REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget - situation at 31 December 2002

[SEC(2003)767]
# TABLE OF CONTENTS

Part One: Events since the Report at 30 June 2002, the risk situation and activation of Budget Guarantees ......................................................................................................................... 4

1. Introduction: types of operation ......................................................................................................................................................... 4
   1.1. Operations with macroeconomic objectives .......................................................................................................................... 4
   1.2. Operations with microeconomic objectives .......................................................................................................................... 4
2. Events since the report at 30 June 2002 ........................................................................................................................................ 4
   2.1. Ukraine ..................................................................................................................................................................................... 4
   2.2. Republic of Serbia and Montenegro ........................................................................................................................................ 4
   2.3. Bosnia and Herzegovina ............................................................................................................................................................ 5
   2.4. Moldova .................................................................................................................................................................................... 5
3. Risk situation ........................................................................................................................................................................................ 5
   3.1. Amount outstanding at 31 December 2002 .................................................................................................................................. 6
   3.2. Maximum annual risk borne by the Community budget: operations disbursed at 31 December 2002 .................................................. 6
   3.3. Maximum theoretical annual risk borne by the Community budget .............................................................................................. 6
4. Activation of budget guarantees .......................................................................................................................................................... 7
   4.1. Payments from cash resources ................................................................................................................................................ 7
   4.2. Activation of the Guarantee Fund .......................................................................................................................................... 7
5. Analysis of the Community's theoretical lending and guarantee capacity in respect of non-member countries ........................................................................................................................................ 7
6. Situation of the Guarantee Fund at 31 December 2002 .................................................................................................................. 8
7. Relative solidity ....................................................................................................................................................................................... 9

Part Two: Evaluation of potential risks: Economic and financial situation of the non-member countries benefiting from the most important loan operations .......................................................................................................................... 10

1. Introduction ........................................................................................................................................................................................................ 10
2. CANDIDATE COUNTRIES ........................................................................................................................................................................ 10
   2.1. Bulgaria ........................................................................................................................................................................................................ 10
   2.2. Romania ..................................................................................................................................................................................................... 11
   2.3. Turkey ....................................................................................................................................................................................................... 12
3. Western Balkans .................................................................................................................................................................................................. 13
   3.1. Bosnia and Herzegovina (BiH) .................................................................................................................................................... 13
Part One:
Events since the Report at 30 June 2002, the risk situation and activation of Budget Guarantees

1. INTRODUCTION: TYPES OF OPERATION

The risks covered by the Community budget derive from a variety of lending and guarantee operations which can be divided into two categories: loans with macroeconomic objectives and loans with microeconomic objectives.

1.1. Operations with macroeconomic objectives

The first of these are the balance-of-payments loans for Member States or non-member countries, normally carrying strict economic conditions and undertakings.

1.2. Operations with microeconomic objectives

These are loans to finance projects which are usually repaid over the long term from funds which these projects are expected to generate; as a rule, they are granted to companies, financial institutions or non-member countries and, in addition to the Community guarantee, are covered by the usual guarantees demanded by banks.

This covers Euratom and NCI² loans in Member States and the Euratom and EIB loans outside the Community (Mediterranean countries, Central and Eastern Europe, countries of Asia and Latin America, Republic of South Africa).

2. EVENTS SINCE THE REPORT AT 30 JUNE 2002

2.1. Ukraine

On 12 July 2002, the Council decided to provide macro-financial assistance to Ukraine. The amount to be granted is € 110 million in the form of a loan with a maximum maturity of fifteen years.

2.2. Republic of Serbia and Montenegro

On 5 December 2002, the Council decided to provide macro-financial assistance to the Republic of Serbia and Montenegro. The amount to be granted is € 55 million in the form of a loan with a maximum maturity of fifteen years and € 75 million in the form of non-repayable grants.

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1 Please note that a Commission Staff Working Paper contains an annex with a set of detailed tables and explicatory notes to this report, [SEC(2003)767].

2 Not active since 1995
2.3. **Bosnia and Herzegovina**

On 5 December 2002, the Council decided to provide macro-financial assistance to Bosnia and Herzegovina. The amount to be granted is € 20 million in the form of a loan with a maximum maturity of fifteen years and € 40 million in the form of non-repayable grants.

2.4. **Moldova**

On 19 December 2002, the Council decided to provide macro-financial assistance for an amount of € 15 million to Moldova in form of non-repayable grant. At the same time the Council decision of 10 July 2000 for macro-financial assistance to Moldova in form of a loan for an amount of € 15 Mio was cancelled.

3. **RISK SITUATION**

There are two methods for evaluating the risks borne by the Community budget:

- The method, often used by bankers, of the total amount of capital outstanding for the operations concerned on a given date (situation described in Annex Table A1);

- The more budgetary approach of calculating the maximum amount which the Community could have to pay out in each financial year.

The second approach itself has been applied in two different ways:

- By reference only to actual disbursements at the date of the report, assuming that there are no early repayments (see Annex Table A2 below showing the lower limit of this maximum risk to the Community budget);

- On a more forward-looking basis, by reference to all the operations decided by the Council or proposed by the Commission in order to estimate the impact on future budgets, assuming that the Commission's proposals are accepted (see Annex Table A3 below showing the upper limit of this maximum risk borne by the Community budget).

The latter exercise gives some idea of the future level of risks connected with the proposals made. However, a number of assumptions have to be made about dates of disbursement and terms of repayment (details are given in the Annex) as well as interest\(^3\) and exchange rates\(^4\).

The results are shown in Annex Tables A1 to A3, which make separate assessments of the risks relating to countries inside the Community and countries outside the Community.

The overall figures quoted cover risks of different types; loans to one country in the case of macro-financial assistance and loans for projects guaranteed by the borrowers in the case of NCI and EIB operations, for example.

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\(^3\) An interest rate of 5.49% has been applied for the new operations in Table A3.

\(^4\) The exchange rates used for loans in currencies other than the euro are those of 31. December 2002.
The following analysis distinguishes between total risk, the risk in respect of Member States and the risk in respect of non-member countries.

3.1. **Amount outstanding at 31 December 2002**

The total risk at 31 December 2002 came to € 15.216 million, as against € 15.118 million at 30 June 2002. Details are shown in Annex Table A1.

The following table shows the operations which have had an effect on the amount outstanding since the last report.

<table>
<thead>
<tr>
<th>TABLE 1: Capital outstanding at 31 December 2002*</th>
<th>€ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount outstanding at 30 June 2002</td>
<td>15.118</td>
</tr>
<tr>
<td>Loan repayments</td>
<td></td>
</tr>
<tr>
<td>Euratom</td>
<td>0</td>
</tr>
<tr>
<td>NIC</td>
<td>0</td>
</tr>
<tr>
<td>Financial assistance</td>
<td>-242</td>
</tr>
<tr>
<td>EIB</td>
<td>-649</td>
</tr>
<tr>
<td>Loans disbursed</td>
<td></td>
</tr>
<tr>
<td>Euratom</td>
<td>25</td>
</tr>
<tr>
<td>NIC</td>
<td>0</td>
</tr>
<tr>
<td>Financial assistance</td>
<td>0</td>
</tr>
<tr>
<td>EIB</td>
<td>1.194</td>
</tr>
<tr>
<td>Exchange rate differences between EURO and other currencies</td>
<td>-230</td>
</tr>
<tr>
<td>Amount outstanding at 31 December 2002</td>
<td>15.216</td>
</tr>
</tbody>
</table>

* all guaranteed loans (Member States, non Member States) confounded

The capital outstanding in respect of operations in the Member States was € 39 million at 31 December 2002, compared with € 45 million at 30 June 2002.

The capital outstanding from non-member countries at 31 December 2002 was € 15.177 million, compared with € 15.073 million at 30 June 2002.

3.2 **Maximum annual risk borne by the Community budget: operations disbursed at 31 December 2002**

- For 2003 the total risk amounts to € 1.818 million.
- The risk in respect of the Member States comes to € 15 million.
- The risk in respect of non-member countries comes to € 1.803 million.

Details of the maximum annual risk are set out in Annex Table A2.

3.3 **Maximum theoretical annual risk borne by the Community budget**

For 2003 the maximum theoretical risk amounts to € 1.930 million. It will increase from 2004 onwards and reach €3.637 million in 2011.
– The trend in the maximum theoretical risk in respect of Member States is the same as in Table A2.

– For the non-member countries it amounts to €1.915 million for 2003. The risk will increase from 2004 onwards to reach €3.637 million by 2011.

Details of the maximum theoretical annual risk is set out in Annex Table A3.

4. **Activation of Budget Guarantees**

4.1. **Payments from cash resources**

The Commission draws on its cash resources, under Article 12 of Council Regulation (EC, Euratom) No. 1150/2000 of 22 May 2000, implementing Decision 94/728/EC, Euratom, on the system of the Communities' own resources, in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying.

4.2. **Activation of the Guarantee Fund**

Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 established a Guarantee Fund for external action. In the event of late payment by a recipient of a loan granted by the Community, the Guarantee Fund is called on to cover the default within three months of the date on which payment is due. If a borrower defaults on an EIB loan guaranteed by the Community budget, the Community will act within three months of receiving a letter from the Bank calling for the guarantee to be activated. The Commission will then authorise the Bank to take the corresponding amounts from the Guarantee Fund.

Default interest for the time between the date on which cash resources are made available and the date of activation of the Fund is drawn from the Fund and repaid to the cash resources.

In the reference period the Fund has not been called on to honour guarantees.

5. **Analysis of the Community's Theoretical Lending and Guarantee Capacity in Respect of Non-Member Countries**

In practice, the Guarantee Fund and reserve facility limit the Community's lending and guarantee capacity to non-member countries, since the appropriations available for provisioning the Fund are limited by the amount entered for the guarantee reserve in the Financial Perspective\(^5\).

At any given time, the lending capacity corresponds to the margin remaining in the guarantee reserve. This margin is equal to the difference between the reserve and the estimated amount needed to provision the Guarantee Fund for operations which have already been adopted and which are in preparation.

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\(^5\) The annual figure entered in the 2000-2006 Financial Perspective is €200 million at 1999 prices.
Table A4 shows an estimate of the Community's lending capacity in respect of non-EU countries over the period 2003-2006 in line with the Guarantee Fund mechanism. The method of calculation and references to legal texts are set out in greater detail in the Annex.

On the basis of the decisions adopted by the Council or the Commission and decisions proposed and in preparation (see Annex Table A4), €194,58 million is expected to be used from the guarantee reserve in 2003, leaving € 22,42 million available at the end of the year.

If account is taken of the effect on the Guarantee reserve of the provisioning of the Fund in respect of loans already decided and loans proposed and in preparation for 2003, the annual capacity available for loans is as follows:

– € 249,11 million for loans with a 100% guarantee under the Community budget, or

At 31 December 2002, outstanding lending and loan guarantee operations for non-member countries totalled € 15.320 million.

<table>
<thead>
<tr>
<th>Table 2: Outstanding lending and loan guarantee operations for non-member countries (€ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Situation at 31 December 2002</strong></td>
</tr>
<tr>
<td>1. Capital outstanding, borrowing and lending 1.441</td>
</tr>
<tr>
<td>2. Capital outstanding, EIB 13.736</td>
</tr>
<tr>
<td>3. Capital outstanding, payments defaults 0</td>
</tr>
<tr>
<td>4. Default Interest</td>
</tr>
<tr>
<td>Unpaid interest due*</td>
</tr>
<tr>
<td>143</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
</tr>
<tr>
<td>15.320</td>
</tr>
</tbody>
</table>

* unpaid interest due within the meaning of the Regulation establishing the Guarantee Fund

The ratio between the Fund’s resources and outstanding capital liabilities, within the meaning of the Regulation establishing the Fund, was 10.71%, which is higher than the target figure of 9% set in Regulation No 1149/1999 amending Regulation No 2728/94 establishing the Fund.

The rules state that at the end of a year the surplus shall be paid back to a special heading in the statement of revenue in the general budget of the European Communities.

The surplus at the end of the financial year 2002 was € 263,33 million.

6. **Situation of the Guarantee Fund at 31 December 2002**

At 31 December 2002, the Guarantee Fund amounted to € 1.645,55 million. The following movements were recorded in the second half of 2002:

– no call to the Fund as a result of defaults;
– no late repayment (no arrears);
– net revenue of € 44.6 million on investments from the Fund’s assets;
– transfer of € 166.72 million from the 2002 reserve;
– an amount of € 372.46 million was repaid to the budget as Fund surplus as of 31 December 2001 in August 2002.

7. **RELATIVE SOLIDITY**

The ratio between the amount in the Fund at 31 December 2002 (€ 1.645.55 million) and the maximum annual risk for loans to non-member countries (defined as the total amount falling due) shown for 2003 in Annex Table A3 (€ 1.909 million) is 86 %.
Part Two: 
Evaluation of potential risks: Economic and financial situation of the non-member countries benefiting from the most important loan operations

1. **INTRODUCTION**

The figures in Part One provide information on quantitative aspects of the risk borne by the general budget. However, this data should be accompanied by an assessment of the quality of the risk, which depends on the type of operation and the standing of the borrower. Recent events, which may influence the portfolio country risk, are analysed below.

As in the previous reports, the country risk evaluation presented in Part Two comprises a table of risk indicators (see Annexes) for each non-member country that has received EC macro-financial assistance and still has outstanding debts to the EC. Moreover, other third countries each representing more than 2% of the total outstanding debt to the EC (notably through guarantees of EIB project related lending) and either categorised as “severely indebted” according to criteria set by the World Bank or facing notorious imbalances in their external or debt situation are also included in the risk evaluation.

To complement this, textual analysis is provided for all the countries studied in order to take into account new information influencing the risk evaluation.

Altogether, the country analysis now covers 40% of the total outstanding debt owned by the EC or guaranteed through its budget, thus providing a meaningful assessment of the risk.

2. **CANDIDATE COUNTRIES**

A trend towards economic stabilisation should be noted but uncertainties remain high in Turkey.

2.1. **Bulgaria**

In spite of the global economic slowdown, Bulgaria continues to benefit from high growth and stability. Real GDP growth was 4.4% in the first three quarters of 2002 and will not be much lower for the year as a whole, thanks to sustained domestic demand arising from private consumption and strong investment as well as a stronger external position than expected. Inflation is on a downward path (5.8% on annual average, 3.8% December-on-December).

The currency board arrangement (EUR 1 = BGN 1.95583) is being maintained and continues to be well covered by foreign reserves. It has not lead to a deterioration of external competitiveness given that real exchange rate appreciation was broadly matched by differences in productivity growth. The current account deficit will be around 4% of GDP in 2002, considerably lower than in previous years where it stood between 5% and 6% of GDP, not least due to higher revenues from tourism, lower interest payments and higher current transfers. However, net inflows of foreign direct investment have been lower than expected in 2002 and might not fully cover the current account deficit. Still, the foreign reserves of the central bank have further increased in 2002.
Fiscal discipline has been maintained over the last years and contributed to internal and external stabilisation. Similar to previous years, the general government sector had a (cash) deficit of 0.7% of GDP in 2002. Public debt is falling rapidly, from well above 100% of GDP in 1997 to below 60% of GDP at the end of 2002. Total external debt has decreased to below 70% of GDP. The government is conducting an active debt management with the objective of reducing risks by gradually shifting from a denomination in USD towards a denomination in EUR, from short-term to long-term maturity, from floating into fixed interest rate bonds and from foreign to domestic financing. In September 2002, a second Brady bond swap has been carried out with a net present value saving of USD 30 million.

2.2 Romania

During the second half of 2002, macroeconomic trends remained positive with sustained growth accompanied by sharper disinflation and renewed external retrenchment.

Romania’s three-year old recovery weathered the economic slow down in the EU as growth remained robust and its composition improved. In the first nine months of 2002, GDP increased by 4.5% as net exports contributed positively to growth for the first time during the current recovery. Despite the slowdown in the EU markets that account for some 67% of all Romanian goods export, in the first nine months of 2002, exports rose by 15.6% over the corresponding period in 2001 and imports by 11.9%. Rising domestic demand continued to underpin the recovery but the tightening of the macroeconomic stance implemented in the latter half of 2001 successfully slowed down booming household consumption growth. Investment expenditures, on the other hand, continued to expand rapidly at an annual rate of 7.8% over the first three quarters of 2002.

Positive economic growth has been accompanied by greater than expected domestic and external stabilisation. In 2002, the average rate of inflation dropped 12 percentage points to 22.5% while the current account deficit dropped sharply dispelling the concerns raised by its growth in 2001. As a result of an early rebound in goods exports, lower prices for energy imports and increasing private transfers from abroad, in fact, the cumulative current account deficit in US Dollar terms over the first 11 months of the year fell by nearly a third compared to the same period in 2001. While of late goods imports have been rising faster, exports have continued to expand at an even faster rate. Still, although the positive underlying influence exerted by rising private and public transfers from abroad should extend into the medium term, the trade deficit is likely to remain significant as rising per capita income and increasing investment needs will continue to suck in imports at a sustained pace.

Reflecting a positive macroeconomic performance, external financing conditions have been improving allowing Romania to easily meet its external financing needs, inter alia by launching its first ten-year euro bond in April 2002. With the debt-to-GDP ratio remaining low at an estimated 33.7% of GDP at end-November, in 2002, average debt maturity lengthened, sovereign risk ratings were repeatedly upgraded and spreads on sovereign bonds dropped to some 270 basis points. Standing at US$ 6.1 billion at end-December, official reserves increased by over 50% over the year.

While the on-going positive macroeconomic trends are likely to continue, structural weaknesses still cast a shadow over medium term prospects. The adoption of a more coherent mix in the context of the IMF stand-by arrangement agreed in October 2001 has proved instrumental in stabilising the external accounts and supporting disinflation. However, despite some progress towards harder budget constraints, excessive wage growth in several public enterprises and persistent arrears to the budget and public utilities are sources of concern.
privatisation process has also continued to stagger along, reflecting the poor attractiveness of various enterprises but also persistently non-transparent procedures and repeated demands for employment and investment commitments by prospective buyers.

2.3 Turkey

In 2002, the Turkish economy has been recovering from one of the sharpest recessions in the Republic's history. After a drastic output decline by 7.4% in 2001, real GDP rose by 6.5% during the first 3 quarters of 2002. For the whole period, an even slightly higher output growth appears possible. However, to a large extent this strong recovery reflects a base year effect, where the economy reaches pre-crisis output levels. National account data identifies restocking as main source of growth, while domestic demand components, such as consumption and investment, play only a minor role. Inflationary pressures have declined significantly during 2002, from a year-on-year CPI increase of 73.2% in January to 29.7% in December. Annual average consumer price inflation declined from 54.4% in 2001 to 45.0% in 2002. Important factors for this decline have been public sector wage increases, which were linked to an end-year inflation target of 35% and weak domestic demand. The 12-month CPI inflation target for end-2003 is 20%.

Due to the economic crisis, unemployment has increased from 8.5% in 2001 to 9.9% in the third quarter of 2002.

At present, the main risk is related to the sustainability of public finances. Due to the costs of bailing out the banking sector after the financial crisis in 2000/2001, the public sector's debt to GDP ratio has increased from 56.4% in 2000 to 101.4% in 2001. The general government deficit increased from 6% of GDP in 2000 to about 28.4% in 2001. The 2002 deficit amounted to about 15% of GDP. The overwhelming part of the additional debt has been financed on the domestic market. About two thirds of this debt are linked to short-term interest rates or the exchange rate, which leads to a very high sensitivity of the debt service towards fluctuations in interest rates and exchange rates. The Turkish government intends to achieve substantial primary surpluses, amounting to 6½% of GDP in 2003 and 2004 in order to reduce the public sector indebtedness.

During the last 5 years, the current account balance has been fluctuating between –4.9% and +2.3% of GDP. In 2002, the current account has been close to balance. In commodity trade, Turkey usually registers a considerable trade deficit amounting to about 3-7% of GDP. However, traditional surpluses in the tourist account and workers’ remittances largely finance this deficit. Foreign exchange reserves usually are at comfortable levels and cover short-term external liabilities. At the end of 2002, the Turkish central bank raised the reserves to USD 28 bn.

The possibility of a conflict in neighbouring Iraq significantly increases the uncertainties related to Turkey. A long lasting increase in oil prices and interest rates could severely impede the ongoing recovery of the Turkish economy, by increasing the costs of debt service and raising inflationary pressures. Continued instability in this region could also severely affect Turkey's tourism industry, which usually accounts for about 10-15% of Turkey's foreign exchange earnings.
3. **Western Balkans**

The sustainability of public and external debt remains an important issue in the region, particularly in the most indebted countries (Bosnia and Herzegovina, Serbia and Montenegro). One of the core objectives of IMF programmes is to ensure a sustainable situation of the budget and of the balance of payments. In the second half of 2002, the IMF approved new upper credit tranche arrangements in Bosnia and Herzegovina as well as Serbia and Montenegro. A new stand-by arrangement with the Former Yugoslav Republic of Macedonia is also to be agreed by the Fund's management in February 2003 and scheduled for Board approval. These recent favourable developments alleviate the economic tensions and uncertainties faced by those countries.

3.1 **Bosnia and Herzegovina (BiH)**

Over the reporting period BiH maintained macro-economic stability, low inflation, and continued efforts towards improved fiscal performance. However, with declining official aid flows, a sustained domestically generated economic growth is not yet apparent. Real output in BiH is estimated to have increased by around 4% in 2002, similar to the level in 2001. Continued strict adherence to the rules of the currency board provides a solid anchor for the downward trend of average inflation, estimated below 1% in 2002. Public sector indebtedness is very high, at 61% of GDP in 2002, and even potentially reaching 87% of GDP including frozen foreign currency deposits. War damage liabilities add a potential risk on indebtedness. Fiscal performance has improved, although the size of the administration remains large, with public spending at around 56% of GDP. Given the better revenue performance recorded in 2002, the estimated consolidated budget deficit has been revised downwards at 9.4% of GDP (4% after grants).

The current account deficit remains very high and (excluding official transfers) will amount in 2002 to 21% of GDP, a slight decrease from the recorded 23% of 2001. Net FDI is expected to have increased to EUR 260 million in 2002, compared with EUR145 million in 2001. Gross official reserves, which increased to over six months of import cover in 2001, due to the increasing shift towards the use of the national currency in the context of the Euro introduction, have stabilised in 2002 and cover around 5 months of imports. Although BiH is current on its external debt service obligations, the balance of payments remains vulnerable due to large external deficits, high public sector indebtedness, declining foreign assistance and low private investment.

External debt reached 52% of GDP at the end of 2002 and is expected to remain at this level over the medium-term. The ratio of debt service to exports has started to pick up (8.3% in 2002), and it will increase even further in 2003 (10%) and beyond, due to obligations to the IMF and the World Bank. The Central State, which ensures external debt servicing obligations, at present has no fiscal resources of its own and relies upon budget contributions from the two Entities to fulfil its obligations. BiH is not rated by the credit rating agencies. EBRD transition indicators, which reflect progress in reforms in Central and Eastern European countries, place BiH towards the low end of the scale, even though some progress has been recorded.

BiH has successfully negotiated a new 15-month IMF Stand-By Arrangement (SBA) (August 2002–November 2003) of about EUR 100 million. The first tranche (around EUR 29 million) was disbursed soon after approval, and the second tranche (around EUR 18 million) on 20 December 2002.
3.2 Former Yugoslav Republic of Macedonia (fYRoM)

The fYRoM economic performance in 2002 has been unimpressive. The political uncertainty surrounding the general elections in September and the lack of an IMF arrangement did not favour the economic and business climate. In 2002, GDP grew by 0.3% against a more positive initial forecast of 3-4%. Consumer prices increased by 2.4% on average. The 2002 general government deficit reached almost 6% of GDP, a slight decline compared to the deficit of 6.2% in 2001.

In February 2003, the national authorities reached an agreement on a long overdue stand-by arrangement with the IMF. The agreed macroeconomic framework for 2003 foresees real GDP growth of 3% and an inflation rate of 3%, and a target for the general government deficit of 2% of GDP (1.6% at the central level). Over the medium-term, the implementation of the new programme agreed with the IMF should deliver macroeconomic stability to the country.

In 2002, the trade deficit increased from USD 520 million in 2001 to around USD 750 million, which is equivalent to around 23% of GDP. The year-on-year increase in imports (+10%) was not matched by a similar trend in exports, which declined by about 4% with respect to 2001. However, thanks to a strong resumption in private and official transfers, the 2002 current account deficit is significantly lower than the trade deficit and estimated at 8.7% of GDP.

Pressures on the foreign exchange market led to a decline of official reserves towards the end of 2002, which however remained above USD 700 million, equivalent to more than four months of imports. The external debt as ratio to GDP is estimated to have increased from 38% in 2001 to 39% at the end of 2002, a level which is considered as sustainable.

3.3 Republic of Serbia and Montenegro

The outlook for the debt servicing capacity of Serbia and Montenegro (new name of the Federal Republic of Yugoslavia after the new Constitution became effective in early February 2003) remains broadly unchanged. In the second half of 2002 economic policies in the country continued to be geared towards sustaining macro-economic stability. Structural reforms continued on the basis of new legal and regulatory frameworks established in 2001, and in particular privatisation gained momentum, also reflected by stronger than expected inflows of Foreign Direct Investment (some USD 475 million for the whole year 2002). The cleaning up of the banking system has made progress, though the financial sector remains rather weak and exhibits a relatively low level of financial inter-mediation.

Confidence in the domestic currency was further strengthened, deposits in the domestic banking system increased substantially, and the value of the Dinar expressed in EUR remained broadly unchanged during the year. A substantial real appreciation was mainly due to price increases of non-tradables. Gross reserves of the National Bank of Serbia (former National Bank of Yugoslavia) almost doubled from around USD 1.200 million at end-2001 to USD 2.280 million at end-2002, to the equivalent of 3.5 months of imports. The large increase was due to a continued inflow of remittances from abroad and official financing by International Financial Institutions.

Even if Serbia and Montenegro continues with macro-economic stabilisation and sustains a good track record in structural reforms as envisaged under the current IMF Extended Arrangement (2002-2005), the external sustainability of the economy remains a major challenge for the authorities. Important financing requirements, mainly resulting from debt...
service obligations and the need to further strengthen foreign exchange reserves, will continue to put a heavy strain on the balance of payments. The country’s capacity to absorb new debt is limited and a cautious approach to new sovereign lending is warranted. Substantial debt relief (66%) is being provided by Paris Club creditors while negotiations with the London Club have not yet been concluded. The external debt (which stood at USD 11.5 billion in end-September 2002) will remain relatively high in 2003-2004 at 67% of GDP despite a planned reduction of the current account deficit from 11.7% in 2002 to 10.7% of GDP in 2004. Debt service obligations will rise considerably from around USD 343 million in 2002 (10.9% of exports of goods and services) to USD 467 million (12.9%) in 2003 and USD 719 million (17.4%) in 2004, reflecting the resumption of debt servicing after the Paris Club debt restructuring agreement of November 2001.

4. NEWLY INDEPENDENT STATES

Thanks to solid growth rates, the economic climate improves in general. However, the insufficient progress in structural reform in several countries in the region impedes any lasting improvement in the debt situation.

4.1 Armenia

The Armenian economy experienced strong growth also in the second half of the year 2002 which brought the real GDP growth rate to a record high level, estimated at 12.9% for the year as a whole (9.6% in 2001). Economic growth continued to be driven by the industrial sector (+14.2%), most importantly the diamonds processing sector but also other industrial sectors such as metallurgy and food processing did well in 2002. Consumer price inflation stayed low at 2% at end-2002 (3% at end-2001). Supported by remittances from abroad (estimated at about 4% of GDP) and a low inflation rate, the dram was fairly stable in nominal terms, in 2002. In real effective terms, the dram depreciated in 2001-2002 supporting significantly the competitiveness of the economy.

The Government managed to narrow the fiscal deficit last year. The central government deficit for 2002 is estimated at about 3% of GDP (further down from a deficit of 3.8% in 2001). VAT is the main factor behind the improved fiscal performance, reflecting both strong growths in domestic demand and better tax administration. VAT revenues increased by nearly 20% and accounted for 40% of fiscal revenues.

The current account deficit was narrowed further during 2002 to about 8.5% of GDP (9.5% in 2001). Exports were 48.5% higher than in 2001 and imports increased by 12.9%, which narrowed the trade deficit to 20.9% of GDP (25.2% in 2001). Precious metals and stones accounted for nearly half of total exports. Foreign direct investment picked up in 2002 with a more diversified sectoral distribution than before and a stronger focus towards SMEs. The WTO General Council approved Armenia’s accession to the WTO in December 2002.

Armenia’s external public and publicly guaranteed debt stock was USD 1.02 billion (about 42% of GDP) at end-December 2002. Nearly 80% of the debt is contracted on concessional terms. The NPV of the external debt stock is estimated to have decreased from 129% of exports in 2001 to about 120% in 2002. In November 2002, Armenia signed a debt-for-equity swap with Russia for the outstanding debt of about USD 100 million. The swap includes the transfer of five enterprises (including a thermal power plant) to Russia in settlement of the outstanding debt. It is projected that as a result of the swap the NPV of the external debt will be reduced to 96% of exports in 2003 when the swap takes place. Armenia is also negotiating
with Turkmenistan to barter commodities for its outstanding debts. The Central Bank’s gross international reserves increased in the second half of the year and were at a comfortable level at the end of the year, equivalent to 4 months of imports.

4.2 Belarus

The Belarusian economy continues to grow at around 4-5% year-on-year. However, industrial growth has slowed, and many enterprises remain non-profitable. Inventories have grown sharply, and investment lags. State-controlled agriculture is in poor financial shape. Export growth stagnated in 2002, and combined with modest import growth, this brought a rise in the trade deficit. The 2002 budget deficit equalled 1.2% of GDP. Inflation, however, has much slowed, which has allowed interest rates to fall, but recent money supply growth could reverse this process. The currency's depreciation against the Russian rouble has remained within the targets set by the central bank's crawling-peg arrangement. However, the National Bank of Belarus (NBB) is far from independent and will prioritise the government's requests for additional money over price stability.

The government is likely to attempt conducting a monetary policy that is sufficiently expansionary to meet the demands of the inefficient industrial and agricultural sectors, but without threatening political stability by allowing inflation to soar. Inflation would then be eased by pressuring commercial banks into buying government bonds and by attempting to attract money into term savings accounts. However, these policies will have only a moderate and temporary effect.

Russia’s willingness to accept payment arrears or extend soft loans is expected to be of major help in financing Belarus' balance of payments imbalances, in the absence of foreign direct investment (FDI) inflows or Western credits. In 2002, Russia has lent Belarus Rb4.5bn (USD 142m) to help stabilise the Belarusian currency, in three equal Rb1.5bn tranches. Aside from Russia, Belarus has few other sources of external funding. This is the primary reason behind the government's low level of indebtedness. In February 2003, the total foreign debt stock stood at USD 813 million or a mere 6% of GDP, according to official sources. In addition, Belarus still owes USD 265m to Russian natural gas suppliers, most of which was accumulated prior to 2001. This debt has been a subject of negotiation for more than three years.

The authorities continue to avoid structural reforms, despite the privatisation plans that were outlined in a new programme. The economic policies espoused by the government since the mid-1990s have sought to preserve much of the heavy industry inherited from the Soviet era and to prevent the emergence of a large private sector outside of state control. As a consequence and in contrast with the more advanced former communist countries in the region, therefore, small and medium-sized firms still only account for a tiny portion of GDP and are located primarily in retail trade and catering. As a result of these policies, almost 95% of the country's output still comes from large state-owned or state-controlled enterprises. The manufacturing sector, in particular, remains under direct government control, and the government routinely pressures commercial banks into providing loans to industrial enterprises at below-market interest rates.

There are no prospects for an IMF-lending programme in 2003.
4.3 Georgia

Preliminary data for the year 2002 show an increase in real GDP growth from 4.5% in 2001 to 5.4%. Agriculture, transport and construction drove economic growth. Consumer price inflation was 5.6% at end-2002 (5% at end-2001). The lari remained fairly stable in 2002 in nominal terms, supported by remittances from abroad.

The Government has taken some measures to improve revenue collection, and it has been able to reduce the stock of expenditure arrears while an overall expenditure restraint has been maintained. The year 2002 budget aims at an increase in the tax-to-GDP ratio for the general government from 14 ¼% in 2001 to 14 ¾%, reducing thereby the general government deficit further from 2% of GDP in 2001 to about 1.5%.

Georgia’s trade balance deteriorated during 2002. Exports increased only by 1.5% while imports went up 6.1% (imports consist mainly of oil and oil products and natural gas). In December 2001, the Parliament introduced a ban on the export of non-ferrous scrap metal (main export item of the country) as an attempt to prevent theft. The export ban was lifted in June 2002 under pressure from IFIs. Export revenues failed to recover sufficiently in the second half of the year, however. Georgia’s current account deficit is estimated to have remained unchanged from 6 ½% registered in 2001 (excluding transfers the deficit would be 10 ½%). An agreement was reached in December 2002 on the construction of the Baku-Tbilisi-Ceyhan oil pipeline and a parallel gas pipeline from Azerbaijan to Turkey through Georgia. Therefore, foreign direct investment will increase from 2003 to about 12% of GDP while in 2002 FDI is estimated to have stagnated at the level of 2001, at about 3% of GDP.

Georgia’s public and publicly guaranteed external debt stock is about USD 1.8 billion (about 54% of GDP), and its net present value currently amounts to over 300% of central government revenues. Because of the projected increase in the external debt service from 2003 onwards, Georgia is expected to seek an additional rescheduling of its bilateral debts. The National Bank’s gross international reserves increased during 2002, amounting currently to the equivalent of 1.7 month of imports.

4.4 Moldova

A favourable regional environment, driven by solid growth in Ukraine and Russia, has helped to bolster the Moldavian economy. Real GDP expanded by 5.9% in 2002, following 6.1% growth in 2001. Strong industrial production (up 11% in the year to 2002) continues to drive growth, spurred by export sales to Russia and rising domestic demand. In 2002, the exchange rate stabilised at 13-13.5 MDL/USD and inflation fell further to just 4.4% year-on-year in December 2002.

The economy is highly dependent on Russia, while the large agricultural sector means that climate conditions also have an important bearing on growth. Export products and markets are still relatively underdeveloped. Investment is limited as domestic confidence is low and FDI inflows have been disappointing. Structural reform, leading to a more transparent and a more business friendly environment would help to revive investment. The institutional framework and the overall investment climate is still relatively poor, with high levels of bureaucracy, corruption and harassment, resulting in high costs of doing business.

Although structural reforms have been accelerated in recent years, transformation to a market economy is far from complete. While land reform is almost completed, the government has only recently started with the privatisation of its key economic sectors. Traditionally,
drawbacks in the legal and administrative framework which directly affects the privatisation process and political interference have hindered the divestment of the large enterprises, in particular in the telecom, energy and wine sectors.

In the absence of serious interest in Moldova's national telecom operator, Moldtelecom, privatisation receipts have been again disappointing in 2002. Fiscal policy has remained tight, but deteriorated, as the government has struggled with the heavy burden of servicing its debts, presently amounting to over 110% of GDP. Debt servicing obligations absorb about half of government revenues, severely constraining the resources available. Dependence on capital flows from multilateral and bilateral creditors remains therefore very high. By April 2003, the IMF had not been able to complete the second review under a three-year USD 147 million PRGF. Going off track with the Fund could jeopardise around EUR 50 million in WB and IMF money and EUR 15 million in macro-financial assistance from the European Community, opening up a balance-of-payments and budgetary funding gap. It would also put a deal with the Paris club (which covers about USD 200 million in bilateral debt) at risk, and would raise doubts over structural reform and the medium-term outlook of the economy.

A combination of these fiscal and balance of payments problems in 2002 prompted the government to restructure its sole Eurobond, issued in 1997 at a maturity of five years and a face value of USD 75 million. After an early buying back of USD 35.6 million, USD 39.4 million was transferred into a seven years amortising bond.

4.5 Tajikistan

Tajikistan’s real GDP growth in 2002 is estimated at 9.1% (10.2% in 2001). Output in agriculture picked up 15% and industrial production increased by 8.2% driven by the aluminium sector. After a declining trend in monthly inflation rates in the first half of the year, rapid growth in reserve money contributed to a spike in inflation in the third quarter as the National Bank of Tajikistan issued directed credits to the cotton sector countervailing its previous policy announcements. The year therefore ended with consumer price inflation at about 14.5% (12.5% at end-2001), with highest increases seen in food prices. The National Bank of Tajikistan maintains a managed floating exchange rate regime allowing the somoni to depreciate in nominal and real terms. In 2002 the somoni depreciated some 15% against the USD, for the most part after the lapse in monetary policy in the third quarter.

The fiscal stance deteriorated slightly in 2002 with a deficit of 1% of GDP (0.1% in 2001) owing to expenditure increased in public salaries and reductions in cotton sales tax rates and income tax rates which are part of a larger tax reform agreed with the IMF. In 2002 the public investment programme (PIP) financed by concessional foreign lending was not yet included in the general government balances. Including the PIP explicitly in the fiscal balances brings the general government deficit to about 3% of GDP.

Owing to a good cotton harvest together with an increase in aluminium production, exports increased by 13% while imports were up by only 4.4%, which brought the trade balance into a surplus in 2002. Aluminium accounted for nearly 55% of total exports. The current account deficit is estimated to have reduced to about 4.2% of GDP in 2002 (7.2% in 2002). Excluding transfers, the current account deficit is estimated at about 12% of GDP (15.3% in 2001).

In December 2002, Tajikistan reached an agreement with Russia on restructuring the outstanding debt, involving also a partial write-down. The agreement contributed to the reduction in Tajikistan’s external debt from USD 1.02 billion (98% of GDP) at the end of 2001 to USD 985 million (88% of GDP) at the end of last year. Debt service was a high
burden on the country in 2002 corresponding to over 40% of fiscal revenues. The National Bank’s gross international reserve increased during 2002 and corresponded to 2,3 months of imports at the end of the year (1,9 months at end-2001).

4.6 Ukraine

Ukraine’s rate of economic growth decelerated from 9,1% in 2001 to 4,1% in 2002. Inflation has continued to surprise on the downside, with the CPI actually falling by 0,6 percent in 2002.

Despite the weaker than expected economic growth, the consolidated government managed to close 2002 with a surplus of about 1- percent of GDP. This reflected the implementation of expenditure cuts but also the accumulation of additional arrears on VAT refunds, despite the commitment under the IMF programme to clear such arrears. The budget for 2003 adopted by the parliament last December foresees a consolidated cash deficit of about 1¾ percent of GDP, which implies a considerable fiscal expansion.

The balance of payments has improved considerably in recent years. The current account has been in surplus since 1999. The surplus is estimated to have been in the order of 3½ percent of GDP in 2002, supported by strong receipts from current transfers and services. The debt rescheduling agreed with private bondholders in April 2000 and by the Paris Club in July 2001 have significantly eased Ukraine’s debt service obligations and official international reserves have continued to rise, reaching about USD 2,8 billion, or 2¼ months of imports, at end-September 2002. Moreover, in early December 2002, Ukraine regained access to the international capital markets (which it lost in the wake of the Russian crisis of 1998) with the issuance of a USD 399 million sovereign Eurobond maturing in 2007. The government plans to issue a new Eurobond in early 2003. FDI inflows, however, remain disappointingly low. The hryvnya has been remarkably stable in nominal terms since the sharp depreciation experienced in 1999.

Progress with structural reforms slowed down in 2001-02. In particular, privatisation revenues were in both years much lower than budgeted, partly reflecting delays in the privatisation of the regional electricity distribution companies (the “oblenergos”) and the state-owned telecommunications monopoly.

Ukraine’s EFF arrangement with the IMF, which had gone off track in early 2002, expired in September 2002. The authorities are currently negotiating a precautionary stand-by arrangement. In July 2002, the EU Council approved a new macro-financial assistance for Ukraine in the form of a loan of up to EUR 110 million. Discussions on the policy conditionality related to the first tranche of this assistance have been delayed due to absence of an operational agreement with the IMF.

5. OTHER NON-MEMBER COUNTRIES

Save for Algeria, the level of uncertainty remains high despite recent positive evolutions.

5.1 Algeria

A relative stable macroeconomic environment continues to prevail in Algeria, while no major structural changes can be observed. GDP is estimated to have increased to around 3,3% in 2002 (from 2,1% in 2001), with stimulus coming from both the fiscal and monetary policy. The 2002 consolidated fiscal deficit is expected to account for 3% of GDP (official target:
+0.4% of GDP) and together with a credit expansion is estimated to have pushed up the inflation rate to around 6% at the end of 2002. Despite its rich resources, Algeria remains plagued by a number of structural problems such as its dependence on hydrocarbon exports sector (>95% of exports, 30% of GDP) and its high agricultural sector. Furthermore, its domestic security problem undermines strongly investment activities.

The latest period of high oil prices is still impacting positively Algeria’s external accounts. Algeria is estimated to have maintained a current account surplus in 2002 (8.1% of GDP), although at a lower level than in 2000-01, as receipts from oil and gas exports started to decline. The oil windfall of the last two years reduced Algeria’s foreign debt level to around USD 21 bn (38% of GDP) in December 2002, while the debt-servicing ratio remains at a moderate level of around 27% of total current receipts. Foreign exchange reserves rose to more than USD 21 bn in December 2002, covering almost two years of imports, thus comforting the strong external position of the country.

5.2 Argentina

Over the last six months, the Argentinean economy has shown increasing signs of stabilisation and a nascent economic recovery. Real GDP is now estimated to have dropped by about 11% in 2002, much less than the 15-20% declines most forecasters were initially anticipating. The exchange rate has recovered inflation and interest rates have declined and funds are returning to the banking system.

By mid-February, the exchange rate had appreciated by about 22 percent relative to the trough of 3.9 reached at end-June 2002. After peaking at 10.5% in April 2002, monthly CPI inflation slowed to less than 0.5% in the final months of 2002. Private sector deposits increased significantly in the third and fourth quarters of 2002, leading the authorities to ease the restrictions of the withdrawal of bank deposits introduced in early 2002.

Reflecting the weakness of domestic demand and the lack of external financing, the current account (on a cash basis and, therefore, excluding interest payments on the defaulted debt) is estimated to have swung from a deficit of 1.7% of GDP in 2001 to a surplus of 7-8% of GDP. The central bank’s foreign exchange reserves have increased to USD 10.5 billion at end-2002, which compares to a trough of about USD 8.9 billion at end-July 2002. The more comfortable balance of payments position has also allowed the authorities to ease substantially, effective on 2 January 2003, their foreign exchange restrictions.

The IMF is bound, in January 2003, to approve a transitional agreement for Argentina effectively refinancing the country’s debt obligations to the IMF through August 2003. The deal includes a SDR 2.2 billion SBA and the extension of certain repurchases totalling SDR 2.8 billion. It is hoped that the IMF agreement will help consolidate the stabilisation and recovery trends. Assuming that this is the case, GDP is projected to recover moderately in 2002 before accelerating to about 5% in 2004. There are, however, serious downward risks to this scenario. The programme supported by the new IMF SBA is not sufficient to ensure medium-term fiscal and external solvency and significant uncertainties remain as to whether the government that will be formed after the April 2003 elections will adopt a more comprehensive programme.
5.3 Brazil

Brazilian currency and bond prices fell sharply in August-September 2002, reflecting fears of contagion from the Argentinean crisis and concerns about the future policies of the left-wing candidate, who was ridding high in the polls for the October presidential election. The prudent economic policies announced by the new administration (in particular, their commitment to fiscal discipline, inflation control and the IMF arrangement), however, have improved market sentiment, leading to a marked recovery in the real and bond prices. The sharp improvement in the current account balance (which has moved from a deficit of 4.6% of GDP in 2001 to around half that level last year) is also helping to reassure investors. To further reassure the markets, the Brazilian government has just announced, without the IMF requesting it, an increase in the primary fiscal surplus target for 2003 (from the 3.75% of GDP target that the IMF had agreed with the previous government to 4.25% of GDP).

But while the risk of a financial crisis has receded, the situation remains fragile and the risk of a debt default significant. Financial markets remain cautious and are waiting to see whether the authorities’ conservative rhetoric is matched by a capacity to implement the announced policies. Assuming that this is the case, growth is projected to pick up this year (to around 2.5%) and to further accelerate in 2004, as a still competitive exchange rate continues to produce strong export growth. Inflation is projected to accelerate moderately in 2003 (to around 10-11%), reflecting the delayed pass-through effects of last year’s depreciation, but to return to single-digit levels in 2004.

The IMF approved in September 2002 a 15-month SBA for Brazil in the amount of SDR 30 billion, the largest IMF loan ever. This arrangement, approved in response to the turmoil experienced by Brazilian markets during the summer, followed a USD 15.7 billion SBA approved in September 2001. The first tranche of the new SBA (USD 3 billion) was disbursed upon approval of the arrangement and the same amount was disbursed upon the successful completion of the first review of the programme in December 2002.

5.4 Jordan

Jordan has made considerable efforts at stabilisation and adjustment, supported by the international community, most recently under a two-year IMF Stand-by Arrangement having started in July-2002. This progress is reflected in strong growth performance (4.2% in 2001, 5% in 2002) despite the impact of increased regional tensions, the global slowdown, and the events of September 11th 2001. Inflation has been kept in check (average CPI of between 3 and 4% in 2001 and 2002) but fiscal deficits remain large at 8.1% of GDP in 2001 (3.7% after grants) and 10.1% of GDP in 2002 (4.1% after grants).

Jordan's external account has been characterised by high trade deficits (30% of GDP) and large service balances surpluses (remittances of 20% of GDP (net)), and grant inflows. Capital and financial account developments have allowed gross foreign exchange reserves to increase to broadly 7 months of imports or USD 2.8bn at the end of 2002. External debt has been reduced from 95% of GDP in 1998 to around 80% and the authorities are aiming to reduce the debt stock to around 60% of GDP by 2007 using privatisation proceeds and by increasing fiscal revenues to reduce deficits. Jordan's external vulnerability has been lowered in recent years, although its debt level can be still regarded as high. Most of the debt reduction was achieved through the use of privatisation proceeds, debt swaps and buy-back operations. The debt service ratio (around 20% in 2001) is expected to improve further, due to the July 2002 agreement with the Paris Club of creditor nations.
Despite the improved policy performance, reflected in stronger economic indicators, which will increase Jordan’s resilience to external shocks, large risks remain to the balance of payments and capacity to service external debt. Any military intervention in Iraq or increased regional tensions would have severe consequences for Jordan’s economy, notably its fiscal and external accounts. These effects would include, a loss of exports, lower tourist receipts, higher oil costs and lower remittances.
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<tr>
<th>Abbreviation</th>
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<tr>
<td>DM</td>
<td>Deutsche Mark</td>
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<tr>
<td>EC</td>
<td>European Community</td>
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<td>EFF</td>
<td>Extended Fund Facility</td>
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<td>EIB</td>
<td>European Investment Bank</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>GDP</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>SBA</td>
<td>Stand-By Arrangement</td>
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<td>US$</td>
<td>Dollar of the United States of America</td>
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