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**EUROPEAN INVESTMENT BANK'S
FINANCIAL ASSISTANCE TO LITHUANIA
AND ITS ROLE IN ECONOMY TRANSFORMATION**

1. Introduction

After Lithuania gained its independence during the transformation process to market economy, the economic restructuring of the country required significant financial resources. In order to attract large funds for investment projects, Lithuania has borrowed money from international financial organizations such as the World Bank, the International Monetary Fund (IMF), the *European Bank for Reconstruction and Development* (EBRD), the Nordic Investment Bank (NIB) and the European Investment Bank (EIB). The major task of the latter, which is the subject of this article, was to contribute towards the integration, balanced development as well as economic and social cohesion of Lithuania. Financial aid from international organizations accelerated the efforts of Lithuanian government towards the transformation to the market economy, i.e. they granted loans on more favourable conditions than market ones, and also provided technical assistance while transferring international finance and project management experience.

In 1996, after the prevention of serious economic shocks in the country, the banking sector recovered and its loan portfolio grew continuously until 2008. Therefore, during that period the country did not experience the lack of credit resources to promote economic development. However, during the last quarter of 2008 credit conditions in financial markets tightened and the capital position of many major banks weakened in the wake of recent financial market turbulence.

At the beginning of the financial turmoil Lithuania borrowed from the EIB. Favourable conditions, which made this loan possible, were the policy of the European Union (EU) and the sound financial status of the Bank. Decreasing the

volume of credit is one of the priority issues of the EU and the exposure of the EIB to the financial turmoil is rather limited.

The main purpose of this article is to generalize the EIB experience in financing projects in Lithuania. The object of this article is the influence of the EIB loans on Lithuanian economic transformation. The authors present first a general overview on the role of the EIB, lending objectives and benefits of the EIB financing and review the main products and services provided by the Bank, paying special attention to a new financial engineering instrument recently developed by EIB. The second part of the article presents a general overview of international institution's activities in Lithuania concentrating on the major infrastructure projects developed in Lithuania. Finally the authors assess the global financial turmoil and implications for the EIB role in Lithuania.

2. Role of the European Investment Bank

The EIB¹ was established in 1958 by the Treaty of Rome as the long-term lending Bank of the EU. The EIB is a non-profit, policy driven bank. The institution makes long-term loans for capital investment projects (mainly fixed assets) but does not provide grants. EIB is one of the largest lenders to the public sector in Europe: in 2008, the EIB lent 57.6 billion euro in support of the objectives of the EU [*Project Financed* 2009]. The EIB's objective is to contribute, by having recourse to the capital market and utilising its own resources, to the balanced and steady development of the internal market in the interest of the Community.²

One of the major benefits of the EIB financing is favourable financing cost. Because the EU Member States are the EIB's shareholders, it issues highly rated triple A (AAA) bonds for the international capital markets. As a result, the EIB can raise large amounts of capital on very competitive terms. It is important that the aim of the Bank, unlike commercial banks, is to foster countries development instead of achieving maximum profit. The EIB cannot, however, lend anymore than 50% of the total cost of an individual project.³

¹ The EIB Group consists of the EIB and the European Investment Fund (EIF). Their relationship encourages a productive sharing of expertise in support of SMEs. The article examines borrowing only from the EIB.

² The institution focuses on six policy priorities: (1) ensuring economic and social cohesion, (2) implementing the Innovation 2010 initiative, (3) developing trans-European transport and access networks, (4) supporting small and medium-sized enterprises, (5) protecting and improving the environment, (6) and ensuring sustainable, competitive and secure energy – and as regards the implementation of the EIB's external lending mandate in third countries.

³ Other benefits of EIB financing are: the ability to make large amounts available over long terms; possible grace periods; the catalytic effect of EIB financing in mobilising the participation of other banking or financing partners in the project, long maturity matching economic life of project assets; sector expertise catalytic effect on the participation of other financing partners [Pietikäinen 2001].

The EIB offers four main services to clients: loans, technical assistance, guarantees and venture capital. The Bank provides the following types of loans: (1) individual loans, provided to viable and sound projects and programmes costing more than 25 million euro which are in line with the EIB lending objectives, (2) intermediated loans – credit lines to banks and financial institutions to help them to provide finance to small and medium-sized enterprises with eligible investment programmes or projects costing less than 25 million euro. Microfinance has also been provided by the EIB in some countries. Intermediated loans may take the form of: (1) a global loan, (2) mid-cap loans, (3) grouped loans, and (4) framework loans [*European Investment Bank Loans...* 2007].

Recently the Bank took part in creating new tools and initiatives to enable the most efficient and sustainable use of Structural and Cohesion Funds in the 2007-2013 programming period. One of the new products developed by the EIB is a new initiative – Joint European Support for Sustainable Investment in City Areas (JESSICA). It is an optional financial instrument intended to address market failures (i.e. lack of investment funds to finance integrated urban renewal and regeneration projects) and facilitate accelerated investments in urban areas in the context of the Cohesion Policy. The EIB has financed urban development projects for many years, however, through individual and global loans [*Financing Investment...* 2007].⁴

The European Parliament considers that in the context of financial turmoil it is very important to mobilise the expertise of the financial engineering instruments like JESSICA in order to speed up the distribution of structural aid [*Resolution of 25 March 2009...*]. In the last section of this article the authors present the adaptation of JESSICA to the housing modernisation projects in Lithuania for the sector which is most severely affected by the financial crisis.

3. Overview of the European Investment Bank activities in Lithuania

As Lithuania is classified as a Convergence Region in the EU, this enables the EIB to support a wide range of projects in various sectors, including economic and social cohesion, a competitive and innovative European economy, efficient and easily accessible trans-European transport and energy networks (TENs), assistance to small and medium-sized enterprises (SMEs), environmental protection, conserving natural resources and improving the quality of life in urban areas, as well as the objectives of efficiency, diversification and security in the energy sector.⁵

⁴ JESSICA serves as a tool for financing projects regarding the regeneration and development of urban areas which allows to combine subsidies, loans and other financial products for that particular purpose [*JESSICA Evaluation Study...* 2009].

⁵ Lithuania became EIB group member together with the other new Member States on 1 May 2004.

Projects are financed directly or through intermediary banks operating in Lithuania. The EIB's activities in Lithuania started in 1994. In 1994-2009 the EIB granted Lithuania 1671.86 million euro worth of loan. The largest part of the loan is composite infrastructure (626 million euro), transport infrastructure (474.4 million euro) and loans for development of health and education (226.4 million euro) (see Figure1).

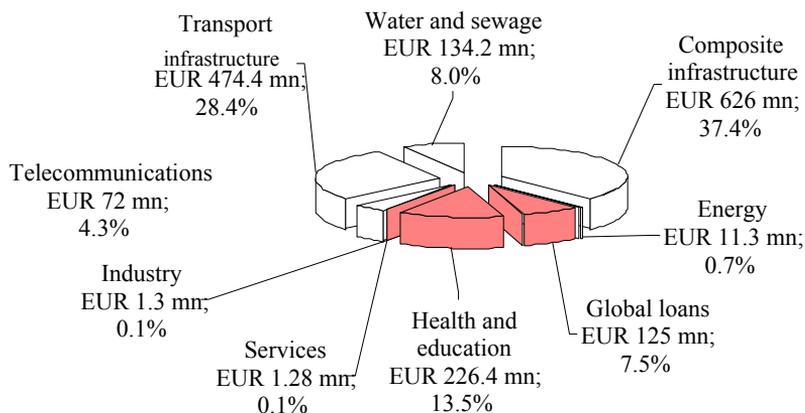


Figure 1. EIB lending in Lithuania: 1.7 billion euro since 1994

Source: [Project Financed 2009].

As the EIB can finance projects directly, with a value of more than 10 million euro, after the restoration of independence the Bank has granted loans to major economic infrastructure projects, of which the most important ones, executed before 2009, were the following: the reconstruction of Vilnius International Airport, Klaipėda Port, Via Baltica highway and railway infrastructure. Since all of the major projects are related to transport infrastructure development, the analysis below describes the projects and their significance for the economic development of Lithuania.⁶

In the context of unstable macroeconomic situation⁷ the EIB has announced its first loan for a project in Lithuania in 1994 providing 10 million euro for the modernisation and upgrading of Vilnius International Airport. The investments covered the rehabilitation of the runway, lighting and drainage works to help the airport meet the required standards of service and safety for performing its function both at regional level and as a feeder to the major hubs of Copenhagen and Frankfurt. Therefore, in the very beginning of economic transformation period, the

⁶ Loans for transport projects represent more than 40% of all individual EIB loans [Turro 2003].

⁷ It should be noted that Lithuania after the restoration of independence was facing difficult economic environment, i.e. 1990-1994 period a transformation period to market economy. The reform of prices initiated in 1991 led to more than 1000% hyperinflation. During 1991-1994 period real GDP fell by 44%. At that time the country suffered from the lack of credit resources [Nausėda 2007].

EIB played a major role helping Lithuania to develop internal and external transportation infrastructure on a cost-effective and durable basis [*First EIB Loan...* 1994].

A year later the EIB implemented another major transport infrastructure project in Lithuania providing a loan for Klaipėda Port infrastructure. Klaipėda Port is considered to be the heart of Lithuanian transport system. In 1995 the EIB lent 14 million euro for the construction of a small container terminal and for upgrading an existing ferry terminal. The institution added another 10 million euro for the renovation and modernisation of port infrastructure in Klaipėda in 2000 [*Project Financed...* 2009]. The Bank, by providing the loan for the infrastructure investments, contributed to the development of Klaipėda port volume growth.

The Via Baltica highway project can serve as a good example of how the progress was made in transport corridor development. In 1996 Lithuania was the first participating country to secure the full financing at a five-year programme for Via Baltica using loans from international financial institutions and local financing [Baublys-Mačiulis (ed.) 2003]. In 1996 one of the sources of financing for upgrading and rehabilitation of selected sections of Via Baltica road corridor was presented by the EIB (20 million euro). An additional loan of 50 million euro was provided in 2001 and included the construction and upgrading of several road sections of the Pan-European Corridors.

Also, the EIB is a committed long term financier and risk participant of the railway sector. In 1996 the institution provided a loan of 22 million euro for priority investments by Lithuania's national railway company Lietuvos Geležinkeliai for the upgrading of the Lithuanian railway network [*EIB loan...* 1997]. The loan helped economic development in the region by linking the Belarus-Lithuania border and the Baltic Sea ports of Klaipėda and Kaliningrad as well as facilitated communication with the EU.

The projects of railway infrastructure development in Lithuania were further expanded in 1999 and 2006. In 2006 the Bank's loan contributed to financing the purchase of 34 modern diesel locomotives that replaced 64 old Soviet-era locomotives in use since the 1970s. The projects provided substantial economic benefits in terms of reduction of maintenance costs, increased efficiency as well as improved safety and higher transport speed, and also led to a positive environmental impact as the performance of the modern locomotives contributed to the reduction of greenhouse gases and other dangerous emissions [*Lithuania: EUR 43 million...* 2006]. In total the EIB provided 104 million euro loans for the development of railway infrastructure in Lithuania.

The projects analysed and indicated the importance of the EIB involvement in transport infrastructure financing and, in particular, in Trans-European Transport Networks (TEN) and in the major links connecting the EU with its neighbours. It should be noted that investments in transport are also an important aspect of the

European Economic Recovery Plan [“A European Recovery...” 2008] and in this context the EIB has the potential to be a key player in environmentally transforming European transport. Therefore, the European Parliament urges the EIB to increase substantially in future its support for railways, urban public transport, inter-modal transport, and transport management [*Resolution of 25 March 2009...*]. In June 2008 the EIB indicated such potential future projects in Baltic States as Rail Baltica, the extension of airports of Baltic capital cities, Baltic ports and rolling stock [Pietikäinen 2001].

4. Global financial turmoil and implications for the European Investment Bank’s role in Lithuania

According to the official data of Lithuanian Department of Statistics, Lithuania’s GDP growth reached 8.8% in 2007. The increasing borrowing both by households and the business sector was an important factor behind the fast economic growth in 2007. Loans extended by the banks amounted to 16 billion euro in January 2008. This approximately accounted for 62% of the 2007 GDP. A 43.5% annual increase in granted loans was registered in January 2008. Loans have been edging up by 11.3% on average per quarter since 2004 [*A Survey of the Lithuanian Economy...* 2008].

Financial conditions in Lithuania slightly began to tighten up in the last quarter of 2007 as banks started to employ stricter lending policies in response to prudential concerns and as borrowing costs increased as liquidity decreased in the local and the EU money [*The Lithuania Business...* 2008]. Lending policy deteriorated considerably in the last quarter of 2008, therefore, loan portfolio development nearly stopped as Lithuania was affected by the global financial crisis what implied impaired loans and increased the quality of new lending risk [SEB 2009].⁸

Recent economic trends in Lithuania⁹ implied the deteriorating supply of financing, in particular from the banking sector, the decline of construction sector due to more strict lending policies of the bank. In such circumstances, the Government of the Republic of Lithuania has chosen to use the aid provided by the EIB in pursuing two aims: (1) to promote the most important economic sectors (such as economic and social, transport, health and education infrastructure, etc.)

⁸ The situation is explained by bank credit cycles which arise naturally as a result of business cycles. The price of bank credit also varies with the business cycle because it incorporates a risk premium. Hence, the expansion of bank credit is typically procyclical, whereas risk premiums and lending standards are countercyclical [*World Economic Outlook...* 2008].

⁹ According to the prognosis of Lithuanian Bank negative GDP growth (since 2008 Q4) is projected for the two coming years. GDP is expected to reach its lowest level in the second half of 2010 [*Economic Outlook for Lithuania* 2009]. Moreover, in March 2009 Ministry of Finance of the Republic of Lithuania projected that GDP could fall 10.5% in 2009 [*Projections of Lithuanian Economic...* 2009].

and (2) to ensure accessibility to credit resources for business through commercial banks (using financial engineering instrument).

The following Lithuanian government's incentives were important in order to implement the EIB financial instrument in the country. At the end of 2008 the new Government of the Republic of Lithuania attached high importance to JESSICA by including a reference to the initiative in its new programme, linking its potential implementation to modernisation and energy efficiency measures in the housing sector [*Resolution of the Government...* 2008]. In January 2009 Prime Minister issued the Decree on the Establishment of the Working Group led by the Ministry of Finance for the issues of the financing of housing renovation [*Decree on the Establishment...* 2009]¹⁰. In February 2009 the Ministry of Economy of the Republic of Lithuania adopted a recovery plan for the economy, which identified the renovation of multi-apartment housing through revolving fund as the major focus of the plan [*Economy Promotion Plan...* 2009]. In April 2009 the Government of the Republic of Lithuania approved a final financing model for the modernisation of multi-apartment houses provided by the Lithuanian Ministry of Finance. The Ministry of the Environment of the Republic of Lithuania is responsible for the implementation of this model of financing, while the Ministry of Finance is assigned to conduct negotiations with the EIB for the control of the proposed revolving fund.

The adaptation of the JESSICA instrument to the housing modernisation projects is an example of engineering the mechanism of the EIB financial instrument at the time of financial turmoil for the sector which is most severely affected by the crisis.¹¹ A decision to invite the EIB to be the fund manager also should be considered as an advantage because of the following reasons [Field 2008]: (1) the experience in implementing financial engineering initiatives, (2) the status of the international financial institution, which could increase credibility of the fund, (3) provision of technical assistance, (4) the best practice of funding of urban development projects and (5) additional loans for the fund [*Economy Promotion Plan...* 2009].¹²

¹⁰ JESSICA evaluation study for Lithuania was launched and a final report presented in January 2009. For an immediate short to mid-term perspective the report recommended the establishment of JESSICA financing in support of energy efficiency improvements in the housing sector [*JESSICA Evaluation Study...* 2009].

¹¹ The macroeconomic prognosis implies that the decline of the construction sector in the value added will be much more pronounced in the coming years. The Government of the Republic of Lithuania, in order to boost the country's economy, intended to finance housing modernization (instead of the construction of new facilities, which at the moment experience oversupply). Creating a revolving fund the government will ensure the involvement of commercial banks in the process of projects financing. The proposed scheme intends to amplify the supply of financing, in particular from the banking sector.

¹² To qualify to use JESSICA, the Member States must include an urban agenda in their Operational Programmes. Managing Authorities of the Member States can then use interim payments from their Structural Fund allocations by placing funds into either an urban development fund or a holding fund. It is possible to use the EIB as holding fund manager.

In addition to the previous activity, in March 2009 Lithuania signed a 1.147 billion euro loan with the European Investment Bank in order to strengthen the competitiveness of the Lithuanian economy and enhance the effective use of the EU grant funds allocated to the country. The operation of 1.132 billion euro is structured as a framework loan and will be used by Lithuania for investments in priority areas identified in the National Strategic Reference Framework and for the projects that were co-financed by the Cohesion Fund in the 2004-2006 programming period. The money will help Lithuania cover the cost of 9.564 billion euro worth of European Union-backed projects.¹³ The 4.2% fixed-rate loan has a 25 year term and that Lithuania would only be required to pay the interest for the first seven years [*Crisis-hit Lithuania...* 2009].

The EIB will also contribute to the real economy through smaller investments in Lithuania, by cooperating with AB DnB Nord Bankas, with a 15 million euro loan, which follows on from a series of other loans totalling 60 million euro over the 2005-2008 period in favour of Lithuania's banking sector [*EIB bolsters key...* 2009].

The lending provided in Lithuania also fits in with the broader measures announced by the EIB in December 2008 under the European Economic Recovery Package and Joint International Financial Institution Action Plan in support of Banking Systems and Lending to the Real Economy in Central and Eastern Europe [*Joint IFI Action Plan...* 2009] signed by the EIB, the EIF, EBRD, and the World Bank Group to support the banking system and the real economy in Central and Eastern Europe.

5. Conclusions

After Lithuania gained its independence, during the transformation process to market economy, the economic restructuring of the country required significant financial resources. The EIB has been financing projects fostering the integration of Lithuania into the European Union since the early 1990s. Following Lithuania's accession to the EU in May 2004, the EIB, as the European Union's policy-driven long-term financing institution, has been increasing its efforts to contribute to the balanced development and strengthened competitiveness of the country.

In the 15-year period 1994-2009 the EIB has been one of the largest multilateral lenders to Lithuania. The institution provided a total of about 1.7 billion euro for projects in Lithuania in support of economic and social growth of the country. Transport has been one of EIB's primary areas of intervention in Lithuania.

Recent economic trends in Lithuania implied the deteriorating supply of financing, in particular from the banking sector, the decline of construction sector

¹³ The loan will be dedicated for the composite infrastructure (556 million euro, 50% of total loan), transport (226.4 million euro, 20% of total loan) water and sewage (113.2 million euro, 10% of total loan), health and education (226.4 million euro; 20% of total loan) sectors [*EIB bolsters key...*, 2009].

due to stricter lending policies of the bank. In such circumstances, Lithuanian government has chosen to use the aid provided by the EIB in pursuing two aims: (1) to promote the most important economic sectors (such as economic and social, transport, health and education infrastructure, etc.), and (2) to ensure accessibility to credit resources for business through commercial banks.

In the present financial turmoil, with the tremendous lack of liquidity and credit for companies, the EIB is playing a major role in Lithuanian economic recovery plans. Lithuania is adopting new EIB financial instrument JESSICA to the housing modernisation projects. Also, in March 2009 Lithuania signed a 1.147 million euro loan with the EIB to co-finance projects financed from the EU structural funds. These measures will strengthen the competitiveness of the Lithuanian economy and help to speed up the effective distribution of the EU structural support.

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