

## Supplement A

Economic trends

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*In this number:  
Report on the implementation  
of macro-financial assistance to  
third countries in 1997 and 1998*

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### I. OVERVIEW

#### *1. Introduction*

*Initially conceived for intra-Community balance-of-payment support, macro-financial assistance from the Community has been extended since 1990 to third countries, mainly those of Central and Eastern Europe, but progressively also to other countries, in the former Soviet Union and in the Mediterranean area, with a view to supporting their political and economic reform efforts.*

*Early in the 1990s, the European Community decided to extend macro-financial assistance to the Central and East European Countries (CEECs) with a view to support their process of transition to a market economy. It was also decided that, in the context of the assistance co-ordination process agreed among the 24 industrial countries (G-24), the Commission should enlist other donors to contribute in a similar way to support the economic programmes that the CEECs were implementing in agreement with the International Monetary Fund (IMF) and the World Bank.*

*A number of balance-of-payment support operations by the EC and the G-24 took place between 1990 and 1994 covering most CEECs. Since then, EC macro-financial assistance in the region has been mainly concentrated in the Balkan countries for two different although not unrelated reasons. Firstly, the relative under-performance of the Eastern Balkans economies and their continued need for international support to cover external imbalances. Secondly, the disintegration of the former Yugoslavia and the subsequent conflicts in the Western Balkans. Thus, since 1996 all disbursements of macro-financial assistance have been in favour of four of these countries, namely Albania, Bulgaria, FYROM and Romania.*

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Outside the region of Central and Eastern Europe, several other operations have been decided by the Council since the beginning of the 1990s. They also support the political and economic reform efforts of the beneficiary countries and are to be implemented in connection with support programmes from the IMF and the World Bank. Thus, in the context of Community support for Mediterranean countries, the Council made available loans to Israel and Algeria in 1991, and a further loan to Algeria was decided in late 1994.

Operations for Newly Independent States (NIS) were approved for the first time in 1994 to cover European NIS. Six loan operations have since then been decided for Belarus, Moldova and Ukraine. In 1997, financial assistance was extended to the Caucasian region, with the adoption by the Council of a Commission proposal to provide Armenia and Georgia with exceptional financial assistance, in view of the difficult political, economic and financial conditions, including their inability to service their financial obligations towards the Community.

Community operations have continued to incorporate the set of principles applying to this type of assistance. These principles underline the exceptional character of this assistance, its complementarity to financing from the IFIs and its macroeconomic conditionality. In particular, Community macro-financial assistance has supported efforts by recipient countries to bring about economic reforms and structural changes. In close co-ordination with the IMF and the World Bank, it has promoted policies that are tailored to specific country needs with the overall objective of stabilising the financial situation and establishing market-oriented economies. The Commission implements the assistance in consultation with the Economic and Financial Committee.

The present report assesses the economic situation, the progress of reforms and the prospects of the countries recipient of macro-financial assistance in 1997 and 1998, with particular reference to the implementation of the conditions attached to it. The present report is submitted in accordance with the Council Decisions regarding Community macro-financial assistance to third countries as listed in Table 1 and follows on from the reports presented in previous years<sup>1</sup>.

The complete list of macro-financial assistance operations decided by the Council with the corresponding disbursements up to the end of 1998 appears in Table 1. Table 2 summarises the macro-financial assistance provided by bilateral and multilateral donors in favour of the countries recipient of EC macro-financial assistance. Finally, macroeconomic performance and progress in reforms in beneficiary countries are summarized in Tables 3 and 4 and discussed country by country in the following chapters.

<sup>1</sup> See the following Communications from the Commission to the Council and the European Parliament with the title 'Report on the implementation of macro-financial assistance to third countries':  
COM(92)400 of 16 September 1992,  
COM(94)229 of 7 June 1994,  
COM(95)572 of 27 November 1995,  
COM(96)695 of 8 January 1997,  
COM(98)3 of 13 January 1998.

## 2. Macro-financial assistance in 1997 and 1998

### New decisions

Compared to 1996, when only one operation for EUR 15 million in favour of Moldova was decided, the year 1997 has registered a rather important amount of activity in terms of new macro-financial assistance operations decided by the Council. Three operations for a maximum amount of *EUR 555 million have been decided in favour of Armenia, Bulgaria, FYROM and Georgia*. The only operation decided in 1998 consisted of a loan of up to *EUR 150 million to Ukraine*.

*FYROM* had undertaken fundamental political and economic reforms and an economic programme had been adopted by its authorities with strong support from the IMF and the World Bank. In this framework and in view of the first signs of crisis in the financial sector, the Council has decided in July 1997 to provide the country with a long-term loan facility of a maximum amount of EUR 40 million. Following the fulfilment of the different conditions attached to the operation, the loan has been released in two tranches of EUR 25 million and EUR 15 million respectively in September 1997 and February 1998.

The third macro-financial assistance operation in favour of *Bulgaria* has also been adopted in July 1997. It consists of a long-term loan facility for a maximum of EUR 250 million with a view to ensuring a sustainable balance-of-payment situation and strengthening the country's reserve position. The operation had been proposed by the Commission in May 1997 in view of the economic programme adopted by the Bulgarian authorities in agreement with the IFIs following the economic difficulties and financial crisis of the winter 1996/1997. The loan has been disbursed in two equal instalments of EUR 125 million in February and December 1998.

The third 1997 operation has covered *Armenia and Georgia* and has combined for the first time a mix of long-term loans and straight grants. The total loan component amounts to a maximum of EUR 170 million, while the grant component should add up to EUR 95 million, bringing the total assistance for both countries to a maximum of EUR 265 million. The relevant Council Decision empowers the Commission to agree with the authorities of the beneficiary countries on the specific amounts of the assistance to each of them. The Commission disbursed in favour of Georgia during the summer of 1998, after fulfilment of the relevant conditions, the first tranche of assistance comprising a loan of EUR 110 million and a grant of EUR 10 million financed from the EU general budget. Armenia also received in December 1998 a first tranche of assistance comprising EUR 28 million in the form of a loan and EUR 8 million in the form of a grant.

In 1998, the Community has decided to provide *Ukraine* with a third macro-financial assistance. Parliamentary elections in Spring 1998 have been followed by the adoption of an ambitious three-year economic programme supported by the IMF under an Extended Fund Facility.

Against this background and the spill-over effects on Ukraine of the Russian financial crisis in the summer 1998, the Council has adopted in October 1998 a Commission proposal to provide supplementary macro-financial assistance in the form of a long-term loan of up to EUR 150 million. It is expected that the first and possibly a second tranche of the assistance will be disbursed in 1999.

### Disbursements

Disbursements of macro-financial assistance to third countries have amounted to a total of *EUR 195 million in 1997 and EUR 421 million in 1998*. Out of the total EUR 616 million for the two years, disbursements in favour of CEECs have amounted to EUR 360 million, while the total amount in favour of NIS has been EUR 256 million. Disbursements related to newly decided operations during the period are commented on in the previous paragraphs.

As far as previously decided operations are concerned, the outstanding second tranche of the 1994 balance-of-payment assistance to *Romania* has been reactivated in 1997 following the IMF approval of a new SBA in April 1997. A total amount of EUR 70 million has accordingly been paid out to Romania in two instalments of EUR 40 million and EUR 30 million respectively in September and December 1997. Also the EUR 100 million second and last tranche, out of the EUR 200 million macro-financial assistance decided in 1995 in favour of *Ukraine*, has been released in September 1997, after fulfilment by the country of the conditions attached to the loan.

### Repayments and undisbursed operations

During 1997 and 1998 all macro-financial assistance loans falling due have been honoured by the beneficiary countries. Thus, the Czech Republic, Hungary and Slovakia have repaid in 1998 the outstanding amounts relating to the assistance decided in 1990 and 1991. Also Romania in March 1998 repaid as scheduled the first tranche of its first EC macro-financial assistance.

Some operations decided in the first half of the 1990s have not been fully disbursed as initially foreseen. This has been the result either of improved external financial conditions, mainly in terms of balance of payments and external debt position as was the case for the Baltic countries, Hungary and Slovakia or of worsening of the political climate and/or the slowing-down of the reform process as in the cases of Belarus and Algeria. The last column of Table 1 shows the undisbursed amounts. The operations for Armenia and Georgia and Ukraine III are likely to be implemented as originally foreseen, while the undisbursed amounts for the CEECs are not programmed anymore.

### Other

By the end of 1998, two Commission proposals are waiting for a decision by the Council. The first one concerns

a EUR 20 million balance-of-payment assistance in favour of *Albania*<sup>1</sup> which, for the first time in the case of this country, would take the form of a loan.

The second proposal concerns the first macro-financial assistance in favour of *Bosnia-Herzegovina*<sup>2</sup>. Given the particularly difficult economic and social situation in the country, the Commission has proposed a high degree of concessionality through an operation totaling EUR 60 million out of which EUR 30 million in the form of grants.

Other outstanding Commission proposals concern Tadjikistan — for which the Commission had proposed a possible aid in the framework of the operation in favour of Armenia and Georgia- and Azerbaijan.

### 3. Trends and tendencies in macro-financial assistance

The new operations in 1997 and 1998 have confirmed the two related trends already evidenced in 1996. The first one refers to the expansion of the geographical coverage, the second one to the widening of the nature of macro-financial assistance operations.

The Community's macro-financial assistance was originally intended to support macroeconomic stabilization and the balance of payments. Over the years the number of countries to which it was appropriate for the Community to extend such support expanded, as a growing number of countries neighbouring the Community committed themselves to rigorous programmes of economic reform. This led to a change in the geographic balance of assistance from the early years, when most beneficiary countries were in the immediate vicinity of the Community. As a result of the conflicts in the Western Balkans, a new tendency for enhanced macro-financial assistance to the countries of this region is emerging as demonstrated by the recent Commission proposals.

It also became clear that, while macro-financial assistance geared to the original objective of supporting macroeconomic stabilization and the balance of payments was still necessary for some countries, in the case of others macro-financial assistance could more usefully be directed to supporting the government's programme of structural reform. This tendency emerged first in some Central and East European countries, where macro-financial assistance for structural reform could be effectively combined with technical assistance from the Phare programme to strengthen the capacity of institutions that were essential to the success of the structural reform programmes. The complementarity of the different forms of Community assistance was enhanced by broadening the dialogue with each beneficiary country to encompass the totality of assistance to reform efforts. This approach has been confirmed in the context of assistance to some NIS and to the Western Balkan countries. A comparable evolution has taken place in the programmes supported by the IMF and the World Bank,

and this has led to closer co-operation between the Commission and these institutions.

### 4. Burden-sharing

In the context of the G-24 assistance coordination process, the European Commission in liaison with the World Bank organises donor's conferences for support to CEECs where the needs of resources are assessed and the contributions from the IFIs and bilateral donors -including the EC- are agreed in principle. For other potential recipient countries, a similar approach is followed through Consultative Group meetings convened at the initiative of the World Bank.

The resources provided by different contributors to support the balance-of-payment needs of the countries recipient of EC macro-financial assistance are summarised in Table 2. Details by recipient country for the years 1997 and 1998 are provided in Table 2.1.

Since the inception of macro-financial assistance, the absolute amounts committed by the EC have fluctuated substantially, in parallel with the balance-of-payment support provided by the international community (see Table 2 and similar tables in previous macro-financial assistance reports).

Initially, an important feature of Community assistance was that very large sums of money were made available to support the programmes of the IFIs. The Community played a key role, both as a major provider of these funds and from 1991 as the co-ordinator of bilateral assistance for the CEECs through the G-24.

However, as the IFIs were progressively able to mobilize more resources through new instruments, their share in the financing packages has risen substantially, in particular when referring only to mobilisation of new funds.

At the same time, contributions by external creditors, both public and private, were mobilized in the form of debt-relief and debt-reduction operations which were particularly important in 1994 and 1995. The countries concerned by these debt-relief and similar operations amongst those receiving EC macro-financial assistance have been: Algeria in 1991 and 1994; Bulgaria in 1991, 1994 and 1997; Moldova in 1996; and Ukraine in 1994 and 1995.

<sup>1</sup> COM(98)507 of 03.09.1998.

<sup>2</sup> COM(98)652 of 13.11.1998.

TABLE 1: **Community macro-financial assistance to third countries**  
(Status of effective disbursements as of December 1996 (in millions of ECU))

Country	Maximum amount authorized	Date and reference of Council Decision	Disbursed	Amounts and Dates of disbursements	Undisbursed
<b>A. Macro-financial assistance to CEECs</b>					
<b>Hungary I</b> (structural adjustment loan)	<b>870</b>	22.02.90 (90/83/EC)	<b>610</b>	350 – Apr. 1990 260 – Feb. 1991	<b>260</b>
<b>Czech and Slovak Federal Republic</b> (BOP loan)	<b>375</b>	25.02.91 (91/106/EC)	<b>375</b>	185 – Mar. 1991 190 – Mar. 1992	
<b>Hungary II</b> (BOP loan)	<b>180</b>	24.06.91 (91/310/EC)	<b>180</b>	100 – Aug. 1991 80 – Jan. 1993	
<b>Bulgaria I</b> (BOP loan)	<b>290</b>	24.06.91 (91/311/EC)	<b>290</b>	150 – Aug. 1991 140 – Mar. 1992	
<b>Romania I</b> (BOP loan)	<b>375</b>	22.07.91 (91/384/EC)	<b>375</b>	190 – Jan. 1992 185 – Apr. 1992	
<b>Albania I</b> (BOP grant)	<b>70</b>	28.09.92 (92/482/EC)	<b>70</b>	35 – Dec. 1992 35 – Aug. 1993	
<b>Baltics</b> (BOP loans) of which:	<b>220</b>	23.11.92 (92/542/EC)	<b>135</b>		<b>85</b>
<b>Estonia</b>	<b>40</b>		<b>20</b>	Mar. 1993	<b>20</b>
<b>Latvia</b>	<b>80</b>		<b>40</b>	Mar. 1993	<b>40</b>
<b>Lithuania</b>	<b>100</b>		<b>75</b>	50 – Jul. 1993 25 – Aug. 1995	<b>25</b>
<b>Romania II</b> (BOP loan)	<b>80</b>	27.11.92 (92/551/EC)	<b>80</b>	Feb. 1993	
<b>Bulgaria II</b> (BOP loan)	<b>110</b>	19.10.92 (92/511/EC)	<b>110</b>	70 – Dec. 1994 40 – Aug. 1996	
<b>Romania III</b> (BOP loan)	<b>125</b>	20.06.94 (94/369/EC)	<b>125</b>	55 – Nov. 1995 40 – Sep. 1997 30 – Dec. 1997	
<b>Albania II</b> (BOP grant)	<b>35</b>	28.11.94 (94/773/EC)	<b>35</b>	15 – Jun. 1995 20 – Oct. 1996	
<b>Slovakia</b> (BOP loan)	<b>130</b>	22.12.94 (94/939/EC)	<b>Cancelled</b>	Jul. 1996	<b>130</b>
<b>FYROM</b> (BOP loan)	<b>40</b>	22.07.97 (97/471/EC)	<b>40</b>	25 – Sep. 97 15 – Feb. 98	
<b>Bulgaria III</b> (BOP loan)	<b>250</b>	22.07.97 (97/472/EC)	<b>250</b>	125 – Feb. 98 125 – Dec. 98	
<b>TOTAL A</b>	<b>3150</b>		<b>2675</b>		<b>475</b>
<b>B. Macro-financial assistance to other third countries</b>					
<b>Israel</b> <sup>1</sup> (structural adjustment soft loan)	<b>187,5</b>	22.07.91 (91/408/EC)	<b>187,5</b>	Mar. 1992	
<b>Algeria I</b> (BOP loan)	<b>400</b>	23.09.91 (91/510/EC)	<b>400</b>	250 – Jan. 1992 150 – Aug. 1994	
<b>Moldova I</b> (BOP loan)	<b>45</b>	13.06.94 (94/346/EC)	<b>45</b>	25 – Dec. 1994 20 – Aug. 1995	
<b>Algeria II</b> (BOP loan)	<b>200</b>	22.12.94 (94/936/EC)	<b>100</b>	Nov. 1995	<b>100</b>
<b>Ukraine I</b> (BOP loan)	<b>85</b>	22.12.94 (94/940/EC)	<b>85</b>	Dec. 1995	
<b>Belarus</b> (BOP loan)	<b>55</b>	10.04.95 (95/132/EC)	<b>30</b>	Dec. 1995	<b>25</b>
<b>Ukraine II</b> (BOP loan)	<b>200</b>	23.10.95 (95/442/EC)	<b>200</b>	50 – Aug. 1996 50 – Oct. 1996 100 – 25 Sep. 1997	
<b>Moldova II</b> (BOP loan)	<b>15</b>	25.03.96 (96/242/EC)	<b>15</b>	Dec. 1996	
<b>Armenia and Georgia</b> <sup>2</sup> (Structural adjustment loans and grants) of which:	<b>265</b>	17.11.97 (97/787/EC)	<b>156</b>		<b>109</b>
<b>Armenia</b>	<b>36</b>		<b>36</b>	28 – 31 Dec. 1998 8 – 29 Dec. 1998	
<b>Georgia</b>	<b>120</b>		<b>120</b>	110 – Jul. 1998 10 – Aug. 98	
<b>Ukraine III</b>	<b>150</b>	15.10.98 (98/592/EC)			<b>150</b>
<b>TOTAL B</b>	<b>1602,5</b>		<b>1218,5</b>		<b>384</b>
<b>TOTAL A + B</b>	<b>4752,5</b>		<b>3893,5</b>		<b>859</b>

<sup>1</sup> Assistance to Israël includes a loan principal amount of ECU 160 million and grants of ECU 27.5 million in the form of interest rates subsidies.

<sup>2</sup> Exceptional financial assistance, which includes loans for a maximum amount of ECU 170 million and grants for a maximum amount of ECU 95 million. Disbursements include an ECU 28 million loan and an ECU 8 million grant for Armenia, and an ECU 110 million and an ECU 10 million for Georgia.

TABLE 2: Balance of payments support to recipients of EU macro-financial assistance by contributor, 1990-1998<sup>1</sup>

2a. In millions US\$								
	1990	1991	1992	1994	1995	1996	1997	1998
<b>IFI's</b>	<b>419</b>	<b>5607</b>	<b>1564</b>	<b>4086</b>	<b>1877</b>	<b>250</b>	<b>732</b>	<b>1949</b>
IMF	219	4177	909	3206	1477	195	584	1259
World Bank	200	1430	655	880	400	55	148	690
<b>Bilaterals</b>	<b>1618</b>	<b>5600</b>	<b>708</b>	<b>11202</b>	<b>3885</b>	<b>67</b>	<b>582</b>	<b>168</b>
EU <sup>2</sup>	1108	2190	423	855	330	19	329	168
Other bilaterals <sup>3</sup>	511	1406	285	702	150	10	73	
of which:								
USA		35		100		10	15	
Japan	200	850	120	350	150		54	
Debt relief		2004		9645	3405	38	180	
Paris Club		554		4920				
London Club				4380				
Other <sup>4</sup>		1450		345	3405	38	180	
2b. In percent of total commitments, including debt relief								
	1990	1991	1992	1994	1995	1996	1997	1998
<b>IFI's</b>	<b>21</b>	<b>50</b>	<b>69</b>	<b>27</b>	<b>33</b>	<b>79</b>	<b>56</b>	<b>92</b>
IMF	11	37	40	21	26	62	44	59
World Bank	10	13	29	6	7	17	11	33
<b>Bilaterals</b>	<b>79</b>	<b>50</b>	<b>31</b>	<b>73</b>	<b>67</b>	<b>21</b>	<b>44</b>	<b>8</b>
EU <sup>2</sup>	54	20	19	6	6	6	25	8
Other bilaterals <sup>3</sup>	25	13	13	5	3	3	5	
of which:								
USA		0		1		3	1	
Japan	10	8	5	2	3		4	
Debt relief		18		63	59	12	14	
Paris Club		5		32				
London Club				29				
Other <sup>4</sup>		13		2	59	12	14	
2c. In percent of total commitments, excluding debt relief								
	1990	1991	1992	1994	1995	1996	1997	1998
<b>IFI's</b>	<b>21</b>	<b>61</b>	<b>69</b>	<b>72</b>	<b>80</b>	<b>90</b>	<b>65</b>	<b>92</b>
IMF	11	45	40	57	63	70	52	59
World Bank	10	16	29	16	17	20	13	33
<b>Bilaterals</b>	<b>79</b>	<b>39</b>	<b>31</b>	<b>28</b>	<b>20</b>	<b>10</b>	<b>35</b>	<b>8</b>
EU <sup>2</sup>	54	24	19	15	14	7	29	8
Other bilaterals <sup>3</sup>	25	15	13	12	6	4	7	
of which:								
USA		0		2		4	1	
Japan	10	9	5	6	6		5	

<sup>1</sup> Based on Council Decisions for EU operations. No operation was decided in 1993.

<sup>2</sup> EU macro-financial assistance.

<sup>3</sup> Including EU Member States.

<sup>4</sup> Syndicated commercial banks loan in favour of Algeria in 1991, debt relief in favour of Ukraine by Russia and Turkmenistan in 1994 and in 1995, debt rescheduling in favour of Moldova by Russia in 1996, debt rescheduling in favour of Bulgaria and FYROM in 1997.

TABLE 2.1: Balance of payments support to recipients of EU macro-financial assistance by contributor, 1997-1998<sup>1</sup>  
(in millions of US\$ and in percent of total commitments and disbursements)

Balance of payments support 1997												
	Total				Bulgaria III				FYROM			
	Commitments		Disbursements		Commitments		Disbursements		Commitments		Disbursements	
	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%
<b>IFI's</b>	<b>732</b>	<b>56</b>	<b>683</b>	<b>54</b>	<b>610</b>	<b>58</b>	<b>610</b>	<b>58</b>	<b>123</b>	<b>47</b>	<b>73</b>	<b>34</b>
IMF	584	44	535	42	510	48	510	48	75	28	25	12
WB (policy based)	148	11	148	12	100	10	100	10	48	18	48	23
<b>Bilaterals</b>	<b>582</b>	<b>44</b>	<b>582</b>	<b>46</b>	<b>442</b>	<b>42</b>	<b>442</b>	<b>42</b>	<b>140</b>	<b>53</b>	<b>140</b>	<b>66</b>
EU	329	25	329	26	284	27	284	27	45	17	45	21
USA	15	1	15	1	15	1	15	1				
Japan	54	4	54	4	50	5	50	5	4	2	4	2
Other bilaterals	4	0	4	0					4	2	4	2
Debt relief	180	14	180	14	93	9	93	9	87	33	87	41
London Club												
Paris Club												
Other	180	14	180	14	93	9	93	9	87	33	87	41
<b>Total</b>	<b>1314</b>	<b>100</b>	<b>1265</b>	<b>100</b>	<b>1051</b>	<b>100</b>	<b>1052</b>	<b>100</b>	<b>263</b>	<b>100</b>	<b>213</b>	<b>100</b>

TABLE 2.1 (continued): Balance of payments support to recipients of EU macro-financial assistance by contributor, 1997-1998<sup>1</sup>

Balance of payments support 1998

	Total				Ukraine III			
	Commitments		Disbursements		Commitments		Disbursements	
	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%
<b>IFI's</b>	<b>1949</b>	<b>92</b>	<b>673</b>	<b>100</b>	<b>1949</b>	<b>92</b>	<b>673</b>	<b>100</b>
IMF	1259	59	333	49	1259	59	333	49
WB (policy based)	690	33	340	51	690	33	340	51
<b>Bilaterals</b>	<b>168</b>	<b>8</b>			<b>168</b>	<b>8</b>		
EU	168	8			168	8		
USA								
Japan								
Other bilaterals								
Debt relief								
London Club								
Paris Club								
Other								
<b>Total</b>	<b>2117</b>	<b>100</b>	<b>673</b>	<b>100</b>	<b>2117</b>	<b>100</b>	<b>673</b>	<b>100</b>

<sup>1</sup> Disbursements are shown under the year of corresponding commitments.

TABLE 3: Selected economic indicators

	1995	1996	1997	1998	
				Programme <sup>1</sup>	Estimates
<b>GDP at constant prices</b>	(Percent change)				
Armenia	6,9	5,8	3,1	5,2	4,5
Bulgaria	2,1	- 10,9	- 7,4	5,0	4,5
FYROM	- 1,2	0,8	1,5	5,0	3,5
Georgia	2,0	10,5	12,0	10,0	5,0
Romania	7,1	3,9	- 6,6	- 4,0	- 7,3
Ukraine	- 12,0	- 10,0	- 3,0	0,0	- 1,7
<b>Consumer price (end year)</b>	(Percent change)				
Armenia	31,9	5,7	21,9	9,0	3,8
Bulgaria	32,9	310,8	579,7	9,0	1,0
FYROM	8,6	- 0,7	2,7	3,0	1,0
Georgia	57,4	13,7	7,3	6,0	12,9
Romania	27,8	56,9	151,4	44,8	40,6
Ukraine	182,0	39,7	10,0	29,0	22,0
<b>Fiscal balance</b>	(Percent of GDP)				
Armenia *	- 12,0	- 9,3	- 5,9	- 5,3	- 5,9
Bulgaria	- 6,4	- 13,4	- 2,6	0,0	1,3
FYROM	- 1,3	- 0,4	- 0,4	- 0,5	- 0,5
Georgia *	- 4,5	- 4,4	- 3,8	- 2,5	- 3,4
Romania	- 2,6	- 4,0	- 3,6	- 3,7	- 4,0
Ukraine	- 4,9	- 3,2	- 5,6	- 2,8	- 3,5
<b>Current account</b>	(Percent of GDP)				
Armenia **	- 37,5	- 27,9	- 27,8	- 21,6	- 23,7
Bulgaria	- 0,5	1,3	4,4	- 0,7	- 0,6
FYROM	- 6,1	- 7,3	- 7,0	- 7,3	- 7,4
Georgia **	- 14,0	- 8,0	- 6,7	- 10,0	- 12,7
Romania	- 4,9	- 7,3	- 6,7	- 7,9	- 7,7
Ukraine	- 4,4	- 2,7	- 3,4	- 2,8	- 1,2
<b>Official foreign exchange reserves (end year)</b>	(Months of imports)				
Armenia	1,6	2,2	3,1	3,3	3,6
Bulgaria	2,9	1,6	4,0	6,7	5,7
FYROM	1,9	2,0	2,0	2,3	2,3
Georgia	2,7	2,7	2,4	2,3	0,6
Romania	1,9	2,1	3,6	NA	3,6
Ukraine	3,7	5,2	5,6	0,9	0,9

<sup>1</sup> Programme targets as set in : the mid-term review for the second annual arrangement under the ESAF in January 98 for Armenia, September 98 (EFF arrangement) for Bulgaria, April 1997 for FYROM , July 1998 for Georgia, October 1998 for Ukraine. For Romania, no target for 1998 were included in the last IMF programme, approved in 1997 and which expired in May 1998. Figures are IMF Staff estimates prepared for the the last Article IV consultations.

\* On a cash basis.

\*\* Excluding official transfers.

Sources: National authorities and IMF.

TABLE 4: Status of economic reforms

<b>ARMENIA</b>	
1. Price liberalisation	Most prices have been liberalised and consumer subsidies have been sharply reduced, including those on bread. Prices of a very few items (public utilities, rents) are regulated.
2. Trade liberalisation	Commitment to a liberal trade regime for goods. Trade in services is largely free of restrictions. Membership of the WTO expected in 1999. Armenia has accepted the obligations set out in Article VIII of the IMF's Articles of Agreement.
3. Exchange regime	Floating exchange rate. Limited official intervention.
4. Foreign direct investment	Liberal policy towards foreign direct investment, notably, absence of restrictions on repatriation of profits and capital.
5. Monetary policy	Appropriate. However, limited instruments available to the central bank. Treasury bills with several maturities. One-year T-bills since June 1997. High interest rates.
6. Public finances	Substantial improvement in tax and customs administration (presumptive tax payments, collection of VAT and excises on imports at the border, improved revenue administration) and in targeting the social safety net.
7. Privatisation and enterprise restructuring	Privatisation of agricultural land and of small and medium-sized enterprises nearly completed, process for large enterprises progressing satisfactorily, mainly through international tenders. Of 1997 GDP 60 % was produced in the private sector. Steps being taken to financially rehabilitate the power industry. Energy Regulatory Commission responsible for setting electricity tariffs.
8. Financial sector reform	The banking system (33 banks, of which three state-owned) is becoming one of the most developed sectors of the economy, thanks to the tight supervision of the central bank and the wide range of measures adopted to strengthen the sector: minimum capital requirements, capital adequacy, and solvency requirements, virtual elimination of bad debts. The Government is currently privatising its assets in the Savings Bank and in the Ardshinbank. Lack of a well-functioning inter-bank market.
<b>BULGARIA</b>	
1. Price liberalisation	The share of controlled prices in the consumer price index basket was about 16 % in early 1998. In addition, the prices of several basic goods are monitored. The prices of energy products are being progressively liberalised.
2. Trade liberalisation	The regime is largely liberalised. The import surcharge which was introduced in 1996 was removed ahead of schedule on 1 <sup>st</sup> January 1999.
3. Exchange regime	Lev pegged to the DM from July 1997 to December 1998, then to the Euro since January 1999, under a currency board regime.
4. Foreign direct investment	Under the new law adopted in late 1997, foreign investors can freely repatriate profits and proceeds from the liquidation of investments. Foreign companies allowed to buy land.
5. Monetary policy	Central bank responsible for operating the currency board. Cannot lend to the government and can lend to commercial banks only if the stability of the banking system is seriously endangered.
6. Public finances	The fiscal stance was tighter than programmed in 1997 and 1998. Tax collection has improved. Further reforms are planned to improve the efficiency of the tax system and increase fiscal transparency.
7. Privatisation and enterprise restructuring	From the beginning of the process in 1992 to late 1998, only 26 % of long-term assets have been privatised. After the rapid progress achieved in 1997, 1998 was marked by a noticeable slowdown in the pace of privatisation.
8. Financial sector reform	The financial position of the banking sector has improved substantially since the crisis in 1996, thanks to tightened bank regulation and supervision. Further restructuring is hampered by slow progress in privatisation.
<b>FYROM</b>	
1. Price liberalisation	Price liberalisation has been essentially completed. Price controls exist for only very few products.
2. Trade liberalisation	A small number of tariff and non-tariff barriers remain in place, but 95 % of goods are freely traded (average tariff rate of 15 %). Revised customs code approved by government.
3. Exchange regime	From early 1994, de facto peg of denar to DM at 27 denar to the DM; since devaluation of July 1997, 31 denar to the DM.
4. Foreign direct investment	The environment for FDI has improved recently. However, approval from the government is still requested to carry out some types of foreign direct investments, while the absence of a properly functioning market for land are also hampering the FDI inflows. FDI inflows increased substantially in 1998 as the authorities have been more open to FDI. Overall, the capital account remains largely regulated.
5. Monetary policy	Tight monetary policy based on the exchange rate anchor.
6. Public finances	Tight fiscal policies continued in 1997 and 1998, (especially through a reform of the pension system and a wage freeze following the devaluation of the denar in July 1997).
7. Privatisation and enterprise restructuring	Privatisation programme begun in 1993; almost 1200 out of 1216 enterprises have finalised privatisation though only some have been restructured. Private sector accounts for more than two-thirds of GDP. Slow progress in privatisation and restructuring of agro-industrial conglomerates.



TABLE 4 (continued): Status of economic reforms

8. Financial sector reform	Two-tier banking system. There are 20 banks, one branch of a foreign bank and 19 savings banks. Sector is dominated by Stopanska Banka, which has been rehabilitated and partially sold to a foreign investor. Banking supervision through National Bank. Lending to 22 largest debtor enterprises closely monitored.
<b>GEORGIA</b>	
1. Price liberalisation	Almost all prices have been liberalised.
2. Trade liberalisation	Liberal international trade policy. Low uniform customs tariff of 5 % and 12 % applied to almost all imports. Export prohibition only on scrap metal. Georgia has accepted the obligations of Article VIII of the IMF Articles of Agreement and is expected to become a member of the WTO in 1999.
3. Exchange regime	The lari is not subject to exchange restrictions. Auctions at the Tbilisi Interbank Currency Exchange (TICEX).
4. Foreign direct investment	Adequate overall legislation. Unlimited repatriation of capital and profits and no limitations on holding foreign-currency bank accounts. Foreign investors allowed only to lease not to own, agricultural land. Foreign residents are allowed to buy real estate and to lease land in the same way as domestic residents. Legal framework for urban and industrial land under consideration by the Parliament.
5. Monetary policy	Central bank intervention in the TICEX and banks' reserve requirements (12 %) were the main instruments of monetary control. Development of indirect monetary instruments. Sales of Treasury bills since August 1997. High interest rates.
6. Public finances	Budgetary revenue estimated at 10 % of GDP; expenditure estimated at 14 % of GDP. Low level of capital expenditure (1.1 % of GDP). Substantial increase in expenditure arrears in 1997 and 1998. Development of a Treasury system.
7. Privatisation and enterprise restructuring	Privatisation of small enterprises virtually completed. Most medium-sized and large enterprises privatised. All arable land except in Abkhazia and South Ossetia distributed to private farmers. Legal framework for a functioning agricultural land market in place. Collection rates in the energy sector and tariffs still low. A privatisation strategy for the power sector (both distribution and generating companies) is being implemented.
8. Financial sector reform	Role of former state banks diminished. 53 commercial banks. Until the Russian crisis, continued improvement in compliance with prudential regulations. Introduction of international accounting standards completed.
<b>ROMANIA</b>	
1. Price liberalisation	Price liberalisation has been essentially completed and consumer subsidies eliminated. Prices of a limited number of items (essentially public utilities and energy) are regulated, representing about 7 % of the CPI basket.
2. Trade liberalisation	Liberalisation of foreign trade regime largely completed, although still characterized by temporary derogations from import tariffs and special tariff quotas. All export restrictions were eliminated as of 1 January 1998. An import surcharge of 6 % was introduced in October 1998 to be gradually reduced over three years.
3. Exchange regime	The leu has been freely floating since February 1997, but the central bank has intervened frequently to smoothen the evolution of the exchange rate. Full current account convertibility implemented in March 1998, following the acceptance of the IMF's Article VIII.
4. Foreign direct investment	The FDI regime is open and non-discriminatory; profit may be freely repatriated. Since early 1997, foreign investors can own land necessary to carry out their activities. Portfolio investment by non-residents in fixed income securities was still not possible, although the T-bills market was technically open to non-residents in September 1998.
5. Monetary policy	National Bank of Romania (NBR) is independent, and financing for the government is limited in amount and time. In 1997 and 1998, the objective of monetary policy was the level of base money, although the central bank ensured an appreciation of the real exchange rate to fight inflation. The NBR stopped its directed credits to the economy and relied more on indirect instruments like open market operations and changes in reserve requirements.
6. Public finances	Basic tax reform already completed. Consolidated government deficit reached 3.6 % of GDP in 1997, but with all previously hidden quasi-fiscal subsidies now appearing in the budget. 1998 saw a small increase in the deficit. Revenues and expenses fell considerably as a percentage of GDP, and are amongst the lowest in the transition countries. The fiscal system is characterised by the existence of many exemptions and special provisions. The government intends to introduce a global income tax in 2000.
7. Privatisation and enterprise restructuring	Acceleration of privatisation and restructuring during the first months of 1997, later on stalled until late in 1998. Large-scale privatisation has been disappointing, although there were a few important transactions at the end of 1998. Financial discipline for the mostly large and loss-making public companies has not improved, with total arrears in the economy growing fast.
8. Financial sector reform	Reform of the banking sector has been slow so far, although new laws passed in 1997 and 1998 greatly improved the legislative framework. Despite a massive recapitalisation of two of the largest public banks in 1997, public banks have continued to experience serious balance sheet problems. Only one small public bank has been privatised since the onset of transition (in late 1998). Capital market developed rapidly in 1997 with higher volumes and more listings, but capitalisation and activity collapsed in 1998.

TABLE 4 (continued): **Status of economic reforms**

**UKRAINE**

1. Price liberalisation	Most goods no longer subject to price declaration (cost coverage is about 80 % on average). Increases for households in prices of coal, electricity, gas and transport, but these are still below full cost-recovery. Rents also increase.
2. Trade liberalisation	System of state orders abolished, except for grain for budgetary reasons. Budget allocations for state procurement of agricultural products limited to needs of budgetary organisations and based on market-determined prices. Import regime free of quantitative restrictions, with a few exceptions, which are primarily for health and safety reasons. Maximum import tariff 30 %. No export quotas and licences (except for hides and skins).
3. Foreign exchange regime	From September 1998, the authorities began intervening administratively in the inter-bank currency exchange.
4. Foreign direct investment	Tax relief granted to some foreign direct investments constituting at least 20 % of an enterprise's charter capital. This relief was granted by a 1993 decree and provided for exemption from income and profit tax for 5 years. In 1997, a law was passed that provided tax exemptions (almost all taxes) to investors which invest more than USD 100 million in the automobile industry.
5. Monetary policy	Central bank credit to commercial banks allocated mostly through the Lombard facility, and to a lesser extent through auction. However, the central bank has conducted a very tight policy and provided very little refinancing. Central Bank refinancing rate adjusted to ensure that it remains positive in real terms.
6. Public finances	Since 1992, budget gradually tightened and rationalised, including reform of VAT, enterprise and income taxes. Reduction of public expenditure from 72 % of GDP in 1992 to some 37 % in 1998. Ratio of revenue/GDP: 35 % in 1998.
7. Privatisation and enterprise restructuring	Mass voucher privatisation programme launched at beginning of 1995 and concluded at beginning of 1998. According to the Ministry of Statistics, privatised enterprises accounted for about 60 % of industrial output and more than 50 % of industrial employment in the first quarter of 1998.
8. Financial sector reform	Measures to strengthen supervision and regulation of the banking sector being implemented with the help of the IMF, the World Bank, the EU (Takis programme) and USAID.

**List of abbreviations**

CBA	Currency Board Arrangement	FYROM	Former Yugoslav Republic of Macedonia
DM	Deutsche Mark	GATT	General Agreement on Tariffs and Trade
EC	European Community	GDP	Gross Domestic Product
EFF	Extended Fund Facility	IFIs	International Financial Institutions
EIB	European Investment Bank	IMF	International Monetary Fund
ESAF	Enhanced Structural Adjustment Facility	SAF	Structural Adjustment Facility
EU	European Union	SBA	Stand-By Arrangement
EUR	Euro	USD	Dollar of the United States of America
FESAL	Financial and Enterprise Structural Adjustment Loan	VAT	Value Added Tax
FDI	Foreign Direct Investments	WTO	World Trade Organisation

## II. ARMENIA

### 1. Introduction

Armenia recovered for a fifth consecutive year in 1998, at a rapid pace (about 5%) in view of the impact of the Russian crisis. Thanks to the relatively small share of exports (17% of the total in 1998) going to Russia and to the sound monetary, fiscal and structural policies, the country coped satisfactorily with this external crisis. In 1998, the current account deficit (excluding grants) narrowed to around 25% of GDP; the level of FDI increased, as a result of rapid progress in the privatisation programme; gross international reserves improved further; and external debt was reduced to less than 45% of GDP. Structural reforms all progressed: substantial advances were made in price and trade liberalisation and with regard to privatisation and banking sector reform. However, the first priority for Armenia was still to improve exports and attract FDI. The country remained heavily dependent on foreign financing on concessional terms.

In February 1996, the IMF Board adopted a three-year Enhanced Structural Adjustment Facility (ESAF) of some USD 150 million in favour of Armenia. In December 1998, it approved a third annual arrangement under this facility.

The Community adopted on 17 November 1997 a Decision aimed at providing exceptional financial assistance to Armenia and Georgia in the form of a mix of long-term loans and successive annual grants (respectively up to EUR 170 million and EUR 95 million). This assistance was subject to the full settlement by both countries of their outstanding financial obligations towards the Community and to the rigorous implementation of the macroeconomic programmes supported by the IMF three-year Enhanced Structural Adjustment Facility.

### 2. Macroeconomic Performance

Following real GDP growth of 3% in 1997, the Armenian economy continued to recover for a fifth consecutive year in 1998. Growth was about 5% in 1998.

Since 1994, inflation has been sharply reduced. The average inflation level fell to 18.6% in 1996 (5.7% on a year-on-year basis in December) and fell further to 14% in 1997. It rose, however, to close to 21% by year-end. The average inflation rate slowed to about 10% in 1998. The budget deficit target of 6.7% of GDP for 1997 was largely met, with higher tax revenues offsetting shortfalls in grants and non-tax revenues. In 1998, the budget deficit (including grants) reached a level equivalent to about 6% of GDP, short of the target of 5.3%. As a result of the financial crisis, the Government tightened its credit policy, raised refinancing rates and reduced its possibility to obtain financing at a reasonable price on the T-Bill market.

Partly because of the blockade imposed on Armenia owing to the unresolved Nagorno Karabakh issue, the current account deficit (excluding official transfers) widened in 1997 to 28% of GDP, but narrowed a little

in 1998, despite the negative effects of the Russian crisis on Armenian exports and the blockade imposed on Armenia by some neighbouring countries. The deficit was expected to be increasingly financed by FDI as a result of rapid progress in the privatisation programme for large enterprises. Gross international reserves increased to almost 250 million USD by end-1997, well above the target, and to around USD 300 million (3.6 months' imports) at the end of 1998.

Armenia's foreign debt, which rose from 200 million USD at end-94 to about 600 million USD (some 38% of GDP) at end-96, represented around 48% of GDP at the end of 1997 but was expected to decrease to 43% in 1998. The country fully settled its outstanding financial obligations to the Community (EUR 51 million) in December 1998.

### 3. Structural Reforms

Important progress was made in price and trade liberalisation. Armenia notified the IMF that it accepted the obligations of Article VIII of the IMF Articles of Agreement and Armenia is expected to become a WTO member in 1999. With regard to privatisation, the Government completed the process for small-scale enterprises and made significant progress with medium- and large-scale enterprises through cash auctions and international tenders. It approved the privatisation of all remaining state flour mills and bakeries. Moreover, 80% of the formerly state-owned housing stock and 90% of the agricultural land was in private hands by the end of 1998. Much remains to be done, however, in large enterprise restructuring, notably with 12 major enterprises in the process of being sold through international tender. Significant progress was made in reforming the banking sector, with adoption of international accounting standards, continued improvement in the prudential indicators and the writing-off of all pre-1997 non-performing loans. Progress in the privatisation of Ardashinbank was stalled as a result of the financial difficulties in Russia. The legal framework evolved further: the law on bankruptcy, some revisions to the major banking and commercial laws necessary for WTO accession were passed in 1997. Public sector reform lagged behind.

### 4. Implementation of the Exceptional Financial Assistance

In order to implement the Council Decision of 17 November providing exceptional financial assistance to Armenia and Georgia, a Commission staff mission visited Yerevan in July 1998 to negotiate the amounts, terms and conditions of this assistance and reached an agreement in principle on the Memorandum of Understanding and Loan Agreement. Both documents were signed in December 1998. The disbursement of the first tranche (EUR 28 million in the form of a loan and EUR 8 million in the form of a grant) of this assistance took place in late December after full settlement by Armenia of its outstanding financial obligations to the Community (EUR 51 million) in the context of an agreement reached between the International Monetary Fund

and the Armenian authorities on a third annual arrangement under the Fund's Enhanced Structural Adjustment Facility (ESAF).

The implementation of this Community programme for Armenia will cover a four-to five-year period. The assistance is, however, conditional on Armenia pursuing rigorously its reform efforts, in particular in terms of privatising and restructuring enterprises and creating the necessary conditions to attract foreign investment.

### III. BULGARIA

#### 1. Introduction

1997 was a year of remarkable contrasts in Bulgaria's economic and political fortunes. At the start of 1997, the country was in deep crisis — without a government, and in the midst of a severe recession. There was a very real prospect of a renewed default on the country's foreign debt, as foreign reserves were practically exhausted. The year ended with a strong and stable government in office, and with the first results of a stabilisation strategy centred on a currency board arrangement. 1998 showed the consolidation of the progress achieved in stabilising the economy.

Bulgaria is receiving substantial support from the international community for its reform efforts. A stand-by arrangement with the IMF was successfully completed in June 1998, and subsequently, the Fund approved a three-year arrangement under the Extended Fund Facility to support the government's medium-term economic programme for the period July 1998-June 2001.

The acute economic and political crisis which occurred in late 1996 and early 1997 appears to have produced a sea change in Bulgaria's attitude to reform, both at a political level, and in the population at large. The government is committed to far-reaching structural reforms. Notwithstanding the short-term impact of restrictive macroeconomic policies and structural reforms on living standards, there is little serious opposition to the government's programme.

#### 2. Macroeconomic Performance

Political and economic difficulties which had been building up during 1996 came to a head in February 1997 with the collapse of the socialist government and a bout of hyperinflation: prices rose by 40% in January 1997, and by 240% in February. A newly elected reformist government opted for a stabilisation strategy based on sound financial policies and an ambitious structural reform programme. The boldness of this programme and the strong commitment of the government to its implementation attracted substantial support from official creditors.

A stand-by agreement was agreed with the Fund in April. The programme's objectives were reached and, in some cases, even surpassed. A key element of the programme was the introduction from July 1997 of a currency board arrangement, under which the central bank

is obliged to buy and sell unlimited amounts of domestic currency at a fixed exchange rate of 1000 leva to the deutsche mark: the immediate consequence of this system is that the size of the domestic money supply is dependent on the central bank's stock of foreign exchange reserves.

1997 outcomes were better than programmed and stabilisation continued to strengthen in 1998. After one and a half-years of recession, economic activity in Bulgaria started to recover in the second half of 1997. Following a contraction by a cumulative 17% in 1996-1997, real GDP is expected to increase by 4% in 1998. Inflation has been slowing faster than anticipated. Since end-1997, inflation has been running at less than 1% per month on average. Interest rates have been converging rapidly towards peg currency levels, mainly as a result of the remonetisation of the economy, reflecting the increased confidence in the currency.

The impressive stabilisation results observed in 1997 and the consolidation of these achievements in 1998 owe much to the strong fiscal stance, the CBA's impact on interest rates and the renewal of structural reform efforts. Expenditure restraint and improvements in tax collection yielded a general government deficit of 2.6% of GDP in 1997, compared with a deficit target of 4% in the programme agreed with the Fund. Fiscal performance continued to be strong in 1998. Latest forecasts point to a budget surplus of 1.3% of GDP against a deficit target of 2.7% of GDP in the budget law.

Successful macroeconomic stabilisation, combined with the government's commitment to accelerating privatisation, produced a substantial rise in foreign direct investments (FDI) in 1997. Inflows of FDI reached the equivalent of 4.8% of GDP, and exceeded the total amount of FDI received between 1991 and 1996. The current account and trade balances moved into substantial surpluses, amounting to 4.3% and 3.9% of GDP respectively. This was the result of a fall in imports, reflecting the depth of the recession, rather than a strong export performance. The net effect of the balance-of-payment developments was a strong increase in the central bank's foreign reserves. These rose from under USD 500 million in January 1997 to USD 1.9 billion in January 1998.

External developments were somewhat unfavourable in 1998. The trade and current account balances deteriorated in the first half of this year, as a result of a rapid growth in imports, driven by rising domestic demand, and a fall in exports due to decreasing foreign demand and lower international prices. On the capital account, inflows of FDI were about a third of the amount recorded in the first half of 1997, reflecting a slowdown in privatisation and the turmoil in emerging markets. The decline in FDI inflows and net portfolio investments was partially compensated by disbursements of balance-of-payment loans from official creditors. The latter contributed to maintaining the reserves of the central bank at a high level, the equivalent of over 5 months of imports of goods and services.

Balance-of-payment developments in 1998 also reflect the impact of the Russian crisis on the Bulgarian economy. Bulgaria's trade links with Russia are relatively small (exports to Russia accounted for 8 % of total exports in 1997) but trade with other CIS countries remains significant (18 % of total exports). A prolonged crisis in Russia with a spillover to neighbouring countries and the European Union could have serious implications for exports and economic growth. By contrast, the turmoil in international financial markets has so far had little impact on the financial sector. The exposure of Bulgarian banks to Russia is limited and the stock market is still underdeveloped. However, prospects for external financing have become less favourable, as a result of the reduced interest of foreign investors in Bulgaria's privatisation programme and costlier access to international financial markets, which has led the government to postpone an issue of Eurobonds.

### 3. Structural Reforms

Since taking office in Spring 1997, the government has moved rapidly to catch up on long-delayed structural reforms. Price controls, which had been progressively reintroduced by the previous administration, have been essentially abandoned: the remaining controls affect mainly energy and public services. The trade regime has been further liberalised. In particular, the import surcharge introduced in 1996 was lowered from 4 % to 2 % on 1 July 1998 according to the agreed timetable, and the Government has decided to remove it ahead of schedule at the end of 1998.

The privatisation process has been relaunched. The government has taken measures to reinvigorate enterprise privatisation and substantial progress has been achieved in this field. The cumulative share of divested state-owned long-term enterprise assets amounted to 26 % in September 1998 against 5.1 % at the end of 1996. However, compared to the spurt of progress made in mid-1997, there has been some slowdown in privatisation in the first half of 1998. A wide range of privatisation methods is used by the government. Management and employee buyouts are the main way of privatising smaller enterprises. This form of privatisation may not be conducive to rapid restructuring. The new owners are likely to have little capital of their own, and will have difficulty in raising funds while banks maintain their current cautious approach to lending.

The companies cut off from the banking system under the Isolation Programme undergo some restructuring before being liquidated or privatised. The programme has been successfully implemented despite some delays. The mandate of the programme has been extended by 6 months, until 1 July 1999. This programme has been instrumental in preventing the widening of the budget deficit and the emergence of quasi-fiscal deficits. Privatisation of the banking sector is proving difficult. To date, two banks have been privatised, one in 1997 (UBB) and another one in 1998 (Postbank). The Bank Consolidation Company (BCC), an institution in charge of the consolidation and restructuring of state banks, developed in early 1998 a strategy for the privatisation of

the four remaining state banks in which the BCC is a majority shareholder (Bulbank, Expressbank, Hebrobank and Biochim).

Since the 1996-1997 banking crisis, progress has been made in strengthening the banking system through measures to reinforce banking supervision and through the closure of the weakest banks. As a result, the financial position of the banking sector has improved significantly, and accordingly, no financial support has been given to state banks. All banks currently meet the minimum capital adequacy ratio of 8 %.

In the medium term, the stock market may provide a source of investment funds for Bulgarian private enterprise. To date, one state enterprise has been privatised through the stock exchange, and it is the only enterprise whose shares are traded on the official floor. However, a lively over-the-counter market has developed, due in part to the decision of the authorities to sell their residual shares in the 1000 enterprises included in the first wave of mass privatisation. The second voucher privatisation programme launched in the autumn should further boost the role of the stock exchange.

Sustained structural reforms now hold the key to Bulgaria's economic prospects. With the exchange rate fixed under the currency board arrangement—and inflation expected to remain above Western European levels for some time—Bulgarian enterprises need to achieve sustained improvements in productivity in order to avoid losing competitiveness. Continued fast privatisation of state enterprises is essential in order to facilitate this process, and fiscal policy must remain supportive of a stable economic climate which will encourage investment. Increased foreign involvement in the banking sector will help improve the efficiency of financial intermediation and allow Bulgarian entrepreneurs to take advantage of the favourable conditions for investment which currently exist.

### 4. Implementation of Macro-Financial assistance

A first macro-financial loan of some EUR 290 million to Bulgaria was decided by the Council in 1991, and disbursed in two instalments in 1991 and 1992. The loan was fully repaid in two instalments in December 1997 and March 1998.

A further EUR 110 million loan was approved in 1992, but because of repeated policy slippages, its disbursement was much delayed. A first instalment of EUR 70 million was disbursed in 1994 in the framework of the stand-by arrangement agreed with the IMF in May of that year. Disbursement of the outstanding EUR 40 million instalment did not take place until the second half of 1996, following the approval by the IMF of a new stand-by arrangement.

A third Community macro-financial loan of EUR 250 million was decided in July 1997 in the framework of the stand-by arrangement agreed with the IMF in April of that year. The first instalment of EUR 125 million was disbursed in February 1998. Disbursement of

the second and last instalment took place in December 1998.

The possibility of further macro-financial support from the Community to Bulgaria is envisaged in order to complement, together with other donors, the resources provided by the IMF and the World Bank under the EFF arrangement reached in July with the Fund.

## IV. GEORGIA

### 1. Introduction

Georgia achieved a very high growth rate in 1997, continuing the positive trend of the economy since 1995. In 1998, as a result of the Russian financial crisis (Russia accounts for about 30 % of exports of goods and also significant inward remittances) and bad results in the agricultural sector (because of drought), GDP growth was expected to decline to below 5 %. In 1997, the tight monetary and credit policies began to bear fruit in the form of a reduced state budget deficit and a deceleration in inflation. However, fiscal difficulties, which were already a cause for concern in 1997, worsened in the second half of 1998, because of slower growth and increasing tax evasion. Public sector salary and social security arrears accumulated further. As a result of the external crisis, the current account deficit, already large in 1997, widened in 1998, and in the second half of 1998 the currency depreciated sharply against the USD. Central bank interventions reduced the country's gross foreign exchange reserves by around 50 %. Progress in structural reforms has been encouraging. Very positive developments have been recorded in privatisation and in bank restructuring.

In July 1998, the IMF Board formally approved the third annual arrangement under a three-year ESAF (USD 245 million) adopted in February 1996. However, in November 1998, an IMF mission was not in a position to conclude favourably the third mid-term review under this ESAF, as a result of very low revenue collection and the inappropriate exchange rate policy.

The Community adopted on 17 November a Decision aimed at providing exceptional financial assistance to Armenia and Georgia in the form of a mix of long-term loans and successive annual grants (respectively up to EUR 170 million and EUR 95 million). This assistance was subject to the full settlement by both countries of their outstanding financial obligations towards the Community and to the rigorous implementation of the macroeconomic programmes supported by the IMF three-year Enhanced Structural Adjustment Facility.

### 2. Macroeconomic Performance

Following a sharp decline from 1990 to 1994, real GDP began to stabilise in 1995. This positive evolution was consolidated by GDP growth of some 10.5 % in 1996 and around 12 % in 1997. Growth decelerated sharply in 1998 as a result of the Russian financial crisis and bad results in the agricultural sector caused by adverse weather conditions.

After hyperinflation in 1994, end-of-period inflation was reduced to some 57 % in 1995 and 14 % in 1996. It decreased further to around 8 % in 1997 thanks to tight monetary and credit policies, but increased in 1998 as a result of the sharp depreciation of the currency against the USD in early December 1998.

The overall deficit of the general government (on a commitment basis and including grants) was further reduced from 4.5 % of GDP in 1996 to around 3.5 % in 1997, but failed to meet the IMF target of 2.8 %. In 1998, the ineffective collection of tax revenues became one of the main threats to Georgia's continuing recovery and financial stability. The overall budget deficit target of 2.5 % of GDP (on a cash basis) agreed for 1998 was not met.

The current account deficit (excluding official transfers) narrowed to about 8 % of GDP (or USD 370 million) in 1996 from 14 % in 1995. It decreased further to 6.7 % of GDP (or USD 340 million) in 1997. However, in 1998, this positive evolution was reversed as a result of expanding imports from and contracting exports to Russia. FDI increased in 1997 and 1998, as a result of growing foreign interest in Georgia. Gross foreign exchange reserves, which represented 2.7 months' imports in 1996, decreased in relative terms to 2.4 months in 1997, and fell sharply to less than 1 month in 1998 as a result of repeated central bank interventions on the markets to prevent the Georgian currency from depreciating. In early December, the central bank ceased its interventions and, consequently, the Lari depreciated by 60 % against the USD.

Since its independence, Georgia has accumulated a foreign debt which amounts to some 30 % of GDP and represents mainly payments arrears. Georgia reached rescheduling agreements with most of its creditors and could face all cash payments obligations. Georgia fully settled its outstanding financial obligations towards the Community (EUR 131 million) in July 1998. A payment of USD 22 million to Turkmenistan in December 1998 opened the way for discussions of a possible rescheduling of Georgia's arrears towards this country.

### 3. Structural Reforms

Structural reforms were implemented in line with IMF and World Bank expectations. Following broad completion of price and trade liberalisation, Georgia remained committed to a liberal trade system and was expected to become a member of the WTO in 1999. Privatisation proceeded satisfactorily: more than 60 % of arable land (arable land on all Georgian territory except Abkhazia and South Ossetia) was distributed to private farmers. Most of the remaining agricultural land was allocated through long-term leases on a competitive basis. Small-scale privatisation was virtually complete and privatisation of medium- and large-scale enterprises was advanced, with more than 960 of 1160 enterprises privatised. In the energy sector, a comprehensive privatisation programme was being implemented, while progress in developing a sound legal and regulatory framework was satisfactory. However, despite repeated efforts, collection rates remained insufficient. A major reduction

in the size of the public sector and a progressive reform of the health sector were under way. A market-oriented legal framework was being developed with the adoption of the civil code, a new tax code, the customs code, laws on customs tariffs, on privatisation, on agricultural land ownership, bankruptcy and the energy sector. Progress in establishing a Treasury system was impressive, and a very thorough plan of bank restructuring was being actively implemented. Less had been achieved, however, in developing the enforcement capacity of the legal system and in fighting corruption.

#### **4. Implementation of Exceptional Financial Assistance**

The Community adopted on 17 November 1997 a Decision aimed at providing exceptional financial assistance to Armenia and Georgia. Towards the end of 1997, Georgia met the necessary conditions to benefit from this assistance. It was willing to shortly settle the total amount of its outstanding financial obligations towards the Community (at that time EUR 127 million, including interest on arrears) and was satisfactorily implementing its adjustment and reform programme in the context of the current IMF ESAF arrangement.

Accordingly, the Commission initiated discussions with the Georgian authorities and reached an agreement in principle on the amounts, terms and conditions attached to this assistance. This agreement was signed by the Georgian authorities and ratified by the Georgian Parliament in late 1997. In August 1998, the Commission disbursed the first tranche under the Community assistance (EUR 110 million in the form of a loan and EUR 10 million in the form of a grant). This disbursement took place after full settlement by Georgia of its outstanding financial obligations towards the Community (EUR 131 million) in July 1997 and in the context of the agreement reached between the International Monetary Fund and the country's authorities on a third annual arrangement under the Fund's Enhanced Structural Adjustment Facility (ESAF).

The implementation of the Community programme for Georgia will cover a four-to five-year period. The assistance is, however, subject to the country pursuing rigorously its reform efforts, in particular in terms of privatising and restructuring enterprises and creating the necessary conditions to attract foreign investment.

The implementation of the second tranche of this assistance (grant tranche of EUR 9 million), which was scheduled for the end of 1998, was postponed to early 1999 as a result of disappointing implementation by Georgia of its third annual programme, notably with respect to targets for collection rates for duties and taxes and as a result of the inappropriate exchange rate policy.

### **V. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA**

#### **1. Introduction**

After the break-up of the Yugoslav Federation and the imposition of trade and transit sanctions, the former

Yugoslav Republic of Macedonia (FYROM) faced a severe economic and financial crisis. Near-hyperinflationary conditions developed and the public deficit reached some 13.5 % of GDP in 1993. At the same time, the balance-of-payment situation worsened and the servicing of foreign debt was temporarily suspended. Between 1990 and 1995, the country's GDP fell by almost two fifths and unemployment increased from 17 % in 1990 to more than 25 % in 1995. Reacting to this situation, the authorities took, especially from 1994, strong stabilisation measures and engaged in structural reform. As a result, in 1996 inflation came down to 2.5 % and the public deficit was reduced to 0.5 %. However, growth remained weak and unemployment continued to increase (32 % in 1996).

The economic programme of the authorities was strongly supported by the international financial institutions. Following disbursement by the IMF of some USD 36 million under a Systemic Transformation Facility (1995) and of some USD 40 million under a stand-by arrangement, a three-year Enhanced Structural Adjustment Facility totalling some USD 80 million was approved in 1997. The second tranche of three under this facility was disbursed in July 1998. The World Bank also provided balance-of-payment support during 1994-97 with several policy-based loans totalling nearly USD 220 million. Priority reform areas were privatisation, the restructuring of larger enterprises, the rehabilitation of the banking sector and the agricultural sector. Furthermore, the World Bank decided on 9 July 1998 to release the first of two tranches (each close to USD 29 million) of a Social Sector Adjustment credit.

The EU supported FYROM through a variety of instruments. Between 1992 and 1995, the EU provided a total of EUR 85 million mainly in the form of humanitarian aid. In March 1996, FYROM became eligible for assistance from the PHARE programme; assistance amounting to EUR 25 million a year was programmed for 1996 to 1998. In 1998, the EIB was invited by the Council to extend loans up to a ceiling of EUR 150 million until 31 December 2000. A first loan agreement (EUR 70 million) was signed in July 1998.

In 1997, the Community approved a balance-of-payment loan of EUR 40 million to cover part of the residual external financing needs for 1997 and 1998 and so to support the country's economic stabilisation and reform programme.

#### **2. Macroeconomic Performance**

In the first part of 1997, economic performance did not improve as expected. After having grown slowly in 1996, industrial production and GDP were again on a declining trend, exports stagnated and unemployment reached 36 %. Moreover, the balance of payments and the exchange rate came under pressure.

The authorities decided, in agreement with the IMF, to devalue the denar by 14 % against the DM (to 31 denar to the DM) in July 1997. At the same time, the authorities declared their intention to persist with their efforts

towards economic reform and to take the necessary steps to avoid the devaluation leading to a major increase in prices. A programme comprising a wage freeze and a cut-back in public expenditure was put into effect, which proved successful in keeping the inflation rate in 1997 at 1.3 % and in 1998 at around 1 %. Government finances were almost balanced, with an overall fiscal deficit of 0.4 % of GDP in 1997 and an only slightly worse result for 1998.

The July devaluation contributed to a recovery in output and export growth after the disappointing figures for the first half of 1997. GDP growth was around 1.5 % in 1997. In the first eight months of 1998, exports increased by 13 % compared to the same period in 1997, and industrial production rose by 5.8 % year-on-year compared to the first eight months of 1997.

While the improvement in the trade balance in the first 8 months of 1998 was limited by a strong rise in imports (+ 7 %), the overall balance of payments improved thanks to a considerably larger inflow of foreign direct investment, and the country's foreign exchange reserves increased by USD 38.6 million to USD 318.6 million. By the end of 1998, FYROM had cleared all its external arrears, including those to the Community and the EIB.

### 3. Structural Reform

In 1997 and 1998, steps were taken to liberalise trade and encourage foreign direct investment. In December 1997, excise duties were lowered on 14 agricultural products and food products by 10 percentage points. Price liberalisation has been largely accomplished.

The legal framework was improved by the adoption of a new employment law and of amendments to the labour relations law and the Collateral Law. Two laws were adopted which will contribute to rebalancing the rights of creditors and debtors in favour of the former. Other important laws (on denationalisation, on ownership and an amendment allowing secondary share trading) were passed. The limited capacity of the judicial system, however, may impede the implementation of these laws. Progress was also registered in the supervision of the banking sector, which resulted in some improvement in the quality of lending portfolios.

Privatisation has proceeded broadly at the pace envisaged under the privatisation programme begun in 1993 and accelerated in 1995. Almost all of the 1216 enterprises, which were identified in the programme, had been privatised by mid-1998. The private sector accounts for more than two-thirds of GDP and employment. In many cases, however, privatisation was not accompanied by a change in management and the necessary restructuring has not been undertaken. Progress in the break-up and privatisation of agro-industrial conglomerates has remained limited.

In 1998, a number of major sales to foreign investors boosted the extremely low foreign direct investment to some USD 70 million in the first eight months of the year. Agreements were reached on the (partial) privatisa-

tion of the dominant Stopanska Banka, of Macedonian Telecom and of a large cement producer.

## 4. Implementation of Macro-Financial Assistance

Following the Council decision on 22 July 1997 to make available Community macro-financial assistance of up to EUR 40 million, the Commission and the authorities of FYROM agreed on conditions and modalities for the disbursement of the loan. The conditions included satisfactory performance under the IMF programme, clearance of all arrears due to the Community and to the EIB, and a number of measures in the areas of trade (trade liberalisation, customs code), private sector development (promotion of foreign direct investment, bankruptcy legislation) and banking sector supervision and reform (lending exposure of banks, privatisation).

The Commission released the first tranche of EUR 25 million on 30 September 1997 and, following the fulfilment of the relevant conditions, the second tranche (EUR 15 million) on 13 February 1998.

## VI. ROMANIA

### 1. Introduction

In 1997, the government which had been elected in November 1996 launched a radical programme of macroeconomic stabilisation and modernisation of the economy. While growth had resumed in 1994, the relatively satisfactory macroeconomic performances registered until 1996 masked insufficient progress on structural reforms and restructuring of the enterprise and agricultural sectors. Breaking with years of timid reforms, the new government took a number of radical measures in the first months of 1997, including liberalisation of most prices and the trade regime, closure of many large loss making state farms and termination of directed credits from the central bank to enterprises. At first, these measures restored the confidence of lenders and international investors and prompted international financial institutions (IFIs) to extend fresh loans to Romania.

However, in the second half of 1997 and most of 1998, the reform momentum stalled. Continuous internal dissent within the ruling coalition—which led to a change of Prime Minister in April 1998 and to frequent replacement of ministers—delayed the adoption of key reforms, encouraged bureaucratic inertia and badly damaged foreign investors' confidence. As a result, the economic situation remained fragile, as testified by the continuous fall in GDP recorded in both 1997 and 1998, the widening of the external imbalances in 1998, the accelerated depreciation of the national currency and repeated reduction in the country's sovereign rating. Insufficient progress on restructuring and privatisation of the large public companies continued to threaten gains achieved in macroeconomic stabilisation. Towards the end of 1998, however, new steps were taken to restore the reform momentum, but international confidence remained low and social protests were increasing.



Romania's relations with the IFIs mirrored the uneven path of reform. After the November 1996 elections, the IFIs took an active role in advising the new government on its economic and social policies. Agreement was reached with the IMF in April 1997 on a USD 430 million Stand-by arrangement (SBA). In June 1997, the World Bank approved USD 550 million of new credits and the release of the USD 80 million second tranche of the Financial and Enterprise Structural Adjustment Loan (FESAL). However, by the second half of 1997, the slow progress of structural reforms led to an interruption of disbursements under these loans. The SBA closed in May 1998 with only two of the five tranches having been disbursed, while the FESAL closed in spring 1998 with the last tranche not disbursed, despite an extension of the loan period. The World Bank was not able to disburse the second tranche of an Agricultural Structural Adjustment Loan before the end of 1998, and extended the loan period. Towards the end of 1998, discussions with the IFIs on new structural adjustment loans resumed, and negotiations were expected to be finalised in the course of the first semester of 1999.

## 2. Macroeconomic Performance

Romania's macroeconomic performance in 1997 and 1998 was worse than anticipated. After falling by 6.6% in 1997, it is estimated that GDP fell again in 1998 by as much as 6-7%. This sharp fall in output was caused by the overall restrictive stance of monetary, fiscal and income policies, although there have been periods of policy relaxation.

One important achievement in 1997 and 1998 has been the reduction in inflation and the improvement of the framework of monetary policy. Inflation surged at the beginning of 1997 (176.9% in March 1997 on an annual basis) because of price liberalisation and the rapid depreciation of the currency. It subsequently declined to reach about 42% at the end of 1998. In addition, the special credits that the National Bank of Romania (NBR) had been forced to extend to the agriculture and enterprise sectors were terminated, which allowed it to focus on its primary responsibility of fighting inflation. This was achieved through a strict control of the monetary base and also through the appreciation of the real exchange rate (although this policy was reversed in the second half of 1998). Tight monetary policy has led to high nominal and real interest rates, which have further dampened economic activity.

Achieving fiscal discipline in the public sector was one significant success of the government in 1997. The consolidated general government deficit fell to 3.6% of GDP, compared to the expected 4.9%. When taking into account the quasi-fiscal subsidies extended by the NBR up until 1996, fiscal consolidation was even more pronounced. However, in 1998, the authorities were confronted with increasing difficulties in controlling the fiscal situation, mainly due to an absence of significant progress in implementing structural reforms: revenues were much lower than expected (due to lower privatisation receipts and the accumulated tax arrears of state-

owned enterprises). At the same time, pressures for higher spending increased. In 1998, two supplementary budgets were approved in order to contain the deficit. Moreover, the financing of the deficit became increasingly problematic in an environment of high interest rates and difficult conditions on international markets.

The external accounts became very fragile. In 1997, the current account deficit amounted to USD 2.4 billion (6.7% of GDP) and further deteriorated in 1998 (it is estimated that the deficit will reach USD 3 billion or about 8% of GDP). The deterioration of the current account deficit in 1998 was caused by the worsening of the trade deficit. Indeed, reversing the trend seen in 1997, and despite the fall in domestic demand, exports fell and imports increased in 1998.

The balance-of-payment constraint has become problematic in 1998, notably because of deteriorating conditions for the financing of the external deficits. Indeed, while there was a surge of long-term investment in 1997 (notably foreign direct investments) which allowed the National Bank of Romania to build up its reserves, this trend was reversed in 1998. Since mid-1997 there has been a growing reluctance of international investors to commit resources to Romania. The repeated downgrading of Romania's sovereign rating in the second half of 1998 and the impact on emerging markets of the Asian and Russian crises further complicated the financing of the country's external financial needs and obligations. Indeed, external debt service became quite important in 1998 and will further increase in 1999.

In 1998, the authorities introduced a 6% import surcharge designed to provide some short-term relief to the balance of payments. However, this did not tackle the fundamental causes of the balance-of-payment problems, which are linked to short term macroeconomic developments (including the real appreciation of the leu) but mostly to structural factors, notably the fundamental weakness of the country's productive base. This in turn is closely linked to the absence of a meaningful restructuring of many of the large state-owned companies.

## 3. Structural Reforms

As the experience between 1990 and 1996 has shown, the hard-won gains of macroeconomic stabilisation can not be sustained unless substantial restructuring of the public enterprises is achieved. Although some important steps were taken in early 1997 and late 1998, the lack of progress in this area has been the main source of disappointment and concern.

The new authorities initiated some important structural reforms in 1997, notably because both the IMF and the World Bank, in the context of their loan conditionality, put a heavy emphasis on structural criteria. For example, the external tariff was substantially reduced, most prices were liberalised, tariffs of the utilities have been adjusted automatically, capital markets were further developed and privatisation was accelerated. While most of these reforms are still in place, the reform

momentum stalled in the second half of 1997, and was only somewhat revived at the end of 1998.

A particularly noteworthy area of progress has been the liberalisation of the exchange rate market, which was implemented in February 1997, when the National Bank of Romania returned their licences to operate on the foreign exchange market to all commercial banks and foreign banks' branches established in Romania.

Restructuring of the large loss-making public enterprises remained very slow. While a number of 'Régies autonomes' were transformed into commercial companies, and restructuring plans were approved for the electricity, mining and railways companies, financial discipline did not make much progress. The amount of arrears, notably to the state and social security budgets and utilities, continued to grow, undermining the fiscal position of the government.

The restructuring of the financial sector did not progress much. The largest public banks have been unable to impose financial discipline on state-owned enterprises. More than half of the commercial banks' assets were non-performing at the end of 1997. This situation led the authorities to carry out the massive recapitalisation of two public banks in 1997 through the issue of government bonds amounting to 1.4% and 1.8% of GDP, respectively. Problems continued to mount in 1998, and it was widely expected that a new rescue plan was needed. As a result of their difficulties, banks have cut drastically their lending to the private sector: the amount of credit to the non-government sector shrank from 24.5% of GDP at the end of 1996 to 14.4% of GDP at the end of 1997, and increased only marginally in real terms in 1998.

Privatisation was uneven. There was an acceleration in 1997, and a lull during most of 1998. The number of companies that were privatised increased significantly compared to previous years. However, most of the enterprises sold were small- and medium-sized. Of the large enterprises (usually the largest loss makers and those with large liabilities), only a small number were sold and mostly to foreign companies. The national telecommunication company was sold in November 1998. Privatisation of two small public banks was repeatedly postponed and only one of them was sold at the end of 1998.

#### **4. Implementation of Macro-Financial Assistance**

In its decision of 20 June 1994, the Council had decided to grant to Romania a medium-term balance-of-payment loan for a maximum amount of EUR 125 million, to be disbursed in two tranches. A first tranche of EUR 55 million was disbursed in November 1995. On 17 March 1997, the Economic and Financial Committee Council endorsed the Commission's intention to reactivate the outstanding second tranche, of up to EUR 70 million. In a supplemental Memorandum of Understanding, the Commission and the Romanian authorities agreed to disburse the EUR 70 million second tranche in two payments, of respectively 40 and up to EUR 30 million. Following the IMF Board approval of the new Stand-by

arrangement in April 1997, a first payment of EUR 40 million was made on 30 September 1997. The second payment, of EUR 30 million, was made on 23 December 1997, following the positive evaluation by the Commission services of progress in macroeconomic stabilisation and structural reforms.

On 19 November 1997, a High Level G-24/Consultative Group meeting took place in Brussels, which reviewed Romania's balance-of-payment situation and the external financing needs for 1998 and beyond. In the light of the IMF's assessment, it was agreed that there was no need for further balance-of-payment assistance from bilateral donors (including the Community) for 1998.

On 18 March 1998, Romania repaid on time the first tranche of EUR 185 million of the first EC macro-financial loan. At the end of 1998, the Commission expressed its intention to support Romania in the context of a new programme of macroeconomic stabilisation and structural reforms to be supported by new IMF and World Bank structural adjustment loans.

## **VII. UKRAINE**

### **1. Introduction**

Although the Ukrainian economy further stabilised in 1997 and 1998, mainly because of the restrictive policies of the central bank, there has been limited progress with respect to key structural reforms which could firmly put the country on to a path of sustainable growth. After a series of fiscal slippages in the run-up to the March 1998 parliamentary elections, Ukraine's economic situation remained fragile and vulnerable to exogenous shocks.

In the latter months of 1998, as international investors reassessed the risks of investing in emerging economies, the Ukraine became a focus of attention. Investors were particularly preoccupied by the risk of default on Ukraine's external and domestic debt, and this fear triggered large withdrawals of portfolio investment from the country's financial markets during the autumn of 1998 and put the national currency (the hryvna) under considerable pressure.

### **2. Macroeconomic Performance**

Despite significant progress in macroeconomic stabilisation achieved in Ukraine in recent years (inflation was reduced from 400% in 1994 to 10% in 1997, and the contraction of real GDP was scaled down from 23% in 1994 to 3% in 1997), the general economic situation remained fragile. This was mainly due to delays in the implementation of key structural reforms which would permit the country to develop fully its economic potential, improve its public finances (the budget deficit was 5.6% of GDP in 1997) and get on to a path of sustainable growth.

Some positive trends were established in the first eight months of 1998. Real GDP grew by 0.2% for the first time since independence in 1991, and inflation was under

control thanks to the central bank's tight monetary policy (year-on-year inflation was 6.9 % in August). These trends, however, were reversed when international investors started to reassess the risks of investment in Eastern Europe in the aftermath of the Asian and, especially, the Russian crisis. Since Ukraine had engaged in large-scale short-term borrowing in 1997, investors were preoccupied with the risk of default on external and domestic debt maturing in the second half of 1998. This fear triggered large withdrawals of portfolio investment from Ukraine's financial markets in the final months of 1998.

In view of the considerable pressure on the hryvna and the significant debt servicing to be carried out by the end of the year, the authorities took two measures to contain the crisis. They first lowered hryvna's trading band against the dollar and, second, successfully rescheduled a large part of Ukraine's short-term external and internal debt that was due to mature in the second half of 1998 in the framework of a scheme, agreed with the creditors (thus avoiding a unilateral restructuring, as had happened in Russia).

Furthermore, the authorities approved a three-year economic programme covering the period July 1998-June 2001, supported by a USD 2.2 billion Extended Fund Facility (EFF) from the IMF. The programme's key objectives are real GDP growth of 4 % in 2001 (against –3 % in 1997) and inflation of 7 % in 2001 (against 10 % in 1997). It further provides for a wide range of structural reforms, including the strengthening of fiscal institutions (especially the tax and customs administration), and reductions in the size of the government, as well as progress in privatisation, deregulation and administrative reforms. At the end of the reporting period, the implementation of the EFF was however suspended because of both fiscal and structural slippages but the IMF intended soon to review the situation in order to assess compliance with the programme and possibly to resume disbursements.

### **3. Structural Reforms**

The authorities' efforts to launch comprehensive structural reforms have often faced the opposition of sizeable conservative forces in Parliament. As a result, progress with reforms in 1997 and 1998 was erratic, uneven and mainly concentrated in the privatisation of small enterprises and in the restructuring of the agriculture and energy sectors.

Although the privatisation of small enterprises has been virtually completed, the privatisation of large enterprises has practically stagnated as a result of both administrative delays and lack of interest by investors. In the agricultural sector, the state order system for grain was eliminated at the state government level, but farmers continued to be under pressure to sell to the government,

as restructuring and privatisation of the national bread corporation was delayed.

Considerable progress was achieved in reforming the energy sector. In the electricity sector, a competitive wholesale market was established, but wholesale prices were not fully passed through to retail prices and the financial position of the sector deteriorated. However, in co-operation with the World Bank, the authorities developed a financial recovery plan for this sector in April 1998, increased tariffs for households by 25 % in May, and started to implement measures to improve collection. In the gas sector, regional restrictions on domestic gas sales were eliminated and prices for industrial and commercial consumers were freed. Furthermore, the government began to auction part of the Russian gas received as a transit fee. In the coal sector, the reforms envisaged under the original programme agreed with the World Bank were not implemented and, as a result, this sector continued to be a drain on the budget (the settlement of miners' wage arrears became a political problem before the parliamentary elections and led to budgetary over-runs, although these payments were not budgetary obligations).

### **4. Implementation of Macro-Financial Assistance**

The European Community has to date provided Ukraine with two macro-financial loans (the first loan of EUR 85 million was decided by the Council in 1994 and disbursed in 1995 and the second of up to EUR 200 million was decided in 1995 and disbursed in two tranches of EUR 100 million each in 1996 and 1997 respectively).

The Council decided on 15 October 1998 to grant Ukraine a third macro-financial loan of up to EUR 150 million to be released in at least two tranches. As with the two previous Community loans, the disbursement of the tranches of this third loan would depend on: (a) a satisfactory track record for Ukraine's macroeconomic programme recently agreed with the IMF in the context of the EFF, and (b) progress with respect to structural reforms, including the observance of a number of performance criteria to be attached to this loan.

The Commission services agreed with the Ukrainian authorities a series of performance criteria for the disbursement of the first tranche of the loan. They relate to trade liberalisation; the reform of the financial sector, which is suffering from both structural weakness and the spill-over effects of the emerging markets' crisis; the improvement of foreign investment conditions; and the acceleration of the reform of Ukraine's energy sector. The first tranche is expected to be of EUR 50 million and will be released when the EFF is back on track.

24 September 1999

## Principal economic policy measures — June/July/August 1999

### Community (EU-15)

3/4.6 The Cologne European Council welcomes the Ecofin Council's draft recommendation on the Broad Economic Policy Guidelines 1999 and recommends its adoption to the Council.

12.7 The Ecofin Council formally adopts the Council recommendation on the Broad Economic Policy Guidelines 1999.

### Belgium (B)

None.

### Denmark (DK)

17.6 The Nationalbank lowers the repo rate by 5 basis points to 2.85 %. The discount rate remains unchanged at 2.75 %. The premium to ECB's refinancing rate is thereby reduced to 0.35 %.

31.8 The Danish government presents the draft budget bill for central government for 2000, scheduled to be adopted by mid December. The draft budget for central government foresees a surplus of DKK 7.9 billion next year, corresponding to 0.6 % of GDP. The central government debt ratio is targeted to be reduced by 2 percentage points during 2000 and amount to 44.0 % of GDP. Together with projections for local governments, general government would reach a surplus of DKK 28.8 billion, corresponding to 2.3 % of GDP.

### Germany (D)

23.6 A first draft proposal for the *federal* budget for the year 2000 is presented by the government. Expenditures are expected to reach DEM 478.2 billion compared to DEM 485.7 billion in 1999. The federal deficit is expected to decline from DEM 53.5 billion in the current year to DEM 49.5 billion next year. Compared to the new government's original medium-term planning, savings of more than DEM 30 billion are now proposed, of which DEM 12.5 billion are by the Ministry for Labour and Social Affairs (slower increase in pensions; reduction in social security benefits for the unemployed). The government also presents a first blueprint for the envisaged reform of corporate taxes in 2001. It aims to bring the highest tax rate down to 35 %, 'financed' partially by the closing of tax loopholes. The corporate sector, however, is to get a tax relief of about DEM 8 billion in 2001 only.

25.8 The Federal Government adopts the proposal on the budget for the year 2000, the proposed changes regarding family allowances (in line with the ruling by the Constitutional Court) and the further steps of the ecological tax reform.

### Greece (EL)

28.7 The Bank of Greece takes additional measures to limit credit expansion.

### Spain (E)

18.6 The government approves the draft for Reforming the Law for the Defence of Competition.

18.6 The government approves the establishment of reference prices for medicines financed by the Social Security System, to be applied from September 1999.

### France (F)

None.

### Ireland (IRL)

None.

### Italy (I)

15.6 Treasury Minister Mr. Amato declares before the Parliament that to reach the budget deficit target of 1.5 % of GDP in 2000, as foreseen in the Stability Programme, the government aims to carry out expenditure cuts of 0.8 % of GDP (ITL 16 trillion or € 8.3 billion) with the next Budget Law.

30.6 The government approves the Document for Economic and Financial Planning (DPEF) for 2000-2003, setting the targets for growth and public finances. The general government deficit is tabled at 2.4 % of GDP this year, 1.5 % in 2000, 1 % in 2001, with the objective of reaching the target of a "close to balance" deficit of 0.1 % of GDP in 2003.

29.7 The Parliament adopts the four-year economic plan (DPEF) for 2000-2003.

### Luxembourg (L)

None.

### Pays-Bas (NL)

None.

### Austria (A)

17.6 The Parliament approves the tax reform to take effect next year. Together with the recent "family package" the net tax relief amounts to some ATS 30 billion (€ 2.2 billion) or some 1.1 % of GDP. The reform's central element is a reduction of income tax rates in the middle income ranges.

### Portugal (P)

18.6 The finance minister blocks a strategic agreement (cross-participation) between the Champalimaud's financial group (Portugal's third largest) and the Santander group (the largest Spanish financial group).

### Finland (FIN)

1.6 The Cabinet Committee on Economic Policy decides to publish recommendations on privatisation policy.

26.7 Government agrees budget proposal for 2000 with projected general government surplus of 4{4,17} % of GDP, up from 3 % in 1999, but defers main tax decisions until outcome is known of current centralised wage negotiations (implying tax concessions are conditional on moderate settlements).

26.7 Government approves revised Stability Programme for 2000-2003.

### Sweden (S)

3.6 The Swedish Riksbank announces in its Inflation Report that it is tracking the underlying inflation rate (UNDIX) closely, in addition to the official inflation measure, the headline inflation rate (CPI). In particular, monetary policy is influenced by the forecast of the underlying inflation rate.

### United Kingdom (UK)

10.6 The Bank of England's Monetary Policy Committee cuts the official repo rate by 0.25 % to 5.0 % with immediate effect.

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