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**REPORT FROM THE COMMISSION TO THE COUNCIL
AND THE EUROPEAN PARLIAMENT**

on the implementation of macro-financial assistance to third countries in 2003

LIST OF ABBREVIATIONS

CAMEL	Capital, assets, management, earnings, liquidity (parameters used in international system for rating banks)
CBA	Currency Board Arrangement
CEECs	Central and East European Countries
CPI	Consumer Price Index
DEM	German Mark
EC	European Community
EFF	Extended Fund Facility
EIB	European Investment Bank
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FESAL	Financial and Enterprise Structural Adjustment Loan
FOREX	Foreign Exchange
FRY	Federal Republic of Yugoslavia
FYROM	The former Yugoslav Republic of Macedonia
GDP	Gross Domestic Product
IFIs	International Financial Institutions
IMF	International Monetary Fund
MFA	Macro-Financial Assistance
NIS	New Independent States
PRGF	Poverty Reduction and Growth Facility (formerly ESAF)
SAA	Stabilisation and Association Agreement
SAF	Structural Adjustment Facility
SBA	Stand-By Arrangement
SOE	State Owned Enterprise
USD	Dollar of the United States of America
VAT	Value Added Tax
WTO	World Trade Organisation

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I. INTRODUCTION

This report assesses the economic situation, the progress of reforms and the prospects of the countries that benefited in 2003 from ongoing macro-financial assistance programmes with particular reference to the implementation of the economic and structural reform conditions attached to it.

Chapter II provides an overview of the EC macro-financial assistance to third countries, with an historical background, a summary of the operations in 2003, and an analysis of the burden-sharing among the international donor community.

The following chapters discuss the economic situation in the countries for which either new macro-financial assistance operations have been decided by the Council or disbursements under previously decided operations have been made or are still outstanding in 2003.

In line with the recommendations of the Court of Auditors in their special report of March 2002, particular attention is paid to the relevant aspects of the transition process and of the implementation of structural reforms in the beneficiary countries. Progress in this respect also reflects the degree to which the corresponding economic policy conditions attached to the EC macro-financial assistance have been met.

Moreover, as regards the recommendation of the Court on improvement of financial management in the beneficiary countries, the Commission plans to conduct operational assessments of their financial circuits and controls related to Macro-Financial Assistance. In this context, an audit firm has been selected following an open call for tenders and a framework contract has been signed in 2003.

In addition, selected in depth ex-post evaluations will be carried out by external consultants in order to measure the impact of MFA operations in the relevant countries.

This report is submitted in accordance with the Council Decisions regarding Community macro-financial or exceptional financial assistance to third countries and follows on from the reports presented in previous years¹.

The complete list of macro-financial assistance operations decided by the Council with the corresponding disbursements up to the end of 2003 appears in Annex 1. Annex 2 summarises the macro-financial assistance provided by bilateral and multilateral donors to the countries that received EC macro-financial assistance. Finally, selected macroeconomic indicators of the beneficiary countries are presented in Annex 3.

¹ 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(1992) 400 of 16 September 1992.
COM(1994) 229 of 7 June 1994.
COM(1995) 572 of 27 November 1995.
COM(1996) 695 of 8 January 1997.
COM(1998) 3 of 13 January 1998.
COM(1999) 580 of 15 November 1999.
COM(2000) 682 of 27 October 2000.
COM(2001) 288 of 1 June 2001.
COM(2002) 352 of 11 July 2002.
COM(2003)444 of 24 July 2003.

II. OVERVIEW

1. Background

Macro-financial assistance (MFA) supports the political and economic reform efforts of the beneficiary countries and is implemented in association with support programmes from the IMF and the World Bank. It has continued to incorporate a set of principles reaffirmed by the Council in its conclusions of 8 October 2002, which underline the exceptional character of this assistance, its complementarity to financing from the IFIs and its macroeconomic conditionality. In particular, Community MFA 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 this type of assistance in consultation with the Economic and Financial Committee.

2. Macro-financial assistance in 2003

The previous years were already years of enhanced MFA to the Balkans countries with eight different operations decided by the Council in the period 2000-2002, respectively for the Former Yugoslav Republic of Macedonia, Kosovo, Montenegro, Bosnia, Serbia and Montenegro. This tendency was confirmed in 2003 with a supplementary MFA granted to Serbia and Montenegro. This situation makes the Balkan countries the main beneficiaries of MFA with a total of new decisions amounting to a maximum of EUR 708 million for the period 2000-2003.

A) *New decisions*

a. The Council decided on 25 November 2003 to provide a supplement in macro-financial assistance to Serbia and Montenegro of up to EUR 70 million, comprising a loan element of up to EUR 25 million and a grant component of up to EUR 45 million, thus increasing the maximum amount granted by the Council decision (2002/882/EC) to EUR 200 million (of which EUR 120 million in grants).

b. The Commission adopted on 23 December 2003 a proposal to provide macro-financial assistance to Albania of up to EUR 25 million (a loan element of up to EUR 9 million and a grant component of up to EUR 16 million). This proposal has been adopted by the Council in the second quarter of 2004.

c. Regarding the NIS, no Council decision was made in 2003.

B) *Disbursements*

Disbursements of macro-financial assistance amounted to a total of EUR 203 million, of which EUR 85 million in the form of grants and EUR 118 million in the form of loans.

The grant part included amounts of EUR 7 million for Tajikistan, EUR 25 million for Bosnia (of which EUR 15 million was disbursed on the basis of procedures initiated in 2002 but finalised in early 2003), EUR 18 million for the former Yugoslav Republic of Macedonia and EUR 35 million for Serbia and Montenegro.

The disbursements of loans represented EUR 50 million for Romania, EUR 28 million for the former Yugoslav Republic of Macedonia and EUR 40 million for Serbia and Montenegro.

C) Repayments and undisbursed operations.

Some MFA operations decided in the first half of the 1990s have not been fully paid out as initially foreseen. This has been the result of either improved external financial conditions (Hungary, Baltics, Slovakia, Algeria), or of a difficult economic or political climate (Albania, Belarus). In these cases, the disbursement of the remaining tranches is not programmed anymore. For more recently adopted operations, implementation, in some cases, has been delayed because of a slowing-down in the reform process (Romania, Georgia). In the case of Moldova and Ukraine, evolving circumstances have led the Commission to reconsider the terms of the existing assistance operations and to reshape them in 2002, as detailed in the previous report. A similar approach has also been proposed in the case of Albania.

The last column of Annex 1 provides details concerning undisbursed, outstanding, suspended or cancelled amounts.

3. Trends and geographical distribution of macro-financial assistance

The EC MFA is intended to support macroeconomic stabilisation of the beneficiary countries and ease their balance of payments (and budget) difficulties. It plays also a very useful role in promoting structural reform. 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 EU faced balance of payments difficulties and 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 countries in Central and Eastern Europe. As a result of the conflicts in the Western Balkans, in particular the Kosovo conflict of 1999 and of the political changes in Serbia and Montenegro (formerly, the FRY), a clear tendency for a relative increase of MFA to the countries of the Balkans developed through the 1999-2003 Council Decisions.

The five MFA decisions taken in 2002-2003 were for traditional balance of payment assistance operations and four of them included grants.

A specificity of the decisions of the 2000-2003 period is indeed the substantial share of grant support in the total amount decided: 42 % instead of 6 % over the 1990-1999 period. The new grant/loan proportion of the assistance packages reflects the assessment made by the EU bodies of the relative degree of poverty of the recipient countries and of their limited debt servicing capacity. As observed already in 2000 and 2001, MFA is aimed not only at promoting macroeconomic stabilisation but also at supporting the recipient governments' programmes of structural reform. Consistently, MFA has been effectively combined with assistance from the PHARE/ISPA, TACIS or CARDS programmes with a view to strengthening the institutional capacity that was essential to the success of the structural reform process.

Tables 1 and 2, and their accompanying Graphs 1a and 2a underline the exceptional character of the EC MFA. The highest volumes of MFA operations were decided and disbursed in the years immediately after the changes in the political and economic systems of the countries of Central and Eastern Europe. Since then, the fluctuations in the amounts of MFA reflect decisions taken on a case-by-case basis after an assessment of the macro-economic situation

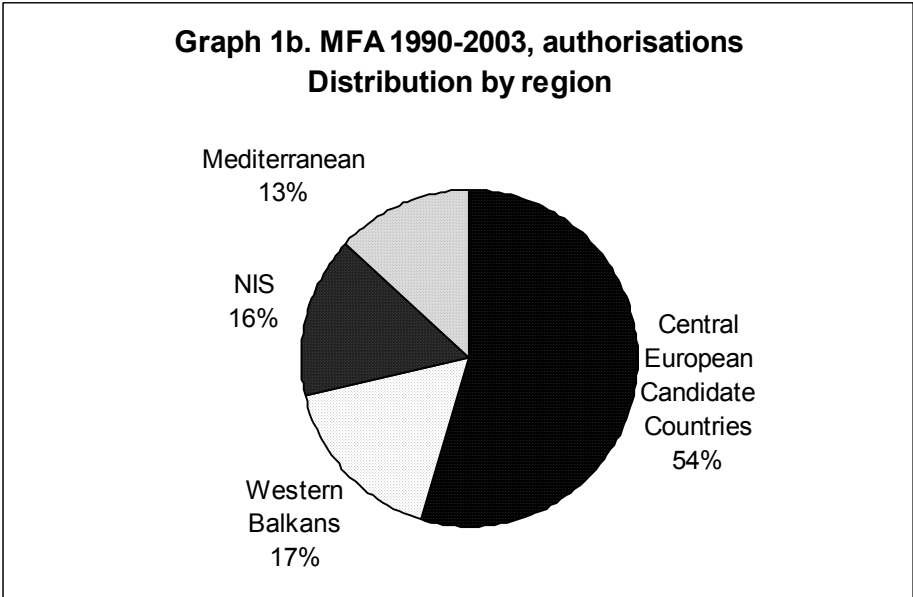
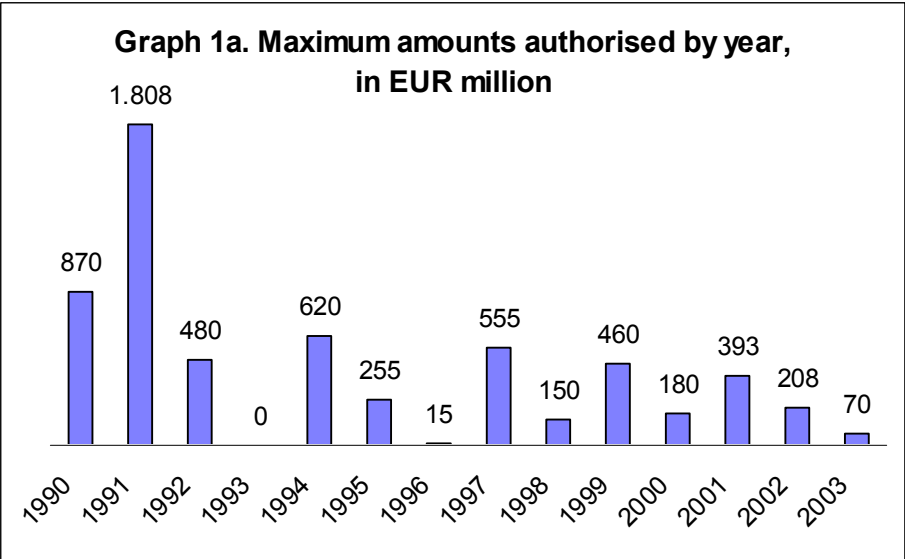
and residual external financing needs of the potential beneficiary countries. Graph 1a - for **net amounts of operations** decided over the whole period from 1990 to 2003 (totalling around EUR 6 billion) - and Graph 2a - for actual amounts disbursed (totalling over EUR 5 billion) - show the important concentration of the assistance in the CEECs new Member States (around 55 % of total macro-financial assistance decided over the last 14 years). However, MFA to these countries was progressively phased out in parallel with their progress in macroeconomic adjustment and reform. More recently, MFA has been mainly provided to the Western Balkans (63.5 % of the operations decided from 1999 to 2002 and 83% for 2000-2003) and some low income NIS. The relatively low amounts for the Mediterranean countries (12 % of the overall amounts authorised, but no new authorisation since 1996) should be considered against the background of other forms of macroeconomic support made available to these countries (notably, the MEDA Structural Adjustment Facilities).

Table 1. Macro-financial assistance, 1990-2003
Maximum amounts authorised, millions euro

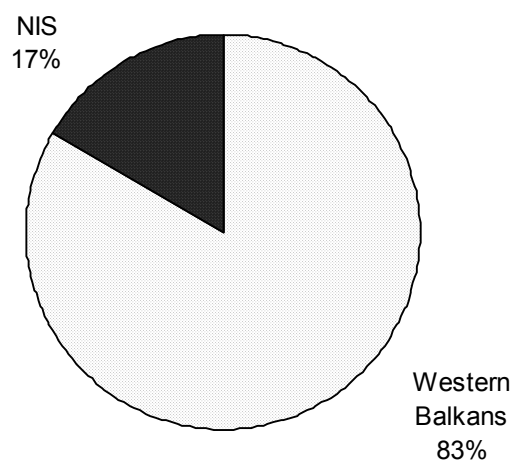
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
By region														
Central European Candidate Countries	870	1.220	410		255			250		300				
Western Balkans			70		35			40		160	55	393	190	70
NIS					130	255	15	265	150		125		18 (a)	
Mediterranean		588			200									
Total amounts authorised	870	1.808	480	0	620	255	15	555	150	460	180	393	208	70
out of which, straight grants		28	70		35			95		70	90	168	130	45
											Kosovo (35)		Serbia and	Serbia and
											Montenegro	fYRoM (18)	Montenegro	Montenegro
											(20)	Serbia and	(75) Bosnia	(45)
								Armenia			Bosnia	Montenegro	(40)	
								and			(40)	Tajikistan	(40)	
								Georgia			fYRoM (35)	Moldova	(120) Kosovo	Moldova (15)
								(95)			(30)	(15)	(30)	(b)
			Albania		Albania									

(a) net amount taking into account (b) and, for Ukraine, new loan of EUR 110 million together with simultaneous cancellation of EUR 92 million out of the EUR 150 million loan decided in 1998.

(b) grant of EUR 15 million and simultaneous cancellation of the EUR 15 million loan decided in 2000



**Graph 1c. MFA 2000-2003, authorisations
Distribution by region**



Disbursements, millions euro

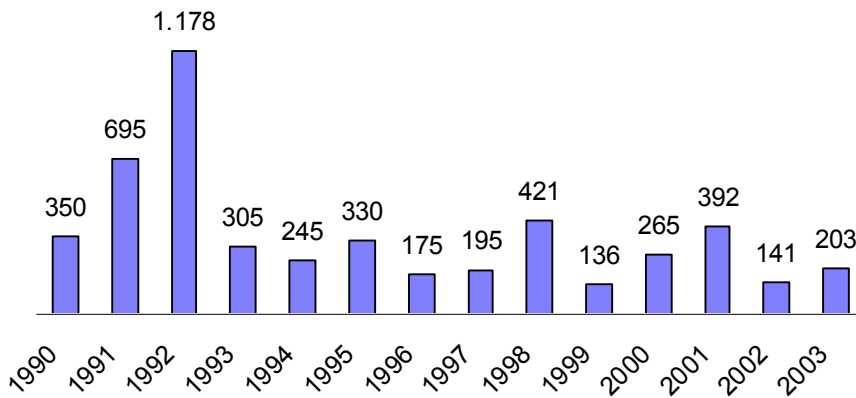
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
By region														
Central European Candidate Countries	350	695	705	270	70	80	40	70	250	40	160			50
Western Balkans			35	35		15	20	25	15	25	105	312	130	146
NIS					25	135	115	100	156	71		80	11	7
Mediterranean			438		150	100								
Total amounts disbursed	350	695	1.178	305	245	330	175	195	421	136	265	392	141	203
out of which, straight grants			63	35		15	20		18	28	85	105	141	85
													Armenia (11)	Bosnia (25,
													Kosovo (15)	Serbia and
													Bosnia (15)	Montenegro
													fYRoM (10)	Montenegro
													Kosovo (15)	(35), fYRoM
													(115)	(18),
													Serbia and	Tajikistan
													Montenegro	(7)
									Armenia	Georgia	Bosnia (10)	Serbia and		
									(4),	(9),	fYRoM (20)	Montenegro		
									Armenia	(8)	Kosovo (35)	(ex FRY) (35)		
			Israel (28)						Georgia	Bosnia	Montenegro	Georgia (6)		
			Albania						(10)	(15)	(20)	Tajikistan (14)		
			(35)	Albania		Albania	Albania							

NB: 2000 figures include disbursements in favour of Bosnia, fYRoM and Montenegro which, for technical reasons, took place in early January 2001.

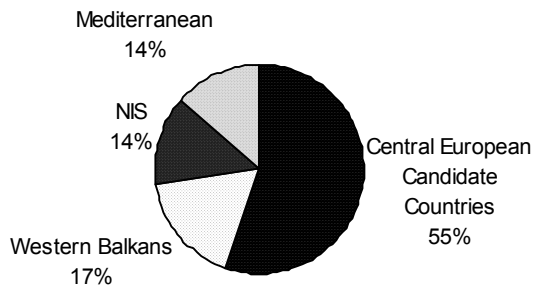
2001 figures include disbursements in favour of fYRoM and Tajikistan which, for technical reasons, took place in early January 2002.

2002 figures include disbursements in favour of Bosnia and Tajikistan which, for technical reasons, took place in early 2003.

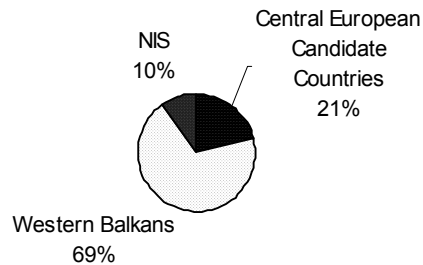
Graph 2a. Amounts disbursed by year, in EUR million



Graph 2b. MFA 1990-2003, disbursements, Distribution by region



Graph 2c. MFA 2000-2003, disbursements, Distribution by region



4. Burden-sharing

In the context of the donor co-ordination process in support of CEECs and the Western Balkans, the European Commission in liaison with the World Bank has, where appropriate, organised pledging conferences with a view to assessing the external financing needs of the beneficiary countries and identifying potential contributions from the IFIs and bilateral donors (including the EC). A similar approach has been followed for other potential beneficiary countries through Consultative Group meetings convened at the initiative of the World Bank.

The resources provided by various donors to support the residual external financing needs of the countries that receive EC MFA are summarised in Annex 2. Details by recipient country for the year 2003 are provided in Annex 2.1.

Since the inception of MFA, the absolute amounts committed by the EC have fluctuated substantially in parallel with the volume of financial support provided by the international community (see Annex 2 and similar tables in previous MFA reports).

Back in 1990, Community assistance was substantial in comparison with funding provided by IFIs. The Community indeed played a key role, both as a major provider of these funds and as the co-ordinator of bilateral assistance for the CEECs through the G-24 process. However, as the IFIs were progressively able to mobilise more resources through new instruments, their share in the financing packages rose substantially over the period, with the exception of years 2000 and 2001.

At the same time, contributions from external creditors, both public and private, were mobilised in the form of debt-relief and debt-reduction operations which took off in 1991 and became particularly important in 1994, 1995 and 2001. Among the countries receiving EC MFA, those concerned by these debt-relief and similar operations were Algeria in 1991 and 1994; Bulgaria in 1991, 1994 and 1997; Moldova in 1996; Ukraine in 1994, 1995 and 1999, and the former Yugoslav Republic of Macedonia, Bosnia and Herzegovina and Albania in 1999. In 2000, no debt relief took place for any country receiving EC MFA. In 2001, Serbia and Montenegro (the then Federal Republic of Yugoslavia) benefited from a substantial debt relief arrangement agreed in the context of the Paris Club. In 2002, debt relief was more limited and benefited to Ukraine and also Serbia and Montenegro, through the Paris Club. Serbia and Montenegro benefited again in 2003 of a moratorium of interests of up to USD 61 million decided by both the Paris and the London Clubs.

III. ARMENIA

1. Executive summary

The Armenian economy continued to grow at a record high rate in 2003 mainly driven by the construction and manufacturing sectors. Real GDP growth reached 13.9 percent although agricultural production suffered from poor weather conditions. Because of acute shortages in some food products, inflation accelerated during the second half of the year (average annual inflation 4.7 percent for 2003 up from 1.1 percent in 2002). Armenia joined the WTO in February 2003. Despite having a liberal trade regime, Armenia has not been able to fully

benefit from increased trade opportunities because of its isolated position, high transportation costs and shortcomings in customs procedures.

There has been gradual progress in structural reforms, notably in the financial sector. An anti-corruption strategy was adopted by the government in November together with an action plan for 2004-2006.

Armenia has implemented satisfactorily the economic programme supported by the IMF. The IMF Executive Board concluded the third and the fourth review under the PRGF-supported three-year arrangement in April and November, respectively. After a staff mission in December 2003, the Commission services concluded that Armenia had made satisfactory progress also in fulfilling the specific conditions for the release of the fifth grant tranche of EUR 5.5 million under the exceptional financial assistance.

2. Macroeconomic performance

Real GDP growth accelerated in 2003 reaching a new record rate of 13.9 percent (12.9 percent in 2002). Economic growth was mainly driven by the construction and manufacturing sectors. In addition to the diamond processing industry which has been growing fast already for some years, new investment in mining, metallurgy and textiles supported industrial production over the past year. The industrial sector as a whole posted growth of 14.9 percent. The construction sector benefited from private external funding from an American Armenian Lincy Foundation which has allocated funds for investment in housing, roads and cultural sites (equivalent to 2-3 percent of GDP both in 2002 and 2003). Agricultural production was affected by frosts in the beginning of the season limiting the growth rate to 4 percent. At about 10 percent the official unemployment rate did not deviate much from the level of unemployment in 2002, despite the continued strong economic growth.

Fiscal policy remained prudent and the government was able to reduce the stock of domestic expenditure arrears to a negligible amount in 2003. Tax revenues as a ratio to GDP are still at a fairly low level. In 2003 the nominal tax collection target was met but the tax revenues-to-GDP ratio is estimated to have decreased to 14.3 percent of GDP, partly because of high growth in grant-financed economic activities which are not being taxed. The fiscal deficit is projected at between 2-2.5 percent of GDP in 2003-2004. As in previous years, the budget deficit is covered mainly through external financing on concessional terms.

Average annual inflation accelerated to 4.7 percent in 2003 (up from 1.1 percent in 2002), exceeding the target rate of three percent of the Central Bank of Armenia. This was mainly due to rapid increases in some food prices such as bread during the year. In December 2003, the 12-month rate of inflation was at 8.6 percent. In nominal terms, the dram has been broadly stable against the US dollar while depreciating against the euro. In real effective terms the dram is estimated to have appreciated very slightly in 2003 after a decline in 2002.

Supported by private and official transfers, the current account position has gradually improved over the past years. The trade balance deteriorated in 2003; owing to high imports' demand by the booming construction sector and higher imports' prices on raw materials and food stuffs. Although the deterioration of the trade balance is partly balanced by higher private transfers, the current account deficit is estimated to have increased from 6.6 percent of GDP in 2002 to 7.5 percent in 2003. The gross international reserves of the Central Bank of Armenia (at USD 526 million at end-2003) are comfortably high covering about four months of imports.

The debt-to-equity swap with Russia (USD 94 million) curbed the increase in the nominal external debt in 2003, and in nominal US dollar terms the external debt remained stable at about 1020 million, while as a ratio to GDP it has declined to below 40 percent.

Armenia also repaid its outstanding debt to Turkmenistan in kind (USD 11 million). On the other hand, robust growth in exports, mainly polished diamonds, has meant that the net present value of the external debt as a ratio of exports declined from about 130 percent at the end of 2002 to an estimated 94 percent in 2003. Armenia has implemented satisfactorily the economic programme supported by the IMF. The IMF Executive Board concluded in April 2003 the third review under the PRGF-supported three-year arrangement. The fourth review was concluded in November 2003, bringing the total amount of disbursements under the PRGF-arrangement to SDR 50 million (USD 72 million). The World Bank approved in March 2003 the Fifth Structural Adjustment Credit (SAC5) in the amount of SDR 30.2 million, which was disbursed to Armenia in two tranches during the year.

3. Structural reform

In August 2003, the government adopted the Poverty Reduction Strategy Paper which was later endorsed by the IMF and the World Bank as a basis for future concessional financing. The priorities set in the PRSP (health, education and social welfare) were broadly reflected in the Medium Term Expenditure Strategy for 2004-2006 adopted by the government in October 2003. The Budget System Law was amended in April 2003 to integrate the Medium Term Expenditure Framework (MTEF) in the annual budget cycle on a regular basis. The expected lower level of external financing in coming years will need to be compensated by fiscal consolidation through higher tax revenues while maintaining a sound expenditure policy prioritising social and infrastructure expenditure. Following the recent decentralisation and organisational reform, a large share of the expenditure in the health and education sectors is incurred by newly created non-commercial enterprises, including hospitals and schools, which raised concerns about transparency and effectiveness of their spending, however. The government is expected to introduce appropriate reporting and comprehensive audits for these enterprises in 2004.

In May 2003, the Central Bank of Armenia established the modalities for a deposit insurance scheme to which banks began to make contributions in July. The deposit guarantee fund for physical persons will become fully operational in 2005. The minimum capital requirement for existing banks was increased to the equivalent of USD 5 million in July 2003. The number of banks has been reduced to 20 (all in private hands) through liquidation, restructuring and mergers and acquisitions. The ratio of domestic credit to GDP is still low at about 10 percent.

Altogether 124 enterprises were privatised in 2003 (up from 93 in 2002) bringing the total number of privatisations since independence to over 9000 enterprises (of which about 7200 are small enterprises). The targets set for medium and large enterprises in the privatisation programme for 2001-2003 have not yet been met, however. On the other hand, the liquidation procedures of non-viable state-owned enterprises are being accelerated.

After the privatisation of the electricity distribution company in 2002, tariff collection rates in electricity transmission and distribution improved clearly from 90 percent of domestic billings to 98 percent and technical and other losses have been brought down sharply. All major changes in the power generation sector over the past year were driven by the government's need to settle outstanding debts; these actions involved two power plants which were passed to Russian ownership and a management contract for the Medzamor NPP.

In November 2003, after a long preparation period, the government adopted an Anti-Corruption Strategy and an Implementation Action Plan for 2004-2006.

Although the initial reactions from the donor community were fairly positive, the government is encouraged to expand further the scope of the strategy and to involve the civil society effectively in the monitoring of its implementation.

Armenia joined the WTO in February 2003. Despite having a liberal trade regime, Armenia has not been able to fully benefit from increased trade opportunities because of its isolated position, high transportation costs and shortcomings in customs procedures.

4. Implementation of macro-financial assistance

Armenia benefits from European Community's exceptional financial assistance which consists of a loan of EUR 28 million (disbursed in December 1998) and a total grant amount of up to EUR 30 million. Four grant instalments, in the total amount of EUR 23 million, were paid under the assistance during the period 1998-2003. Through early principal repayments, Armenia has reduced the outstanding amount of its debt towards the Community to EUR 9 million at end-December 2003.

The specific conditions for the release of the fifth grant tranche of up to EUR 5.5 million were agreed with the Armenian authorities during a Commission staff mission to Yerevan in July 2002. In December 2003, following discussions with the Armenian authorities in Yerevan, the Commission services conducted a review on the implementation of these conditions with a view to releasing this grant tranche. The Commission services concluded that Armenia's macroeconomic performance had been satisfactory in 2002 and 2003. The Government has been implementing successfully the economic programme agreed with the IMF as evidenced by the completion of the fourth review by the IMF Board in November 2003. On structural reforms, the Commission services concluded that, of the eleven specific conditions in total, ten conditions were fulfilled. On the basis of the particular circumstances pertaining to the record high economic growth in 2003 and the tax policy measures planned for 2004, a waiver was given on one condition concerning the tax revenues-to-GDP ratio. Overall, the fifth grant tranche conditionality was therefore met to a satisfactory degree, and the Commission services considered appropriate to proceed with the release of the EUR 5.5 million grant tranche as soon as Armenia will have reduced its debt towards the Community through an early principal repayment of EUR 7 million as agreed.

With regard to the recommendations made in the Court of Auditors' Special Report No. 1/2002 concerning macro-financial assistance to third countries and the requirements of the new Financial Regulation applicable to the general budget of the European Communities, the Commission services carried out a review on the public finance management aspects related to this assistance on the basis of information provided by the IMF, the World Bank and the national authorities. On the basis of this review, some additional reporting requirements are being introduced in agreement with the Armenian authorities in order to enhance the monitoring of the assistance. The Commission intends to incorporate these requirements in the list of conditions for the release of the sixth grant tranche under the programme.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

No administrative prices exist outside the utilities sector. Share of administrative prices at about 8 ½ % of CPI.

2. Trade liberalisation

Liberal trade policy. Simple and relatively open import regime with a low average tariff structure. No quantitative restrictions. Accession to the WTO effective in February 2003.

3. Exchange regime

Floating exchange rate of the dram. Limited official intervention. Interbank market dominant for foreign exchange. No restrictions on the making of payments and transfers for current international transactions in conformity with Article VIII of the IMF's Articles of Agreement.

4. Foreign direct investment

Liberal policy towards foreign direct investment. Absence of restrictions on repatriation of profits and capital. Net FDI inflows 4.6% of GDP in 2002.

5. Monetary policy

Low inflation environment maintained through prudent monetary policies conducted by the Central Bank of Armenia.

6. Public finances

Total fiscal revenues incl. grants estimated at around 18 ½ % of GDP in 2003, tax revenues about 14 ½ % of GDP. Total expenditure estimated at about 20 ½ % of GDP. Medium term expenditure framework (MTEF) has been developed and is being integrated to the annual budget process.

7. Privatisation and enterprise restructuring

The three-year privatisation programme (2001-2003) targeted at over 900 medium and large-scale enterprises of which only around one third were privatised. Measures are being taken to accelerate the liquidation of non-viable SOEs.

8. Financial sector reform

Minimum capital requirement for existing banks was increased to USD 2 million in July 2003, and is scheduled to increase by 2005 further to USD 5 million, which is already applied to new banks. The number of banks reduced to 20 (30 in 2001) through mergers and acquisitions, restructuring and liquidation.

IV. BOSNIA AND HERZEGOVINA

1. Executive summary

In 2003 Bosnia and Herzegovina maintained macro-economic stability, low inflation, and continued efforts with fiscal consolidation. The latest estimates point to a slowdown of real GDP growth, at 3.5% (down from 5.5% in 2002) weakened by a negative external environment and a drought, but also reflecting poor sources of domestically-generated growth. The external situation remains vulnerable, with still large high current account deficits, especially in a context of declining official aid.

The Feasibility Study adopted in November by the Commission identifies 16 priorities in which Bosnia and Herzegovina needs to make significant progress in the course of 2004, before further steps can be taken on negotiations of a SAA. In this context, the authorities committed to achieve significant progress already by mid-2004, which could provide a strong stimulus to the reform agenda. In the economic sphere, the priority areas range from public finance reform, to consistent trade policies and efforts towards a single economic space. The IMF programme remained on-track during 2003, with the second and third review completed in June 2003, and it was recently extended through end-February 2004, when it is expected to be satisfactorily concluded.

The implementation of the November 2002 Council Decision to provide Bosnia and Herzegovina with further macro-financial assistance of up to €60 million, (up to €20 million loan and €40 million grant) continues. The first tranche of a €15 million grant was disbursed in February 2003, upon the positive outcome of the IMF review. Following satisfactory progress on the conditions, the Commission disbursed the second tranche of €10 million grant in December, and the €10 million loan in January 2004.

2. Macroeconomic performance

The negative external environment (low growth in Europe) and a drought slowed down growth in 2003 at 3.5% of real GDP, down from a 5.5% rate in 2002. According to official data, between January and September 2003 industrial output in the Federation of Bosnia and Herzegovina declined on average by 0.3%, and by 2.4% in the Republika Srpska (RS). Official unemployment rates remained around 40% in both Entities in 2003, although unofficial estimates point to an actual rate of around 20%.

Strict adherence to the currency board has kept inflation under control, which in the first nine months of 2003 was 0.6% on average, and is expected to remain contained around zero for the whole year. With the Convertible Mark (KM) pegged to the Euro at an unchanged rate since the introduction of the EU currency in January 1999, the exchange rate of the KM remains stable. The level of gross official reserves remains comfortable, equivalent to 4.5 months of imports cover (4.6 months at end-2002).

Although the size of public expenditure remains high, it is estimated to have declined at 47% of GDP in 2003, against 51% in 2002. After the improved revenue performance recorded in 2002, with an estimated consolidated budget deficit revised downwards at 7.1% of GDP (2.2% after grants), for 2003 the authorities targeted a level of 6.4% of GDP (2.2% after grants). However, due to persistent good revenue performance, as well as savings on the expenditure side (notably on the debt service), this target has been over-achieved, and the

general government deficit is now estimated at 3.4% of GDP (with a slight surplus after grants).

Under the IMF programme, the authorities adopted in mid-December a comprehensive plan on domestic debt, estimated at around 70% of GDP. The plan foresees cash settlements for 4% of claims, issuance of long-term bonds for 31% of claims, and the cancellation of the remaining 35%.

On the external side, both the trade and the current account continue to post important deficits. Owing to some tightening of monetary policy to counteract a credit boom, the current account deficit is estimated to have slightly decreased to just below 18% of GDP (against 18.5% in 2002). Efforts to improve the investment climate continue. In particular, following action taken to increase transparency and reduce administrative barriers (notably through the 'Bulldozer Committee' initiated by the OHR) FDI in Bosnia and Herzegovina almost doubled in 2002, at around €244 million, and this positive trend is estimated to have continued in 2003, with FDI at around €280 million.

External public debt, at around € 2.3 billion, reached 45% of GDP at the end of 2002 (revised downwards from the projected 52%) and is expected to decline further in 2003 (at around 37%). Debt service in percent of exports of goods and services, which started to pick up in 2002 (8.5%), mostly due to repayments to the IMF and the World Bank, is expected to remain at this level in 2003 before going down in the coming years.

3. Structural reforms

In November 2003 the Commission finalised a Feasibility Study concerning the opening of negotiations on a Stabilisation and Association Agreement (SAA). It identifies 16 priorities in which Bosnia and Herzegovina needs to make significant progress in the course of 2004, before the Commission can recommend to the Council the opening of negotiations. In this context, the authorities committed to achieve significant progress already by mid-2004, which could provide a strong stimulus to the reform agenda. In the economic sphere, the priority areas range from public finance reform, to consistent trade policies, as well as efforts towards a single economic space. Also, Bosnia and Herzegovina adopted in December 2003 its 'Medium-Term Development Strategy - PRSP'.

Reforms in the area of public finances continue at a sustained pace. The Treasury system that was introduced in early 2002 in both Entities and the State is being implemented smoothly, with further extension foreseen at sub-Entity level (Cantons and Municipalities). All budget users are now included in the system and a Single Treasury Account is being used, instead of previously sixty.

A major reform of the tax and customs administrations is under way. The Indirect Tax Policy Commission established by the OHR in February 2003 drafted legislation foreseeing a single Indirect Tax Authority (ITA), which was adopted in the course of the year by government and parliament. The ITA will collect indirect taxes at the State-level by establishing a unified customs administration, prepare for the introduction of State-level VAT, and through its Governing Board involve also the State in fiscal policy formulation. Progress in this area is also closely monitored in the context of the priorities of the Feasibility Study.

While the privatisation of small and medium enterprises is virtually complete in both Entities, progress on the sale of "strategic" enterprises (e.g. in mining, refineries, tobacco plants, car

parts), which could attract foreign investors, has been lagging behind. Poor political will, social concerns, and problems of corporate governance, high debts, and corruption are all factors discouraging potential (foreign) investors. Towards the end of 2003 the authorities tried to revitalise the process, and launched a campaign to gain public support. A number of tenders have been initiated since December, and further progress is expected in early 2004.

More generally on the business environment, the 'Bulldozer Committee', which was launched by the High Representative in November 2002 in order to dismantle administrative barriers to business operation and creation, successfully pushed through the adoption of 50 economic reforms in May 2003, and a second round of proposed reforms is being prepared. The Entity governments adopted in 2003 fully harmonised bankruptcy legislation, still under parliamentary consideration by the end of 2003. However, the environment remains uncertain for foreign investors, with a perception of high risk, costly business procedures and non-transparent policies.

Bank privatisation has been completed in both Entities and foreign capital in the banking sector is significant. Banking supervision was strengthened by enforcing the current prudential regulations (e.g. increased minimum capital requirements). Under the IMF programme, the authorities have also enacted further banking regulatory reforms (notably on foreign exchange exposure, liquidity and core capital), bringing the sector closer to international standards. A large part of banks now comply with the requirements of the State Deposit Insurance Agency.

4. Implementation of macro-financial assistance

In November 2002 the Council approved Community macro-financial assistance of up to €60 million to Bosnia and Herzegovina (Decision 2002/883/EC), comprising a loan element of up to €20 million and a grant element of up to €40 million, following a first macro-financial assistance operation concluded in December 2001 (Decision 1999/325/EC). This new assistance was foreseen in support of a comprehensive economic and structural adjustment programme in the context of an IMF Stand-by arrangement approved in August 2002. Like the first package, the implementation of this assistance is linked to progress with specific economic policy conditions.

Following the signature of a Memorandum of Understanding (MoU) in late December 2002 and the positive outcome of the first IMF Review, the first grant tranche of €15 million was disbursed in February 2003. Out of this amount, 25% was made available directly to the State (€3.75 million), while the remainder was allocated on a one third-two thirds basis between the RS and Federation Bosnia and Herzegovina respectively, as in the case of the previous MFA operation.

A Commission staff mission took place to Bosnia and Herzegovina in early June 2003, and a Supplemental MoU (SMoU) was signed with the authorities in late July. The SMoU fixed the second tranche at €20 million (€10 million grant and €10 million loan) and set out a number of economic policy conditions for the release of the third tranche. It also identified areas where further progress was needed to fulfil the economic conditionality attached to the second tranche, i.e. concerning the Entity adoption of harmonized laws on Bankruptcy and Liquidation, a State decision on the establishment of a Competition Council, and progress on the Insurance legislation. In the meantime the IMF successfully completed in June its second and third reviews, and the programme remained on-track. Following: (i) satisfactory progress on the SMoU outstanding conditions mentioned above, (ii) ratification by the Bosnia and

Herzegovina authorities of the Loan Agreement (in early December), and (iii) the acceptance by Bosnia and Herzegovina of a series of provisions (on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption) to take account of the obligations implied by the new Financial Regulation, the Commission launched disbursement procedures in December 2003. These led to the payment of the second tranche of €10 million grant in December, and the €10 million loan in January 2004.

Out of the €10 million grant, 50% was made available directly to the State (€5 million), while the remainder was allocated on a one third-two thirds basis between the RS and Federation Bosnia and Herzegovina respectively.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Most prices have been liberalised with the exception of a few selected public services.

2. Trade liberalisation

The network of regional Free Trade Agreements (FTAs) in South East Europe has been completed, and Bosnia and Herzegovina already applies those with Croatia (1/01/2001), the former Yugoslav Republic of Macedonia (01/07/2002) and Serbia and Montenegro (01/06/2002). Accession to the WTO slowly moves ahead and is now planned in the course of 2004.

3. Exchange regime

Since June 1998 Bosnia and Herzegovina has established a Currency Board Arrangement; the common currency, the KM, is pegged to the Euro at the fixed rate of 1.96 KM.

4. Foreign direct investment

Efforts continue to improve the business environment: apart from the creation of the Foreign Investment Promotion Agency (FIPA), a Bulldozer Committee was established by the OHR in late 2002 in order to dismantle administrative barriers to business operation and creation. In May 2003 it successfully pushed through the adoption of 50 economic reforms, and a second round of proposed reforms is being prepared. However, the environment remains uncertain for foreign investors, with a perception of high risk and non-transparent policies.

5. Monetary policy

The Central Bank of Bosnia and Herzegovina is responsible for operating the Currency Board Arrangement. The CBBH and other banks are prohibited from lending money to the government.

6. Public finances

The share of public spending in GDP is diminishing, although it remains very large at around 47% of GDP in 2003. Of this share, 39% is spent on wages, and public expenditure is often associated with large inefficiencies. However, significant fiscal consolidation has been achieved over time, together with tax harmonisation between entities. An important customs and taxation is underway (including VAT introduction), also thanks to the pressure of the international community.

7. Privatisation and enterprise restructuring

While the privatisation of small and medium enterprises is virtually complete in both Entities, progress on the sale of large-scale 'strategic' enterprises, which could attract foreign investors, has lagged behind.

8. Financial sector reform

Bank privatisation has been completed and foreign capital in the banking sector is significant. Banking supervision was strengthened by enforcing the current prudential regulations (e.g. increased minimum capital requirements). Under the IMF programme, the authorities have amended regulations on banks' foreign currency exposures, in line with international practices.

V. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

1. Executive summary

In 2003, real GDP growth of the former Yugoslav Republic of Macedonia reached 3%, broadly in line with initial forecasts. The general government deficit (1.5% of GDP) marked a significant improvement by more than four percentage points with respect to the previous year. The trade deficit as share of GDP declined to around 17% in 2003 from more than 20% in 2002. The 2003 current account deficit (before grants) is estimated at 8.3% of GDP. Monetary and exchange rate stability was maintained. In October 2003, the IMF Executive Board approved the first review of the 14-month Stand-By Arrangement, which had been approved in April 2003.

The structural reform process regained momentum in the course of 2003. The authorities made some progress in liquidating large loss-making enterprises and in public administration reform and management of public finances. In September 2003, the Parliament approved a law setting up the Agency for Promotion of Entrepreneurship. However, the business environment remains poor and, in particular, the inability to enforce effectively contracts and creditors' rights hampers the lending activity of the banks, in turn affecting investment and economic development.

The Commission completed the disbursement of the EC macro-financial assistance decided by the Council in November 1999 (€ 80 million), which was increased by € 18 million in December 2001. The third *tranche* of this assistance (€ 10 million grant and € 10 million loan) was released in May-June 2003 following the approval the new IMF Stand-by arrangement. The fourth and last *tranche* (€ 18 million loan and € 8 million grant) was released in December 2003 upon fulfilment of the economic policy conditions set in the Supplemental Memorandum of Understanding (SMoU) between the European Community and the former Yugoslav Republic of Macedonia authorities signed in September 2002.

2. Macroeconomic performance

- (1) In 2003, real GDP growth of the former Yugoslav Republic of Macedonia reached 3%, broadly in line with initial forecasts and improving against 2001-2002 (-4.5% and +0.7 %, respectively). According to preliminary data, industrial production increased by 4.7% compared to 2002. However, this resumption in economic activity has not been yet sufficient to recover the pre-crisis GDP level of 2000 and remained insufficient to reduce unemployment and substantially improve living standards. In 2003, the level of officially registered unemployment increased to around 37% of the labour force, from 32% in the previous year. However, taking into account the informal sector, real unemployment figures are probably lower than official data.
- (2) Inflation continued to be low in 2003, with consumer prices increasing by 1.2% on average, well below the projected 3.0%. Along with a drop in food prices, which had surged in 2002, the downward trend can be explained by the depreciation of the dollar, since the Macedonian Denar (MKD) remains de-facto pegged to the euro – at around MKD 61 per euro. In the course of 2003, average interest rates on Central Bank bills – the main instrument to control liquidity – dropped from 14.7% in January to around 6% at the end of the year. However, commercial banks did not fully pass this decline

through to their customers. In December, average lending rates were still high at 14.6% against an average deposit rate of around 7%.

- (3) In 2003, fiscal performance substantially improved with respect to the previous year. The general government deficit reached around 1.5% of GDP compared to 5.7% in 2002. The drastic fiscal adjustment by 4 percentage points of GDP with respect to the previous year is accounted for by the significant reduction in expenditure from 41% of GDP to 36% of GDP. This was the result of the reduction or elimination of some significant non-recurrent expenditure in 2002 - such as security-related expenditures and the one-off repayment to depositors involved in the TAT pyramid scheme – as well as the insufficient execution of budgeted capital expenditure. Total revenues (34.5% of GDP) have been in line with the projections, thanks to the over-performance in the collection of social insurance contributions, customs duties and non-tax revenue, compensating for a lower than projected VAT revenue.

On the external side, in 2003, there was a slight decline in the overall trade exchange in nominal (euro) terms. Exports remained broadly stable compared to 2002, while imports decreased by 5%. The trade deficit reached more than EUR 700 million or 17.2% of GDP, lower than in 2002 in euro terms and as a share of GDP, but widening when measured in dollar terms owing to exchange rate effects. The 2003 current account deficit (before grants) is estimated at 8.3% of GDP or 6.2% of GDP after taking into account foreign assistance (2.1% of GDP). Foreign exchange reserves were maintained in 2003 to a level equivalent to around four months of imports, which is the target set by the IMF programme. The external debt significantly declined to 33% of GDP at the end of 2003, a rather moderate level compared to other countries in the region.

A long overdue Stand-by Arrangement (SBA) with the International Monetary Fund of SDR 20 million (around EUR 25 million) was approved on 30 April 2003, allowing the release of substantial foreign financial assistance from other donors. The first review of the SBA was successfully completed in October 2003.

3. Structural reforms

Price liberalisation is now essentially completed, except for most utilities, and various items such as oil and oil by-products.

The privatisation process of small and medium size enterprises (SMEs) is almost completed. As of end of September 2003, 1,683 enterprises had been privatised, while 81 state companies of those included in the privatisation programme that began in 1993 were left for sale. The Action Plan for the restructuring, liquidation or privatisation of 40 large loss-making enterprises, which was launched in 2000, was finally completed. The authorities are now focusing on a new priority: private sector development. In September 2003, the Parliament approved a law setting up the Agency for Promotion of Entrepreneurship. However, the generally poor business environment and, in particular, the difficulty to enforce effectively contracts and creditors' rights hampers the lending activity of the banks, in turn affecting investment and economic development.

In 2003, the authorities also made progress in public administration reform and management of public finances, launching the functional analysis in most of administrative entities, developing the General Secretariat, setting up a single Treasury account, improving VAT administration and adopting a plan for the development of a government securities market.

Moreover, in December 2003, after lengthy discussions, the Government finally adopted a law on Local Government Financing, which needs to be approved by the Parliament. However, the scope for improvement in this broad area is still large, encompassing the implementation of the “functional” analysis, the decompression of the civil service salary structure, greater control of expenditure in extra-budgetary funds, the introduction of audits throughout the whole administration, and the actual development of a market for government securities. The implementation of the fiscal decentralisation process and, in particular, the strengthening of the capacity of local entities to manage expenditure and collect revenues, remains a great challenge.

The financial sector is dominated by the banking sector, whereas non-bank financial institutions play a very limited role. The soundness of the banking sector has improved over the recent years. The three largest banks, accounting for around two thirds of total liabilities and assets, have relatively prudent and sound banking practices. However, the IMF Financial System Stability Assessment report published in December 2003 notes that the financial system remains vulnerable to weak governance in smaller banks and also to weaknesses in the banks’ balance sheet, which are reflected in the high percentage of non-performing loans (16% of total portfolio assets as of mid-2003). In 2003, six banks were under enhanced supervision by the National Bank, but the repercussions on financial stability of the whole system were rather limited, given the small size of these banks.

The former Yugoslav Republic of Macedonia was the first country to sign a Stabilisation and Association Agreement (SAA) with the EC in April 2001, followed by the entry into force of the Interim Agreement on trade and trade-related matters in June 2001. The process of ratification of the SAA has been completed in the course of 2003 and the Agreement will enter into force on 1 April 2004. On 4 April 2003, the former Yugoslav Republic of Macedonia became the 146th member of the World Trade Organisation. The country already completed the network of free trade agreements with neighbouring countries promoted by the Stability Pact.

4. Implementation of macro-financial assistance

On 8 November 1999, the Council decided to provide the former Yugoslav Republic of Macedonia with a second macro-financial assistance of up to €80 million (loan up to €50 million and grant up to €30 million). This Council decision was revised on 10 December 2001, allowing for the extension of the assistance until the end of 2003 and increasing the grant element by €18 million (to a grant total of up to €48 million out of a total of up to €98 million).

A first tranche of €30 million (€20 million grant and €10 million loan) had already been released in December 2000/January 2001. In January 2002, a second tranche of €22 million (including €10 million grant) was disbursed, exceptionally on the basis of an IMF Staff Monitored Programme, taking into account the difficult political and economic situation in the country in the aftermath of the spring 2001 ethnic conflict.

In 2003, the Commission completed the disbursement of the macro-financial assistance decided in 1999 and extended in 2001, implementing the third and fourth tranche. The third tranche of €20 million (€10 million grant and €10 million loan) was released in May-June 2003 following the approval the new IMF Stand-by arrangement (see above). The fourth and last tranche of €26 million (€18 million loan and €8 million grant) was released in December 2003 upon: i) satisfactory fulfilment of the economic policy conditions set in the

Supplemental Memorandum of Understanding (SMoU) between the European Community and the former Yugoslav Republic of Macedonia authorities signed in September 2002; and ii) the acceptance by the former Yugoslav Republic of Macedonia of a series of provisions (on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption) to take account of the obligations implied by the new Financial Regulation.

The conditions attached to the last fourth tranche included progress in the areas of public administration reform, public expenditure management and fiscal reform, enterprise restructuring and private sector development, and financial sector reform.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Price liberalisation has been essentially completed, except for most utilities and various items such as oil and oil by-products..

2. Trade liberalisation

The Interim Agreement on trade and trade-related matters with the EU, which entered into force in June 2001 after the signature of the Stabilisation and Association Agreement, implies more liberal market access for EU products and gradual reduction of tariffs on most important products. On 4 April 2003, the former Yugoslav Republic of Macedonia became the 146th member of the WTO. The country has completed the network of free trade agreements with neighbouring countries promoted by the Stability Pact.

3. Exchange regime

From early 1994, de facto peg of the denar to the DM, and since the 1st of January 2002 to the euro. Since the devaluation of July 1997, the denar stands at an equivalent of some 61 denar to one euro.

4. Foreign direct investment (FDI)

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 is also hampering the FDI inflows. FDI inflows have been erratic in recent years and largely dependent on a few large transactions, declining to less than 2% of GDP in 2002 and 2003.

5. Monetary policy

The central bank is independent from the government by law. Central bank lending to the government is not allowed, except for non-renewable one-day loans. Monetary policy is oriented towards price stability, the main statutory objective. The exchange rate anchor is the intermediate target of the central bank.

6. Public finances

VAT was introduced in April 2000 and represents a significant source of revenue. In 2003, the authorities amended the Budget Law and the Law on Public Procurement and merged separate budget users' accounts into a single account within the Treasury, which is now operational. Internal controls and audit are in place in the Ministry of Finance, but must be strengthened and broadened to the whole public administration.

7. Privatisation and enterprise restructuring

The privatisation programme which begun in 1993 is almost completed with almost 1,700 small and medium sized enterprises being privatised. Firms and organisations conducting activities of special national interest, public services and utilities are not part of the programme. The national telecom operator was sold to the Hungarian company Matav in 2001. In 2003, the liquidation of 40 large loss-making companies, which were identified in the Action Plan of 2000, was finally completed.

8. Financial sector reform

The banking law of 2000 established the legal framework for modernised and strengthened banking sector. The financial sector is dominated by the banking sector, with a very limited role of non-bank financial institutions. The banking sector is largely privatised and highly concentrated, with the three largest banks accounting for around two thirds of total liabilities and assets.

VI. GEORGIA

1. Executive summary

In Georgia economic growth was not affected by the political uncertainty surrounding the parliamentary elections, which finally led to the resignation of president Shevardnadze in November 2003. At 8.6 percent real GDP growth reached the highest rate since 1997. Robust rates of growth were registered in several sectors including construction, agriculture and manufacturing. Average rate of inflation decreased to 4.8 percent. Because of the high imports demand stemming from the construction of the BTC oil pipeline, the current account deficit deteriorated to an estimated deficit of 10 percent. In structural reforms there were some positive developments in 2003, notably in the financial sector and in privatisation, but the main challenges for the new government still lay in the energy sector, public finance management and civil service reform.

Due to slippages in fiscal policies, Georgia was not able to resume borrowing from the IMF and in September 2003 the PRGF arrangement was suspended. The regime change that followed the public protests in November created an opportunity for resuming relations with the IMF and discussions on a successor PRGF arrangement are under way. Under these circumstances, no grant payment was made to Georgia under the EC's exceptional financial assistance during 2003.

2. Macroeconomic performance

Real GDP growth accelerated in 2003 to 8.6 percent, the highest rate of growth since 1997, owing mainly to strong growth performance in construction and agriculture. The construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline started on Georgian territory in April and the construction continues until 2005. Agriculture is the largest sector of the economy (20 percent of GDP), and in 2003 weather conditions were favourable contributing to about 10 percent growth in agricultural production. In addition to agriculture and construction, the extraction sector (aluminium, alloys, copper, gold and scrap metals) and manufacturing (wine, fertilisers, mineral water) have also registered strong growth rates. Industrial output increased by 10.6 percent in 2003. Official unemployment rates decreased slightly during the year averaging 11.8 percent in the first nine months.

A large part of economic activity remains unrecorded and smuggling is pervasive. Therefore, the robust growth rates registered across several sectors of the economy did not translate into an improvement in tax revenue collection as expected. At the time of the November 2003 elections and in the immediate aftermath before the new regime established in power, tax collection, on VAT in particular, virtually halted. Furthermore, the autonomous province of Adjara continued to withhold revenues which were collected on its territory to the central government budget. On commitment basis, a fiscal deficit of about 3 percent of GDP is estimated for 2003 (2 percent in 2002), while on cash basis the deficit is actually slightly lower than in 2002 because of the net accumulation of expenditure arrears. The political uncertainty brought additional difficulties for fiscal management in November and December but donor funds were made available to the government for some immediate needs. The draft 2004 budget, which was submitted to the parliament in October 2003, was recalled for revision by the new government. The parameters of the fiscal programme are discussed with the IMF in early 2004.

The National Bank of Georgia has maintained a consistently prudent monetary policy stance. The good conditions in the agricultural sector contributed to the decline in the average inflation rate from 5.6 percent in 2002 to 4.8 percent in 2003. In November-December the 12-month inflation rate increased however to 7 percent. This was mostly attributable to the political uncertainty following the elections. The lari remained broadly stable against the US dollar (also during November and December), while depreciating against the euro. In real effective terms the lari is estimated to have appreciated slightly in 2003.

The current account deficit increased rapidly in 2003 to about 10 percent of GDP (6 percent in 2002) owing mainly to the capital imports for the construction of the BTC pipeline. These imports are financed by foreign direct investment in the pipelines. The gross international reserves of the National Bank of Georgia decreased to about USD 190 million at the end of 2003, which is equivalent to 1.5 months of imports (excluding the pipeline-related imports). In US dollars, the external debt of Georgia continued to increase in 2003 reaching about USD 1.85 billion, but as a ratio to GDP the nominal debt stock declined to 48 percent. Georgia was not able to approach its bilateral creditors in the Paris Club for a rescheduling of 2003 loan maturities as foreseen in the 2001 Paris Club agreement, because the country's arrangement with the IMF was suspended in September 2003. Therefore, pending the rescheduling, Georgia is technically in default on its bilateral debt service having accumulated approximately USD 50 million in arrears on principal payments due to Paris Club creditors in 2003.

3. Structural reform

In June 2003 the government adopted the Economic Development and Poverty Reduction Programme of Georgia which was later endorsed by the IMF and the World Bank as a basis for future concessional financing. The preparation of the programme was not associated with the budget planning process, and therefore a medium term expenditure framework still needs to be developed. Progress in ongoing reforms in budget preparation and treasury management on the basis of the new Budget Systems Law which was adopted in April 2003 is necessary to facilitate the implementation of the EDPRP. Following the regime change after the resignation of president Shevardnadze, the new government is now expected to address the question of potential elaboration of the EDPRP where necessary.

A new tax code was approved by the parliament in August 2003, including a marked increase in the VAT threshold, introduction of a small business tax and elimination of a number of nuisance taxes. The immediate impact of these reforms was envisaged to be neutral in terms of total revenue collection. The system for VAT refunds has also been overhauled recently. Various interest groups continue to be protected by numerous exemptions on the corporate income tax and VAT. Moreover, combating wide scale tax evasion of fuel excises and import duties could bring significant revenues to the budget.

Some progress was made with privatisation of large-scale enterprises in 2003, notably with the Azot chemical plant and the Zestafoni Ferro Alloys plant. Concessions for some parts of the Poti Port were concluded and management contracts were awarded in aircraft manufacturing, electricity transmission and dispatch as well as in electricity distribution (the United Distribution Company). The larger role that private operators now have in the power sector was not yet reflected in the collection rates which remained at about 70 percent in the capital and well below that in other regions. To improve the management of state-owned enterprises, an Enterprise Management Agency was established under the aegis of the Ministry of Economy.

In agreement with the IMF, the government has launched comprehensive audits in three major SOEs but regular audits have not yet been made a requirement for all SOEs.

The National Bank of Georgia has made progress in strengthening banking regulation and supervision including through the adoption of a new analytical framework for the resolution of insolvent banks and “fit and proper” criteria for bank managers and owners in 2003. Anti-money laundering legislation was adopted in 2003 but this was not deemed to fully meet international standards.

4. Implementation of macro-financial assistance

Following a Commission staff mission to Tbilisi in December 2002, an agreement *ad referendum* was concluded with the Georgian authorities on the payment of the fourth grant tranche under the EC’s exceptional financial assistance in the amount of EUR 6.5 million. The Commission services made, however, the payment conditional on the positive completion of the third review by the IMF Board under Georgia’s three-year PRGF arrangement. Georgia faced increasing difficulties in meeting the structural conditionality under the PRGF program during the first half of 2003, mainly due to significant slippages in fiscal policy. By September 2003, it had become clear the authorities were not able to obtain parliamentary support for a revised 2003 budget which would have closed the emerging fiscal gap. As a result, the IMF did not complete the third review under the PRGF arrangement, and the three-year arrangement expired in January 2004. Under these circumstances, no payment was made to Georgia under the Community’s exceptional financial assistance in 2003.

The regime change that followed the November 2003 parliamentary elections and the resignation of president Shevardnadze, created an opportunity for resuming relations with the IMF, and the new Georgian Government is engaged in discussions on a successor arrangement under the PRGF. The Community’s exceptional financial assistance to Georgia can only be resumed after the IMF Board’s approval of a new financing arrangement.

European Community’s exceptional financial assistance has been made available to Georgia in the form of a loan of EUR 110 million (disbursed in July 1998) and a total grant amount of up to EUR 65 million foreseen to be paid in several instalments. Owing to uneven progress in the fulfilment by the authorities of the conditionality for the successive grant payments, only three grant instalments, in the total amount of EUR 25 million, were paid under the assistance during the period 1998-2003. Through early principal repayments, Georgia has reduced the outstanding amount of its debt towards the Community to EUR 92 million at the end of 2003 (unchanged from end-2002).

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

No administrative prices exist outside the utilities sector. Share of administrative prices at about 3% of CPI.

2. Trade liberalisation

Liberal trade policy. Georgia has been member of the WTO since June 2002. Based on margins allowed during WTO accession, Georgia has raised the number of tariff bands and the maximum tariff leading to an increase in the weighted average tariff to the level of about 11.3%. Non-tariff barriers allowed for environmental, security and health reasons only.

3. Exchange regime

Floating exchange rate of the lari. Limited official intervention. Interbank market dominant for foreign exchange. No restrictions on the making of payments and transfers for current international transactions in conformity with Article VIII of the IMF's Articles of Agreement.

4. Foreign direct investment

Adequate overall legislation. Unlimited repatriation of capital and profits. Net FDI inflows 3.9% of GDP in 2002.

5. Monetary policy

The prudent monetary policy has contributed to the stabilisation of the inflation rate at a low level. Dollarisation of the economy remains high (over 80% of bank assets and lending in foreign currencies).

6. Public finances

Total fiscal revenues (including grants) estimated at 15.6% of GDP in 2003, of which tax revenues 14.4% of GDP. Total expenditure and net lending estimated at 18.4% of GDP. A number of improvements in the budget system are being introduced under the new Budget System Law was adopted in April 2003 and became effective on January 1, 2004 (not yet an organic law, however).

7. Privatisation and enterprise restructuring

Small and medium size privatisation has been largely completed. Some progress in privatisation of large SOEs in 2003 after a standstill. The Ministry of State Property Management dissolved in 2003, and the new division of tasks between the Ministry of Economy and the new Enterprise Management Agency expected to accelerate the restructuring of remaining SOEs.

8. Financial sector reform

Several measures have been taken to strengthen bank regulation and supervision in recent years. At present there are operating 25 banks. Further consolidation is encouraged in the sector through the gradual increase of the minimum capital requirement up to the equivalent of EUR 5 million.

VII. MOLDOVA

1. Executive summary

The upswing that began in 2000 continued in 2003, as year-on-year GDP growth reached 6.3%, despite a sharp weather-related drop in the output of the important agricultural sector (-14.1% on the year). Growing exports and buoyant remittances from Moldovans working abroad continue to drive the economy's expansion. Domestic demand is strong and industrial production is continuing its recovery.

Although exports grew strongly, the dynamics of imports were even more pronounced, so that Moldova's large trade deficit rose further. As a result, the current account deficit rose too, reaching around 8% of GDP.

Inflation accelerated sharply on the back of sustained money supply growth: the consumer price index rose by 15.7%, compared to 4.4% in 2002.

Fiscal policy remained tight in 2003, but plans for 2004 indicate relaxation; a financing gap could emerge, as budgetary assumptions look optimistic. Although thanks to debt restructurings and write-offs in 2002, the public debt-to-GDP ratio has dropped significantly, to around 52%, the burden of servicing debts remains high (debt service due would absorb over one third of central government revenues). Hence, dependence on capital flows from multilateral and bilateral creditors is set to remain high in the medium term. Moldova has continued to accumulate arrears in 2003, most notably to the Russian gas supplier Gazprom and to Russia itself. In 2003, Moldova attempted unsuccessfully to obtain a debt restructuring agreement from the Paris Club.

After a promising start at the beginning of the 1990s, structural reforms have slowed. The transformation to a market economy is far from complete. While land reform has progressed, the privatisation of key economic sectors of the economy has advanced little (the EBRD estimates that 50% of the economy is still controlled by the State). Privatisation is severely complicated by the country's unfavourable business climate and by excessive State interference.

Moldova received no EC-macro-financial assistance in 2003. Disbursements under the grant of €15 million approved in December 2002 could not start in the absence of a working financing arrangement with the IMF

2. Macroeconomic performance

Moldova's economic recovery has continued from last year, with real GDP up by 6.3% year-on-year in 2003. Strong industrial growth (+14% y-o-y) continues to drive expansion, spurred by continued demand from Russia and Ukraine as well as rising domestic demand.

After a deceleration in 2002, when the growth in the consumer price index (CPI) fell to 5% in the annual average, a strong pickup in inflation was recorded in 2003; the CPI rose by 12% in the annual average, due largely to rapid money growth fuelled by largely unsterilised purchases of foreign exchange. The National Bank of Moldova has now indicated it would pursue a tighter monetary policy, given that the increase in rates enacted during 2003 proved insufficient to prevent a build-up of inflationary pressures.

Given strong constraints to deficit financing, the general government cash balance posted a surplus of 0.5% of GDP in the first three quarters of 2003; this result, however, was obtained not only thanks to robust collection of VAT and customs duties but also, notably, by an accumulation of external arrears for 0.6% of GDP. In 2004, despite wage increases in the public sector, the government's budget plans project an unchanged expenditure-on-GDP share, whereas tax cuts will result in a decline of the revenue share. Hence, prospects for 2004 are for a cash deficit of around ¾% of GDP, implying a loosening of the fiscal stance by over 1 percent of GDP. According to the IMF, current budgetary policies might result in further accumulation of new arrears (the "flow" financing gap, excluding arrears payments, could reach 2% of GDP).

Moldova's total external public debt stands presently at around 52% of GDP (although the stock of non-publicly guaranteed external debt is much higher). This level is significantly lower than in 1999, reflecting a series of re-scheduling that have reduced the value of the outstanding debt. Nevertheless, servicing of the debt remains a difficult and challenging task: in 2003, payments falling due amount to over 36% of central government revenue. Moldova has not resumed payments to Gazprom, the Russian gas supplier, suspended in 2001, or to a number of other bilateral creditors suspended after August 2003; in the first three quarters of 2003, it has accumulated new external arrears for 1.3% of GDP. Given low foreign exchange reserves (less than two months of imports) and the substantial structural current account deficit, which has worsened over time and in 2003 accounted for around 8% of GDP, the country is expected to remain dependent on additional support from the IFIs and bilateral donors. Indeed, the large official transfers (primarily technical aid and humanitarian assistance), and a high level of remittances from abroad can only partly mitigate the chronically high merchandise trade deficit.

3. Structural reform

Although Moldova had a good start on structural reform in the beginning of the 1990s (which led notably to an early accession to the WTO), a subsequent slowing of reform efforts and poor implementation of laws have resulted in a still largely unsatisfactory business environment. Corruption and a generally unsatisfactory regulatory framework pose significant obstacles to private sector-led growth; furthermore, the government continues to own or control a large part of the economy (50% according to the EBRD 2003 Transition Report). In 2002, the government's privatisation plan covered 450 enterprises, of which the 22 amongst the largest are being privatised individually (two electricity grids, Moldtelecom, the tobacco monopoly, eight wineries and a number of industrial plants); privatisation proceeds however, have been disappointing and remained well below target.

Deloitte & Touche, acting as the government's advisor in privatising the electricity grids, recommended putting off privatisation owing to unfavourable market conditions, while tobacco privatisation has been postponed until the industry has been liberalised. The largest privatisation so far was the sale of half the country's electricity distribution network to Union Fenosa of Spain in 1998, backed by the European Bank for Reconstruction and Development (EBRD). However, following disagreement on electricity tariffs with the government, the Spanish investor has alleged that the government and the business community have tried to impede its activity. This state of things has been discouraging private foreign investment, as shown by declining FDI inflows. Overall, Moldova's main investors remain public bodies like the EBRD and the US-supported Western Newly Independent States Enterprise Fund (WNISEF), which often have to cover for departing western private investors.

4. Implementation of macro-financial assistance

The European Community provided in the 1990s two macro-financial assistance packages worth EUR 45 million and EUR 15 million to Moldova. Moldova has so far serviced scrupulously its external financial obligations towards the Community.

On 19 December 2002, the Council adopted a decision granting a *new MFA* to Moldova. This new assistance in the form of a grant in the amount of EUR 15 million replaced and cancelled the loan of an equivalent amount approved by the Council in 2000 and never disbursed, in the absence of a working financing arrangement with the IMF. In March 2003 the Commission staff conducted a mission to Chisinau to hold discussions on the policy conditions to be attached to the first tranche of the grant. However, these discussions could not be completed in 2003, in the absence of a working financing arrangement with the IMF.

The three-year PRGF for Moldova approved by the IMF Board in December 2000 went off track in the beginning of 2003. The programme finally expired in December 2003, due to weak implementation – and even to reversals – of agreed structural reforms. At the same time, implementation of macroeconomic targets PRGF-supported programme was broadly satisfactory. For the same reason of poor record in structural reforms, the World Bank's Structural Adjustment Credit (SAC III) expired in September 2003 was largely undisbursed.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Most prices have been liberalised

2. Trade liberalisation

Relatively liberal international trade policy on paper, but formal or informal restrictions on some key commodities exist (notably sunflower seed and scrap metal). Moldova became a member of the WTO in June 2000.

3. Exchange regime

The lei is convertible for current account operations. Floating exchange rate.

4. Foreign direct investment

Unlimited repatriation of capital and profits and no limitations on holding foreign currency bank accounts. Adequate overall legislation, but implementation is often problematic, which weakens the business climate. There has been a trend toward increasing administrative interference on foreign investors, notably in the energy sector. FDI has been declining.

5. Monetary policy

High money supply growth, due largely to non sterilized foreign exchange reserves' accumulation, have led to a sharp acceleration of inflation. Hikes in policy rates have been largely unsuccessful so far in slowing inflation. The National Bank has indicated it will pursue a tighter policy course.

6. Public finances

The government has been attempting to increase budget revenues and strengthen fiscal discipline. Tax and duties collection has picked up, although customs reform remains a priority. In 2003, a small cash budget surplus was recorded, but that was achieved largely through accumulation of arrears. Authorities plan a cash deficit of 0.7% of GDP in 2004. However, budgetary plans seem optimistic and a financing gap of up to 2% of GDP might appear (excluding arrears repayment). Public external debt amounts to about 52% of GDP; 2004 debt service would absorb over one third of central government revenue.

7. Privatisation and enterprise restructuring

Structural reforms have slowed. The transformation to a market economy is far from complete. Privatisation of the key economic sectors suffered delays and are currently made difficult by bad market sentiment.

8. Financial sector reform

The financial sector is in a relatively good shape, but further strengthening is crucial to mobilize savings and promote investment. Although the share of bad loans has been declining, given rapid credit growth, attention will have to be maintained to prevent vulnerabilities.

VIII. ROMANIA

1. Executive summary

Macroeconomic trends remained favourable in 2003 with sustained growth of investment and household consumption accompanied by further disinflation. However, the current account widened considerably due to a surge of merchandise imports and prompted the authorities to announce a tighter policy stance and a close monitoring of external developments for 2004.

The macroeconomic policy mix, consisting of a fairly prudent fiscal policy and a monetary policy aimed at disinflation while preserving external competitiveness, underpinned these overall positive trends and contributed positively to further disinflation.

With regard to the implementation of structural reforms, progress occurred in a number of fields, notably in privatisation of state-owned enterprises, control of the wage bill in the public sector and adjustments in the price level and structure in the energy sector.

Strengthening enterprise financial discipline remains a key unresolved issue, and measures should focus on the root causes of the persistent arrears to the budget and public utilities. Also, notwithstanding various initiatives to improve the business environment, the efficiency of the public administration and of the judiciary must substantially improve in order to level the playing field in the market and ensure unhindered market entry and exit.

Romania can be considered a functioning market economy once the good progress made has continued decisively. In addition, a vigorous and sustained implementation of its structural reform programme is required in order for Romania to be able to cope with competitive pressure and market forces within the Union in the near term.

In January 2002, the EU Council agreed in principle to make available to Romania EUR 100 million, pursuant to Council decision 99/732/EC, in two sub-tranches, subject to the satisfactory implementation of the present SBA and adequate progress in the country's structural adjustment process. Conditions for the disbursement of the first sub-tranche of EUR 50 million were fulfilled in the first half of 2003, and disbursement took place on 17 July 2003.

2. Macroeconomic performance

Romania has since 2001 experienced a sustained economic recovery, with robust economic growth, significant decline in inflation and increased openness and competition in the economy. In light of the turbulent times for Romania in the second half of 1990's, which were characterised by continued failure to stabilise the economy, a protracted transitional recession and a lukewarm attitude to liberalisation of prices and markets, this is a major achievement.

In 2003, Romania's four-year old economic recovery weathered the economic slowdown in the EU as growth remained robust. According to preliminary figures, real GDP growth stood at 4.8% in 2003. However, growth was increasingly unbalanced and driven solely by domestic demand. In particular, household consumption increased sharply on the back of surging consumer credit and high wage growth. On the other hand, government consumption expanded only slightly. Together with stronger growth in tax revenue and further savings on interest payments the target for the budget deficit for 2003 was therefore slightly undershot.

Private sector investment continued to rise rapidly, pointing to the replacement of Romania's capital stock, and reflected also in a sustained import growth. Growth of exports decelerated at the same time over 2003 and appeared considerably less vigorous compared to the strong export performance since 2000. This was also reflected in industrial production growing at a significantly lower pace in 2003 than in previous years. Consequently, a significant deterioration of the trade balance occurred, and, after contributing positively to growth in 2002, net exports turned strongly negative during 2003.

The current account deficit widened significantly over 2003 to close to 6% of GDP. While not necessarily of a deep-rooted structural character, the current account deficit needs to be monitored closely. The policy mix consists of a fairly prudent fiscal policy and a monetary policy aimed at disinflation while preserving external competitiveness, and remains appropriate although adjustments may be warranted in light of external developments. A more restrictive fiscal policy than originally intended has been announced for 2004, and measures in the banking system were implemented by 1 February aimed at limiting the credit growth to a pace consistent with keeping the current account deficit at sustainable levels.

In 2003, inflation remained on a downward path. The average rate of consumer price inflation reached 15.3%. By December, the year-on-year rate declined to 14.1% despite the increases in energy prices mandated over the year, thereby allowing the government's target for the year to be met. After accelerating in the first half of the year on the back of a substantial rise in the minimum wage, the pace of real wage growth was more moderate in the latter part of the year, resulting in an average real wage increase of close to 9% in 2003.

The unemployment rate (harmonized rate based on labour force survey) stood at 6.6% in 2003. It has been fairly stable in the vicinity of 7% since 1999. Registered unemployment stood at an average of 7.6% in 2003 and has been declining since 1999. However, methodological changes and redefined eligibility criteria for safety net entitlements limit the comparability across time for both measurements. The apparently low unemployment rate may, however, also be due to the need of a further deepening of economic restructuring.

Inflows of foreign direct investment (FDI) passed EUR 1 billion in 2003, pointing to a modest increase compared to previous years. This improvement did, however, not match the pace of deterioration in the current account. So far, Romania has not yet seen a strong increase in FDI inflows, and 2003 did not record a step change in FDI inflows. Since 1999, annual net inflows have remained at around 2.5% of GDP, and measured by per capita inflows Romania still ranks low compared to more advanced transition economies. Sustained growth, improved track record in macroeconomic stability and advances in the functioning of the market mechanisms point, however, to a potential pick-up of inflows in the future.

Due to a high demand in the FOREX market and the efforts of the central bank to limit the downward pressure on the Romanian Lei, Romania's official international reserves levelled off towards the end of 2003. Reserves remained, however, at a comfortable level of 3.7 months of goods and services import. Moreover, reflecting the broadly positive macroeconomic performance, external financing conditions have been improving. Better growth, enhanced reform prospects and continued collaboration with the IMF allowed Romania to meet its external financing needs in 2003. Romania's sovereign debt rating was upgraded by several credit agencies in December 2003 both for national and foreign currency denominations. Foreign debt rose further in 2003, but the debt-to-GDP ratio remained fairly low at an estimated 20.5% of GDP at end-2003.

Much of the progress over recent years can be attributed to a renewed commitment by Romania to achieve durable macroeconomic stabilisation of the economy and further pursue the economic reform path. These efforts have been embedded in the process of negotiating Romania's accession to the EU and fulfilling the Copenhagen economic criteria as well as in the arrangements with international financial institutions. In October 2003, Romania successfully concluded the final review of an IMF arrangement for the first time ever in the post-Communist period.

3. Structural reforms

In 2003, Romania recorded substantial progress in privatisation, which, by imposing hard-budget constraints and exposing the enterprises to market mechanisms, has strengthened the exit mechanisms, thereby improving effective competition. Under the administration of the privatisation agency APAPS, privatisation has advanced in the industrial sector, with the sale of the majority of state-owned large enterprises. Preparations for divestitures in the public utilities sector have moved beyond the first steps, although more slowly than originally planned. Layoffs in some of the largest state-owned enterprises were carried out in order to improve their financial performance and privatisation prospects.

The incentives for a more efficient allocation of resources have also been strengthened thanks to efforts to tighten enterprise financial discipline and improving the institutional framework for a market economy. Accumulation of arrears remains, however, one of the major unsolved problems in the Romanian economy. Over 2002 and 2003, arrears to the budget and the energy utilities continued to accumulate. In the case of a number of monitored state-owned enterprises, the stock of arrears to the general government increased from 4.0% of GDP at end-2001 to 4.5% at end-2002 and continued rising over the first half of 2003. This increase occurred despite various rescheduling and write-off arrangements in the context of enterprise restructuring and privatisation.

The functioning of the energy sector represents a particular problem at both the macro and micro level. Despite further advances, progress in energy sector reform remained uneven. Complex issues, such as enterprises' large stock of arrears, the pricing system and the valuation of past environmental liabilities, slow down the privatisation. In the enterprise sector, persisting difficulties have been observed in imposing payment discipline on end-users of energy, and arrears have accumulated at all levels. Moreover, for a hard core of state-owned enterprises the budget has continued to assume payments of energy bills until privatisation. In the residential sector, $\frac{3}{4}$ of households using district heating spend over 10% of their income on heating bills and despite high transfers to low-income households many households choose not to pay their heating bills.

Recently, however, steps have been taken to establish a credible medium-term strategy for the sector. The authorities have stepped up the enforcement of payment obligations and started to disconnect perennial non-payers, which has improved collection rates. Moreover, the adjustment of energy tariffs has been stepped up gradually in order to ensure cost coverage and incorporate a sufficient margin for long-term investments. New pricing methodologies have been developed and are expected to be implemented from 2005. Preparations for planned sales of energy utilities have moved forward, although more slowly than originally planned. Negotiations are underway for the privatisation of two electricity distributors as well as for two main gas distributors. In addition, the authorities have launched the privatisation

process for two more electricity distributors. Letters of interest have been received for the national oil company.

Preparations for the sale of production facilities for thermal and hydroelectric power have started. Restructuring of the companies in preparation for privatisation also facilitates opening of the energy market to competition. Preliminary steps such as unbundling of production, distribution and transport have been taken, and the government has announced a 40% opening of both the gas and electricity market as from 2004.

After many delays, Romania has achieved important progress towards putting the banking system on a sounder basis, and the financial sector appears today generally sufficiently capitalized, liquid and well supervised. Capital adequacy ratios remained in 2003 robustly above 20%, while bad loans amounted to less than 10% of total lending. However, the interest rate spread between lending and deposit rates remains at between 10-15%, which indicates a substantial cost of financial intermediation and limited competitiveness in the sector.

Yet, various sources of vulnerability remained. In 2003, lending to the corporate and private sector has expanded at double-digit rates. In particular, consumer lending surged as banks began targeting automotive- and real estate-buyers. The recent high credit growth risks outpacing necessary improvements in the intermediation expertise, as well as in the regulatory and supervisory framework. In part to minimize prudential and macroeconomic risks stemming from the lending boom, the National Bank of Romania raised the reference rate several times of late, setting it at 21.25% in February 2004, compared with 17.4% in April 2003, when the bank first reversed its policy of progressively reducing rates.

Following various unsuccessful tenders, the government managed in September 2003 to sell one fourth of the largest bank (BCR) to the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC). With this sale the share of state ownership in the bank has fallen below 50%. Since BCR alone holds roughly one third of Romania's total banking assets, its successful further privatization and restructuring is seen as vital to increase financial markets' dynamics.

The non-banking financial sector is still in its infancy. However, the authorities have prepared the legislative framework for the introduction of a three pillar pension system, which could over time deepen the securities markets and further develop the insurance sector. The main elements of the envisaged pension reform are the establishment of a second-pillar mandatory scheme to which both employers and employees contribute, and an optional third-pillar occupational pension scheme. The aim of the reform is to alleviate over time the burden on the insufficiently funded first pillar. The reform will be embedded in a three-year action plan, supported by the World Bank, and is expected to be fully implemented in 2007.

The business and investment climate continued to be hampered by a lack of efficiency of the public administration and the judicial system. Complex administrative procedures still hamper market entry and exit. Efforts to enhance the investment climate have, however, been stepped up in 2003. Attempts to cut red tape included establishing one-stop offices for registering and authorising firms, and introducing a silent approval procedure for the issuing and renewal of the large majority of licences issued by the public administration. Other measures include amendments to the bankruptcy framework, which has already led to an increase in both the number of new bankruptcy cases and the rate of their resolution.

In terms of tax policy, 2003 has witnessed the adoption of a new tax code and its implementing provisions, which should ensure greater transparency and stability of the tax legislation. Moreover, the VAT system has been reformed, inter alia by introducing reduced rates in line with current EU legislation and abolishing a number of exemptions.

Various administrative measures to improve tax administration have also been taken in 2003, as the creation of a large tax-payers unit in Bucharest. In 2004 a number of tax offices at the local level will moreover be transformed into “excellence units”, and the authorities will also over the course of 2004 unify the collection, audit and enforcement of health, pension and unemployment contributions. As a newly announced step, the government will, in 2004, switch the personal income tax from a progressive regime with rates from 18% to 40% to a flat rate of 23%. By eliminating the higher rates and simplifying the regime, the government hopes to reduce tax evasion and bring more jobs onto the official market.

4. Implementation of macro-financial assistance

Since 1991, the EU has supported Romania’s transition process through four macro-financial assistance operations, the latest of which was approved in November 1999 when the EU Council granted Romania a balance-of-payments loan, of up to EUR 200 million, within the framework of a SDR 400 million SBA (Council Decision 99/732/EC). After the release of the first EUR 100 million tranche in June 2000, however, the IMF programme went off track and eventually expired. No further disbursements of EU macro-financial assistance could therefore take place.

In October 2001, however, the IMF Board approved a new 18-month SBA for SDR 300 million (approximately USD 383 million). In 2002, lengthy negotiations with the World Bank for a second Private Sector Adjustment Loan (PSAL) of USD 300 million were also concluded. Performance under the IMF programme was mixed and, by end-2002, the completion of the third review had been delayed. Notwithstanding these – typically due to slippages in wage policy and privatisation – and extension of the programme by 6 months – due to the failure to find a suitable strategic investor for Romania’s largest bank (BCR) - Romania eventually completed the arrangement in October 2003. The programme achieved important results in terms of sound macro-economic policies and structural reforms, in particular notable progress with regard to disinflation, energy tariffs realignment and budgetary policy.

Within the context of the now finalised SBA and following a request from the Romanian authorities, the EU Council agreed in principle in January 2002 to make available to Romania EUR 100 million, pursuant to Council decision 99/732/EC, in two sub-tranches, subject to the satisfactory implementation of the SBA and adequate progress in the country’ structural adjustment process. After lengthy negotiations, a Supplemental Loan Agreement and a Supplemental Memorandum of Understanding (SMOU) were signed in November 2002.

After long delays, the structural policy conditions for the disbursement of the first sub-tranche were met in the first half of 2003 paving the way for the release of the first EUR 50 million sub-tranche of the last tranche of outstanding EU macro-financial assistance, which was disbursed on 17 July 2003.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

In 2003, special regulatory provisions applied to eighteen goods and services. The number of administered goods and services in the consumption basket accounted for a share of 21.7%. Regulated prices in the energy sector were adjusted over and above inflation on a regular basis.

2. Trade liberalisation

According to the 2003 WTO trade report, Romania's applied MFN Tariffs for non-agricultural products averaged 16.2%, which compares to an EU-level of 4.2%. Trade liberalisation has been a key element of Romania's economic transformation towards a market economy. In tandem with major domestic economic reforms, Romania has pursued an active role in the multilateral trading system and its integration into the European regional agreements. It is consistently implementing its commitments on market access and other Uruguay Round Agreements and participating actively in ongoing multilateral negotiations. Romania's objective of accession to the EU has a major impact on its foreign trade regime.

3. Exchange regime

The leu floats within a managed float regime and the exchange rate is used as the main anti-inflationary instrument as long as this does not endanger the external balance. Within this framework, the central bank moved to a policy of less frequent but sizeable interventions allowing for greater exchange rate fluctuations.

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. Laws regulating and promoting FDI and portfolio investment have been repeatedly modified, creating legal uncertainty.

5. Monetary policy

The National Bank of Romania enjoys a high degree of independence. The Law on the statute of the central bank defines its main objective as ensuring the stability of the national currency in order to contribute to price stability. Although the law still allows for a limited amount of direct financing to the government, this facility was not utilised in 2002.

6. Public finances

A basic tax reform has been completed, but major steps to consolidate public finances remain to be implemented, including pension and health reforms. In 2003, however, the application of new VAT and profit tax laws, measures to improve the institutional framework for budgetary policy and tax administration. The elimination of the majority of extra-budgetary funds brought about much needed progress towards the elimination of widespread tax exemptions and the improvement of collections. The new Fiscal Code which came into force in January 2004 unifies and simplifies a range of tax regulations and represents a step forward in terms of transparency and predictability of tax legislation. The adoption of a new Budget Law in 2003 improved further the budgeting and expenditure control procedures.

7. Privatisation and enterprise restructuring

Privatisation advanced in the industrial sector, with the sale of additional large enterprises while preparations for divestitures in the energy sector moved beyond the first steps, although much more slowly than originally planned. Large layoffs in some of the largest state-owned loss-makers were carried out in order to improve their financial performance and their privatisation prospects. In the banking sector, the largest remaining state-owned bank (BCR) could not be sold to a strategic investor as originally intended. Following various unsuccessful tenders, the government managed instead in September 2003 to sell 25% of the bank's shares to the EBRD and the IFC.

8. Financial sector reform

Against the background of improving macroeconomic stability and strengthening banks' balance sheets, the banking sector was developing further in 2003. While still low, financial intermediation continued to increase quickly, and in late 2003 total financial assets represented just over 40% of GDP. The financial sector appears generally sufficiently capitalized, liquid and well supervised. Mergers and licence revocations have further reduced the number of banking institutions and more than two thirds of banks are majority foreign-owned. Foreign banks account for well above half of total banking sector assets, lending to the non-governmental sector and total deposits.

IX. SERBIA AND MONTENEGRO

1. Executive summary

The economic situation in 2003 was characterised by a decline in industrial and agricultural production with services and construction remaining the main sources of a 3% real growth (after 4% in 2002). Inflation was further reduced from 15% to 8% while the exchange rate of the Dinar depreciated by some 11% vis-à-vis the euro. Foreign exchange reserves continued to increase markedly by more than one billion euro, as a result of strong net capital inflows, in particular resulting from unexpectedly high FDI as well as from official financing.

Following a quick start with remarkable achievements in 2001/2002, structural reforms advanced at a slower pace in 2003 and stalled towards the end of the year during the pre-election phase in Serbia. In particular, the restructuring of large socially- and state-owned enterprises and the process of bank privatisation have been delayed. A new reform impetus is clearly necessary to improve prospect for future growth and employment creation. This should also include the continuation of institutional reforms and further visible progress with the creation of a functioning single market in Serbia and Montenegro.

In early November 2002, the Council decided to provide to the country further Community macro-financial assistance of up to €130 million in the context of a three-year IMF programme (2002-2005), following a first €345 million package implemented in 2001/2002. The amount was revised upwards to up to €200 million through a revision of the Council Decision in November 2003, to help addressing additional financing needs identified by the IMF in the course of the year. Two tranches amounting to €105 million (€40 million in December 2002/February 2003 and €65 million in August 2003) have already been disbursed.

2. Macroeconomic performance

In 2003, the growth performance in the country worsened somewhat with an expected 3% increase of real GDP (down from 4% in 2002), compared to the initial target range of 3.5 to 4.5%. In Serbia, 2003 real GDP growth is estimated at 3.1%, while the Montenegrin economy has grown by an estimated lower rate of 1.5%. As in the previous year, growth in Serbia is mainly driven by a good performance of the service sector (trade, financial services and construction). However, agricultural output is estimated to have dropped by 10 to 15% compared to 2002 due to an extended Spring-Summer drought, and industrial production has reportedly fallen by some 3%. The main sources of growth of the Montenegrin economy were industrial production and tourism with annual increases of 8.4% and 11%, respectively, in the first eight months of 2003 compared to the same period in 2002.

Annual retail inflation in Serbia (end of period) in 2003 came down from 15% (end 2002) to around 8%, despite an increase of electricity prices in July (by 15% on average) in line with the IMF programme, and higher food prices as a result of the Spring drought. In Montenegro, annual inflation was further reduced in 2003 from 9.5% to around 8% by end-year. This is still a relatively high inflation for a euro-ised economy, partly driven by the introduction of VAT in April and a 23% average increase of electricity prices.

The consolidated fiscal deficit of the country for 2003 was initially planned to be maintained at 4.5% of GDP, composed of a 4.1% deficit in Serbia and a 0.4% deficit in Montenegro, the latter representing some 5.6% of Montenegrin GDP. The overall level of spending was set to

be reduced by 2 percent of GDP to make room for a lower tax burden, in particular in Serbia. In Serbia, the consolidated general government deficit was later revised downwards to 3.5% of GDP. Higher than planned privatisation revenues led to an over-financing of the budget by 2% of GDP, allowing for an equivalent reduction of net public debt. Montenegro remained under fiscal pressure in 2003. In Montenegro, the introduction of VAT in April contributed to an increase in budget revenues, however, the overall fiscal stance in 2003 is yet difficult to assess, also due to the lack of reliable data. Uncertainties remain especially with respect to the actual size and financing of the Montenegrin deficit.

The National Bank of Serbia (NBS) continued its stability-oriented monetary policy in 2003. In early 2003, the NBS temporarily increased reserve requirements on deposits to absorb excess commercial banks' liquidity that resulted from a shift of government deposits to banks in the context of the payment reform. Since May 2003, monetary policy was somewhat relaxed through subsequent reductions of the compulsory reserve rate. Throughout 2001 and 2002, the exchange rate policy was geared at stabilising the nominal exchange rate of the Dinar, which significantly facilitated a process of disinflation in Serbia. Since early 2003, the National Bank of Serbia conducted a more flexible approach taking also into account real exchange rate developments and aspects of international competitiveness. From end-December 2002 to end-December 2003, the dinar/euro exchange rate depreciated by around 11% in nominal terms, but remained rather stable in real effective terms.

The current account deficit of Serbia and Montenegro in 2003 is estimated to have lowered to 11% of GDP before grants (12.8% in 2002), mainly as a result of a lower import demand and modest export recovery. The capital and financial account balance came under some pressure in the first half of 2003, but for the year as a whole important net capital inflows were eventually recorded, especially in the form exceptionally large net inflows of FDI (€1,060 million compared to an initially projected level of €550 million). Foreign exchange reserves rose by about one billion euro and reached more than €3 billion (equivalent to 4.5 months of projected imports) by the end of the year.

Overall, the external sustainability remains a major challenge for Serbia and Montenegro. Despite substantial debt relief that is being provided by Paris Club creditors, the external debt (estimated at €12.7 billion at end-2003 or 61% of GDP) remains relatively high. In particular, debt service obligations are projected to rise considerably from around 2.2% of GDP and 10% of exports of goods and services in 2003 to 4.1% and 16.1%, respectively, in 2005.

3. Structural Reforms

In Serbia, public finance reform continued and expenditure control has been improved through the gradual introduction of a Single Treasury Account in the NBS for budget execution, which covers most ministries and other direct spending units. However, the management and control of extra-budgetary funds and budgets of local government need to be further enhanced. Tax collection improved through the re-organisation and modernisation of the Public Revenue Agency. Envisaged tax policy legislation, including on the introduction of VAT as well as on income and profit taxation, did not come into force due to the blockage in the work of the Parliament and the fact that it was dissolved later in the year. In Montenegro, following the introduction of a Treasury in the Ministry of Finance, the authorities have embarked on further reforms to contain public spending. In March 2003, the government adopted an employment and wage policy action plan that foresees a reduction of redundant public employees and a larger differentiation of salaries. The introduction of VAT in

Montenegro in April 2003 marked a major reform step despite subsequent and temporary difficulties in revenue collection.

A Montenegrin Law on Public Administration which provides the policy and legal framework for reforms in the public administration was adopted in July 2003. Moreover, a new Pension and Disabled Insurance Law based on a three pillar system came into force in September 2003.

In Serbia, a number of laws, which aim to improve the legal and regulatory framework for private sector development, including legislation on enterprises, competition, company registration as well as on bankruptcy procedures and procurement, have been prepared or adopted in 2003 by the government. However, these laws have not yet come into force. A new Accounting Law was adopted in February 2003 and a number of laws that broaden the scope for secured lending came into force in August 2003. It is now important that these laws are fully implemented and applied in order to facilitate financial intermediation and thus real investment and growth in the economy.

The privatisation process in Serbia gained momentum with the sale of some important companies, such as two tobacco factories, the second largest oil company, a steel mill and a brewery. By end-2003, some 900 enterprises had been sold by auction (of which 206 in 2002), 32 by tender (of which 12 in 2002) and 103 through the Share Fund (of which 48 in 2002). As a result, revenues from privatisation reached more than € 900 million in 2003 (€ 345 million in 2002). In Montenegro, the process of privatisation of the largest Montenegrin company, Aluminium Factory KAP-Podgorica, started with the selection of the financial advisor, but as the sale is also related to some strategic decisions (imports of electricity) the process is not expected to be finalised soon. The privatisation of the Nikšić steel-mill and Podgorica tobacco factory are at an advanced stage. Towards the end of 2003, the Montenegrin Government also announced an accelerated privatisation of 20 smaller and less attractive factories. The process of restructuring of some 50 large insolvent companies in Serbia has not much advanced owing to the unsolved problem of outstanding liabilities of these companies. In an attempt to accelerate the restructuring process, the authorities have developed a new approach of “conditional tendering”, which would imply to offer the companies for sale with the un-restructured debts and leave the bidders to come with a proposal on how much debt they will be ready to accept. It still remains to be seen whether this new strategy will be more successful.

In the financial sector, the Serbian authorities strengthened the regulatory and supervisory control over the local banking system by adopting the new Law on the National Bank in July 2003 together with the amendments to the Banking Law. The process of privatisation of the 15 banks in which the Serbian government acquired shares through a debt-for-equity swap in 2002 was delayed, also due to a change in the top management of the Bank Rehabilitation Agency. The privatisation of the first three banks out of the 15 banks is not likely to occur before mid-2004. The banking sector is still burdened with the unresolved problem of claims on heavily indebted companies and a strategic decision concerning non-performing loans in the portfolios of the banks will have to be taken. In Montenegro, the institutional framework for banking supervision has been strengthened over the past year with the introduction of new regulations on licensing, minimal capital, asset classification and provisioning and large exposures. The authorities also adopted an anti-money laundering law in September 2003. The previously largest bank in the republic, Montenegro Banka, was eventually sold in July 2003 and the preparation for the privatisation of the last remaining bank with majority state ownership, Podgorica Banka, has progressed. Another important development in 2003 was

the decision of the Ministry of Finance to revoke all licences given to the offshore banks registered in Montenegro. A continued growth in deposits through 2003 confirms strengthened confidence in the banking sector.

4. Implementation of macro-financial assistance

In early November 2002, the Council decided to provide the country with further Community macro-financial assistance of up to €130 million, following a first €345 million package implemented in 2001/2002. The objective of this assistance is to underpin economic policies in the context of the three-year IMF Extended Arrangement (2002-2005) approved in May 2002, and in particular to support the balance of payments and strengthen the foreign exchange position of the country. A Memorandum of Understanding (MoU) was negotiated and agreed between the Commission Services and the authorities in December 2002. It specifies the economic policy conditions and structural measures for the release of the second and the third tranche of this assistance. It also requires action towards the establishment of a single market within the country. The authorities have agreed to allocate 90% of the proceeds under this assistance to Serbia and 10% to Montenegro.

The grant component of the first tranche (€ 30 million) was released in end-December 2002, following the signature of the MoU. The loan part of the first tranche (€10 million) was disbursed in February 2003 following the ratification by the state union Parliament of the Loan Agreement between the EC and the country. Following the assassination of the Serbian Prime Minister in March 2003 and a subsequent financial request from the Serbian Ministry of Finance, the Commission, supported by the Council, proposed to front-load the remaining macro-financial assistance with a relatively large second tranche in order to address a tightened financial situation of the country. The second tranche of €65 million, comprising a €35 million grant, was released in August, after the Commission had verified that the economic policy conditions in the areas of public finance reform and administration, banking sector reform and private sector development had been fulfilled to a satisfactory degree. In October 2003, a Commission staff mission was carried out to review the conditionality for the third tranche. This mission found that substantial additional progress was necessary before the third tranche can be released.

In November 2003, the Council decided to increase the current macro-financial package by €70 million to up to €200 million through a revision of the Council Decision of November 2002, to help addressing additional financing needs identified by the IMF in the context of the current stabilisation programme. The modalities of this additional assistance, including the precise tranching and attached conditionality, still remain to be negotiated with the authorities.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Most price categories are liberalised except for some public services and utilities. Energy prices are being gradually adjusted towards cost recovery levels. Electricity prices were raised by 15% in Serbia and by 23% on average in Montenegro.

9. Trade liberalisation

Substantial progress in harmonising tariff rates of Serbia and Montenegro, but no agreement so far on the harmonisation of agricultural tariffs and alignment of import levies. Liberalisation measures included phasing out of non-tariff barriers, the planned elimination of all import quotas and the liberalisation of crude oil imports. Trade relations with the EU were negatively affected by inadequate controls of origin of some sugar exports. Bilateral trade agreements are being concluded with neighbouring countries.

10. Exchange regime

Managed floating system in Serbia under which the nominal exchange rate was kept rather stable in 2001 and 2002 leading to a substantial real appreciation of around 50% during that period, though from a supposedly undervalued level at end-2000. In 2003, the Dinar depreciated by some 11% against the euro while it remained rather stable in real effective terms. Montenegro is fully euro-ised with the euro as the sole legal tender; much higher inflation in the republic compared to the euro-zone implies a substantial real appreciation.

11. Foreign Direct Investment

Appropriate FDI legislation as well as foreign investment promotion agency is in place. However, important legislation to improve business environment is still pending, in particular with respect to company registration. FDI is largely related to big privatisation deals; green field and equity investments remain low.

12. Monetary policy

Continuation of stability-oriented monetary policy in 2003 directed at reducing annual inflation to single digit levels for the first time since the start of reforms in late 2000. This includes tight restraint on central bank credit to the general government sector. Change of reserve requirements remains the most important policy instrument to affect liquidity in the banking sector. In Montenegro, the scope for an independent monetary policy is very limited.

13. Public Finance

Further progress with reforms aimed at improving expenditure control in both republics, but continued need for further fiscal consolidation and prioritisation of public spending. VAT was introduced in Montenegro in April; its introduction was postponed to mid-2005 in Serbia. Major reform step in Serbia was the reform of the Public Revenue Agency and the abolition of the old payments bureau.

14. Privatisation and Enterprise Restructuring

Privatisation in Serbia gained some momentum with the successful sale of many small companies through auctions and some big flagship enterprises through tenders. Privatisation revenues were larger than expected amounting to around €900 million in 2003. However, the process of the restructuring and privatisation of large insolvent companies has slowed down in 2003. In Montenegro, the privatisation of parts of the giant Aluminium factory is under way.

15. Financial Sector Reform

Banking supervision has been strengthened in Serbia and Montenegro. The process of bank restructuring and privatisation in Serbia has been delayed. Montenegro Banka was sold in August 2003, and the privatisation of the last state-owned bank in Montenegro, Podgorica Banka, is under preparation.

X. TAJIKISTAN

1. Executive summary

Tajikistan's macroeconomic performance remained strong in 2003 and the sources of growth continue to become more diversified. Traditional sectors (cotton and aluminium) showed modest expansion, while strong growth has been recorded in other sectors, such as services (mostly trade), construction, energy and textiles. Growth in domestic demand was supported by a large expansion of migrants' remittances.

Mixed results are noted in the area of structural reforms. Total tax collection of the general government increased, mainly thanks to improved administration of the VAT. Privatisation of medium and large enterprises has proceeded at a slow pace over the last few years. The authorities are preparing a debt reduction strategy for state-owned farms that includes a provision for writing-off the domestic debt of farms that are being restructured. In the banking sector, the restructuring of the state-owned Amonatbank is nearly completed and the largest bank, Agroinvestbank (AIB), has completed an inventory of its non-performing loans.

Two grant tranches (up to € 7 million each) remain undisbursed under the exceptional financial assistance and Tajikistan's outstanding debt to the EC is now €44 million. The exact amounts of the 2003 grant tranche and the early debt repayment (up to € 7 million and € 12 million respectively) will depend on the findings of the review mission conducted in mid-March 2004.

2. Macroeconomic performance

Tajikistan's macroeconomic performance remained strong in 2003, with real GDP growth estimated at 10.2%, compared to 9.1% in 2002. The sources of growth continue to become more diversified. Traditional sectors (cotton and aluminium) showed modest expansion, while strong growth has been recorded in other sectors, such as services (mostly trade), construction, energy and textiles. Growth in domestic demand was supported by a large expansion of migrants' remittances (for 2003 these are estimated to be equivalent at 15% of GDP).

The overall fiscal surplus for 2003 is estimated at 0.6% of GDP. The Public Investment Programme and quasi-fiscal deficits are not included in the official budget figures. The IMF estimates that the quasi-fiscal deficit in the energy sector amounts to 5.5% of GDP. About two thirds result from low tariffs and technical losses, while the remainder stems from low collection rates. The tax to GDP ratio increased from 14.7% in 2002 to an estimated 15.5% of GDP in 2003 and is projected to increase further in 2004 to 16.2%. In any case, the government will remain reliant on multilateral financing to cover its budget deficit.

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

Several factors have contributed to an acceleration in inflation in 2003, most of which occurred in the first quarter of the year. In this period, there was a loosening of monetary policy, as directed credits were issued to the cotton sector.

The unusually severe winter weather resulted in a strong pick-up in food prices, rising by 7.8% year on year in the first four months of 2003. Higher than expected global energy prices, combined with a rise in fuel and energy tariffs, have also pushed inflation upwards. Besides, services prices rose by almost 32% year on year in January-April 2003. The 2003 year-end inflation is estimated at 13.7%.

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

3. Structural reforms

The strong increase in tax collection is mainly due to improved administration of the VAT, including completion of the transition to the destination principle. To enhance VAT collections, the authorities have begun a taxpayer education program and have reduced delays in issuing VAT refunds. They are also gradually reducing tax arrears of key state-owned enterprises. The authorities have completed a draft of a new tax code, intended to simplify and enhance tax administration. Further, the authorities plan to restructure the Ministry of State Revenues and Duties (MSRD), introduce a system of single taxpayer identification numbers and update the database of taxpayers.

Privatisation of medium and large enterprises has proceeded at a slow pace over the last few years. By end-2002 about 500 enterprises had been privatised, representing about 40 percent of the total listed for privatisation. However, there has been activity last year. In July 2003, the State Committee for State Property has launched a tender for six large industrial enterprises (flour-grinding, steel, leather processing, electronics and a shoe factory).

The authorities are currently preparing a debt reduction strategy for state-owned farms that includes a provision for writing-off the domestic debt of farms that are being restructured. The ADB is assisting the authorities to prepare proposals for reducing or restructuring the external debts of these state-owned farms. One option that is being considered is a mechanism for selling the external debt of the farms in exchange for temporary cotton marketing rights.

The authorities plan to work with independent third parties to enhance the transparency of the farm restructuring process. They expect to reach understandings by end-March 2004 with these groups – including international NGO's – to monitor the privatisation of at least 25 state-owned farms. Further, to improve the governance of the farm privatisation process, the authorities will submit amendments to the law on local government and the land code to parliament (by end-March 2004) that will prevent local authorities from interfering in the farm privatisation process or the operations of restructured farms. Also, the authorities plan to make officials of the State Land Reform Committee independent of the local authorities. To

ensure that privatised farms have clear and unequivocal land rights, the authorities agreed to issue 5,000 additional land share certificates (between 1st October 2003 and end-March 2004).

A new energy law has been enacted to promote the incorporation of Barki Tajik (the state-owned electricity company) and to establish an independent regulation body in the energy sector.

A working group chaired by the minister of energy was established by presidential decree on 3 June 2003 to lead the restructuring of the energy sector. Several models have been studied and an unbundling of the Barki Tajik into a generation company, an independent transmission company and (four) regional distribution companies is envisaged at present.

The number of commercial banks has declined from 17 in 2001 to 13 (as of March 2003). The restructuring of the state-owned Amonatbank is nearly completed, according to the IMF. Compliance with prudential requirements has improved significantly and the bank is now making a profit. The largest bank, Agroinvestbank (AIB) has completed an inventory of its non-performing loans. AIB will be restructured into two independent entities: a commercial bank and a non-bank financial institution financing cotton sector operations.

In 2002 only five banks met the minimum capital requirement of USD 1.5 million and the National Bank of Tajikistan gave waivers to the non-complying banks. The scheduled increases in the minimum capital requirement have been postponed so that the requirement for existing banks will be increased to USD 2 million at end-2004 instead of end-2003. Not all banks have yet provided the required independent audits of their accounts.

4. Implementation of Macro-Financial Assistance

Tajikistan has benefited from an assistance package which consists of a loan of € 60 million (disbursed in March 2001) and a total grant amount of up to € 35 million to be disbursed in successive annual tranches over the period to end-2004.

As Tajikistan has made satisfactory progress in macroeconomic policies and in structural reform, it has benefited from maximum annual grant tranches, € 21 million so far. On the other hand, the EC has not pushed for the maximum annual debt repayments which the MoU would have allowed. Both in 2001 and 2002, Tajikistan was asked to repay €8 million only, whereas the MoU would have allowed requesting € 12 million. Tajikistan's outstanding debt to the EC is now €44 million. The exact amounts of the 2003 grant tranche and the early debt repayment (up to € 7 million and € 12 million respectively) will depend on the findings of the review mission conducted in mid-March 2004.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Most prices are liberalised (with the exception of public utilities).

2. Trade liberalisation

Relatively liberal trade system with persistent non-tariff barriers. Import tariffs were unified at 5% in May 2002. Tajikistan has applied for membership in the WTO (observer status since 2001). The Eurasian Economic Community (including Russia, Belarus, Kazakhstan, Kyrgyz Republic and Tajikistan) aims at promoting regional economic co-operation.

3. Exchange regime

Relatively liberal exchange regime. The official exchange rate was unified with the curb market rate in July 2000 when an interbank foreign exchange market began operating. The new currency, somoni, was introduced in October 2000. A managed floating regime of the somoni is in place.

4. Foreign direct investment

Modest foreign direct investment due to high perceived country risk, despite a relatively liberal legal regime. There are no legal obstacles to foreign direct investment or to foreign ownership of shares, no restrictions on the repatriation of profit and capital. FDI inflows 3.0% of GDP in 2002 and 1.4% estimated for 2003.

5. Monetary policy

The NBT continued to issue directed credits in late 2002 and early 2003, granted by NBT branch managers to cotton sector enterprises. However, in February 2003, the NBT issued a decree withdrawing lending authority from all branch managers, department heads and deputy chairpersons.

6. Public finances

Total tax collection of the general government increased from 14.7% in 2002 to an estimated 15.5% of GDP. This increase is mainly due to improved administration of the VAT, including completion of the transition to the destination principle.

7. Privatisation and enterprise restructuring

The privatisation of small enterprises is largely completed, but for medium and large enterprises it has proceeded at a slow pace over the last few years. In July 2003, the State Committee for State Property has launched a tender for six large industrial enterprises (flour-grinding, steel, leather processing, electronics and a shoe factory).

8. Financial sector reform

Progress was made in improving banking regulation and supervision. Restructuring agreements were signed between the NBT and the four main banks. The restructuring of the state-owned Amonatbank is nearly completed. The largest bank, Agroinvestbank (AIB), has completed an inventory of its non-performing loans. AIB will be restructured into two independent entities: a commercial bank and a non-bank financial institution financing cotton sector operations.

XI. UKRAINE

1. Executive summary

Ukraine continued to show a broadly satisfactory macroeconomic performance in 2003. GDP growth accelerated to 9.3%; inflation remains in the single digits, although it has risen reflecting the rapid pace of economic growth and the unwinding of a previous decline in food prices; and the fiscal position ended the year near balance.

The balance of payments remains in a relatively comfortable position. The current account finished 2003 with a sizeable surplus, the hryvnia has remained stable, and official foreign exchange reserves have continued to increase. Moreover, Ukraine has regained *access to the international capital markets* with the issuance of several sovereign eurobonds. FDI inflows, remain low, however.

This favourable macroeconomic situation contrasts with the insufficient progress detected with the *structural reforms*. Although the authorities took encouraging measures in a number of sectors during 2003, reform progress in areas such as the energy sector and large-scale privatisation remains disappointing.

The IMF is expected to approve in late March 2004 a precautionary stand-by arrangement (SBA) for Ukraine. In July 2002, the Council adopted a Decision granting a new macro-financial assistance (MFA) to Ukraine in the amount of up to €110 million and cancelling the non disbursed part of the 1998 loan facility. The discussions on the conditionality of the new facility were launched in June 2003.

2. Macroeconomic Performance

Ukraine has continued to show a broadly satisfactory macroeconomic performance. After slowing down to 4.1 percent in 2002, the rate of growth of real GDP accelerated to an estimated 9.3 percent in 2003, amply exceeding expectations. Growth is being driven by both a strong export performance and the expansion of domestic demand.

This high rate of economic expansion, combined with rapid wage growth and the unwinding of the previous decline in food prices in the context of a less favourable harvest, has rekindled inflationary pressures. After the unprecedented deflation seen in 2002 (when the CPI fell by 0.6%), annual inflation accelerated to 9.3% by end-2003.

Reflecting the faster than expected economic growth and prudent expenditure policies, fiscal performance in 2003 was better than budgeted, with the consolidated government ending the year with a small cash deficit (of about ½ % of GDP). The budget for 2004 adopted by parliament is consistent with a consolidated budget target of 1½ % of GDP. However, the need to clear arrears on VAT refunds, civil servant wage pressures and medium-term trends in the pension system together with the need to move to a simpler tax system less prone to distortion, continue to pose significant challenges for fiscal policy.

After depreciating sharply during 1999, the hryvnia has shown an impressive degree of stability. Real exchange rate indices have experienced some appreciation in recent years,

reflecting Ukraine's cumulative inflation differential with its main trading partner, but the exchange rate is thought to remain at a relatively competitive level.

The National Bank of Ukraine has backed up its floating exchange rate regime with a relatively prudent monetary policy. While monetary aggregates continued to grow very rapidly in 2003 (47% for broad money, 30% for base money), this has largely reflected the increase in demand for real money balances related to the ongoing process of re-monetisation.²

The balance of payments remains in a relatively comfortable position. Since 1999, the current account has been consistently in surplus. The surplus is estimated to have shrunk from 7.7% of GDP in 2002 to 6% of GDP in 2003 reflecting the strength of domestic demand³. This current account surplus has contributed to a significant build-up in official foreign exchange reserves, which reached about US\$7.2 billion (over 3 months of imports) in early February 2004.⁴ The debt re-scheduling agreed with private bondholders in April 2000 and by the Paris Club in July 2001 have significantly eased Ukraine's debt service obligations. Debt and debt service ratios have shown a downward trend since 2000, although the country's debt service is expected to rise temporarily in 2003-06. In December 2002, Ukraine regained access to the international capital markets (which it had lost in the wake of the Russian financial crisis of 1998) with the issuance of a US\$350 million eurobond. This was followed in early June 2003 by the issuance of a US\$800 million, 10-year eurobond, which was oversubscribed and carried an annual interest rate of only 7.65%⁵. Since 2001, secondary market yield spreads on Ukrainian eurobonds have narrowed markedly and the main international rating agencies have upgraded Ukraine several times.

A persistent weakness in Ukraine's balance of payments is its low inflow of FDI, however. Despite the strengthening of macroeconomic performance, FDI inflows (see the data provided in the summary table on the status of economic reforms) remain well below those seen in the countries of Central and Eastern Europe. A weak investment climate, including a volatile and business-unfriendly regulatory environment, insufficient progress with structural reforms and political instability, are possible factors explaining this disappointing FDI record.

3. Structural Reforms

The remarkable achievements shown by Ukraine on the macroeconomic front in recent years contrast with the insufficient progress detected with the structural reforms. Although the authorities took encouraging measures in a number of sectors during 2003, reform progress in areas such as the energy sector and large-scale privatisation remains disappointing. This section reviews recent developments in the reform areas emphasised by the conditionality of the EU's macro-financial assistance.

² The share of broad money in GDP increased from 10% in 1996 to 29% at end-2002.

³ However, the ratio of the current account surplus over GDP is likely to be exaggerated because the official GDP data, which do not fully incorporate the magnitude of Ukraine's large underground economy, significantly underestimate GDP.

⁴ In recent months, however, the reported increase in reserves has largely reflected valuation effects stemming from the marked depreciation of the dollar, which increases the dollar value of the share of official foreign exchange reserves that Ukraine holds in other currencies.

⁵ An additional issue of US\$200 million of the same series (with similar terms) was placed in October 2003 to compensate for lower than initially planned disbursements by the World Bank.

During 2003, there were some signs of reactivation in the privatisation process. Following two years of much lower than targeted privatisation revenues, the government exceeded the 2.23 billion hryvnias privatisation target for 2003.

In mid-2003, the government submitted to parliament an ambitious medium-term privatisation programme that proposes the reduction in the number of large enterprises excluded from privatisation for strategic reasons and the completion of the privatisation process by 2008. The adoption of this programme has encountered difficulties in parliament, however.

In the area of financial sector reform, progress is being made to restructure the operations of the loss-making State Savings Bank. Thus, in the context of the World Bank's Programmatic Adjustment Loan (PAL), the authorities signed in mid-2003 a Memorandum of Understanding defining a set of transitory measures for restricting the lending activities of this bank and preparing the ground for a comprehensive restructuring of its activities. Significant weaknesses remain in the banking system, however. In particular, non-performing loans continue to represent about one fifth of the total bank loans and the banking system remains highly concentrated, with the largest eight banks accounting for over 60% of its total assets.

The degree of banking intermediation remains low but the banking system has been growing quickly since 2000. This rapid growth largely reflects a welcome return of confidence in the banking system in the context of an improved macroeconomic situation. But it also carries with it considerable risks. In particular, the fast pace of credit expansion is placing strains on banks' ability to evaluate loan applications with due care. In order to put a brake on this excessive credit expansion, the central bank raised the capital adequacy ratio for banks from 8% to 10% in June 2003.

In the trade area, Ukraine still maintains certain regulations that are incompatible with the Partnership and Cooperation Agreement (PCA). In particular, it imposes export duties and other export restrictions on a number of products and continues to discriminate against imported products (notably automobiles and alcoholic beverages) in the application of certain internal taxes. Also, and despite significant progress in recent years, the regulations relating to customs, import licensing, technical standards and the enforcement of intellectual property rights need to be strengthened to better align them with EU requirements.

Ukraine applied for accession to the WTO in 1994 and has completed bilateral negotiations on market access with a total of 23 WTO members (including the EU). It has yet to agree, however, on the non-tariff aspects of the negotiations. Ukraine is aiming at joining the WTO in 2004, possibly coinciding with the accession of Russia. The EU is supporting Ukraine's preparation for accession to the WTO through the provision of technical assistance.

The government is pushing through parliament an ambitious tax reform agenda aimed at reducing the use of exemptions and tax privileges, improving tax administration, limiting tax evasion, and making the tax system less distortive. This agenda includes important changes in the personal income tax, the profit tax and the VAT law. Effective in January 2004, the profit tax rate was cut from 30% to 25% and a new personal income tax replaced the current progressive rate structure with a flat rate and a higher non-taxable threshold. Also, the parliament has passed legislation significantly reducing the number of sectors exempted from the VAT.

There has also been progress recently in dealing with the problem of the arrears on VAT refunds to exporters. In November 2003 an action plan for dealing with these arrears

amounting at that time to about 3.2 billion hryvnias, or some 1.3 percent of GDP, was adopted. In December, the government cleared in cash about 1.3 billion hryvnias of these arrears. The remaining 1.9 billion hryvnias were swapped against 5-year government bonds in January 2004.

In June 2003, the World Bank approved a US\$200 million loan aimed at strengthening Ukraine's tax administration, part of which could deal with the underlying factors causing the recurrent arrears on VAT refunds. The Commission is considering complementing this project with additional technical assistance on the matter.

Reform progress in the energy sector remains elusive and Ukraine continues to exhibit one of the lowest energy efficiency ratios in the world. The privatisation of the regional electricity distribution companies (the oblenegos) remains on hold and energy prices are estimated to remain significantly below economic cost recovery levels. Although cash collection ratios have increased significantly in recent years, the energy sector is plagued by arrears, both towards suppliers and the government (tax arrears) and on its receivables. The restructuring and privatisation of the gas sector continues to be postponed. Moreover, the accounts and operation of the state-owned company that controls the gas monopoly (Naftagas) suffer from a lack of transparency. On the nuclear sector, discussions on the EBRD/Euratom-financed K2R4 project, which aims at compensating the closure of Chernobyl by completing the construction of reactors in two other nuclear power plants, have encountered a number of difficulties.

In recent years, Ukraine has made substantial efforts to increase the transparency of its budgetary procedures and accounts, and to bring accounting and disclosure rules for companies and financial institutions in line with international standards. In the budgetary sphere, a new Budget Code was adopted in 2001 that clarifies the fiscal roles of the executive and legislative branches of government and strengthens the transparency of budgetary operations. The government has put in place a relatively modern Treasury system and is adapting the reporting of its fiscal statistics to the IMF's government finance statistics (GFS) rules. But some deficiencies remain in this area. In particular, the Accounting Chamber—the supreme external audit institution established in 1997—is not allowed to audit the revenue side of the budget. At present, the Accounting Chamber is only authorised to audit the tax and customs administrations as spending units (their expenditures on electricity, salaries, equipment, etc.). Another anomaly concerns the extra budgetary funds, the accounts of which continue to be presented outside the general budget.

4. Implementation of Macro-Financial Assistance

On 12 July 2002, the Council adopted a decision granting a new MFA to Ukraine in the amount of €110 million and cancelling the non disbursed part of the 1998 loan facility. In June 2003 the Commission staff began discussions in Kiev on the policy conditions to be attached to the first tranche of the loan. However, these discussions could not be completed in 2003, in the absence of a working financing arrangement with the IMF.

The extended arrangement approved by the IMF in 1998 expired in September 2002. In December 2003, the IMF staff agreed with the authorities on a draft Letter of Intent and Memorandum of Economic Policies describing an economic programme to be supported by a precautionary SBA. Ukraine has implemented the prior actions requested by the IMF. These included, in particular, the net clearance of 800 million hryvnyas of arrears on VAT refunds to exporters by December 2003 and the elimination of most VAT exemptions⁶. The IMF Board is expected to approve the precautionary SBA in late March 2004.

In early December 2003, the World Bank approved a new, US\$250 million PAL, which covers several areas of structural reform⁷. The first tranche of this loan (US\$75 million) was disbursed upon Board approval.

⁶ The law on the 2004 Budget eliminated temporarily (for one year) most VAT exemptions. A law passed by Parliament in early February made this elimination permanent.

⁷ A first PAL, of the same amount, was approved in September 2001 and has been fully disbursed.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Most prices have been liberalised. Communal service tariffs (such as gas, electricity, heating, and rents) are subject to administrative controls and tend to be below full-cost recovery levels.

2. Trade liberalisation

Import regime free of quantitative restrictions, with a few exceptions for health and safety reasons. In 2001, Ukraine adopted a relatively liberal Customs Code. The trade-weighted average import tariff was about 7% at end-2002 and the effective average import duty is even lower reflecting the widespread use of exemptions. On the other hand, tariff duties show a relatively high degree of dispersion, ranging from 0% to 70%, and a few export restrictions (on sunflower seeds, live animals, cow hides and skins, and scrap metals) remain. A Partnership and Cooperation Agreement with the EU entered into force on 1 March 1998.

3. Foreign exchange regime

Full current account convertibility (Article VIII status at the IMF) since September 1996. Certain foreign exchange restrictions on current transactions were reintroduced between September 1998 and August 1999 to defend the currency.

4. Foreign direct investment

FDI inflows have remained low. Annual net FDI inflows averaged only about 1.8% of GDP in 1999-2002. Cumulative per capita net FDI inflows between 1989 and 2001, for their part, stood at less than 100 US dollars.

5. Monetary policy

It mostly relies on indirect monetary instruments. Central bank credit to commercial banks allocated mostly through the Lombard facility, credit auctions and repos.

6. Public finances

Consolidated government expenditure reduced from about 70% of GDP in 1992 to about 37% of GDP in 2002. Public employment cut by 1 million (to 4.7 million) between 1994 and 1998. Consolidated government deficit reduced from 5.2% of GDP in 1997 to 0.5% of GDP in 2003. Social security contributions, the VAT and the profit tax are the main sources of revenue, accounting together for about 70% of consolidated government tax revenues.

7. Privatisation and enterprise restructuring

Small-scale privatisation virtually completed. Over 9,500 enterprises privatised through a mass (voucher) privatisation scheme launched in early 1995. Privatisation programme is now focusing on the large enterprises, including those in the energy and telecommunications sectors. Limited involvement of foreign or strategic investors. According to the EBRD, the private sector accounted for about 65% of industrial output in 2002.

8. Financial sector reform

Significant efforts made since 1997 to strengthen banking supervision and regulation, including the adoption of laws on the central bank and on banking activities in 1999-2000, the introduction of the International Accounting Standards, and the establishment of a new reporting system for banks. Most banks are privately owned. The banking system, however, remains vulnerable, with some of the largest banks in poor condition. Capital markets remain underdeveloped.

XII. OPERATION INITIATED: ALBANIA

In June 2002, the IMF approved a second PRGF-supported 3-year programme covering the period June 2002-June 2005. Reviews under this programme were successfully completed in January and July 2003. During the latest review, the IMF identified for 2004 a balance of payment residual financing gap of some US\$ 46 million. In August 2003, the Albanian authorities addressed to the Commission a request for EC concessional macro-financial assistance.

In 1999, the Council had approved ⁸a macro-financial assistance of up to € 20 million in favour of Albania, in the form of a loan. This assistance, which had been made available in the context of the Kosovo crisis, was never implemented, because the Kosovo crisis turned out to be relatively short, refugees returned home rapidly and the country's balance of payments position turned out to be better than expected. Therefore, the Albanian authorities indicated to the Commission services (a first time in December 1999 and a second time in June 2000) that they did not require the release of the Community macro-financial assistance in the form of a loan. As a result, the Commission deprogrammed this assistance in 2001⁹.

Following the Albanian request of August 2003, and after reviewing the situation in liaison with the IMF, the Commission services prepared a proposal for a Council Decision repealing the 1999 Council Decision and providing macro-financial assistance to Albania for an amount of € 25 million. The purpose of this new assistance is to underpin the PRFG-supported programme as well as to facilitate the efforts of the Albanian authorities to implement reforms, in the context of the Stabilisation and Association process. Given the country's relatively low level of development (Albania has a GDP per capita of some US\$ 1400 and is still an IDA recipient), it was considered appropriate to provide a significant part of this assistance in the form of a grant (€ 16 million) and the remainder (€ 9 million) in the form of a loan.

The proposal was prepared so as to take into account requirements of the new Financial Regulation. An ex-ante evaluation of the proposed assistance was presented together with the proposal and fraud-proofing provisions were inserted in the Council Decision. Before proceeding with the actual implementation of this assistance, the Commission will check the reliability of Albania's financial circuits and administrative procedures expected to be concerned by this assistance.

The Commission adopted this proposal on 23 December 2003¹⁰. After consultation of the European Parliament, the next step is for the Council to adopt a decision, which is expected for the second quarter of 2004.

⁸ OJ. L 110, pp. 13-15 – Council Decision (1999/282/EC) of 22 April 1999.

⁹ See Report to the Council and the Parliament on the implementation of EC macro-financial assistance in 2001 – COM(2002) 352.

¹⁰ COM(2003) 834 final.

ANNEXES

Annex 1A - COMMUNITY MACRO-FINANCIAL AND EXCEPTIONAL FINANCIAL ASSISTANCE TO THIRD COUNTRIES BY DATES OF COUNCIL DECISIONS

Status of effective disbursements as of end-December 2003 (in millions of euro)

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			<u>Undisbursed</u>
	<u>Date of Council Decision</u>	<u>Reference of Council Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals</u>	
Hungary I (Structural adjustment loan)	22.02.90	90/83/EC	870	Apr. 1990 Feb. 1991	350 260	610	260 (Suspended)
Czech and Slovak Federal Republic (BOP loan)	25.02.91	91/106/EC	375	Mar. 1991 Mar. 1992	185 190	375	
Hungary II (BOP loan)	24.06.91	91/310/EC	180	Aug. 1991 Jan. 1993	100 80	180	
Bulgaria I (BOP loan)	24.06.91	91/311/EC	290	Aug. 1991 Mar. 1992	150 140	290	
Romania I (BOP loan)	22.07.91	91/384/EC	375	Jan. 1992 Apr. 1992	190 185	375	
Israel (I) (Structural adjustment soft loan)	22.07.91	91/408/EC	187,5	Mar. 1992	187,5	187,5	
Algeria I (BOP loan)	23.09.91	91/510/EC	400	Jan. 1992 Aug. 1994	250 150	400	
Albania I (BOP grant)	28.09.92	92/482/EC	70	Dec. 1992 Aug. 1993	35 35	70	
Bulgaria II (BOP loan)	19.10.92	92/511/EC	110	Dec. 1994 Aug. 1996	70 40	110	
Baltics (BOP loans) of which :	23.11.92	92/542/EC	220			135	85 (Suspended)
Estonia			(40)	Mar. 1993	20	(20)	(20)
Latvia			(80)	Mar. 1993	40	(40)	(40)
Lithuania			(100)	Jul. 1993 Aug. 1995	50 25	(75)	(25)
Romania II (BOP loan)	27.11.92	92/551/EC	80	Feb. 1993	80	80	
Moldova I (BOP loan)	13.06.94	94/346/EC	45	Dec. 1994 Aug. 1995	25 20	45	
Romania III (BOP loan)	20.06.94	94/369/EC	125	Nov. 1995 Sep. 1997 Dec. 1997	55 40 30	125	
Albania II (BOP grant)	28.11.94	94/773/EC	35	Jun. 1995 Oct. 1996	15 20	35	
Algeria II (BOP loan)	22.12.94	94/938/EC	200	Nov. 1995	100	100	100 (Suspended)
Slovakia (BOP loan)	22.12.94	94/939/EC	130	Jul. 1996			130 (Cancelled)
Ukraine I (BOP loan)	22.12.94	94/940/EC	85	Dec. 1995	85	85	
Belarus (BOP loan)	10.04.95	95/132/EC	55	Dec. 1995	30	30	25 (Suspended)
Ukraine II (BOP loan)	23.10.95	95/442/EC	200	Aug. 1996 Oct. 1996 Sep. 1997	50 50 100	200	
Moldova II (BOP loan)	25.03.96	96/242/EC	15	Dec. 1996	15	15	
fYRoM I (BOP loan)	22.07.97	97/471/EC	40	Sep. 1997 Feb. 1998	25 15	40	
Bulgaria III (BOP loan)	22.07.97	97/472/EC	250	Feb. 1998 Dec. 1998	125 125	250	

Armenia, Georgia and Tajikistan (2) (Structural adjustment loans and grants) of which	17.11.97 28.3.00	97/787/EC modified by 00/244/EC	375			260	115
Armenia			(58)	Dec. 1998 (loan) Dec. 1998 (grant) Dec. 1999 (grant) Feb. 2002 (grant) Dec. 2002 (grant)	28 8 4 5,5 5,5	51	7
Georgia			(175)	Jul. 1998 (loan) Aug. 1998 (grant) Sep. 1999 (grant) Dec. 2001 (grant)	110 10 9 6	135	40
Tajikistan			(95)	Mar. 2001 (loan) Mar. 2001 (grant) Dec. 2001 (grant) Feb. 2003 (grant)	60 7 7 7	81	14
Ukraine III (BoP loan)	15.10.98 12.07.02	98/592/EC 02/639/EC	150	Jul. 1999	58	58	92 (Cancelled)
Albania III (BOP loan)	22.04.99	99/282/EC	20				20
Bosnia I (3) (BOP loan and grant)	10.05.99 10.12.01	99/325/EC modified by 01/899/EC	60	Dec. 1999 (grant) Dec. 1999 (loan) Dec. 2000 (grant) Dec. 2000 (loan) Dec. 2001 (grant)	15 10 10 10 15	60	
Bulgaria IV (BOP loan)	08.11.99	99/731/EC	100	Dec. 1999 Sep. 2000	40 60	100	
fYRoM II (4) (BOP loan and grant)	08.11.99 10.12.01	99/733/EC modified by 01/900/EC	80 18	Dec. 2000 (grant) Dec. 2000 (loan) Dec. 2001 (loan) Dec. 2001 (grant) May 2003 (grant) June 2003 (loan) Dec. 2003 (loan) Dec. 2003 (grant)	20 10 12 10 10 10 18 8	98	
Romania IV (BOP loan)	08.11.99	99/732/EC	200	Jun. 2000 July 2003 (loan)	100 50	150	50
Kosovo I (5) (Grant budgetary support)	19.02.00	00/140/EC	35	Mar. 2000 Aug. 2000	20 15	20 15	
Montenegro (5) (Grant budgetary support)	22.05.00	00/355/EC	20	Aug. 2000 Dec. 2000	7 13	20	
Moldova III (BOP loan)	10.07.00 19.12.02	00/452/EC 02/1006/EC	15				15 (Cancelled)
Kosovo II (3) (Grant budgetary support)	27.06.01	01/511/EC	30	Sep. 2001 Dec. 2002	15 15	30	

Serbia and Montenegro (ex FRY) I (6) (BOP loan and grant)	16.07.01	01/549/EC	345	Oct. 2001	225	345	
		modified by		Oct. 2001	35		
	10.12.01	01/901/EC		Jan. 2002	40		
				Aug. 2002	45		
Ukraine IV (BOP loan)	12.07.02	02/639/EC	110				110
Serbia and Montenegro II (ex FRY) (7)	05.11.02	02/882/EC	130 (7)	Dec. 2002 (grant)	30	105	25
				Fev. 2003 (loan)	10		
				Aug. 2003 (grant)	35		
				Aug. 2003 (loan)	30		
	modified by						
	25.11.03	03/825/EC	70				70
Bosnia II (8)	05.11.02	02/883/EC	60	Fev. 2003 (grant)	15	25	35
				Dec. 2003 (grant)	10		
Moldova IV	19.12.02	02/1006/EC	15				15
TOTAL			6170, 5 (10)			5023,5	1201

- (1) Assistance to Israel includes a loan principal amount of € 160 million and grants of € 27.5 million in the form of interest subsidies.
- (2) Exceptional financial assistance, which includes a ceiling of euro 245 million for the loans and a ceiling of euro 130 million for the grants
Out of the global amount of euro 375 million, maximum amounts of euro 58 million, euro 175 million and euro 95 million were actually agreed with the beneficiary countries.
- (3) Includes a loan principal amount of up to € 20 million and grants of up to € 40 million.
- (4) Includes a loan principal amount of up to € 50 million and grants of up to € 48 million.
- (5) Exceptional financial assistance.
- (6) Includes a loan principal amount of € 225 million and grants of € 120 million.
- (7) Includes a loan principal amount of € 55 million and grants of € 75 million
- (8) Includes a loan principal amount of € 20 million and grants of € 40 million
- (9) Gross amount

**Annex 1B - COMMUNITY MACRO-FINANCIAL AND EXCEPTIONAL FINANCIAL ASSISTANCE
TO THIRD COUNTRIES BY REGION**

Status of effective disbursements as of end-December 2003 (in millions of euro)

<u>Country</u>	<u>Authorisations</u>		<u>Maximum amount</u>	<u>Disbursements</u>		<u>Totals</u>	<u>Undisbursed</u>
	<u>Date of Council Decision</u>	<u>Reference of Council Decision</u>		<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>		
<u>A. EU Accession countries</u>							
Baltics (BOP loans) of which :	23.11.92	92/542/EC	220			135	85 (Suspended)
Estonia			(40)	Mar. 1993	20	(20)	(20)
Latvia			(80)	Mar. 1993	40	(40)	(40)
Lithuania			(100)	Jul. 1993 Aug. 1995	50 25	(75)	(25)
Bulgaria I (BOP loan)	24.06.91	91/311/EC	290	Aug. 1991 Mar. 1992	150 140	290	
Bulgaria II (BOP loan)	19.10.92	92/511/EC	110	Dec. 1994 Aug. 1996	70 40	110	
Bulgaria III (BOP loan)	22.07.97	97/472/EC	250	Feb. 1998 Dec. 1998	125 125	250	
Bulgaria IV (BOP loan)	08.11.99	99/731/EC	100	Dec. 1999 Sep. 2000	40 60	100	
Czech and Slovak Federal Republic (BOP loan)	25.02.91	91/106/EC	375	Mar. 1991 Mar. 1992	185 190	375	
Hungary I (Structural adjustment loan)	22.02.90	90/83/EC	870	Apr. 1990 Feb. 1991	350 260	610	260 (Suspended)
Hungary II (BOP loan)	24.06.91	91/310/EC	180	Aug. 1991 Jan. 1993	100 80	180	
Romania I (BOP loan)	22.07.91	91/384/EC	375	Jan. 1992 Apr. 1992	190 185	375	
Romania II (BOP loan)	27.11.92	92/551/EC	80	Feb. 1993	80	80	
Romania III (BOP loan)	20.06.94	94/369/EC	125	Nov. 1995 Sep. 1997 Dec. 1997	55 40 30	125	
Romania IV (BOP loan)	08.11.99	99/732/EC	200	Jun. 2000 July 2003	100 50	150	50
Slovakia (BOP loan)	22.12.94	94/939/EC	130			Cancelled (Jul. 1996)	130 Cancelled
TOTAL A			3305			2780	525

B. Western Balkans

Albania I (BOP grant)	28.09.92	92/482/EC	70	Dec. 1992 Aug. 1993	35 35	70	
Albania II (BOP grant)	28.11.94	94/773/EC	35	Jun. 1995 Oct. 1996	15 20	35	
Albania III (BOP loan)	22.04.99	99/282/EC	20				20 (Cancelled)
Bosnia I (1) (BOP loan and grant)	10.05.99	99/325/EC	60	Dec. 1999 (grant) Dec. 1999 (loan)	15 10	60	
	10.12.01	modified by 01/899/EC		Dec. 2000 (grant) Dec. 2000 (loan) Dec. 2001 (grant)	10 10 15		
fYRoM I (BOP loan)	22.07.97	97/471/EC	40	Sep. 1997 Feb. 1998	25 15	40	
fYRoM II (2) (BOP loan and grant)	08.11.99	99/733/EC	80	Dec. 2000 (grant) Dec. 2000 (loan)	20 10	98	
	10.12.2001	modified by 01/900/EC	18	Dec. 2001 (loan) Dec. 2001 (grant) May 2003 (grant) June 2003 (loan) Dec. 2003 (loan) Dec. 2003 (grant)	12 10 10 10 18 8		
Kosovo I (3) (Grant budgetary support)	19.02.00	00/140/EC	35	Mar. 2000 Aug. 2000	20 15	35	
Kosovo II (3) (Grant budgetary support)	27.06.01	01/511/EC	30	Sep. 2001 Dec. 2002	15 15	30	
Montenegro (3) (Grant budgetary support)	22.05.00	00/355/EC	20	Aug. 2000 Dec. 2000	7 13	20	
Serbia and Montenegro I (ex FRY) (4)	16.07.01	01/549/EC	345	Oct. 2001 (grant) Oct. 2001 (loan)	35 225	345	
	10.12.2001	modified by 01/901/EC		Jan. 2002 (grant) Aug. 2002 (grant)	40 45		
Serbia and Montenegro II (ex FRY) (5) (BOP loan and grant)	05.11.02	02/882/EC	130	Dec. 2002 (grant) Fev. 2003 (loan) Aug. 2003 (grant) Aug. 2003 (loan)	30 10 35 30	105	25
	25.11.03	modified by 03/825/EC (7)	70				70
Bosnia II (6) (BOP loan and grant)	05.11.02	02/883/EC	60	Fev. 2003 (grant) Dec. 2003 (grant)	15 10	25	35
TOTAL B			1013			863	150

(1) Includes a loan principal amount of € 20 million and grants of € 40 million.

(2) Includes a loan principal amount of up to € 50 million and grants of up to € 48 million.

(3) Exceptional financial assistance.

(4) Includes a loan principal amount of € 225 million and grants of € 120 million.

(5) Includes a loan principal amount of € 55 million and grants of € 75 million

(6) Includes a loan principal amount of € 20 million and grants of € 40 million

(7) Includes a loan principal amount of € 25 million and grants of € 45 million

C. New Independent States (NIS)

Armenia, Georgia and Tajikistan (8) (Structural adjustment loans and grants) of which	17.11.97 modified by 28.3.00	97/787/EC 00/244/EC	375			260	115
Armenia			(58)	Dec. 1998 (loan) Dec. 1998 (grant) Dec. 1999 (grant) Feb. 2002 (grant) Dec. 2002 (grant)	28 8 4 5,5 5,5	(51)	(7)
Georgia			(175)	Jul. 1998 (loan) Aug. 1998 (grant) Sep. 1999 (grant) Dec. 2001 (grant)	110 10 9 6	(135)	(40)
Tajikistan			(95)	Mar. 2001 (loan) Mar. 2001 (grant) Dec. 2001 (grant)	60 7 7	(74)	(21)
Belarus (BOP loan)	10.04.95	95/132/EC	55	Dec. 1995	30	30	25 (Suspended)
Moldova I (BOP loan)	13.06.94	94/346/EC	45	déc-94 Aug. 1995	25 20	45	
Moldova II (BOP loan)	25.03.96	96/242/EC	15	Dec. 1996	15	15	
Moldova III (BOP loan)	10.07.00 19.12.02	00/452/EC 02/1006 EC	15				15 (cancelled)
Moldova IV (BOP grant)	19.12.02	02/1006/EC	15 (15)				15
Ukraine I (BOP loan)	22.12.94	94/940/EC	85	Dec. 1995	85	85	
Ukraine II (BOP loan)	23.10.95	95/442/EC	200	Aug. 1996 Oct. 1996 Sep. 1997	50 50 100	200	
Ukraine III (BoP loan)	15.10.98 12.07.02	98/592/EC 02/639/EC	150	Jul. 1999	58	58	92 (cancelled)
Ukraine IV (BOP loan)	12.07.02	02/639/EC	110 (15)				110
TOTAL C			1065 (9)			693	372

D. Mediterranean countries

Israel (9) (Structural adjustment soft loan)	22.07.91	91/408/EC	187,5	Mar. 1992	187,5	187,5	
Algeria I (BOP loan)	23.09.91	91/510/EC	400	Jan. 1992 Aug. 1994	250 150	400	
Algeria II (BOP loan)	22.12.94	94/938/EC	200	Nov. 1995	100	100	100 (Suspended)
TOTAL D			787,5			687,5	100
TOTAL A+B+C+D			6170,5			5023,5	1147

(8) Exceptional financial assistance, which includes a ceiling of euro 245 million for the loans and a ceiling of euro 130 million for the grants
Out of the global amount of euro 375 million, maximum amounts of euro 58 million, euro 175 million and euro 95 million were actually agreed with the beneficiary countries

(9) Assistance to Israel includes a loan principal amount of ECU 160 million and grants of ECU 27,5 million in the form of interest subsidies.

**Annex 2: Balance of payments support to recipients of EU
macro-financial assistance by contributor, 1990-2003 (1)**

2a. In millions US\$

	1990	1991	1992	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
IFI's	419	5607	1564	4086	1877	250	732	2800	1751	36	439	1128	407
IMF	219	4177	909	3206	1477	195	584	2200	1009	12	284	860	307
World Bank	200	1430	655	880	400	55	148	600	742	24	155	268	100
Bilaterals	1619	5600	708	11202	3885	67	582	168	872	238	3483	305	145
EU (2)	1108	2190	423	855	330	19	329	168	556	189	375	196	84
Other bilaterals (3)	511	1406	285	702	150	10	73		264	49	93	81	
of which													
USA		35		100		10	15		75	13	22	17	
Japan	200	850	120	350	150		54		22	7		6	
Debt relief		2004		9645	3405	38	180		52		3015	28	61
Paris Club		554		4920					52		3015	24	
London Club				4380								4	
Other (4)		1450		345	3405	38	180						61

2.b In percent of total commitments, including debt relief

	1990	1991	1992	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
IFT's	21	50	69	27	33	79	55	94	66	13	11	79	74
IMF	11	37	40	21	26	62	44	74	38	4	7	60	56
World Bank	10	13	29	6	7	17	11	20	28	9	4	19	18
Bilaterals	79	51	32	74	68	21	44	6	33	87	90	21	26
EU (2)	54	20	19	6	6	6	25	6	21	69	10	14	15
Other bilaterals (3)	25	13	13	5	3	3	5		10	18	3	1	
of which													
USA		0		1		3	1		3	5	1		
Japan	10	8	5	2	3		4		1	3			
Debt relief		18		63	59	12	14		2		77	6	11
Paris Club		5		32					2		77	6	
London Club				29									
Other (4)		13		2	59	12	14						11

2c. In percent of total commitments, excluding debt relief

	1990	1991	1992	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
IFT's	21	61	69	73	80	90	65	92	68	13	48	85	83
IMF	11	45	40	57	63	70	52	59	39	4	31	54	63
World Bank	10	16	29	16	17	20	13	33	29	9	17	31	20
Bilaterals	79	39	32	27	20	11	36	8	31	87	51	20	17
EU (2)	54	24	19	15	14	7	29	8	21	69	41	14	17
Other bilaterals (3)	25	15	13	12	6	4	7		10	18	10	6	
of which													
USA		0		2		4	1		3	5	2		
Japan	10	9	5	6	6		5		1				

(1) Based on Council Decisions for EU operations.

No operation was decided in 1993.

(2) EU macro-financial assistance.

(3) Including EU Member States.

(4) Syndicated commercial banks loan in favour of Algeria in 1991, debt relief in favour of Ukraine by Russia and Turkmenistan in 1994 and 1995, debt rescheduling in favour of Moldova by Russia in 1996, debt rescheduling in favour of Bulgaria and fYRoM in 1997 and combined Paris/London Clubs relief to Serbia-Montenegro in 2003.

**Annex 2.1.: Balance of payments support to recipients of EU
macro-financial assistance by contributor, 2002-2003 a)**
(in millions of US\$ and in percent of total commitments and disbursements)

Balance of payments support 2002

	Total				Kosovo*				Federal Republic of Yugoslavia			
	Commitments		Disbursements		Commitments		Disbursements		Commitments		Disbursements*	
	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%
IFI's	1128	79	559	72					30	19	15	22
IMF	860	60	321	41								
WB (policy based)	268	19	238	31					30	19	15	22
Bilaterals	304	21	216	28	3	100	17	100	131	81	53	78
EU	196	14	143	18			14	82	64	40	21	31
USA	17	1							17	11		
Japan	5	6	5	1	3	100	3	18	2	1	2	3
Other bilaterals	58	4	40	5					48	30	30	44
Debt relief	28	2	28	4								
London Club	4	5	4	1								
Paris Club	24	2	24	3								
Other												
Total	1432	100	775	100	3	100	17	100	161	100	68	100
	<u>Bosnia and Herzegovina</u>				<u>Serbia and Montenegro</u>				*As of November 2002			
	Commitments		Disbursements		Commitments		Disbursements					
	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%				
IFI's	103	79	89	96	995	88	455	76				
IMF	40	31	26	28	820	72	295	49				
WB (policy based)	63	48	63	68	175	15	160	27				
Bilaterals	28	21	4	4	142	12	142	24				
EU	24	18			108	9	108	18				
USA												
Japan												
Other bilaterals					10	1	10	2				
Debt relief	4	3	4	4	24	2	24	4				
London Club	4	3	4	4								
Paris Club					24	2	24	4				
Other												
Total	131	100	93	100	1137	100	597	100				

Balance of payments support 2003

	<u>Total</u>				<u>Kosovo*</u>				<u>FYROM</u>			
	<u>Commitments</u>		<u>Disbursements</u>		<u>Commitments</u>		<u>Disbursements</u>		<u>Commitments</u>		<u>Disbursements*</u>	
	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%
IFI's			407	74								
IMF			307	56								
WB (policy based)			100	18								
Bilaterals	79	100										
EU			84	15								
USA												
Japan												
Other bilaterals												
Debt relief	79	100	61	11								
London Club												
Paris Club												
Other												
Total	79	100	552	74								
	<u>Bosnia Herzegovina</u>				<u>Serbia and Montenegro</u>				*As of November 2002			
	<u>Commitments</u>		<u>Disbursements</u>		<u>Commitments</u>		<u>Disbursements</u>					
	mio US\$	%	mio US\$	%	mio US\$	%	mio US\$	%				
IFI's							407	74				
IMF							307	56				
WB (policy based)							100	18				
Bilaterals					79	100	145	26				
EU							84	15				
USA												
Japan												
Other bilaterals												
Debt relief					79	100	61	11				
London Club												
Paris Club												
Other												
Total					79	100	552	100				

a) Disbursements are shown under the year of corresponding commitments.

* (excl. designated donorgrants for the budget)

ANNEX 3: Selected economic indicators

		2000	2001	2002	2003	
					Programme (1)	Estimates
GDP at constant prices	(Percent change)					
Albania		7,3	7,6	4,7	6,0	6,0
Armenia		6,0	9,6	12,9	7,0	13,9
Bosnia-Herzegovina		5,0	4,5	5,5	5,5	3,5
Bulgaria		5,3	4,1	4,8		4,5
Serbia and Montenegro		6,7	4,0	4,0	4,5	3,0
fYRoM		4,5	-4,5	0,7	2,8	3,0
Georgia		1,9	4,7	5,3	7,0	8,6
Moldova		2,1	6,1	7,2	5,0	6,5
Romania		2,1	5,7	5,0		4,9
Tajikistan		8,3	10,2	9,1	9,0	10,3
Ukraine		4,5	9,1	4,8		9,0
Consumer price (end year)	(Percent change)					
Albania		4,2	3,5	1,7	2,8	3,6
Armenia		0,4	2,9	2,0	2,0	8,6
Bosnia-Herzegovina (period average)						
Federation		2,0	1,9	-0,2	0,0	0,0
Republika Srpska		15,0	7,0	1,7	1,7	1,7
Bulgaria		11,4	4,8	3,8		5,6
Serbia and Montenegro		115,0	39,0	14,2	2,0	8,0
fYRoM		6,1	3,7	1,0	2,2	2,6
Georgia		4,6	3,4	5,4	4,5	7,0
Moldova		18,5	6,5	4,4	8,0	11,7
Romania		40,7	30,3	17,8		14,1
Tajikistan		61,0	12,5	12,2	9,0	13,7
Ukraine		27,0	6,1	-0,6		9,3
Fiscal balance	(Percent of GDP)					
Albania		-9,2	-8,2	-6,9	-5,6	-6,4
Armenia *		-4,0	-4,0	-2,6	-3,4	-2,2
Bosnia-Herzegovina (General government)		-9,9				
Federation		-2,3	-0,6	-1,7	0,6	0,7
Republika Srpska		-2,9	-2,0	0,0	0,4	0,5
Bulgaria		-0,6	0,2	-0,8	-0,8	-0,1
Serbia and Montenegro		-0,9	-1,4	-4,5	-4,5	-4,5
fYRoM		1,8	-7,2	-5,7	-2,5	-1,5
Georgia *		-3,9	-1,6	-1,9	-1,7	-1,1
Moldova		-3,1	-0,1	-1,8	-2,2	-0,2
Romania		-4,6	-3,3	-2,6		-2,3
Tajikistan		0,2	-0,1	-0,1	0,9	0,9
Ukraine		-1,5	-1,6	1,0		-0,5
Current account	(Percent of GDP)					
Albania			-3,2	-6,5	-6,3	-6,1
Armenia **		-19,8	-10,0	-6,6	-6,5	-7,7
Bosnia-Herzegovina		-20,9	-15,5	-18,5	-17,5	-17,5
Bulgaria		-5,4	5,0	6,1		6,5
Serbia and Montenegro		-3,9	-8,8	-8,8	-8,6	-8,1
fYRoM		-2,1	-6,8	-8,6	-6,3	-6,2
Georgia **		-13,7	-6,5	-6,0	-11,0	-10,1
Moldova		-4,4	-6,5	-6,0	-11,0	-10,1
Romania		-3,9	-5,5	-3,4		-5,8
Tajikistan		-3,9	-7,2	-2,7	-1,3	-2,9
Ukraine		4,0	3,5	7,7		6,0

Official foreign exchange reserves (end year)	(Months of imports)				
Albania	4,2	4,3	4,3	4,4	4,4
Armenia	3,5	3,6	4,7	4,3	4,0
Bosnia-Herzegovina	2,1	5,0	4,8	4,7	4,5
Bulgaria	5,4	5,0	6,1		6,5
Serbia and Montenegro	1,2	2,4	3,2	4,5	4,5
fYRoM	3,5	4,7	4,1	4,0	4,0
Georgia	1,0	1,4	1,8	1,3	1,5
Moldova	2,4	2,1	2,1	2,9	2,2
Romania	3,7	3,0	4,0		3,7
Tajikistan	1,9	1,9	1,8	1,8	1,8
Ukraine	0,8	1,9	2,5		3,3

(1) Programme targets set in IMF programmes, if any.

* On a cash basis.

** Excluding official transfers.

*** Kosovo Consolidated Budget before grants

Sources: National authorities and IMF