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REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget situation at 31 December 2003

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Part One:
Events since the Report at 30 June 2003, the risk situation and activation of Budget Guarantees[1]

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 to Member States or non-member States, normally carrying strict economic policy conditions.

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 States and, in addition to the Community guarantee, are covered by the usual guarantees demanded by banks.

This covers Euratom and NCI[2] 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 and Russia).

2. EVENTS SINCE THE REPORT AT 30 JUNE 2003

Regarding macro-financial assistance provided to third countries, a new Council decision amending Decision 2002/882 with regard to additional macro-financial assistance to Serbia and Montenegro was adopted on 25 November 2003[3]. Loan disbursements were carried out on the basis of existing decisions in favour of Romania (EUR 50 million), Serbia and Montenegro (EUR 30 million) and FYROM (EUR 18 million).

Regarding Euratom, no new Commission decision was adopted during the period and no new loan tranche disbursement was carried out on the basis of the existing decisions.

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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.
2 Not active since 1995
3 JO L 311, 27.11.2003, p. 28

3. RISK SITUATION

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

– The method, often used by bankers, of calculating 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 pending and planned Commission 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[4] and exchange rates[5].

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 in the case of NCI and EIB operations, for example.

The following analysis distinguishes between total risk, the risk in respect of Member States and the risk in respect of non-member States.

3.1. Capital outstanding at 31 December 2003

The total risk at 31 December 2003 came to EUR 15.062 million, as against EUR 15.067 million at 30 June 2003. Details are shown in Annex Table A1.

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

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4 An interest rate of 5,49% (communicated by the EIB) has been applied for its new operations in Table A3.

5 The exchange rates used for loans in currencies other than the euro are those of 31 December 2003.

Table 1: Capital outstanding at 31 December 2003*		EUR million (rounded)
Amount outstanding at 30 June 2003		15.067
Loan repayments		
	Euratom	0
	NIC	0
	Financial assistance	-115
	EIB	-640
Loans disbursed		
	Euratom	0
	NIC	0
	Financial assistance	98
	EIB	1.051
Exchange rate differences between EUR and other currencies		-399
Amount outstanding at 31 December 2003		15.062

* all guaranteed loans (Member States and non-member States) confounded, excluding unpaid interests due and payments defaults.

The capital outstanding in respect of operations in the Member States was EUR 24 million at 31 December 2003, compared with EUR 32 million at 30 June 2003.

The capital outstanding from non-member States at 31 December 2003 was EUR 15.037 million, compared with EUR 15.035 million at 30 June 2003.

3.2 Maximum annual risk borne by the Community budget: operations disbursed at 31 December 2003

– For 2004 the total risk amounts to EUR 1.962 million.

– The risk in respect of the Member States comes to EUR 24 million.

– The risk in respect of non-member States comes to EUR 1.938 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: operations disbursed and decided at 31 December 2003

For 2004 the maximum theoretical risk amounts to EUR 2.076 million. It will increase from 2005 onwards and reach EUR 3.712 million in 2012.

– The maximum theoretical risk in respect of Member States is the same as in Table A2.

– For the non-member States it amounts to EUR 2.053 million for 2004. The risk will increase from 2005 onwards to reach EUR 3.712 million by 2012.

Details of the maximum theoretical annual risk are 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 the Commission.

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 guarantee is called upon at the earliest 3 months of the date on which payment has fallen due. The Community will act within three months of receiving such 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 owed by loan beneficiaries for the time between the date on which cash resources are made available by the Community budget and the date of activation of the Fund is drawn from the Fund and repaid to the cash resources. For EIB loans, default interest is calculated for the time between the due date of a defaulted loan instalment and the date of receipt of the cash resources by the Bank from the Commission.

5. ANALYSIS OF THE COMMUNITY'S THEORETICAL LENDING AND GUARANTEE CAPACITY IN RESPECT OF NON-MEMBER STATES

In practice, the Guarantee Fund mechanism limits the Community's lending and guarantee capacity to non-member States, since the appropriations available for provisioning the Fund are limited by the amount entered for the guarantee reserve in the Financial Perspective[6].

At any given time, the lending capacity is limited by 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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[6] The annual figure entered in the 2000-2006 Financial Perspective is EUR 200 million at 1999 prices; in 2003, the amount was EUR 217 million and will be EUR 221 million in 2004.

Table A4 shows an estimate of the Community's lending capacity in respect of non-EU countries over the period 2004-2006 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 forecasted (see Annex Table A4), an amount of EUR 208,07 million is expected to be used from the guarantee reserve in 2004, leaving EUR 12,93 million available for further guarantee lending operations.

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 forecasted for 2004, the annual capacity available for loans is as follows:

– EUR 143,71 million for loans with a 100% guarantee under the Community budget, or

– EUR 221,09 million for loans with a 65% guarantee (in accordance with Council Decision 2000/24/EC of 22 December 1999).

At **31 December 2003**, outstanding lending and loan guarantee operations for non-member States totalled EUR 15.186 million.

Table 2: Outstanding lending and loan guarantee operations for non-member States in EUR million (rounded)	
1. Capital outstanding, borrowing and lending MTA, EURATOM	1.461
2. Capital outstanding, EIB	13.576
3. Payments defaults	3
4. Default Interest	0
5. Unpaid interest due*	146
Amount outstanding at 31 December 2003	15.186

* 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 10,48%, 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 Union. The surplus at the end of the financial year 2003 was EUR 223,16 million.

6. SITUATION OF THE GUARANTEE FUND AT 31 DECEMBER 2003

At 31 December 2003, the Guarantee Fund amounted to EUR 1.592,13 million. The following movements were recorded in the second half of 2003:

– on 22 August 2003 the Fund was called as a result of a default on a loan to the Republic of Argentina for an amount of USD 2.688.551,39 (EUR equivalent 2.468.518,13);

- the Commission was informed by EIB about arrears on a loan to the Republic of Argentina for an amount of USD 2.689.781,25 which could lead to a call on the Fund in the first half of 2004;

- net revenue of EUR 30,3 million on investments from the Fund's assets;

- the first annual transfer amounted to EUR 145,67 million from the Reserve into the Fund. The Fund's surplus of the year 2002 amounted to EUR 263,33. Those two amounts were netted under the mechanism for offsetting, resulting in a payment of EUR 117,66 million on 25 August 2003 from the Fund to the budget of the European Union. The second transfer was the subject of payment of EUR 2,25 million dated 2 January 2004.

7. RELATIVE SOLIDITY

The ratio between the amount in the Fund at 31 December 2003 (EUR 1.592,13 million) and the maximum theoretical annual risk for loans to non-member States in 2004 (EUR 2.053 million) amounts to 78% (see Annex Table A3).

Part Two:
Evaluation of potential risks: Economic and financial situation of the non-member States 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 is covering 44.8% 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

Real growth rates were maintained at above 4% in the region which helped the fiscal stabilisation but fuelled a substantial increase in imports leading to deterioration in external current accounts.

2.1. Bulgaria

In spite of the difficult global economic situation in 2003, the Bulgarian economy continued to benefit from high growth and stability. Real GDP continued growing at a rate of 4.2% in the first three quarters of 2003. It is sustained by strong private consumption and investment as a consequence of high increases in bank credits, employment and FDI inflows. However, strong domestic demand spilled over into high import growth which was not fully matched by export growth. Following a period of low inflation rates in the first half of 2003, these moved somewhat up in the second half due to higher food and energy prices. Inflation was therefore 2.3% on average and 5.6% at the end of 2003. Unemployment decreased substantially to 12.7% of the labour force until September 2003, and was more than 4.5% points lower compared to one year earlier. Many jobs were created in both the private sector and government employment schemes. The partly delayed privatisation programme could see a boost in the next weeks and months due to decisions to finalise the telecom privatisation in February and to implement a new strategy of a piecemeal sale of the tobacco company. The IMF Stand-by Arrangement of February 2002 was successfully completed in February 2004 and a new Pre-cautionary Arrangement is being considered.

The currency board arrangement, which is tying the national currency to the euro at a rate of BGN 1.95583= EUR 1, continues to be supported by high foreign reserves. The strong appreciation of the euro vis-à-vis the US dollar has contributed to some deterioration of external competitiveness, although the effects should be limited by the structure of Bulgaria's foreign trade, which has a high dollar-denominated share on the import side (energy, raw materials) and a high euro-denominated share on the export side (manufactured goods, tourism). Balance-of-payments figures available until November 2003 reveal that the current account deficit was much higher than in previous years because of a high trade deficit which was not offset as much as in previous years by other items of the current account. However, net errors and omissions were still above 2% of GDP and could result in a better outcome once final figures are available. Net inflows of foreign direct investment will see a record high in 2003, already reaching 6.6% of GDP until November. The foreign reserves of the central bank continued to increase and amount to more than 6 months of imports of goods and non-factor services.

Fiscal discipline continues to be a crucial element in preserving internal and external stability. Over the year 2003, the general government sector was running a cash surplus peaking at 2.8% of GDP in October. Following some extraordinary spending towards the end of year, a nearly balanced budget could have been achieved for the full year. Public debt has continued falling from above 100% of GDP in 1997 to below 50% of GDP in the second half of 2003. Total external debt has decreased to below 70% of GDP, also due to the high share of debt denominated in US dollar. The government continues its active debt management strategy with the objective of reducing risks by gradually shifting from a denomination in US dollar towards a denomination in euro, from short-term to long-term maturity, from floating into fixed interest rate bonds and from foreign to domestic financing.

2.2 Romania

During the second half of 2003, macroeconomic trends remained broadly positive with sustained growth accompanied by a further decline in inflation. However, growth appeared increasingly unbalanced, and signs of a widening current account deficit were clearly confirmed.

In October 2003, Romania successfully completed the final review of its Stand-By Arrangement with the IMF, which had contributed to sound macroeconomic policies and progress in structural reforms. Fiscal policy has remained fairly prudent, and monetary policy continues to pursue disinflation while preserving external competitiveness. In 2003, inflation remained on its downward path and with a 14.1% year-end inflation recorded, the Government's target for the year was met.

Romania's four-year old economic recovery was sustained as economic growth remained robust. After growing by 4.9% in 2002, real growth stood at 4.7% year-on-year during the first three quarters of 2003. However, growth was driven solely by domestic demand, characterised in particular by a sharp increase in household consumption at an annual rate of above 6% in the third quarter on the back of surging consumer credit and an average real wage increase of close to 9% in 2003.

With investment expenditure continuing to expand rapidly at an annual rate of nearly 8% over the first three quarters of 2003, import growth remained sustained and amounted to nearly 12% over the corresponding period in 2002. Export growth at the same time decelerated considerably over 2003 to slightly above 8% over the corresponding period in 2002. This was also reflected in industrial production growing at a significantly lower pace in 2003 than in previous years. As a result, the contribution of net exports to growth became negative in 2003.

The current account deficit widened significantly over 2003 and is expected to accumulate to well above 5% of GDP over the year. Against this background, fiscal measures have been announced for 2004 and measures in the banking system are under way aimed at limiting the credit growth to a pace consistent with containing the current account deficit.

While still at a relatively modest level, net foreign direct investment inflows passed EUR 1 billion in the first ten months of 2003, pointing to a modest increase compared to previous years.

Romania's official international reserves levelled off towards the end of 2003, but remained at a comfortable level of 3.7 months of goods and services import. Its sovereign debt rating was in December upgraded by several credit agencies both for national and foreign currency denominations. After rising to EUR 14.9 billion at end-2002, foreign debt rose further to EUR 16.0 billion in October 2003, but remained unchanged in terms of GDP (34.4% of GDP).

2.3 Turkey

In the short and medium-term, the Turkish authorities are faced with the challenging task of implementing IMF-backed reforms and servicing the country's heavy debt burden in a context of a widening current account deficit driven by recovering demand and a substantial real exchange-rate appreciation.

Economic output increased by more than 5% in 2003, based on strong exports and restocking, while consumption, so far, has remained subdued reflecting weak growth of real disposable income. One of the most important features during the last months has been the continued decline in inflationary pressures, reaching a new long-term low of 18.4% year-on-year consumer price inflation in December 2003. The official end-year target for 2003 was 20%, while the December 2004 target is 12%. The annual average inflation rate thus declined from 45.0% in 2002 to 25.3% in 2003. Key factors for this favourable development have been a strict fiscal policy and the significant real appreciation of the Turkish currency. Important reasons for the strength of the Turkish currency are improved market confidence, inverse currency substitution and the still high real interest differential. The continued downward trends in inflationary pressures and declining inflation expectations have allowed the

Turkish Central Bank to substantially reduce key interest rates. This should help to stimulate investment and consumption. Furthermore, financing costs of the public sector deficits have declined markedly.

Despite a number of generous expenditure measures by the present government, fiscal policy so far has remained largely on track. However, in view of local elections in March 2004 there is a risk of fiscal slippage in the near term. In 2003, the Turkish authorities remained on track with the IMF-agreed primary surplus target for the central government of 5% of GDP. The general government primary surplus is likely to be close to the official 6.5% of GDP target. The gross debt ratio is expected to decline from 95% of GDP in 2002 to 86.3% by the end of 2003.

The external balance has been deteriorating during the second half of 2003, from a deficit of 1.8% in the first 6 months to about 2.5% by November. Yet, tourism revenues performed surprisingly well after the rapid end of the war in neighbouring Iraq, while FDI inflows remained negligible. The central bank's foreign exchange reserves amounted to EUR 38 billion in December 2003 and covered approximately 6 months of imports.

3. WESTERN BALKANS

No marked change in the weight of public and external debts for countries of the region has occurred since the last report. The situation in FYROM has however continued to improve.

3.1 Bosnia and Herzegovina (BiH)

Under the current IMF programme (on-track), recently extended to end February 2004, in 2003 BiH maintained macro-economic stability, low inflation, and continued efforts with fiscal consolidation. The latest estimates point to a slowdown of real GDP growth, at 3.5% (down from 5.5% in 2002) weakened by a negative external environment and a drought, but also reflecting poor sources of domestically-generated growth, in a context of declining official aid. Strict adherence to the currency board has kept inflation under control, which in the first nine months of 2003 was 0.6% on average. Although the size of public expenditure remains high, it is estimated to have declined at 48% of GDP in 2003, against 51% in 2002. After the improved revenue performance recorded in 2002, with an estimated consolidated budget deficit revised downwards at 7.1% of GDP (2.2% after grants), for 2003 the authorities targeted a level of 6.4% of GDP (2.2% after grants). Due to good revenue performance, but also savings on the expenditure side, this target seems to have been over-achieved (September data), and the general government deficit is now estimated at 3.4% of GDP (with a slight surplus after grants). The size of domestic public debt (which includes arrears, war damages, and frozen currency deposits) still needs to be fully identified. It may have reached a level of around 45% of GDP, hence bringing total public debt at around 80% of GDP.

Owing to some tightening of monetary policy to counteract the credit boom, the current account deficit is estimated to have slightly decreased to just below 18% of GDP (against 18.5% in 2002). The level of gross official reserves should be equivalent to around 4.2 months of imports cover (against 4.8 months at end-2002).

According to the latest data, the external public debt (mostly due to repayments to the IMF and the World Bank) reached 39% of GDP at the end of 2002 (revised downwards from the projected 47%) and is expected to decline slightly over the medium-term. The ratio of debt service to exports, which increased to 8.5% in 2002, remained at the same level in 2003, and is expected to go down in the coming years. 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.

Overall, over the second semester of 2003, although BiH remained current on its external debt service obligations, the balance of payments and external debtor situation continued to be vulnerable due to large external deficits, declining foreign assistance, and high internal public sector indebtedness.

3.2 Former Yugoslav Republic of Macedonia (FYRoM)

GDP growth in the Former Yugoslav Republic of Macedonia is estimated to have reached 3% in 2003, which is broadly in line with the initial forecasts of the authorities and the IMF. Inflation continued to be low in 2003, with consumer prices increasing by 2.6% in December on an annual basis. Fiscal performance has improved considerably in 2003. The general government deficit is estimated at around 1.5% of GDP, against a forecast of 2.7% at the beginning of the year and compared to the 5.7% deficit which was recorded in 2002. In October 2003, the IMF Executive Board approved the first review of the Stand-By Arrangement, which will expire in June 2004.

On the external side, in 2003, there was a slight decline in the overall trade exchange in nominal (euro) terms. Exports remained stable compared to 2002, while imports decreased by 6%. The trade deficit is expected to have reached approximately EUR 700 million or 17.2% of GDP, lower than in 2002 in euro terms and as a share of GDP, but widening when measured in dollar terms owing to exchange rate effects. The 2003 current account deficit (before grants) is estimated at 8.3% of GDP or 6.2% of GDP after taking into account foreign assistance (2.1% of GDP). Foreign exchange reserves were maintained in 2003 to a level equivalent to around four months of imports, which is the target set by the IMF programme. The external debt significantly declined to 33% of GDP at the end of 2003, a rather moderate level compared to other countries in the region.

Risks to the balance of payments may arise from possible speculative pressures on the foreign exchange market, larger than expected imports due to tariff cuts and a decline in the inflow of private transfers. Over the medium-term, the main risks remain associated with the internal political situation and, in particular, persistent ethnic tensions within the country. Overall, over the second semester of 2003, the risk profile of the country continued to improve thanks to the fiscal consolidation and the maintenance of a sound macro-economic framework in agreement with the IMF.

3.3 Serbia and Montenegro

In the second half of 2003, macro-economic policies in Serbia and Montenegro continued to be geared towards sustaining macro-economic stability in line with the current IMF programme, a three-year Extended Arrangement approved in May 2002.

However, structural reforms advanced at a slower pace in 2003, and in particular the restructuring of large socially - and state-owned companies and the process of bank privatisation have been delayed. Real GDP grew by an estimated 3% (compared to an initial growth target of 3.5 to 4.5%) and was mainly driven by a good performance of services and transport while industrial and agricultural production declined as compared to the previous year. Inflation continued to decline to 8% by end 2003.

In the context of the IMF programme, the current account deficit of Serbia and Montenegro for 2003 was programmed to be lowered to 11% of GDP before grants (12.8% in 2002), as a result of a lower import demand and continued export recovery. The export/import ratio is still only 38.5%, and the trade deficit is estimated to have increased to 23.3% of GDP. Net current transfers, mostly in the form of remittances, increased by 37% (in the first eight months of 2003) and have helped financing a substantial part of the trade deficit. Some negative trends in the capital and financial account in the first half of 2003 were reversed in the remainder of the year, due to some successful privatisation deals in Serbia, which significantly contributed to a large net inflow of foreign direct investment (FDI) at EUR 1,060 million compared to an initially projected level of EUR 550 million. As a result, foreign exchange reserves continued to rise and are reported to have reached more than EUR 3 billion by the end of 2003 (equivalent to 4.5 months of imports). However, it is expected that the inflow of FDI will be substantially lower in the following years and it will become increasingly important that the reform process in Serbia and Montenegro drives moregreenfield FDI to ensure the external sustainability of the country.

As for external debt (estimated at EUR 11.5 billion or about 61% of GDP, end-September), after the overall agreement with the Paris Club (a phased reduction of the debt by 66%) had been reached in 2001, bilateral agreements with the main Paris Club members (except Italy, Japan and Finland) have been concluded. In November 2003, important agreements on debt relief were signed with China and the Russian Federation. However, despite a renewal of negotiations and efforts on the part of the authorities, Serbia and Montenegro has not yet reached an agreement with the London Club of commercial creditors, which have been reluctant to accommodate the authorities' objective to be granted generous terms similar to those of the Paris Club. Overall, after a difficult first semester, the external situation generally improved over the second half of 2003. However, the external sustainability of the economy will remain a major challenge in the coming years.

4. NEW INDEPENDENT STATES

Healthy growth rates contributed to budgetary stabilisation and overall improvement in external current accounts. If pursued and accompanied with progress in structural reform, this trend could lead to positive effects on debt sustainability.

4.1 Armenia

Armenia's economic growth performance continues to exceed expectations. During the first three quarters of 2003, real GDP growth reached 15.2%, mainly driven by the diamond polishing, construction, mining and metals sectors. Private grants and loans from Diaspora Armenian sources financed investments in housing, roads, and cultural sites equivalent to 2-3% of GDP both in 2002 and 2003. According to preliminary figures, economic growth for 2003 as whole is estimated at a new record rate of 13.9%. Industrial production increased nearly 15% while in agriculture the growth rate was only 4%. The 12-month rate of inflation was at 8.5% in December 2003, exceeding the target rate of three percent of the Central Bank of Armenia, owing to rapid increases in some food prices during the year. Fiscal policy remains prudent and the government was able to reduce the stock of domestic expenditure arrears to a negligible amount in 2003. Tax revenues as a ratio to GDP are still at a fairly low level (14.6% in 2002). In 2003 the nominal tax collection target was met but the tax revenues-to-GDP ratio is estimated to have decreased, partly because of high growth in grant-financed economic activities which are not being taxed. The fiscal deficit is projected at between 2-2.5% of GDP in 2003-2004. As in previous years, the budget deficit is covered mainly through external financing on concessional terms.

Supported by private and official transfers, the current account position has gradually improved over the past years. The trade balance deteriorated in 2003, owing to high imports' demand by the booming construction sector and the particular imports-exports cycles of the diamond processing sector. The current account balance is estimated to have increased from 6.6% of GDP in 2002 to 7.7% in 2003. The gross international reserves of the Central Bank of Armenia are comfortably high covering nearly four months of imports. The dram has been broadly stable, and in real effective terms it is estimated to have appreciated very slightly in 2003 after a decline in 2002. The debt-to-equity swap with Russia curbed the increase in the nominal external debt in 2003, and in nominal US dollar terms the external debt remained stable at about 1020 million in 2003, while as a ratio to GDP it is estimated to have declined to below 40%. Armenia also repaid its outstanding debt to Turkmenistan in kind. On the other hand, robust growth in exports, mainly polished diamonds, has meant that the net present value of the external debt as a ratio of exports declined from about 130% at the end of 2002 to an estimated 94% in 2003.

4.2 Belarus

According to the preliminary official figures, real GDP growth in Belarus in 2003 accelerated from 4.7% in 2001-2002 to 6.8%. Belarus seems therefore to be back on the growth track after a marked slowdown recorded in recent years when the country's performance was significantly lagging in the former Soviet Union economic space. The Belarus' economy follows closely that of Russia and its rebound in 2003 is largely explained by Russia's buoyant economic performance. Indeed, much of the Belarus manufacturing sector is closely integrated with Russian enterprises, Russia absorbs a substantial portion of Belarus' exports – both industrial and agricultural – and many Belarus nationals work in Russia.

In 2003 inflation still exceeded 25% (the highest annual inflation in the former Soviet Union). Although these inflation rates represent a clear improvement compared to the hyperinflation of the last few years (in 2000, CPI inflation had amounted to 169%), they reflect a still relatively loose monetary policy stance, which is inconsistent with a hard peg of the exchange rate to the Russian rouble (Belarus is aiming for full monetary union with Russia, planned for January 2005). In order to reduce inflation permanently, wage increases should not exceed productivity gains and the provision of easy credit should be curtailed, which is politically difficult given the large role of State-owned enterprises and the persistence of an economic model intent on perpetuating the administration's tight control over the country's political and economic space. A tighter monetary policy would also provide real incentives for restructuring the outmoded and inefficient economic structures in place, given that typically, important firms are kept solvable through generous credit financing. This stance has consistently blocked the resumption of any financing by the IMF.

Since the start of 2000 the government has accepted the need to unify the currency's various exchange rates, has replaced all quasi-fiscal operations by the central bank with subsidies through the government budget and has promised to curb pressure on the commercial banks to issue credit to key sectors. The government's exchange-rate liberalisation and the proposed currency union with Russia could prove to be a major improvement, if underpinned by comprehensive structural reforms.

Since late 2001 the government has been negotiating the sales of petrochemical enterprises to Russian companies – as settlement for gas deliveries and in the hope that this might provide the additional financing needed to preserve economic growth and low unemployment without needing to change current policies.

Although the current account position of Belarus is threatened by a growing negative trade balance and very low international reserves, the country's fiscal situation is stable and the general government cash deficit is low (it was estimated at little more than 1% of GDP in 2003). Belarus has a low level of State foreign debt (reportedly 4.4% of GDP at end-2003). It is servicing debt to the EU regularly. Foreign debt declined by 9.4% in 2003.

4.3 Georgia

Real GDP growth was 8.3% year-on-year in the first three quarters of 2003, owing mainly to strong growth performance in construction and agriculture. The construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline started on Georgian territory in April and the construction continues until 2005. The preliminary estimates give a real GDP growth rate of about 8.5% also for 2003 as a whole. Agriculture is the largest sector of the economy, and in 2003 weather conditions were favourable contributing to about 10% growth in agriculture. In addition to agriculture and construction, the extraction sector (aluminium, ferro-alloys, copper, gold and scrap metals) and manufacturing (wine, fertilisers, mineral water) have also registered strong growth.

A large part of economic activity remains unrecorded and smuggling is pervasive. Therefore, the robust growth rates registered across several sectors of the economy did not translate into an improvement in tax revenue collection. On commitment basis, a fiscal deficit of 2.9% of GDP is projected for 2003, while on cash basis the deficit is actually lower than in 2002 because of the net accumulation of expenditure arrears. The political turmoil in November brought additional difficulties for fiscal management but donor funding was available for immediate needs. The draft 2004 budget, which was submitted to the parliament in October 2003, was recalled for revision by the new government. The parameters of the fiscal programme shall be discussed with the IMF in early 2004.

The National Bank of Georgia has maintained a consistently prudent monetary policy stance. Despite the favourable year in agricultural production which subdued some inflationary pressures, the consumer price inflation increased to 7% at end-December 2003. This was partly due to increases in tariffs and utility prices, but also because price increases were evidenced during the political turmoil in November. The lari remained remarkably stable against the US dollar also during November and December. In real effective terms the lari is estimated to have appreciated slightly in 2003.

The current account deficit increased rapidly in 2003 to about 10% of GDP owing to the imports for the construction of the BTC pipeline. The increase in the deficit is financed by foreign direct investment. The gross international reserves of the National Bank of Georgia declined from an already low level to about the equivalent of 1.5 month of imports (excluding the pipeline-related imports). In terms of US dollars, the external debt of Georgia continued to increase in 2003 but as a ratio to GDP the nominal debt stock is projected to have declined to 48% at the end of 2003. Georgia was not able to approach its bilateral creditors at the Paris Club for a rescheduling of 2003 loan maturities as foreseen in the 2001 Paris Club agreement because the country's arrangement with the IMF was suspended in August 2003.

4.4 Moldova

In 2003, Moldova's GDP grew by around 6%, largely thanks to a very favourable economic situation in Russia and Ukraine, Moldova's main trade partners. This year, a generally sound policy mix is expected to ensure moderately strong growth at around 5%, and contain significant price and currency instability.

Although exports have continued to increase at a rapid pace, imports, fuelled by very high remittances from Moldovans working abroad, have grown faster still, worsening Moldova's structurally high current-account deficit. Even if oil prices eased relatively quickly, for the next few years Moldova is expected to record annual trade deficits equivalent to roughly 25% of GDP, and annual current-account deficits ranging between 7% and 8% of GDP in the coming years.

The risks created by the concentration of Moldova's export base on a narrow range of products (notably wine and agricultural produce) are mitigated by the likelihood that inflows of remittances from abroad will remain large. In the short term, remittances remain of crucial importance for Moldova, given that the country is expected to have difficulty to access external financing or attract investment in the short run. In the medium and long term, however, the pace of economic development will hinge on Moldova's ability to attract inflows of foreign direct investment (FDI) and to regain access to the Eurobond market.

Despite satisfactory GDP growth rates the budgetary situation remains grave. The foreign debt to GDP ratio is unsustainable[7], despite a series of bilateral rescheduling

[7] As at end-2002, total external debt was 102% of GDP. Public and public-guaranteed debt was lower at 65% of GDP.

between 1999 and 2002; servicing debt fully would require close to half the State revenues. Moldova suspended debt payments to Gazprom at end-2001 and to bilateral creditors in August 2003, while continuing to pay multilaterals and Eurobond holders.

Under pressure, the government has tightened considerably the fiscal stance, cutting social expenditure sharply. In 2003, a primary budget surplus of around 2% of GDP was achieved. Despite positive GDP growth since 2000, budgetary planning has continued to rely heavily on privatisation proceeds, which, however, have fallen far short of hopes because of slow progress in structural reform and of the difficulties encountered by Western investors in Moldova, which have led to very low levels of inward FDI.

The government is unlikely to reverse the fiscal improvements achieved since 1999, but has little room for manoeuvre, given the limited financing options. It has failed to secure IMF and World Bank financing in 2003, except small sums for targeted projects, and its privatisation targets seem optimistic. In 2004 problems with budget planning and implementation are unlikely to diminish; given that IMF projections indicate a sizeable financing gap and the prospects for a new IMF programme look slim. Generally, budgetary policy remains hampered by poor administrative capacity and by a continued risk that parliament might force through populist measures, and by very high debt servicing requirements.

4.5 Tajikistan

Real GDP growth was strong in the first three quarters of 2003, increasing by 7.9% compared to the same period a year earlier. The sources of growth continue to become more diversified. Traditional sectors (cotton and aluminium) showed modest expansion, while services (mostly trade), non-aluminium manufacturing and non-cotton agriculture accounted for two-thirds of growth in the first nine months of 2003. Growth in domestic demand was supported by a large expansion of migrants' remittances (for 2003 these are projected to be equivalent at 15% of GDP). Given the strong output performance and the high world prices for cotton and aluminium, growth is projected to be 9% for 2003 as a whole.

The overall fiscal surplus for 2003 is estimated at 0.6% of GDP. The Public Investment Programme and quasi-fiscal deficits are not included in the official budget figures. The IMF estimates that the quasi-fiscal deficit in the energy sector amounts to 5.5% of GDP. About two thirds result from low tariffs and technical losses, while the remainder stems from low collection rates. Due to high economic growth and better tax collection, the tax to GDP ratio increased from 14.1% in 2001 to 14.7% in 2002. Tax collection for 2003 as a whole is estimated at 15.5% of GDP and is projected to increase further this year to 16.2%. This increase is mainly due to improved tax administration, particularly for VAT. Little budgetary support is to be expected from the privatisation programme, from which revenue remains extremely weak. In any case, the government will remain reliant on multilateral financing to cover its budget deficit.

Although Tajikistan's external debt is large, it has declined from 82% of GDP at end-2002 to a projected 73% at end-2003, due to debt restructuring agreements with bilateral creditors and the strong growth of GDP in last years. The grace period provided in the restructuring agreement with Russia (December 2002) ends in 2005 and therefore debt service costs are expected to rise significantly for the period 2005-2009.

The current account balance strengthened in the first nine months of 2003, compared to the same period a year earlier. This reflects higher than projected migrants' remittances combined with higher international prices for cotton and aluminium. The increased volume of migrants' remittances sent through commercial banks reflects increased confidence in the banks as well as a higher number of migrants working abroad due to the lack of domestic employment opportunities. Gross international reserves increased by 38% during the first nine months of 2003. Significantly higher imports associated with rapid growth, however, means that import coverage is projected to be unchanged at end-2003 (1.8 month) compared to end-2002.

4.6 Ukraine

Ukraine's GDP growth accelerated from 4.1% in 2002 to 8.5% in 2003, amply exceeding expectations. This high rate of economic expansion, combined with the effect of the poor harvest on food prices, has rekindled inflationary pressures (after the unprecedented deflation seen in 2002) but inflation remains in the single digits. Reflecting the faster than expected economic growth, fiscal performance in 2003 was better than budgeted, with the consolidated government ending the year with a small surplus. The budget for 2004 is consistent within a consolidated budget target of 1.5% of GDP.

Ukraine's balance of payments has strengthened very significantly since 1990. Since 1999, the current account has been consistently in surplus, with the surplus reaching about 5% of GDP in 2003. The current account surplus has contributed to a significant build-up in official foreign exchange reserves, which rose from about USD 1 billion at end-1999 to USD 7 billion (just over 3 months of imports) in early January 2004. The debt rescheduling agreed with private bondholders in April 2000 and by the Paris Club in July 2001 has significantly eased Ukraine's debt service obligations. Debt and debt service ratios have shown a downward trend since 2000, although the country's debt service is expected to rise temporarily in 2003-06. In December 2002, Ukraine regained access to the international capital markets (which it had lost in the wake of the Russian financial crisis of 1998) with the issuance of a USD 350 million Eurobond. This was followed in early June 2003 by the issuance of a USD 800 million, 10-year Eurobond, which was oversubscribed and carried an annual interest rate of only 7.65%. Since 2001, secondary market yield spreads on Ukrainian Eurobonds have narrowed markedly and the main international rating agencies have upgraded Ukraine several times.

Progress with structural reforms, which slowed down significantly in 2001-02, remains the country's key economic challenge. During 2003, encouraging measures were taken in a number of areas, including tax reform and the adoption of new pension legislation, but progress in other areas, notably the energy sector, remains very disappointing.

Ukraine is close to agreeing on a pre-cautionary stand-by arrangement with the IMF and is considering repaying ahead of schedule part of its debts to the IMF. It is also discussing with the European Commission the possible policy conditions to be attached to the disbursement of a macro-financial assistance of up to EUR 110 million approved by the Council in July 2002.

5. OTHER NON-MEMBER STATES

The overall trend in these economies is of improvement of their current accounts which have posted surplus for all of them in 2003.

5.1 Algeria

In 2003, economic growth has accelerated significantly to around 7%, mainly on the back of a strong recovery in the agriculture sector and a surge in hydrocarbon revenues. Cereal output expanded by more than 20% this year, owing to better meteorological conditions, but also to government financial assistance and higher investments in the agricultural sector. The strongest contribution to growth came from the hydrocarbon sector, as crude oil production amounted to an average 1.11 million barrels/day. With regard to fiscal policy the overall fiscal balance reached a surplus in 2003, as strong expenditure growth was outpaced by the increase in oil revenues. However, the primary non-hydrocarbon deficit deteriorated to around 32% of GDP. The 2004 budget retains the current expansionary fiscal stance, with the primary non-hydrocarbon deficit projected to amount to its – already high – 2003 level.

Algeria’s external account situation improved further in 2003. Exports advanced strongly in the first eight months of 2003, reaching USD 15.2 billion, up 30% compared to the same period a year earlier. This was mostly due to a surge in hydrocarbon exports, coupled with favourable oil price developments, while non-oil exports dropped by 10.7%. Algeria achieved another substantial current account surplus in 2003 (11.5% of GDP), while the debt-servicing ratio remained below the 20% level. External debt indicators have improved in 2003 thanks to debt repayments. The external debt, which already decreased from USD 28.3 billion at the end of 1999 to an estimated level of USD 23 billion at the end of 2002 (40% of GDP), declined further to around 33% of GDP by the end of 2003. The favourable composition of the maturity structure of foreign debt - 99.3 % of the debt is medium- and long term debt - softens Algeria's immediate vulnerability, in particular given the presence of strongly increasing foreign exchange reserves (USD 31.5 billion at the end of December 2003).

Despite the current comfortable external account and debt situation a number of risks related to the sustainability of the debt situation and macroeconomic stability remain. First, a long and sustained lasting decline in oil prices could result in a significant rise in public debt, as oil revenues currently account for 95% of export revenues and 60% of budgetary revenues. Secondly, the fiscal expansionary stance and the related increase in liquidity increases inflationary risks and are detrimental for macroeconomic stability. Finally, the slow process of structural reforms as well as the related slow pace of job creation does not allow alleviating pressures stemming from high labour force growth rates and significant poverty.

5.2 Argentina

Argentina's economic and financial situation has continued to strengthen. Real GDP is estimated to have expanded by 7-8% in 2003, reflecting a strong rebound in manufacturing and construction. At the same time, inflation remains under control, with the CPI estimated to have increased by only 3.7% in 2003, significantly below the 5.6% projected under the IMF programme. The delay in the adjustment of utility tariffs is partly responsible for this better than programmed inflation performance, however.

Fiscal policy remains in line with the IMF programme, with tax revenues moderately exceeding the programme's projections. Congress has approved a Budget for 2004 that is consistent with the IMF programme's objective of a primary fiscal surplus of at least 3% of GDP. As regards monetary policy, the quantitative performance criteria set under the IMF programme for end-October were met with wide margins and there has been further progress in the process of redemption of quasi monies. Funds have continued to return slowly to the banking system and the exchange rate has been relatively stable, fluctuating most of the time within a relatively narrow band of 2.9-3 pesos per dollar. The current account continues to show a sizeable surplus and official foreign exchange reserves rose to about USD 14 billion at end-2003.

On 20 September 2003, the *IMF* approved a new, three-year stand-by arrangement (SBA) for Argentina in the amount of about USD 12.5 billion, as well as a one-year extension of repurchases amounting to about USD 2.43 billion. The completion of the first review of the SBA programme, which was initially scheduled to be completed in December, was delayed until 28 January. Although Argentina met all the macroeconomic performance criteria for end-October 2003, it failed to implement some of the structural measures, which required the IMF Board to grant several waivers. Also, many Directors expressed doubts about the authorities' compliance with the good faith criterion in its debt negotiations with private creditors, a criterion that needs to be satisfied for the IMF to lend to countries in arrears.

The completion of the first review allowed Argentina to make a purchase of about USD 335 million. An important purchase (of about USD 2.9 billion) is scheduled for mid-March 2004, coinciding with a repurchase of the same magnitude. The release of this purchase is linked to the completion of the second review of the IMF programme. The authorities have indicated that the repayment due in March will be conditional on the approval of the second review, underlying, once again, the risk that Argentina may again default on its debts to the international financial institutions. Finally, regarding EIB loans, a new default of payment had to be recorded in the second half of 2003 (see § 4.2. and § 6. in Part I).

5.3 Brazil

The Brazilian economy recorded a disappointing growth performance in 2003, with GDP being nearly flat. Economic activity began to recover in the third quarter of 2003, however, and GDP growth is projected to accelerate to 3.5% in 2004 and 4.5% in 2005. Inflation, which had jumped from around 7% in mid-2002 to nearly 18% in

May 2003, has been on a downward trend since then. The government is targeting an inflation rate range of 5.5 ± 1.5 percentage points for end-2004.

The prudent policies implemented by the new administration and increased investor appetite for emerging market assets have resulted in an impressive correction in financial market indicators. The exchange rate has appreciated by about 30% since President Lula da Silva was elected and official reserves have risen considerably. Spreads on Brazilian bonds have narrowed to levels not seen since 1998, Brazilian issuers have regained access to the international capital markets and foreign portfolio inflows have pushed the stock market index to an all-time high. One factor that has contributed to the improvement in market sentiment is the steady progress with the structural reform agenda, including the congressional adoption of key laws on tax reform, pension reform and bankruptcy.

Since June 2003, the central bank has cut interest rates by about 8% points, reversing the sharp tightening of monetary policy that took place between October and February. Fiscal policy has been tight, overperforming the IMF programme's targets. The 2004 budget targets a primary surplus of 4.25% of GDP, the same as in 2003, which is consistent (under reasonable macroeconomic assumptions) with a significant reduction in the debt/GDP ratio over the medium term. The public sector borrowing requirement is projected to decline from 5.5% of GDP in 2003 to about 3.25% of GDP in 2004.

Supported by strong exports and subdued domestic demand, the current account posted a small surplus last year but it is projected to move back into deficit in 2004-2005 as the recovery of domestic demand gathers momentum. The authorities have continued to make progress in improving the composition of public debt so as to reduce vulnerability to external financial shocks. Brazil's external financial position remains vulnerable, however: FDI inflows have fallen sharply, debt repayments are scheduled to increase quite markedly this year and Brazil's ratio of gross reserves to short-term debt remains below 1.

5.4 Jordan

The conflict in Iraq adversely affected performance in 2003, with real GDP growth decelerating to about 3% from 5% the previous year. Considering the unfavourable regional environment, such performance is however relatively positive and is mainly due to massive foreign support as well as improved economic conditions in the second half of 2003 (in particular, the recovery of the transport and tourism sectors, the resumption of exports to Iraq and some recovery of domestic demand). Inflation is estimated to have risen to about 3.6% y-o-y at the end of 2003, due to increases in goods and services taxes and increased money supply.

The current account ended with a large surplus of about 7% of GDP, particularly due to additional donor assistance. Jordan's external vulnerability has been lowered in recent years due to improved policy performance and structural reforms including privatisation. This is reflected in stronger economic indicators and a higher level of reserves (USD 4.5 billion or over 10 months of imports), which increases Jordan's resilience to external shocks. Although its debt level is very high, particularly the external debt, sound policies and reforms are expected to lead to further improvements. Government external debt has been reduced from 95% of GDP in

1998 to below 80% in 2003, and the authorities are aiming to reduce the debt stock to around 50% of GDP by 2007 by reducing deficits and allocating privatisation proceeds to debt reduction. Importantly, the debt service ratio has also decreased substantially from around 34% ten years ago to 21% in 2003, reducing the risk of external default.

In mid 2003 Moody's rating agency upgraded the rating of Jordan's sovereign foreign currency bonds to Ba2 from Ba3, and the government's domestic debt to Baa3 from Ba3. All the new ratings carry stable outlooks. This upgrade reflects the positive impact on macro-economic performance of the reforms undertaken over the past few years and the rise of foreign currency reserves.

List of abbreviations

EC	European Community
EIB	European Investment Bank
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
SBA	Stand-By Arrangement
USD	Dollar of the United States of America