COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget situation at 31 December 2004

{SEC(2005) 915}

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Part One: Events since the Report at 30 June 2004, the risk situation and activation of Budget Guarantees [1]

1. INTRODUCTION: TYPES OF OPERATION

The risks covered by the Union budget derive from a variety of lending and guarantee operations which can be divided into two categories: loans granted by the European Communities with macroeconomic objectives (balance-of-payments loans to Member States and macro-financial assistance (MFA) loans to non-member States) and loans with microeconomic objectives (Euratom and EC-NCI[2] loans in Member States and Euratom and European Investment Bank (EIB) loans[3] in non-member States).

2. EVENTS SINCE THE REPORT AT 30 JUNE 2004

Regarding macro-financial assistance provided to third countries, the Council decided on 7 December 2004 to extend previous decisions providing further macro-financial assistance to Serbia and Montenegro (2004/862/EC) and to Bosnia and Herzegovina (2004/861/EC). Regarding the New Independent States (NIS), no new Council Decision was made, whereas the Commission adopted on 10 December 2004 a Communication on the implementation of macro-financial assistance in Armenia, Tajikistan and Georgia.[4]

Disbursement amounted to a total of EUR 22 million in the form of grants: EUR 10 million for Serbia and Montenegro, EUR 5.5 million for Armenia and EUR 6.5 million for Georgia.

Regarding Euratom, a loan disbursement was carried out on the basis of an existing decision in favour of Bulgaria (Kozloduy, EUR 30 million).

A new Commission decision amending decision (C(2000)3812) of 13 December 2000 was adopted and reduced the Euratom loan amount decided in favour of Ukraine for the K2R4 plant[5].

Concerning the EIB's mandates, on 22 December 2004[6], the Council decided to amend Decision 2000/24/EC to take into account the enlargement of the European Union and the European Neighbourhood Policy.

On the same date[7], the Council decided to grant a Community guarantee to the EIB against losses under loans for certain types of projects in Russia, Ukraine, Moldova and Belarus; the

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1 Please note that the annex contains a Commission Staff Working Paper with a set of detailed tables and explanatory notes to this report.
2 New Community Instrument, not active since 1995. The last loan was fully amortized by 17.12.2004.
3 The details concerning the EIB Mandates are displayed in Table A1 of the annex.
4 COM(2004)793 final.
5 C(2004)2817/3 of 20.7.2004 (EUR equivalent of USD 83 000 000).
6 OJ L 21, 25.01.05, p.9.
7 OJ L 21, 25.01.05, p.11.

overall ceiling amounts to EUR 500 million. The EIB benefits of an exceptional Community guarantee of 100%. The guarantee is to cover loans signed until 31 January 2007 (extendable by six months).

With a view to the accession of ten new Member States on 1 May 2004, the Council adopted the Regulation No. 2273/2004[8] to amend Council Regulation No. 2728/94 establishing a Guarantee Fund for external actions.

According to the Commission Communication on the Financial Perspectives 2007 - 2013[9], the amount of financing of the Guarantee Fund will not, in theory, be limited in the future as the funding of the Guarantee Fund will be carried out through a budget line under Heading 4 (External Relations) and not, as at present, through a dedicated Reserve.

3. RISK SITUATION

The following risk analysis uses the established measures of capital outstanding, maximum annual risk and maximum theoretical annual risk borne by the Community budget (its methodology is explained in the Commission Staff Working Paper). Detailed figures can be found in Annex Tables A1, A2 and A3 respectively.

3.1. Capital outstanding at 31 December 2004

The total risk at 31 December 2004 came to EUR 15,284 million, as against EUR 15,519 million at 30 June 2004.

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

Table 1: Capital outstanding at 31 December 2004*		**EUR million (rounded)**
Amount outstanding at 30 June 2004		15,519
Loan repayments		
	Euratom	0
	NCI	-18
	Macro-financial assistance	-145
	EIB	-747
Loans disbursed		
	Euratom	30
	Macro-financial assistance	0
	EIB	1,265
Exchange rate differences between EUR and other currencies		-621
Amount outstanding at 31 December 2004		15,284

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

8 OJ L 396, 31.12.04, p. 28.
9 COM(2004) 487.

The capital outstanding in respect of operations in the Member States was EUR 3,360 million at 31 December 2004, compared with EUR 3,635 million at 30 June 2004.

The capital outstanding in respect of operations in non-member States at 31 December 2004 was EUR 11,924 million, compared with EUR 11,885 million at 30 June 2004.

3.2. Maximum annual risk borne by the Union budget: operations disbursed at 31 December 2004 (see Table A2 in Annex)

– For 2005 the total maximum annual risk amounts to EUR 1,848 million.

– The risk in respect of Member States comes to EUR 544 million.

– The risk in respect of non-member States comes to EUR 1,304 million.

3.3. Maximum theoretical annual risk borne by the Union budget: operations disbursed and decided at 31 December 2004 (see Table A3 in Annex)

– For 2005 the maximum theoretical risk amounts to EUR 1,957 million and is estimated to reach EUR 3,546 million in 2013.

– The maximum theoretical risk in respect of Member States is the same as the maximum annual risk reported in paragraph 3.2.

– For the non-member States it amounts to EUR 1,413 million for 2005. The risk is estimated to reach EUR 3,324 million by 2013.

4. ACTIVATION OF BUDGET GUARANTEES

4.1. Payments from cash resources

The Commission draws on its cash resources[10] 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, as amended, established a Guarantee Fund for external actions. In the event of late payment by a recipient of a loan granted or guaranteed by the Community, the Guarantee Fund is called on to cover the default within three months of the date on which payment is due.

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[10] Under Article 12 of Council Regulation (EC, Euratom) No. 1150/2000 of 22 May 2000, as amended, implementing Decision 94/728/EC, Euratom, on the system of the Communities' own resources.

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 current Financial Perspectives[11].

Table A4 shows an estimate of the Community's lending capacity in respect of non-member States over the period 2005-2006 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.

Table 2 shows that outstanding lending and loan guarantee operations for non-member States totalled EUR 12,068 million at 31 December 2004.

Table 2: Outstanding lending and loan guarantee operations for non-member States in EUR million (rounded)	
1. Capital outstanding, EC (MFA), Euratom	1,384
2. Capital outstanding, EIB	10,540
3. Payments defaults	0
4. Default Interest	1
5. Unpaid interest due[1]	143
Amount outstanding at 31 December 2004	12,068

[1] 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 10.55%, 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.

6. SITUATION OF THE GUARANTEE FUND AT 31 DECEMBER 2004

At 31 December 2004, the Guarantee Fund amounted to EUR 1,612.09 million. The following movements were recorded in the second half of 2004.

– The first and second transfers: EUR 181.875 million.

– The Fund's surplus of the year 2003: EUR 223.16 million.

– Payment of a call on 27 August 2004: USD 2,687,444.26 (EUR equivalent 2,230,059.13).

[11] The annual figure entered in the 2000-2006 Financial Perspectives is EUR 200 million at 1999 prices; in 2004, the amount was EUR 221 million and it is EUR 223 million in 2005.

– Recovery of arrears on 21 December 2004: from the Republic of Argentina: USD 10,013,111.37 (EUR equivalent 7,456,334.33).

– The total arrears, at 31 December 2004, i.e. penalty interest with the Republic of Argentina, amount to USD 1,718,492.13 (EUR equivalent 1,261,649.75).

– Net revenue of EUR 28.9 million from investment of the Fund's assets as of 31 December 2004.

7. RELATIVE SOLIDITY

The ratio between the amount in the Fund at 31 December 2004 (EUR 1,612.09 million) reduced by the amount of EUR 338,831,402.07 following Regulation No 2273/2004 and the maximum theoretical annual risk for loans to non-member States in 2005 (EUR 1,413 million) is estimated at 90% (see Annex Table A3).

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. Tables on the country risk evaluation are presented separately in the Commission Staff Working Paper[12]. A brief summary of this analysis is provided below. A section analysing the situation of the other non-member countries can be found under point 3.1 of the Annex.

2. CANDIDATE COUNTRIES

In **Bulgaria,** GDP growth continued to be strong, at 5.6% in the first three quarters of 2004 year-on-year. The current account deficit was high at about 7.5% of GDP in 2004, but lower than in 2003 and largely covered by net FDI inflows. Foreign debt was stable relative to GDP at slightly above 60% of GDP, with a declining trend of public debt and an increasing trend of private debt so that they now have almost equal shares in total foreign debt.

During the first three quarters of 2004, **Romania**'s real GDP grew by 8.1%. Growth was driven by strong domestic demand, which caused strongly negative net exports and the persistence of a significant current account deficit in the vicinity of 6% of GDP. A considerable pick-up in FDI enabled the total foreign debt-to-GDP ratio to remain stable at around 34% of GDP.

Turkey's GDP increased by 8.7% year-on-year in the first three quarters of 2004, driven by strong private consumption growth and a surge in domestic investment. High growth of domestic demand and higher international oil prices led to a sharp rise in imports in 2004, easily offsetting the benefits of higher exports and a record tourism season. As a result the current account deficit rose to an estimated 5.2% of GDP. Debt levels have been falling strongly. Foreign debt amounted to 53% of GDP at the end of 2004.

3. WESTERN BALKANS

Albania's GDP grew by an estimated 6.2% in 2004, facilitated by improvements in agricultural production, a buoyant service sector and a rise in construction. The current account deficit is projected to have reached 5.8% of GDP in 2004 and the external debt level to remain relatively modest with a debt-to-GDP ratio of about 22.4%.

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In **Bosnia and Herzegovina,** GDP grew by an estimated 5% in 2004, driven mainly by rising industrial production and domestic demand, and the economy is projected to continue growing at the same pace in 2005. Despite a record inflow of FDI and increasing exports during 2004, high imports resulted in the current account deficit remaining above 18% of GDP. External debt has been on the decline over recent years and reached 34% of GDP in 2004.

In the **Former Yugoslav Republic of Macedonia** GDP growth declined by 0.5% during the first three quarters of 2004, mainly due to continued weak growth in manufacturing. However, for 2004 as a whole, a positive growth rate is likely, while for 2005 acceleration to 2.5% is expected. The current account deficit reached nearly 7% of GDP in 2004, owing to a large trade deficit and lower private and official transfers. Foreign exchange reserves declined to 3.5 months of imports in the second half of 2004 from 4 months at the end of 2003. In 2004, the external debt-to-GDP ratio increased marginally, from 35.2% at end-2003 to 35.7% at end-2004.

GDP growth has recovered in **Serbia and Montenegro** and is estimated to have reached 7.2% in 2004, reflecting a rebound in industrial output and agricultural production. External imbalances, fuelled by week export performance, remain on the high side. In 2004, the current account deficit is estimated to have reached about 12% of GDP. However, the debt-to-GDP ratio declined to 57%, as a result of a restructuring agreement with the London Club of creditors.

4. NEW INDEPENDENT STATES

In **Armenia,** where output growth remained over 10% in 2004, strong remittances and other transfers helped to narrow down the current account deficit to below 5% of GDP in 2004. The Central Bank's international reserves are comfortably high covering nearly four months of imports. The public external debt is about USD 1.1 billion, or about 33% of GDP (down from about 39% in 2003).

Georgia's current account deficit widened somewhat as high import demand for the construction of the BTC pipeline offset the increase in remittances and official transfers. Yet, the National Bank managed to increase its international reserves to nearly two months of imports. Georgia's public external debt remained broadly unchanged in nominal terms but decreased as a ratio to GDP from 46% in 2003 to about 37%. In the second half of 2004, Georgia concluded bilateral agreements with most of its Paris Club creditors in line with the July 2004 agreement.

In **Ukraine,** GDP growth reached a record high rate of 12%. At the same time, inflation of 12.3% exceeded all projections. The National Bank of Ukraine tightened monetary policy gradually but the fiscal imbalances (the general government deficit was over 4% of GDP in 2004) have yet to be addressed by the new Government. The current account ended with a surplus of over 10% of GDP. Foreign exchange reserves increased to an equivalent of above three months of imports. The ratio of public external debt to GDP decreased further, in line with the strong GDP growth, to about 19%.

The economy of **Belarus** has continued benefiting from growth in Russia, its main trade partner (in 2004, GDP growth reached 11%). Inflation was cut from 28% in 2003 to 14% in 2004 but it remains the highest in the region, reflecting lax financial policies. However, the

General Government account turned to a surplus for the first time for several years. External debt has remained modest, and the debt-to-GDP ratio has dropped to less than 20%. Despite the improvement, however, the Belarus economy remains constrained on a number of accounts; in particular, foreign exchange reserves are very low.

In **Moldova,** GDP growth exceeded 7% in 2004 but inflation remained in double-digits reflecting strong domestic demand accommodated by rapid money growth (the result of booming remittances). The fiscal stance was relaxed considerably in 2004. Moldova has secured some debt relief from its private creditors and has resumed paying interest to Paris Club creditors. As a result, the debt-to-GDP ratio was cut to less than 40%. Yet the economy remains extremely fragile. The current account deficit approached 7% of GDP and foreign direct investment is held back by a history of State interference in the economy.

Tajikistan's economy continues to grow strongly – real GDP growth was about 10.5% in 2004. The current account deficit widened from 1.3% to nearly 2% as increasing export revenues and migrants' remittances were more than offset by import increases associated with rapid growth. Import coverage of gross official reserves exceeded 2 months by year-end. At end-2003, total external debt amounted to USD 1 billion (73% of GDP), of which USD 300 million was owed to Russia. In October 2004, an agreement with Russia was signed, writing off 80% of Tajikistan's bilateral debt and exchanging the remainder for equity (by end-2008).