are still weak, and further reform is necessary to ensure proper enforcement. In this process, there is a role for the international organizations, and engagement of new actors may be desirable.

The international financial institutions are reconsidering their priorities in the front-runner states and even disengaging themselves from some areas. They are seeking to define a new role for themselves in supporting the transition process. But what exactly is the financing problem - if there is one - in these countries? Are domestic funds insufficient, or are there not enough profitable ideas and entrepreneurs to invest in? Why are private investors not seizing these “obvious” profit opportunities? What is the existing or emerging institutional “gap” that international institutions should fill? Is there a need for a new institution, a Baltic Sea Investment Bank?

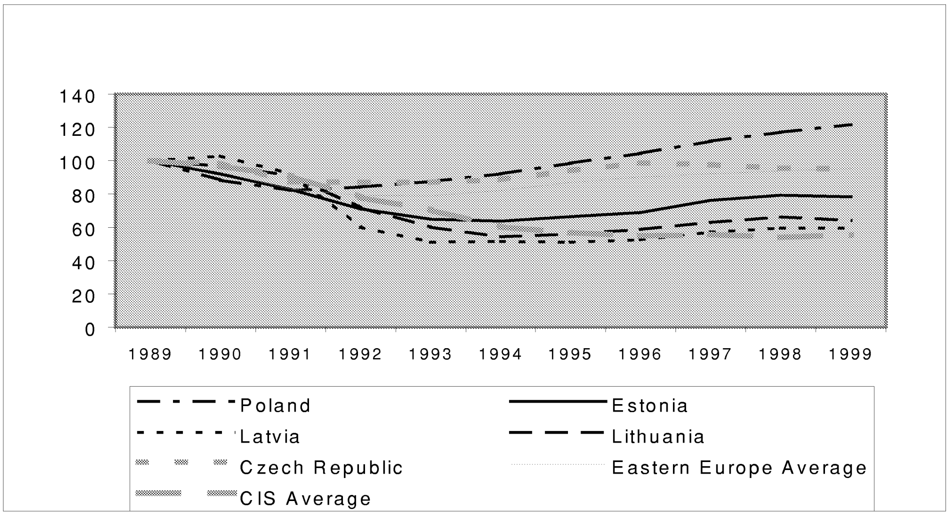
This article sets out to answer these questions. We investigate the financing problem by looking at available data on growth, investment and financial systems and identify a “gap” that is often associated with late-stage transition reforms, a gap that is currently not being filled by existing institutions. As a challenge to these institutions we consider the proposal of creating a new development bank to attempt to fill this gap, the Baltic Sea Investment Bank, and discuss what role it might take on. We also review the international experience of development banks, and point out some of the lessons and pitfalls. Creating a new entity is a risky undertaking, and existing institutions may have the capacity to fill the gaps, but it is up to them to show that a new entrant is unnecessary.

2. The Baltic Growth and Development Challenge – The Capital Need

There are five transition countries with a coastline on the Baltic Sea. The three Baltic countries and Poland differ in their levels of income and in the quality of their institutions, but for our purposes their common features are the most important. All of these countries are frontrunners in the transformation from socialism to modern market economies. They all suffered from long periods of Soviet domination and experienced significant output falls in the early phase of transition. But they have also seen considerable reversals in growth trends, and remarkable institutional development has been achieved in just a decade. All four countries have in this very short time gone through a dramatic reorientation of their trade from East to West in less than ten years. For these four, EU membership is more or less certain, even though the timing of the respective accessions may vary.

Russia's story is different in many respects. The country was the very heart of the Soviet system, and central planning permeated economic life much more deeply and for a longer period. The initial decline in official GDP has also been more protracted, and only recently has the country been able to show positive growth. Even though inflation has been coming down, macroeconomic stability is not yet assured. Much has been achieved in terms of institutional development, but enforcement is still wanting. Perhaps most importantly, unlike the other four countries, the Russian reform has run its course without a natural disciplining outside anchor, corresponding in the other four cases to the prospect of EU membership. While acknowledging the importance of Russia to the Baltic Sea region, the report focuses on the three Baltic states and Poland. To do justice to the specific situation in Russia would require a much more extensive document.

Figure 1: GDP Growth 1989-1999 (1989 = 100)



Source: Economic Survey of Europe, 2000 No1.

Despite the achievements shown here, official data suggest that only Poland has reached it pre-transition level of income. Obviously however, the figures are highly uncertain and important aspects of human welfare are not accounted for in these data. All four countries face a tremendous growth challenge as they aspire to "catch up" in terms of levels of income and institutional quality with other developed market economies in the Baltic area. Table 1 offers an admittedly simplistic measure of the "catch-up growth challenge", assuming a growth rate differential of 5 per cent in real terms; sustaining such growth rates would amount to major success. Figure 2 provides an estimate of the "institutional development challenge" based on a composite of measures of institutional quality. Much remains to be done to catch-up with the industrialized world, but the four countries have come a long way in a short time.

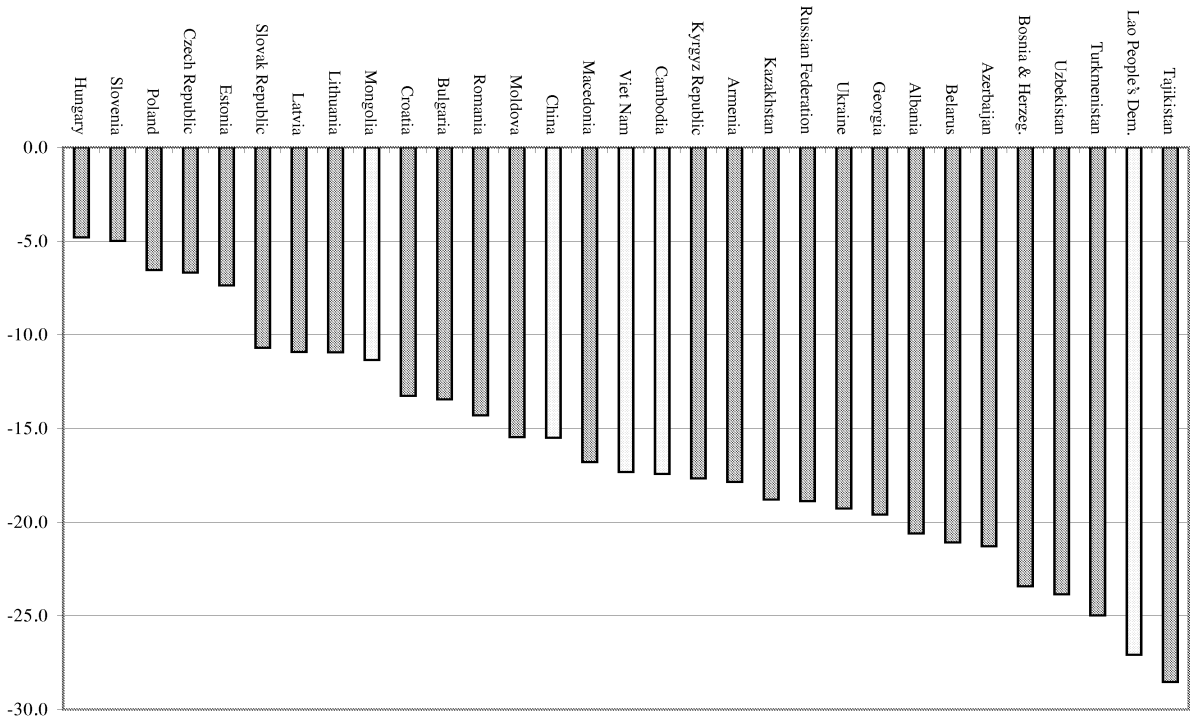
Table 1: GDP Differentials and the Catch-up Period

	Nominal GDP (1999; bln USD)	Nominal GDP per capita (bln USD)	PPP for GDP per capita[1]	Average time to catch-up[2]	Investment rate[3]
EU Baltic Rim Average[4]	1720	26,292	25,312	43	
EU (15) Average	8495	22,632	22,303	40	20.9
EU Minimum (Greece)	124	11,007	15,207	29	16.9
CEEC Average	100	3,512	8,638	11	27.3
Poland	154	3,984	8,845		27.4
Estonia	5.2	3,739	8,223		31.4
Lithuania	10.5	2,950	6,436		28.1
Latvia	6.5	2,703	6,074		27.4

[1]PPP adjusted GDP for the Baltics is the 1998 figure
[2]Average time for the four countries to catch-up assuming 5% growth differential in nominal GDP.
[3]Percent of GDP; weighted by PPP GDP.
[4]Denmark, Finland, Germany and Sweden.

Source: OECD Main Economic Indicators, IMF Staff reports (1999)

Figure 2: Deviation of Overall Average Institutional Quality (1997) from the Mean of Industrialized Countries



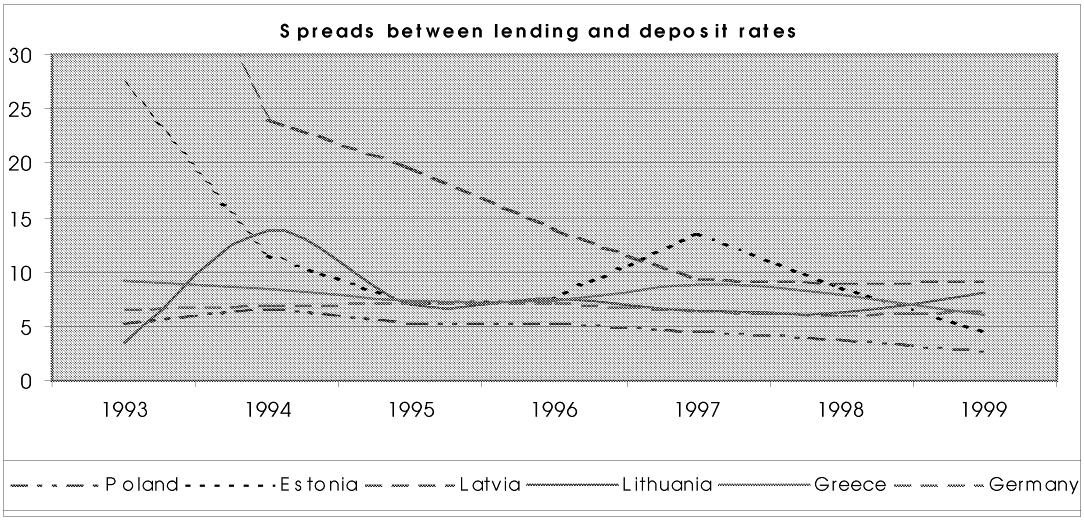
Source: Kaufmann Daniel, Aart Kraay and Paolo Zoido Lobaton(1999b), "Aggregating Governance Indicators", mimeo, The World Bank.

3. Meeting the Growth Challenge – The Financing Problem

The financial systems of these countries will be important factors determining whether the countries can achieve the growth rates that will be necessary to catch up with the other countries in the Baltic region. Simply put, financial systems transfer funds from savers to the enterprise sector and allocate them across different sectors and projects. A well-functioning financial system also monitors how funds are used, and ensures that investors receive a reasonable return on their capital. In addition, it should provide insurance and liquidity to investors.

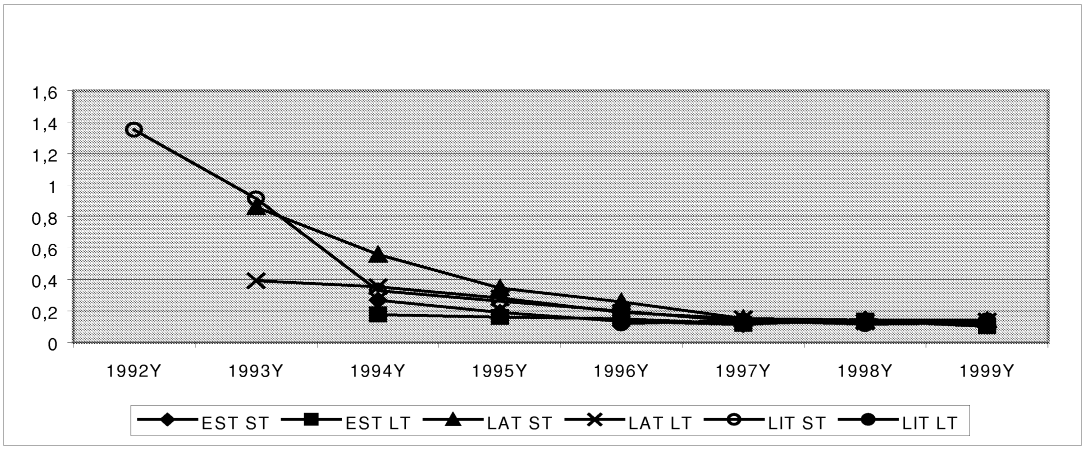
The financial systems in the three Baltic states and Poland are still underdeveloped compared to Western Europe, with a narrow set of financial institutions and small markets (Table 3 and Figures 4 and 5 show different measures of the degree of development of the financial systems in the four countries). An important indication of the underdeveloped nature of markets and institutions is the difference between lending and borrowing rates (see Figure 3). While these "spreads" have now come down significantly, both in level and volatility, they are still high by, for example, German standards.

Figure 3: The Difference between Lending and Deposit Rates



Source: National Central Banks

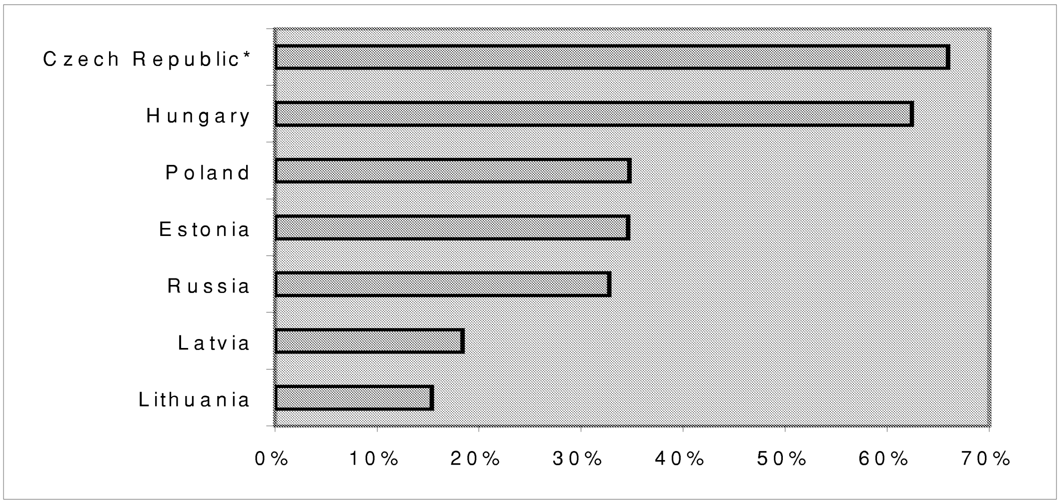
Figure 4:The Long and Short Term Deposit Rates



Source: National Central Banks

The basic functions of financial systems can be organized in different ways using different combinations of financial institutions and markets. An important international debate has discussed the relative merits of bank-based financial systems compared to systems with more developed financial markets. In many respects, this debate is moot in the four countries concerned since the choices of basic institutions have already been made. While there is considerable variation across countries in both development path and institutional structure, the financial systems emerging share important common features. At least for the foreseeable future, commercial banks will play a crucial role in corporate finance, and ownership and control of enterprises will be strongly concentrated, reducing the liquidity in equity markets. The markets for corporate bonds are also likely to remain underdeveloped for years to come. However, it is important to emphasize that financial development does not imply a choice between financial institutions and financial markets – institutions and markets complement each other, and the simultaneous development of both is needed to meet the financing challenge.

Figure 5: Domestic Bank Credit Relative to GDP, 1999



Source: National Stock Exchanges

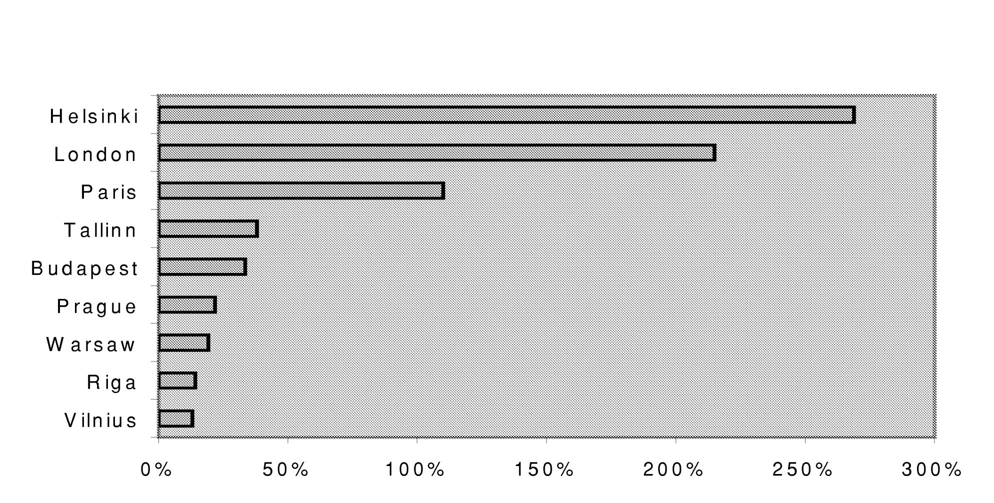
Due to the size of its economy, Poland has the largest banking sector in absolute terms, but the banking sectors of Estonia and Latvia are larger (and Lithuania smaller) measured by the size of banking assets relative to GDP (see Table 2). In terms of security markets, Poland again is much larger in terms of capitalization, but both the Estonian and the Lithuanian markets are relatively larger if we take into account their levels of income. Turnover relative to GDP and capitalization is higher in Estonia and Poland than in Lithuania and Latvia. But the market capitalization of these exchanges relative to GDP is still small in comparison with, for example, Helsinki and London (Figure 6).

Table 2: Securities Market Statistics, 1999

	Estonia	Latvia	Lithuania	Poland
Capitalisation Mn US$	1933	879	3471	31105
Capitalisation as % of GDP	38%	14%	33%	19%
Turnover Mn US$	1140	50	576	23722
Turnover as % of GDP	67%	27%	30%	48%
Bond Turnover as % of GDP	2%	0,07%	0,10%	1,60%
Ratio of Turnover to Capitalisation	0,59	0,06	0,17	0,76

Sources: National Stock Exchanges

Figure 6: Stock Market Capitalization Relative to GDP (1999)



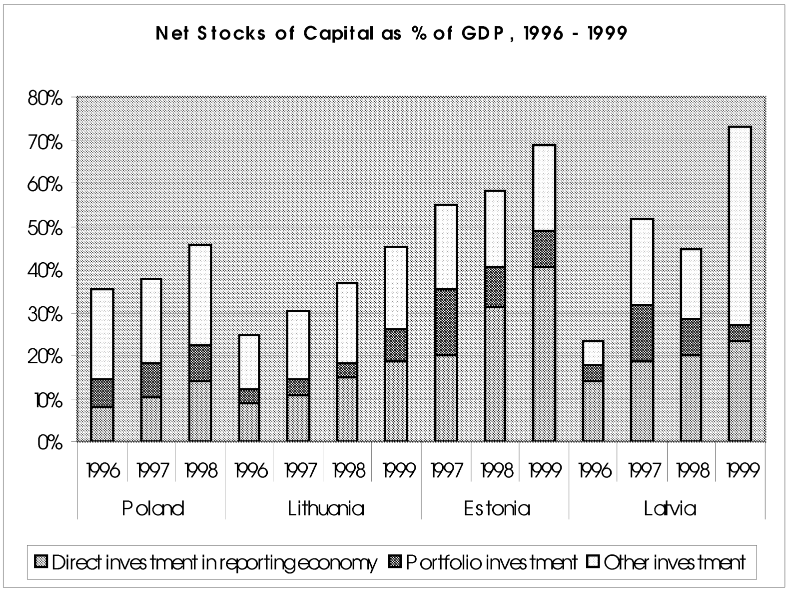
Sources: National Stock Exchanges

Differences in financial systems are reflected in how corporations are financed. Unfortunately, data on the sources of funds for enterprise finance in these countries are poor, but it is safe to say that internal funds, or retained earnings, is the most salient source in all these countries. Financial markets currently supply funds to the corporate sector at only a negligible level. External finance, if any, must come from banks and other types of financial institutions. Given the relative underdevelopment of other financial institutions, the functioning of the banking system will be a main factor in promoting growth. However, the development of various specialized financial arrangements, such as venture capital and micro finance, could also help provide individual entrepreneurs with access to funds. Some transition countries have benefited from large inflows of foreign capital, both in the form of foreign direct investment and portfolio investment. Foreign direct investors typically precede portfolio investors and have more information about local markets. It is often claimed that portfolio investors are more mobile, but the evidence is less clear in this respect. In the Baltic region Poland and Estonia have both enjoyed large inflows of both foreign direct investment and portfolio capital (Figures 7 and 8, and Table 3). Public flows have also been substantial.

Financial sector development is often hard to measure but is lacking in three important respects:

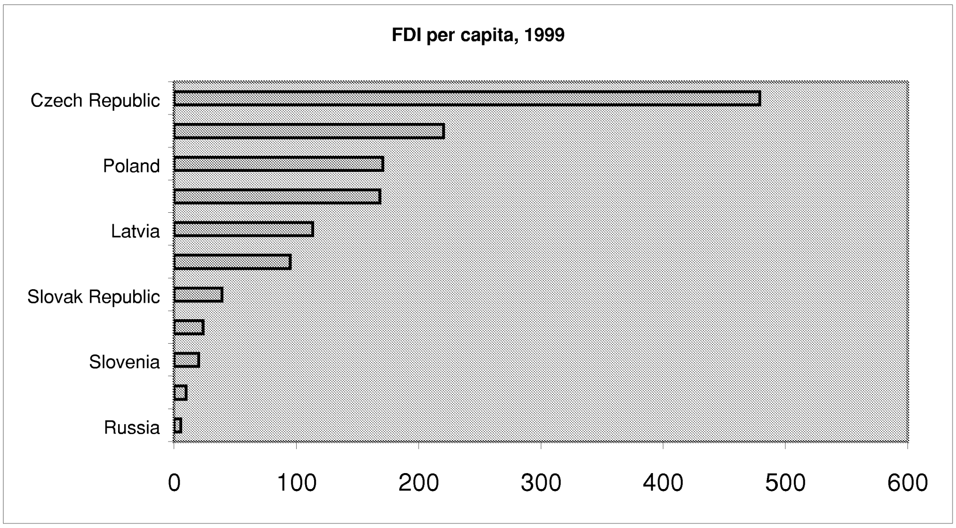
1. enforcement of banking regulation
2. transparency and disclosure standards in equity market
3. security market institutions, both wholesale and retail.

Figure 7: Net Stock of Capital Inflow Relative to GDP (1996-1999)



Source: National Central Banks

Figure 8: Stock of Foreign Direct Investment Per Capita (1999)



Source: National Central Banks; *Economic Survey of Europe*, No1, 2000.

Table 3: FDI Inflows into Central and Eastern Europe

	FDI inflow per capita		FDI/GDP		Cumulative inflow /GDP
	1998	**1999**	**1998**	**1999**	**1999**
Eastern Europe	*132*	*162*	*3.7*	*4.7*	*675*
Czech Republic	265	498	4.9	9.6	1,612
Hungary	201	193	4.3	4	1,967
Poland	**132**	**174**	**3.3**	**4.4**	**527**
Slovak Republic	94	45	2.5	1.3	384
Slovenia	83	42	0.8	0.4	681
Baltic States	*247*	*131*	*8.3*	*4.4*	*794*
Estonia	**406**	**256**	**11.2**	**7.1**	**1,430**
Latvia	**147**	**113**	**5.6**	**4.1**	**836**
Lithuania	**251**	**95**	**8.6**	**3.3**	**523**
CIS	*24*	*19*	*1.8*	*2*	*133*
Russia	19	18	1	1.4	135
Ukraine	15	10	1.8	1.6	63
Belarus	14	24	1.3	2.3	70

Source: Economic Survey of Europe, 2000 No1.

4. Is There a Financing Problem?

These four countries have obviously have made considerable progress in building their own financial systems and attracting foreign capital. So is there a financing problem?

- Are non-financial constraints on their economic development more significant?
- Are there sufficiently promising ideas and entrepreneurs to warrant more investment?
- Do the countries have the capacity to absorb additional international capital?
- Is there a problem in quantity of available financing resources or in its composition?
- Is a multinational institution a solution?

These questions are not easily answered, but in this article we argue that there are significant financial constraints to meeting the growth challenge. We argue that these constraints mostly concern the composition of finance; while there may be sufficient traditional lending capacity, there is a lack of "entrepreneurial" finance. Additionally, many institutional structures which have been created during the early transition years for the purpose of creating an environment supporting decentralized and entrepreneurial activity (laws, regulatory and facilitating institutions, disclosure requirements, openness to entry) are untested or underdeveloped.

The main indication of financial constraints is the large risk premium charged on investments in these countries. The key to sustaining high economic growth is bringing down this high-required rate of return. We should be able to understand better what it takes to do so by looking at the different components of the premium.

An obvious contributor to the risk premium is macroeconomic instability. The three Baltic countries have all had major swings in their macroeconomic indicators over the last decade, and Poland is currently facing one of its most difficult challenges since reforms started. Obviously, increased stability in the macroeconomy is desirable, but it is not clear what a Baltic Sea Investment Bank or any other financial institution could do in this respect. All three Baltic countries have opted for very strict currency regimes, the Estonian currency board being the most extreme example. Poland, on the other hand, has chosen a more flexible regime. There is little convincing evidence that any one solution is most preferable. Ultimately, macroeconomic stability is determined by the ability of a country's legal, political and social institutions to prevent domestic imbalances from developing and to accommodate external shocks.

Strongly related to macroeconomic stability and the feasibility of different currency regimes is the fragility of domestic financial institutions. All three Baltic states have experienced severe banking crises during the course of the transition. A combination of a weak capital base, poor lending practices and inadequate supervision generated successive crises. There has been considerable learning, and the local institutions seem much less fragile today. Increased foreign ownership of banks, in particular in Estonia and Latvia but also in Poland, has radically improved the stability of individual institutions. Supervision is also much better in most countries. Connected lending is nevertheless still widespread. Lending by financial institutions to related companies is a natural response to a poorly functioning legal environment and concentrated ownership of enterprises.

The framework for bank recapitalization and better prudential regulation is largely in place; laws for insolvency and bankruptcy have been written in the commercial code. One of the main challenges at this stage is that economic practice has still to fully adopt the use of legal proceedings. Second, prudential regulations necessary at this early stage of supervision history and experience impose tight constraints on banks' forms of financing. This is appropriate at this stage of development: banks represent the basis of the financial system and their stability must not be in question. For financing newer and more risky ventures, a new layer of intermediaries is needed.

Financial markets are still small, and they play a subordinate role in corporate finance. The privatization programs grossly overstate the data on new issues. Liquidity in both primary and secondary markets varies considerably across countries and over time, largely in response to the inflow of foreign portfolio capital.

By their very nature capital markets cannot be built by institutional intervention by their very nature; they require a diffuse, grass-root entry of investors with local expertise. Moreover, as the modern literature on financial markets recognize, securities, being standard, transferable contracts, depend more than bank lending on a stable and transparent framework of "enforceable" laws.

In the absence of large macroeconomic imbalances the main determinant of the risk premium is likely to be the quality of the legal framework protecting investors and, more generally, basic property rights. By now, most of the countries have implemented fairly elaborate legal texts specifying the rules that should apply. The predominant problem is that these laws have not been fully tested and enforced. Enforcement is still subject to long delays, ambiguity, and current economic practices often bypass these formal mechanisms. Yet for the establishment of an open, decentralized and reliable trading environment, the private use of laws should be encouraged. Most importantly, the enforcement of rules and functioning of institutions depend on a sufficient degree of transparency and information dissemination among the public and away from corporate insiders and public agencies.

Figures 9 and 10 compare the extensiveness and effectiveness of legal frameworks in the transition world. In most countries there is a considerable gap between these two measures, suggesting that much remains to be done to make the new laws effective. Poland and Estonia again seem to have come further than have Latvia and Lithuania, but the more striking difference is between these four countries as a group and the southern CEECs and the CIS countries.

Figure 9: Extensiveness of Laws

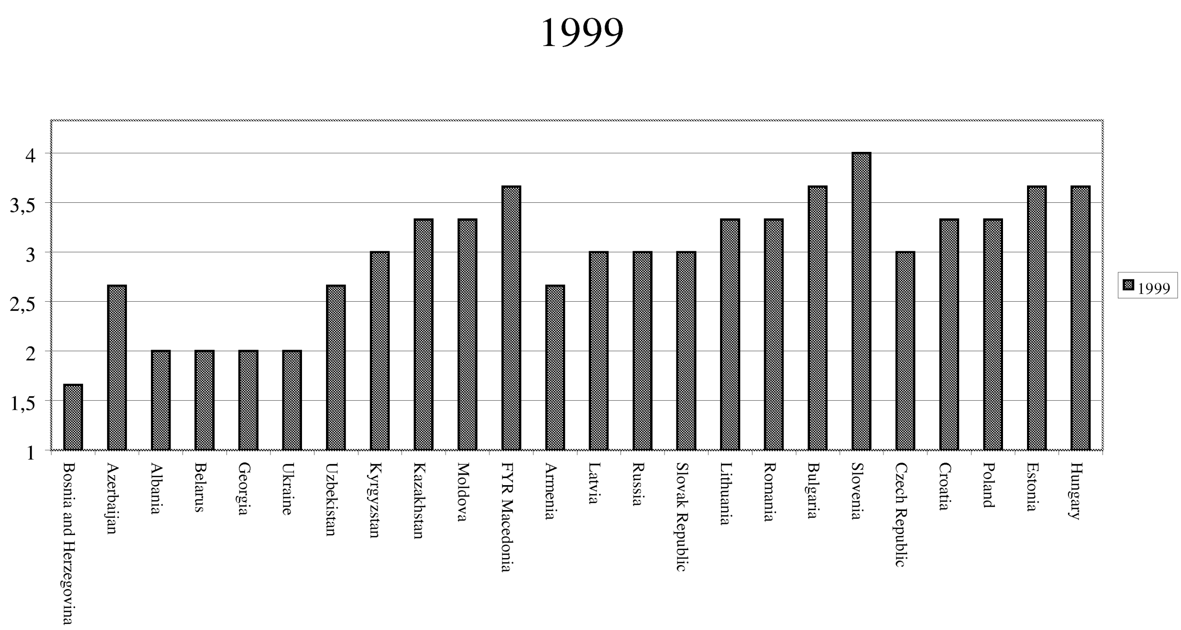
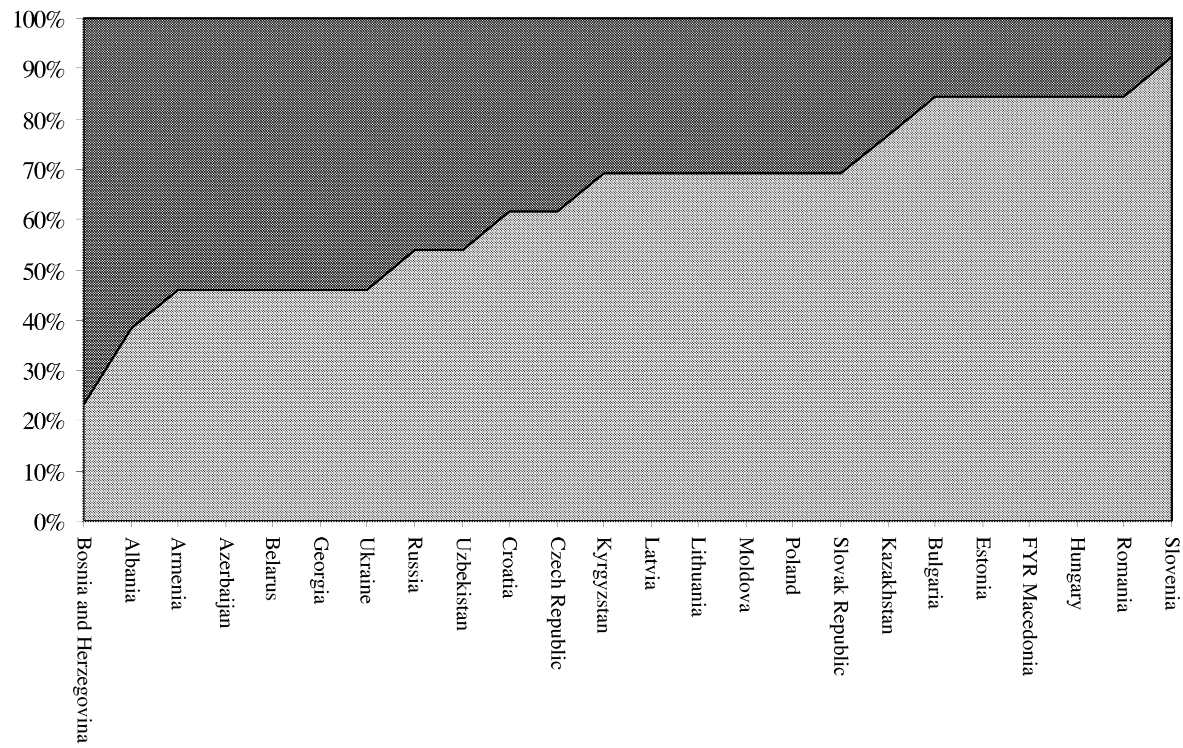


Figure 10: Legal Effectiveness



Source: EBRD Transition Report, 1997 and 1999.

So there does seem to be a financing problem arising out of the underdevelopment of basic financial institutions and markets. But exactly whom does the problem affect? First, the general financing problem is the high risk premium that deters potential investors from committing resources and enterprises from making investments. This problem is particularly severe for companies that depend more on external finance. The financing problem may also be important for new companies and SMEs with limited access to connected lending and other informal enforcement mechanisms that have emerged in the legal vacuum.[1]

Bringing down the risk premium requires changes in the general financial architecture and simultaneous efforts in its implementation and diffusion of relevant information and experience. The specific problems of SMEs and firms with high dependence on

[1] The argument that small businesses are particularly disadvantaged is not new to transition countries and should be examined more carefully. Entrepreneurs are often reluctant to give up benefits and control to outside investors, thus increasing the cost of capital. In fact, it could be argued that the general imperfections of the financial systems in transition countries swamp variations across firms, and that smaller firms are less disadvantaged in transition countries, at least in a relative sense. They often carry less baggage from pre-transition, and they can more easily exploit the imperfections of tax collection. However, small new firms typically depend on banks for the external funding needs and thus suffer when banks are inefficient. They also find it more expensive to pay the high fixed costs of entering securities markets. Moreover, when connected lending is widespread and old nomenklatura ties are important for access to subsidized government firms these firms are at a disadvantage.

external finance, e.g., high-tech companies normally financed through venture capital, should be addressed more directly through support to new institutions and markets.

5. The International Experience of Development Banks

The traditional response to the financing problem in developing countries in the past has been the creation of development banks at the national, regional and international levels. To evaluate the role of similar institutions in mitigating the financing problem in the Baltic region, a look at the international experience is useful.

The launch and expansion of special development banks or agencies started in the early sixties and lasted for about a decade. They were initially most prevalent in Latin America, Africa and Asia (Philippines), although some smaller scale versions have been set up in most developing countries. Development banks are financial institutions that derive their funds mainly from national governments. Their funding has been mostly drawn via direct capital contributions from the state, refinancing from a central bank and state-guaranteed bonds and foreign loans.

The assumption behind the creation of development banks was that economic growth needed direct channelling of credit from the government budget. State intervention was motivated, it was argued, because underdeveloped capital markets could not provide enough long-term capital for industry and infrastructure to develop to their full potential. The argument was supported by a visible need to restore or upgrade the overall infrastructure in the country in question. To evaluate the case for state intervention, it is useful to distinguish between industrial investment and infrastructure. While both require long-term finance, it is easier to argue that infrastructure investment has general benefits for the economic environment, in the sense of producing positive externalities which individual private investors may not take into account when making decisions.

From a theoretical point of view, direct state involvement may only be appropriate when there are pure public goods for which it is impossible to charge users, or some of them, for the services. Still, there is no overwhelming case for direct state financing, since public subsidies are a more transparent form of support than, for instance, state financial guarantees. In fact, an important cost of state ownership and sponsorship is the loss of transparency allowing situations of inefficiency or privilege to go unscrutinized, thus undermining incentives and leading to misallocation of resources.

But state intervention does not need to mean direct or indirect state financing. In the past, the problem underlying private financing of infrastructure has often been investors' lack of confidence in their ability to earn back their investment in areas of public utility, where there are political temptations to limit user costs once the large initial investment has been sunk. This calls in many cases for a clear government policy, rather than direct funding. In the last ten years many forms of infrastructure, such as the "public utilities" once believed to be natural state monopolies, have been privatised successfully, while the state has redefined its task as one of regulator.

5.1 *(Under)development of capital markets*

Here, we might take a brief look at the causes of the underdevelopment of capital markets. Originally, it was believed that structural economic circumstances in developing countries made it impossible to develop strong domestic capital markets. More concretely, the underdevelopment of bond markets was attributed to a history of large budget deficits and high inflation; while weak equity markets were attributed to high agency costs and poor information in developing countries. Yet in recent years the emergence of new capital markets has led to a situation where many developing countries have ratios of stock market capitalisation to GNP higher than some developed economies.[2] Thus other factors than income per capita or capital intensity must account for the variation in capital market development and its ability to fund long-term development.

The limited stock of domestic savings is also frequently viewed as a limit for the funding of large investment. But state involvement does not resolve this issue, unless it is offered in the form of a state guarantee; and the experience is that large contingent liabilities created by such guarantees often end up devastating domestic savings - often by inflation triggered by large state bailouts. A better option to expand the stock of funding is thus to attract foreign inflows, which often actually consist of returning capital flight that was caused by financial repression aimed at forcing savings into domestic investment on inappropriate terms.

Yet the financial literature of the last twenty years recognises that specific problems in private financing may arise from problems of valuation due to a poor information structure (asymmetric information between managers and market investors) or difficulties in monitoring the use of funds by enterprises due to agency problems. These problems are recognised, for instance, in the work of Joseph Stiglitz, former chief economist of the World Bank and a supporter of a greater state role in financing. But also the underlying causes of asymmetric information and agency conflicts may be addressed more directly. In the last few years, financial underdevelopment is increasingly attributed to poorly defined contractual frameworks and weak legal rights for creditors and investors. Mitigating these problems most certainly involve state intervention, but again as a facilitator and regulator of market transactions.

5.2 *Problems of a centralized financing system*

The main issue of financial underdevelopment is not that developing countries have too little capital; it is rather that they tend to misallocate it, and in the process, to cause capital flight. The main mistake has been to substitute the state for the necessary development of the legal and contractual infrastructure, which alone can encourage local investment and generate market financing. State financial intervention often does not solve the issue, it just papers over it. If the state were allocating capital efficiently enough, there would be a case for considering state

[2] Modigliani and Perotti (2000).

financing as a temporary development stage. A state bank suffers from both an ex ante allocation problem and an ex post enforcement problem.

State ownership of banks naturally politicises resource allocation. Ultimate control resides with the owner of a bank; and whatever the initial stated intent to ensure efficient lending, it is not possible to prescribe efficiency; proper incentives have to be created. Yet managerial decisions in a state-owned firm naturally respond to what the ex post reward will be. Since elected governments have a stake in politically sensitive projects, it is not only natural but inevitable that ex ante project screening will be driven by the anticipated preference of the current owner for favouring specific constituencies or political goals.

The state is also poor at enforcing financial obligations when inefficiency leads to nonpayment. There are two reasons for this: state lending tends to either follow or create a political constituency, and a centralized financial allocation system has a tendency to refinance illiquid projects since past investment is a “sunk” cost.[3] Under some circumstances, such as a development stage in which direct economic incentives are not important, e.g., in the 1950s in Japan and later in Korea, centralized finance may have its advantage. For years, the Japanese planning agency MITI conducted an industrial policy whose main goal was to pump credit, raised cheaply by savers in a repressed financial system, to industry. The policy worked acceptably in years when Japan had to catch up and simply build plants with established technologies. Once the easy job was done, more forced channelling of resources created disaster.

A centralized system (such as a state-guaranteed development bank), besides being poor at enforcing repayment, tends to survive the problem it was meant to address. Recent research on productivity growth of sectors privileged by MITI in the 70s and 80s show that the policy slowed down resources allocation and adjustment to new market opportunities. State-sponsored technology programs in Japan (in space, semiconductors and electronics) were very expensive with little to show in terms of results. At the same time, independent Japanese firms such as Sony and Matsushita forged ahead by learning to compete and innovate in international markets, while America leapt ahead via diffused, non-sponsored innovation in computers, software and communications. A more dynamic economy requires decentralized, frequent, rapid and well-informed reallocation of resources and harder budget constraints. Even liquidation of viable but marginal projects may be efficient if it liberates resources needed in new sectors.[4]

5.3 *The performance of development banks*

The international experience of development banks has invariably been close to disastrous, at least in developing countries. Their lending has been directed from the top down and dominated by political, often regional, interests. On the asset side, these banks are often concentrated on specific groups of borrowers, typically, from the agricultural sector or "strategic" industries. These institutions do not serve as financial intermediaries transforming deposits into loans. Instead, they are used by the

[3] Dewatripont and Maskin, 1995.
[4] Dewatripont, Maskin and Roland (2000)

government to channel state resources, just as the Soviet Gosbank was used, and funds provided are effectively state subsidies. Therefore these banks have built little expertise in credit analysis, and since they typically lack a retail basis their ties to the local economy are weak. The directed lending has also kept target firms from developing the capacity to access investors and financial markets. None of these banks has achieved independence in funding. Instead the state-sponsored lending has created large contingent liabilities for the state budget, which in most cases overwhelm the scale of government investment and its explicit policy subsidies.

These “banks” are often set up to attempt to channel funds into the real sector through special institutions. Since they are designed to allocate subsidies to selected borrowers, such institutions tend to become notorious for corruption, misappropriation of resources and low efficiency of financed projects. The bias may reflect electoral advantage rather than outright corruption: agricultural banks focusing on small loans to farmers have gone bankrupt in practically all cases in Eastern Europe, as most of their borrowers realise that they would be spared the consequences of not meeting their obligations by political intervention.[5]

Government control of finance politicizes resource allocation for the sake of getting votes or bribes for office holders, softens budget constraints and lowers economic efficiency. Italy is a case in point: there is much evidence that Italian state-owned banks got in trouble because they pursued political objectives in their lending policies[6]. The same is true of the experience with Greek development banking, a case perhaps closer to the degree of development in the Baltic countries[7]. In most development banks, lending has primarily gone to “prestige”, politically connected large firms with regional significance rather than economic prospects. This has predictably resulted in an extremely low repayment rate, rapidly depleting any initial or subsequent capital allocation. In the last twenty years development banks have generally been a vanishing breed. Upon closure, losses are rarely less than two-third of the assets.

In some cases development banks have been set up to lend to small firms (typically in farming). In these cases, the repayment rate has invariably been very poor. While they may have served some function of welfare policy, the use of credit for this goal has undermined the notion of contractual obligation as well as the credibility of the liquidation threat in ensuring loan performance and hard budget constraints. Interestingly, small-loan programs run by cooperative banks or NGOs (such as Grameen Bank in Asia) have been much more successful in this respect. These institutions have repeatedly turned down offers of state support of their operations, recognizing that it would come at a high cost in terms of efficiency (i.e. political capture) in both credit allocation and repayment rates.

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[5] In contrast to other countries, such banks in Russia usually have standard banking licenses and operate as commercial banks. In some cases they even accept household deposits, as SBS-ARGO did. Given the risky nature of operations of development banks it creates enormous contingent liability for the government and threatens general fiscal stability.

[6] Sapinieza, P., What do State-owned Firms maximize? Evidence from the Italian banks”, Northwestern University, mimeo, 1999.

[7] Frangakis, M. Bank reform in Greece with reference to Eastern Europe: The case of Hellenic development bank, mimeo, 1998.

Recent economic research shows that special development banks were of little use in promoting economic growth. On the contrary, a larger share of government ownership is usually associated with slower subsequent development of the financial system, lower economic growth, and in particular lower growth of productivity.[8] Since state-sponsored banks are in general less efficient than private ones, their privatisation is currently felt to be the best solution. Only in some special cases when state ownership appears indispensable to strengthen confidence of depositors (such as for Sberbank in Russia) there may be a case for keeping them at least for some time under state control, while the needed strengthening of prudential regulation and competition policy takes place.

In sum, the international experience shows that development banks are not really instrumental in promoting economic growth, and too often create distortions in financial markets. They often crowd out the independent development of private lending, just as food aid too often destroys the incentives of local farmers to raise crops and create a cycle of financial dependence. Thus even when the main financing problem is an issue of scarcity of funds, state funding tends to destroy resources rapidly.

Most of the evidence has been from national development banks. At the international and regional levels a number of development banks are operating and, despite constant challenges, have managed to establish a certain degree of legitimacy. Have these institutions truly been more successful? If so, why? Is there something about the multinational nature of these institutions that make them less vulnerable to the problems of development banks? We will return to these issues when discussing the desirability of a Baltic Sea Investment Bank. The next section first discusses what existing international institutions are doing now to mitigate the financing problem in the Baltic region.

6. What Do the Existing International Institutions Do?

Reform of a country's general financial architecture and the filling of specific institutional "gaps" can be achieved through either a top-down approach applying the authority of the government and external pressure (the traditional development bank approach), or a bottom-up approach reinforcing grass-root initiatives and organic growth of institutions. The European Union and the various international financial institutions have used both of these modes of institutional reform in different proportions. Bilateral assistance primarily relies on bottom-up approaches.

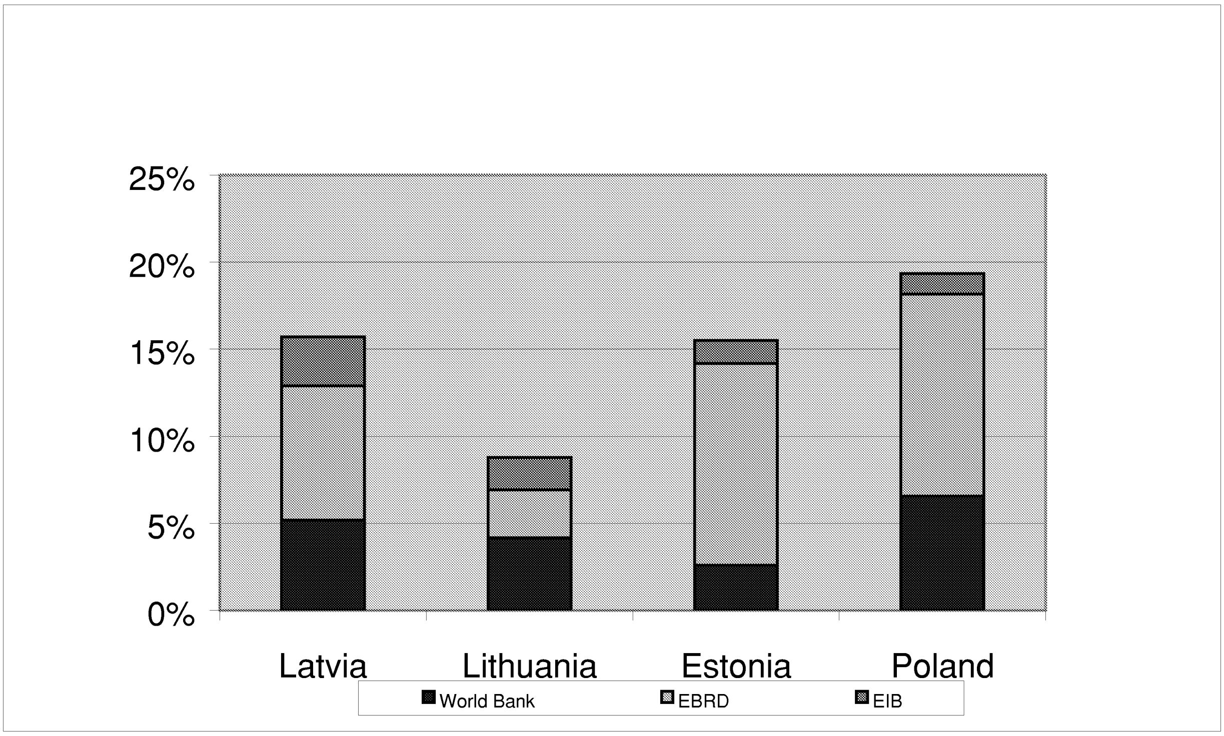
By far, the EU is the most influential external actor in these countries. The role of the EU as an external anchor for the reform process in Central and Eastern Europe in general, but in the Baltic states and Poland in particular, is hard to exaggerate. From the coarse criteria in the Treaty of Copenhagen, a very refined and comprehensive set of criteria for evaluating institutional progress has emerged. The strong leverage

[8] La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Government Ownership of Banks. NBER WP #7620, March 2000.

exercised by the accession process has accelerated the implementation of reform by many years. The enforcement powers of the EU will become much weaker once the countries are members. The current situation is presenting a unique opportunity for the EU to make use of the top-down approach based on external pressure, but the EU also attempts to promote bottom-up initiatives, with varying success.

The international financial institutions have largely been free-riding on the strong leverage exercised by the EU in these countries. In particular, the IMF with its more limited agenda has been able to follow on the efforts of the European Commission, and its traditional top-down approach has not played an important role. The EBRD has been very active, primarily in supporting the development of financial institutions and in promoting entrepreneurial activity. But it rarely exercises top-down approaches, and its charter severely limits what it can do to foster grass-root initiatives. The World Bank is more involved in broad structural reform and tries to use both top-down and bottom-up approaches, with more emphasis on the latter. The Nordic Investment Bank and the European Investment Bank both have specialized in large infrastructure projects and to some extent in providing finance to small and medium-sized enterprises.

Figure 11: The International Financial Institution Investment (% of GDP)



Source: EBRD, World Bank country offices, EIB website

Figure 12: EU total assistance to the CEECs 1990 – 1997

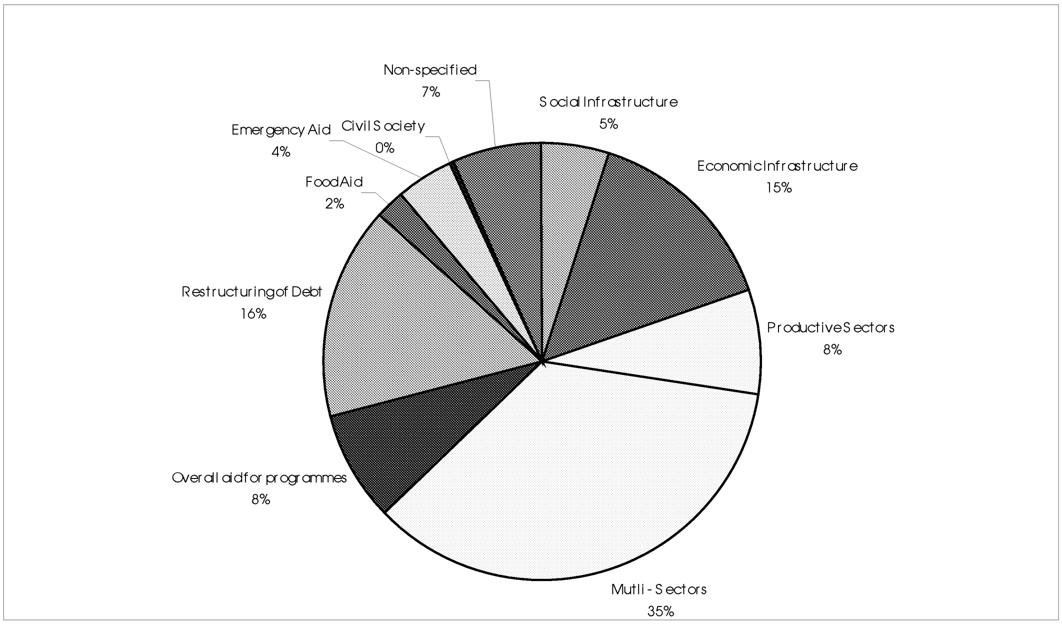
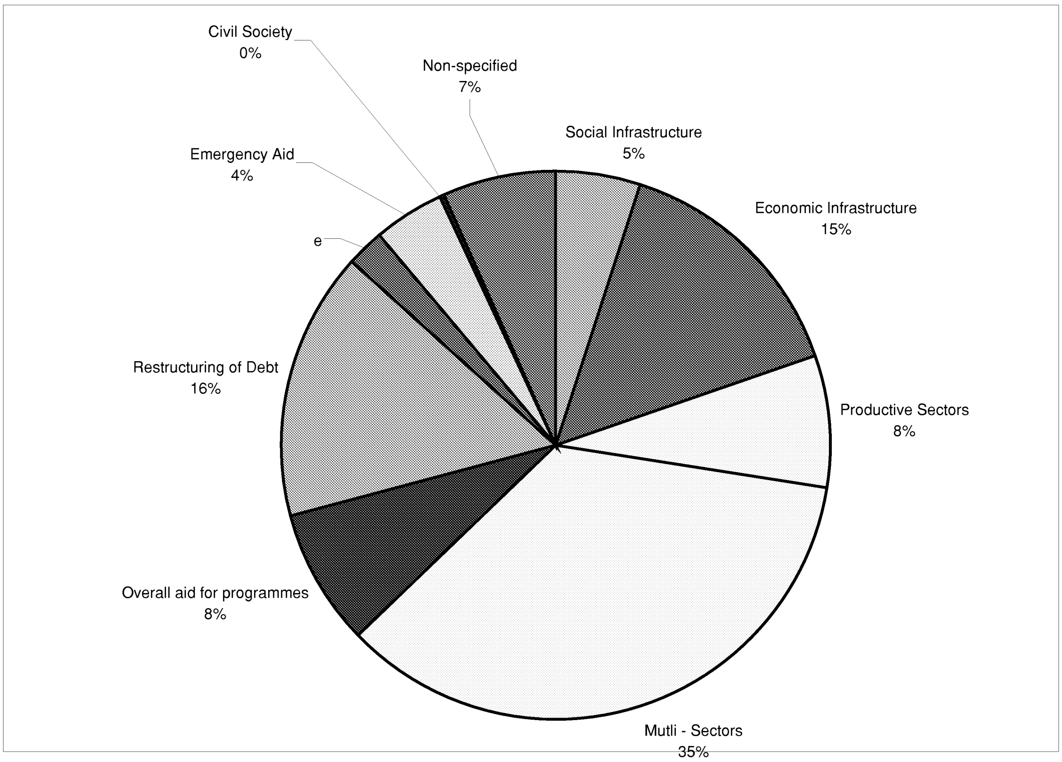


Figure 13: FIs total assistance to CEECs 1990 – 1997



The process of EU accession offers potential complementary roles for the IFIs. The World Bank, for example, has taken upon itself to provide the accession countries with institutional support in the negotiation process with the European Commission. Another possible role for IFIs would be to soften the impact of the accession reforms. Yet another could be to coordinate the negotiations across accession countries.

In terms of our distinction between top-down and bottom-up approaches, it seems that the EU is completely dominating the top-down efforts. It would be extremely hard for any of the other international financial institutions or a new institution to match the influence or complement these efforts by the Union. Several institutions are also involved in financing large-scale infrastructure projects ("hardware").

However, more should be done to promote grass-root initiatives. There is at this stage of transition an institutional "gap" between the formal rules of a market economy and their practical use. What is needed is more intervention in the areas of market access, building absorption capacity and promoting civil society. Individuals and enterprises need help to learn to use the new rules and institutions. There is a need to build up an implementation record for the set of rules and institutional arrangements created in the last few years, and create new service institutions with the necessary expertise to guide firms through this process. Arguably, entrepreneurs need such services more than conventional financial resources, which often have minimum scale requirements, demand collateral or state guarantee. Further encouragement for entrepreneurial activity is also important to promote additional regional integration.

All the international financial institutions, and the European Union, have been concerned not to crowd out private investments or undercut existing or future financial markets. This would also be a concern with any new institution. In response to the dynamic development in the transition frontrunners the IFIs have also been forced to reconsider their roles. In some cases they are radically reducing their funding commitment and in others they are drastically changing the orientation of existing programs. It is in this dynamic context that any potential role for a new institution would have to be evaluated.

Some defenders of the existing international financial institutions would say that what should be created is not a peer of these institutions, but rather another type of institution, perhaps a new NGO or a coalition of such organizations. Indeed some institutions are constrained by their charters from engaging in such activities. The question is less whether existing institutions can fill the gap, but rather whether they are willing to do so. If not, there may be a need for a new institution.

7. The Case for a BSIB – A "Venture Catalyst"?

Let us consider, for a moment, the idea that a new institution is needed to solve the financing problem as we have presented it. We assume that the goal of the new entity would not be to re-establish a form of state support but to promote self-reliant, market-oriented institutions and enterprises, and to encourage regional integration in the Baltic area. What type of institution would this be? We view the main choices as being whether:

(1) the proposed agency should be long-term or temporary;
(2) it should work independently or in association with other IFIs; and
(3) it should be working through a top-down (i.e., large-scale, institutionally designed or managed initiatives) or a bottom-up approach, meaning promoting smaller scale, more entrepreneurial initiatives independently developed.

This set of options covers a spectrum of possible institutional structures. At one extreme, it would be a sustainable supplier of long-term capital (a development bank) identifying large-scale projects to fund, at the other extreme, a temporary independent small-scale regional agency promoting private initiatives. The institution we would envisage is much closer to the latter. The missing actor in these countries is a catalyst, a "venture catalyst", rather than a financier or a benevolent dictator. It is an agency that, for example, can bring together institutional investors in venture capital funds or philanthropic foundations in initiatives to build capacity in legal advice and reliable legal enforcement. We would aim to create permanent effects without setting in place a permanent institution. This new institution would be involved primarily in building soft infrastructure and promoting individual enterprise. Promoting regional integration and decentralized economic decision-making would also be part of the BSIB mission.

What type of institution would this be? What we have in mind is an agency with a charter clearly delimiting the life span of the institution as a state-sponsored development entity. This agency would pursue a portfolio of activities. In fact, the BSIB should focus on advice at least as much as on investment (although small capital contributions would support a strong relationship).
Areas of activity could include legal advice, consulting, market research and trade promotion. Helping to set up venture capital funds and markets supporting such funds could also belong to the portfolio, as could building credit rating institutions. A critical task would be to assist the countries to reverse the brain drain through education and training and by "trying" existing institutions, e.g., by bringing lawsuits, demanding disclosure or market access, or pursuing bankruptcy procedures.

This "venture catalyst would need to have a charter that clearly puts a time limit for state involvement. The life span of the institution as a state-sponsored development bank. Most importantly, the institution should be destined for ultimate privatization from the start. This should happen either as a whole or in parts, given that the various parts of the agency may develop different skills.

One interesting possibility would be a public-private partnership. Public support is critical initially, otherwise the institution is unlikely to see daylight, but over time the share of the private stakeholders could be increased. To weaken special interests decision-making should be decentralized but interregional. Cross-posting of personnel outside their home country, initially on a small scale, would be important to develop a strong regional identity.

In what sense is this institution a "bank"? While providing financing would not be the main role of the BSIB, we believe that it is critical for its credibility that it can contribute its own capital. Without a capital contribution it will be harder to convince other actors to invest in a venture. The Bank's incentives to screen and follow-up projects are also weaker when it has no stake of its own. In fact, it could even be argued that control stakes are desirable, only then is alignment of incentives sufficiently strong. The idea emerging from this discussion is that, if created at all, the institution should be a venture catalyst with a hands-on approach and clear exit incentives.

8. The BSIB Challenge to the Existing IFIs

The key problem of late transition, at least as currently facing the three Baltic countries and Poland, is that of poor institutional quality, in particular when it comes to the enforcement of existing laws and regulations. We have suggested that the strong leverage exercised by the European Union drastically reduces the need for top-down approaches by other actors. The efforts of international financial institutions should be directed towards promoting various bottom-up initiatives promoting entrepreneurial and civil society activities. Constituencies must be built for greater transparency and improved implementation and enforcement of existing laws. Massive investments are necessary in building local capacity in law, economics and social sciences and civil society more generally. What is needed is investment in software rather than in hardware.

In the case of the Baltic region, an additional question is the division of tasks between any new institution and the EBRD and the IBRD, both of which have chosen small business as a priority area. Although admittedly there has been only limited intervention, it is clear that a very strong case needs to be made before an additional `top-down` institution is created alongside these institutions. It may well be that creation of a special fund, earmarked for small scale lending in this area, is a more appropriate solution. On the other hand, it is possible to envision a regional agency, operating on a small scale, with limited state involvement and no long-term charter. This would avoid bureaucratization and entrenchment beyond the desirable period of practical use.

Is a BSIB a necessity? There are many examples of failed attempts to establish similar institutions. As we mentioned earlier, national development banks have failed in most places where they were introduced. The record of regional institutions is more mixed. Perhaps the closest counterpart would be the Black Sea Development Bank with the countries around the Black Sea as founding members. The experience of this institution is unlikely to convince skeptics. The traditional international financial institutions, like IMF, the World Bank and the EBRD, have stronger records, but their legitimacy is constantly challenged. The most important concern is that these institutions become agents of particular political agendas or captured by special interests. International financial institutions certainly are not immune to such forces, as seen for example in the pressure on them to bail out Russia in 1998, but their multinational governance structures may help in this regard.

To prevent capture and resist pressures to violate its charter, any new institution must be truly independent from individual governments and business interests. A new institution introduces new governance problems and recruitment issues. As an alternative, the prospect of future privatization is crucial. Attracting high-quality human capital would be difficult given the presumed temporary nature of the institution. But a prospect of future privatization may mitigate these problems. Another serious issue is whether the institution would actually dismantle itself once it has fulfilled its role.

The BSIB has been presented as a challenge to existing international financial institutions. If these do not move to fill the institutional gaps we have identified, other forces might. New institutions may even be launched to shake up current structures. To understand the scope for creative responses from incumbent institutions, we need to know more about the existing barriers to change. Some institutions are simply constrained by their charters. For example, the EBRD instructions, at least the way they have been interpreted by recent presidents, severely limit the scope of its activities. Other institutions sense constraints from their shareholders. The IMF, for example, if anything is under pressure to focus its strategic orientation.

In designing a charter for a new institution one fundamental question must be answered: What is it about this charter that would make it behave differently from that of existing financial institutions? If that question cannot be answered in a convincing way, there is no case for a Baltic Sea Investment Bank.

Policy Implications

- There is no obvious lack of activism by the IFIs and private investors providing external financial resources to the Baltic Sea countries, but the high legal risk premium reduces investment, particularly in new and smaller companies, the potential engines of innovation and integration.

- Institutional intervention is needed not to channel savings but to build up experience in the practical use and implementation of laws, regulatory and facilitating institutions, in particular those directed at enforcing contractual compliance, disclosure requirements, and openness to entry.

- The classic development bank structure is inappropriate to address these problems, and may politicise resource allocation. It is also potentially very expensive and may persist too long. The European Union also covers the need for institutional development through top-down conditionality, but more can be done in terms of bottom-up initiatives.

- What is needed is a "venture catalyst", a decentralized agency with a mission to promote "access" to both finance and markets, helping new private initiatives to test the effective enforcement of legislation and activating the new institutions needed to support market transaction (such as regulators, courts, arbitrators, independent evaluators, etc).

- The focus of such an agency would be on "software support" and advice rather than investment (although equity stakes or guarantees could be part of the relationship). Another critical task should be a policy of assisting companies to "test" existing legal institutions, e.g., by bringing lawsuits, demanding disclosure or market access, or pursuing bankruptcy procedures.

- To avoid political capture such an institution should be a multinational venture between the government and private sector with a time limit for the public sector involvement. The agency should be destined for ultimate privatization from the start, presumably divided in a venture and investment fund component, and several advisory companies, to motivate top quality personnel.

- The ultimate question is: What is it about the charter of this agency that makes it more effective than existing international financial institutions and less vulnerable to the dangers of traditional development banks?