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

**Report from the Commission to the Council and the European Parliament
on the implementation of macro-financial assistance to third countries in 2006**

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COMMISSION STAFF WORKING DOCUMENT

WORKING PAPER FROM THE COMMISSION SERVICES ON THE IMPLEMENTATION OF MACRO-FINANCIAL ASSISTANCE TO THIRD COUNTRIES IN 2006

LIST OF ABBREVIATIONS

CBA	Currency Board Arrangement
CEECs	Central and East European Countries
CPI	Consumer Price Index
EC	European Community
EFF	Extended Fund Facility
EGPRSP	Economic Growth and Poverty Reduction Strategy Paper
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
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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INTRODUCTION

This working document is published in parallel with the Report from the Commission to the Council and to the European Parliament on the implementation of macro-financial assistance to third countries in 2006. This document provides economic and financial information regarding the situation of the beneficiary countries. Statistical data sorting the different macro-financial assistance decisions since 1990, by date and by regions, are included in the annex.

HORIZONTAL SECTION

1. WESTERN BALKANS

Economic developments in the Western Balkans¹ were overall favourable in 2006: the average GDP growth rate was around 5.4%. Inflationary tensions, which had resumed in 2005 particularly in Serbia, somewhat dampened in 2006, with the annual CPI increase coming down to 5.4% on average. External imbalances remained significant, with an average current account deficit of some 10.7% of GDP in 2006. Fiscal consolidation was pursued further: general government balances improved in 2006 and recorded an average surplus of 0.4% of GDP, with only Albania and the former Yugoslav Republic of Macedonia posting deficits. Serbia in particular posted a sizeable budget surplus of 1.6% of GDP. Structural reforms have progressed at an uneven pace. A large share of privatisation programmes – except in Montenegro and Serbia where the process started later – are now fairly advanced, though important enterprises in the telecom and utilities sectors still remain in state ownership. Restructuring of energy utilities and markets has begun, boosted by the signature on 25 October 2005 of the South Eastern Europe Energy Treaty. In other areas, notably factor markets and the judiciary, progress remains uneven.

COUNTRY SECTIONS

2. ALBANIA

2.1. Executive summary

Economic growth remained high in 2006 and reached a satisfactory degree of resilience, despite the energy crisis at the end of 2005. Fiscal indicators have continued to improve; monetary policy has been prudent and managed to keep inflation relatively low. However, the trade and account deficits remained considerably high, inducing the mid- and long-term vulnerability of the country's external position. The booming credit growth has remained a challenge in view of these external account imbalances. The privatisation and restructuring of remaining

¹ Data without Croatia which did not benefit from any macro-financial assistance. Given the lack of up-to-date statistical information, aggregate data on the region for 2006 to do not include Kosovo either.

large state-owned enterprises, in particular of the telecommunication and energy utilities, have been delayed. Some progress was achieved in the public finance management and improving the business environment; nevertheless the strengthening of the institutional capacity for debt management, continuing improvements in tax administration and public sector governance, improving the enforcement of property rights and the efficiency of the judicial system remain some of the key challenges for the authorities. Cooperation with international financial institutions continued to be an important anchor for economic policies. A new three-year IMF programme started in February 2006 following the successful completion of the previous programme in November 2005.

2.2. Macroeconomic performance

Albania maintained a fairly stable macroeconomic environment throughout 2006, characterised by strong GDP growth and subdued inflation. Nevertheless, the repercussions of the energy crisis at the end of 2005, combined with weakening economic activity in the construction sector, decelerated GDP growth to an estimated 5% in 2006. Economic growth continued to be led mainly by domestic demand fed by booming credit and significant remittances inflows.

Average annual inflation remained moderate and stood at 2.4% in 2006, thereby remaining at the lower end of the Bank of Albania's informal $3\pm 1\%$ inflation target range. After a temporary drop in the first quarter of 2006, modest inflationary pressures resumed in the second quarter of 2006 as a result of rapid growth in credit to private sector, foreign exchange inflows, increases in administered prices and pressures from commodity markets. In order to contain these, the Bank of Albania tightened its monetary policy stance in July and November by raising the main policy rate each time by 25 basis points. The lek appreciated against the Euro by approximately 3% in nominal terms during 2005, while it remained relatively stable vis-à-vis the Euro throughout 2006.

The labour market situation continued to improve. The unemployment rate (based on the official registered data) fell somewhat to 14.2% in 2005 and further to 13.8% in 2006. The trends in employment are nevertheless difficult to assess due to limited reliability of the available data and significant informal employment, particularly in the agricultural and construction sectors.

External deficits widened considerably in 2005 and the estimates of the authorities for 2006 do not suggest a reversal. The trade deficit widened to 23.8% of GDP in 2005 and remained close to this level also in 2006. The financing of the trade deficit remained largely dependent on significant remittances and other current transfers² estimated at 13.5% of GDP in 2006. As a result, the current account deficit reached 8.6% of GDP in 2005 and was expected to reach the same level also in 2006. Gross reserves continued to rise throughout 2006 and reached the equivalent of EUR 1,290 million at the end of 2006, which amounts to around 4 months of imports.

2 According to national sources, they have reached 33% of disposable income of an average family and almost 40% in rural areas.

The public debt-to-GDP ratio has been substantially reduced over recent years, from 71% in 2000 to 55% in 2006. However, the level of domestic public debt, at 37.8% of GDP at the end of 2006, remains still relatively high and a more vigorous stance for further debt reduction is critical. The Albanian government's external debt is estimated at around 17% of GDP at the end of 2006, representing around of 31% of total public debt.

Fiscal consolidation has further progressed. In 2006, the relatively prudent fiscal stance contributed to and benefited from a favourable macroeconomic environment. Combined with solid progress in implementation of reforms aiming at improving the tax administration and reducing tax evasion, this led to higher than expected revenues. Mainly for this reason, together with considerable under-spending of planned capital expenditure, the programmed general government deficit of around 4% of GDP was undershot and amounted instead, according to Albania's latest estimates, to 3.2% of GDP. The slow execution of capital expenditure is partly a result of capacity constraints in some ministries and weak procurement management. In light of a favourable budget performance in the first half of 2006, in terms of risen tax revenues, the authorities reached an agreement with the IMF on a supplementary budget for the second half of 2006. It was adopted by the Assembly on 31 July and included additional expenditure of 2.2% of GDP. A large part of this amount has been allocated as additional investment in infrastructure projects.

Moody's is currently preparing the first rating of Albania's sovereign risk, expected to be issued in spring 2007. This is an important step, as it witnesses the ongoing stabilisation in the country and paves for the way for better access to international capital markets.

2.3. Structural reforms

Progress in public administration reform has continued, the authorities took a number of actions to implement a number of measures to reform the tax administration and public finance management throughout 2006. These measures relate to strengthening fiscal discipline, tax administration efficiency, tax collection as well as improving the quality of public expenditure and building capacity for debt management. In particular, the strengthening of debt management capacity should get prominent attention. Certain progress has been achieved in improving the business environment, however, enforcement of property rights has continued to be weak and only marginal progress has been achieved in improving the efficiency of the judicial system.

Whereas privatisation of small- and medium-sized enterprises has been completed, large-scale privatisation has suffered delays, in particular in the telecommunications and energy sectors. The ratification of the sale agreement that would complete the privatisation of Albtelecom, the incumbent operator, was rejected by the Albanian parliament in October 2005. This led to a review of the sale contract and the tender procedure. The privatisation of Albanian Refining and Marketing Oil failed in the absence of satisfactory bids. The privatisation of the state-owned insurance company INSIG has been prepared.

2.4. Implementation of macro-financial assistance

The MFA operation in favour of Albania came to an end in 2006. In April 2004, the Council had decided to provide macro-financial assistance to Albania for an amount of up to EUR 25 million, comprising of EUR 16 million of grants and EUR 9 million of loans, to support Albania's balance of payments and strengthen its foreign exchange reserves. Negotiations on a Memorandum of Understanding, defining specific policy conditions, have been completed in October 2004. The disbursement of the first tranche, amounting to a total of EUR 12 million, was completed on 23 March 2006 (the grant component of the first tranche of EUR 3 million was already disbursed in November 2005, while the payment of the EUR 9 million loan component was completed on 23 March 2006). The second and final tranche of the assistance (grant of EUR 13 million) was disbursed on 31 July 2006, following a positive assessment by the Commission of Albania's progress in reforming key areas such as public finance management, public administration, financial sector, business environment and private sector development.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Most price categories are liberalised except for some public services and utilities. Prices of electricity and oil have been increased towards cost recovery levels under the oversight of the Regulatory Authority. Electricity prices for poor families are however still subsidised. Pricing for telecommunication is fully liberalised, even for international calls. Railway transport prices remain subsidised.

2. Trade liberalisation

Albania is a WTO member since 2000 and has concluded Free Trade Agreements negotiations with the former Yugoslav Republic of Macedonia, Croatia, Bulgaria, Kosovo (under UNSCR 1244), Romania, Serbia and Montenegro, Moldova, and Bosnia and Herzegovina.

3. Exchange regime

Albania maintains an independent floating exchange rate regime. However, the Bank of Albania intervenes when necessary to smooth out strong fluctuations and accumulate reserves. The appreciation pressures of the Albanian lek against the Euro eased towards the end of 2005 and the lek remained stable vis-à-vis the Euro in 2006.

4. Foreign Direct Investment

In 2006, foreign direct investment is estimated to having reached EUR 273 million (about 3.7% of GDP) against EUR 224 million (about 3.3% of GDP) in 2005. Administrative barriers to market entry were reduced in 2006. However, several major challenges still remain, especially the relatively high cost of starting and closing a business, the limitations of cadastral records and the size and scope of the informal economy. The business climate continued to suffer from a weak legal environment such as a lack of clearly defined property rights, from poor infrastructure and unreliable power supply, which represent major impediments for a substantial inflow of foreign investment.

5. Monetary policy

The Bank of Albania continued with its stability-oriented monetary policy in 2006 and maintained its 3% implicit inflation target with a fluctuation band of $\pm 1\%$. The Bank of Albania tightened its monetary policy stance in July and November 2006 by raising the main policy rate each time by 25 basis points. The Bank of Albania started to examine prerequisites for a gradual change in its monetary strategy towards an explicit inflation targeting regime with the aim of enhancing transparency and credibility of its monetary policies.

6. Public Finance

The performance in terms of revenue collection has been improved compared to previous years. The authorities progressed in implementing a number of measures to reform the tax administration and public finance management throughout 2006. These measures relate to strengthening fiscal discipline, tax administration efficiency, tax collection as well as improving the quality of public expenditure and building capacity for debt management. In particular, the strengthening debt management capacity should get prominent attention.

7. Privatisation and Enterprise Restructuring

The process of restructuring and privatisation of large companies such as of Albtelecom and ARMO (fuel company) has been delayed. The operational and financial performance of the electricity utility KESH deteriorated, which is a significant cause of concern.

8. Financial Sector Reform

The banking sector is now close to 100% in private hands. The regulatory framework for banking supervision is, following its recent comprehensive overhaul, well developed and in a continuing process to be further aligned with best international practice. Nevertheless, the regulatory, governance and supervisory framework for the non-banking financial sector remains weak, lacking sufficient capacity, transparency and independence. Certain progress has been recorded in establishing the new Financial Supervision Authority to supervise insurance, pensions and capital markets, nevertheless its

institutional capacity need to be still significantly strengthened.

3. BOSNIA AND HERZEGOVINA

3.1. Executive summary

The economy of Bosnia and Herzegovina continued to grow at a favourable pace and expanded by around 6% in 2006. Inflation picked up from previous low levels and was mainly driven by price increases related to the introduction of VAT in January 2006. Exports grew strongly during 2006, while import growth was relatively low. This was partly due to temporary factors related to VAT introduction. In addition, external imbalances continued to be relatively large. Structural reforms continued to be rather slow, although some achievements were noted in the fields of indirect taxation and privatisation.

In the course of 2005 the Council Decision of November 2002, as amended in December 2004 to extend its expiry date until 2005, and providing Bosnia and Herzegovina with up to EUR 60 million of macro-financial assistance, came to its final stage of implementation. The first two tranches had been disbursed in February 2002 and in December 2003/January 2004 respectively, after satisfactory compliance with the attached conditionality. The grant part of the third tranche, amounting to EUR15 million, was released in June 2005. The release of the corresponding loan part of EUR10 million was delayed pending ratification of the loan by the BiH State Parliament and took place in February 2006.

3.2. Macroeconomic performance

The economy continued to grow at a relatively strong pace of around 6% in 2006. An important driver behind growth was the strong expansion of industrial production, in particular in the Republika Srpska (RS). Industrial production grew by 20% in the RS and 7.6% in the Federation during the year. This expansion was largely driven by output growth in the mining and processing industries, but certain manufacturing industries also started to gain ground.

After three years of annual inflation rates below 1%, inflation picked up to 3.7% in 2005 and further to around 7% in 2006. The increase in 2006 was mainly due to the introduction of VAT by first of January and related price hikes. Inflation increases gradually levelled off during the year and inflation dropped significantly in January 2007. Through the Currency Board arrangement the Convertible Mark (KM) has been pegged to the Euro at an unchanged rate since the introduction of the Euro in January 1999. The size of public spending remains comparatively high at around 50% of GDP. Public spending increased further during 2006, partly due to the pre-election political climate. Nevertheless, as a result of strong revenue inflows following VAT introduction, the budget balance is estimated to have recorded a small surplus in 2006.

The external imbalances continue to be large, mainly driven by a sizeable trade deficit. However, the current account deficit was significantly reduced during 2006, partly as a result of temporary factors. Exports grew strongly at around 30%, supported by improved reporting of exports as well as stronger performance and favourable price developments in some sectors. Import figures for 2006 were

reduced by the forward shift of imports to end-2005 because of VAT introduction on 1 January 2006. Partly due to these temporary factors, the current account deficit decreased significantly during 2006 to around 15% of GDP. Foreign direct investment (FDI), after very strong inflows of 2004, weakened in 2005 to 5.2% of GDP. The downward trend continued in 2006 and inflows dropped by 8% in the first half of the year compared to the same period in 2005. FDI inflows remain intimately linked to the privatisation process.

The downward trend of public external debt continued. The debt stock amounted to 27.2% of GDP at end 2005 and it decreased by 4% in Euro terms during the first nine months of 2006. Private external debt on the other hand rose in 2005 and is estimated to represent around 30% of total external debt, but with limited data on developments available. Some progress has been made concerning agreeing on terms and conditions for the settlement of the large outstanding domestic debt claims, but the final costs and fiscal impacts of debt restructuring are still not clear.

3.3. Structural reforms

An important area of reform has been indirect taxation and the creation of an Indirect Tax Authority (the ITA). The ITA board, comprising the finance ministers at Entity and State levels and their respective experts, started functioning during the first half of 2004 and was responsible for the introduction on 1 January 2006 of a single VAT rate of 17%. The introduction went rather smoothly and is an important step to harmonise indirect taxation between the entities and to improve revenue collection. However, the mechanism on how to divide the collected indirect tax revenues between different levels of government has been a contested issue. Funds were blocked in the single account several times during 2006, resulting in delays of transfer of funds to the entities and the Brsko district.

The privatisation process remained relatively slow in 2006, although some progress was achieved in particular in the Republika Srpska. Complicated organisational structures as regards the responsibilities for privatisation, vested interests and the financial status of companies have slowed down the process. Loss-making public companies are a source of inefficient use of public resources, which negatively affects savings and investment. Improved bankruptcy legislation has been adopted but its implementation remains limited.

The banking system is one of the sectors in BiH where previously the most rapid reforms and structural transformation have taken place. The sector is currently dominated by foreign-owned banks. However, supervision is still carried out by separate institutions in the two entities and the institutional setup is hampering further improvements in the regulatory environment. Supervision of other parts of the financial sector, such as leasing and insurance, continues to be weak.

3.4. Implementation of macro-financial assistance

In November 2002 the Council approved Community macro-financial assistance of up to EUR 60 million to BiH (Decision 2002/883/EC), comprising a loan element of up to EUR 20 million and a grant element of up to EUR 40 million. In order to allow the full implementation of this assistance, and given the expiry of the initial Council

Decision on 9 November 2004, the Commission proposed in September an extension of the expiry date of this assistance, which the Council approved on 7 December 2004 (Council Decision 2004/861/EC)³.

The first tranche was disbursed in February 2003 (EUR15 million grant), following the approval by the IMF board of a new stand-by arrangement and the signature by the Commission and the BiH authorities of a Memorandum of Understanding (MoU) laying out the conditionality attached to the first two tranches. The second tranche was released in December 2003 (EUR 10 million grants) and January 2004 (EUR 10 million loans).

In June 2003 a Supplemental Memorandum of Understanding was signed, outlining the economic policy conditions attached to the release of the third and last tranche of up to EUR 25 million. The conditions covered the areas of public finance and administration reform, private sector and business environment, financial sector reform and the area of statistics. After the performance of an “operational assessment”, assessing the soundness of BiH’s financial circuits and administrative controls, in August 2004 the Commission requested measures to be taken prior to the disbursement of the third tranche. In May 2005 conditions and additional prior actions related to the release of the third tranche were considered as fulfilled and the grant part of this last tranche was disbursed in mid 2005. The disbursement of the loan component of the third tranche required the adoption of the loan agreement in the BiH Parliament and the loan could thereafter be disbursed in February 2006.

The operation has thereby come to an end.

³ OJ-L-370/80

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

Regulated prices largely prevail for utilities and infrastructure as well as in some other areas. Price regulations are decided upon separately in the two entities and are also in certain areas handled on municipality and cantonal level.

2. Trade liberalisation

BiH has started its process of negotiation to join the World Trade Organisation and has signed all the FTAs foreseen by the Stability Pact's Memorandum of Understanding on trade.

3. Exchange regime

Since June 1998 BiH has a Currency Board Arrangement under which the national currency, the Convertible Mark (KM), is pegged to the Euro at the fixed rate of 1.96 KM.

4. Foreign direct investment

FDI inflows have increased significantly over the last years. They amounted to around 7% of GDP in 2004, but declined somewhat to 5.2% in 2005. FDI inflows have largely been related to a rather small number of privatisation transactions, as investment is still hampered by some weaknesses in the business climate and partly mutually inconsistent frameworks of the two entities.

5. Monetary policy

The Central Bank of BiH is responsible for operating the Currency Board Arrangement and this arrangement limits the scope of monetary policy. The CBBH and other banks are prohibited from lending money to the government.

6. Public finances

The share of public spending in GDP increased during 2006, from an already high level of around 50% of GDP (not taking the informal economy into account) and public expenditure is often associated with large inefficiencies. Important customs and taxation reforms, including VAT introduction, has been introduced.

7. Privatisation and enterprise restructuring

The privatisation process has been slow. However, some sales in particular the metal and mining sectors were successfully concluded in 2004 and some further progress was made, in particular in the Republika Srpska, during 2005 and 2006. Complicated organisational structures as regards the responsibilities for privatisation, vested interests and the weak financial standing of many companies have impeded the process.

8. Financial sector reform

Further improvements in the regulatory framework of the financial sector have largely stalled. The banking sectors in the two entities are still partly fragmented and are supervision in the two entities is not fully integrated.

4. MONTENEGRO

4.1. Executive summary

In Montenegro, GDP grew sharply, by around 6.3% year-on-year in the first nine months of 2006. Retail price inflation (RPI) accelerated to 2% in December 2006. The unemployment rate decreased to 14.7%. However, the current account deficit widened to around 25.6% of GDP in the four quarters prior to September 2006, while the net inflow of FDI reached 25.9% of GDP in 2006. The general government budget recorded a surplus of 1.2% of GDP in 2006. The privatisation process is well advanced. At present, some 85% of the capital of former publicly-owned enterprises is already privatised.

4.2. Macroeconomic performance

In 2006 the Montenegrin economy benefited from a relatively high degree of macroeconomic stability. The stronger performance in tourism, construction and forestry were responsible of further acceleration of GDP by 6.3% in the first nine months of 2006. In the first nine months of 2006, tourist arrivals increased by 16.6%, effective hours in construction went up by 18%, and production of wood assortments grew by 14% compared to the same period a year ago. Economic growth had a positive impact on the labour market. Employment rose by 6.1% in the first nine months of 2006 compared with the same period the previous year. The unemployment rate declined to 14.7% in December 2006, from 18.4% a year earlier. At the end of 2006, inflation (RPI) slightly increased to 2% on the back of an acceleration of agricultural and oil prices. The current account deficit considerably widened to around 25.6% of GDP in the third quarter of 2006. Net FDI amounted to EUR 475 million in 2006, mostly in the form of greenfield investment. Broad money increased by 84.5% in 2006. The annual growth of domestic credit accelerated sharply, to around 125% in 2006, from less than 34% in 2005, driven to a large extent by the increase in the amount of loans to households. The execution of the 2006 budget resulted in an estimated surplus of around 1.2% of GDP against a budgeted deficit of 2.5% of GDP. The better than expected fiscal performance was the result of a strong growth of revenues of almost 25% over 2005, outpacing the growth of public expenditures. Public debt continued to relatively decline from around 41% of GDP in 2005 to 38.3% of GDP at the end of 2006.

4.3. Structural reforms

The privatisation process is well advanced. At present, some 85% of the capital of former socially-owned enterprises is already privatised. The majority of remaining companies still under state ownership are the airports, railways, public institutions of general interest (health, education, social protection and culture) and the utilities controlled by the municipalities.

The banking sector has started to expand rapidly, a growth which is driven by the completion of the privatisation process in 2006. Total domestic credit growth rose by around 125% in 2006. At the end of 2006, aggregate lending by the banking sector amounted to 46.1% of GDP. The recently witnessed surge in domestic credit, and in particular consumer lending, could lead to deteriorating asset quality and an increase

of non-performing loans, and requires proper prudential and supervision measures. Moreover, given the strong foreign bank participation, the central bank aims at strengthening international cooperation.

The insurance sector is still small and dominated by non-life, especially by mandatory Third Party Liability (TPL) motor insurance. However, the life insurance sector is growing strongly. A new insurance law was adopted in December 2006 which is in line with the International Association of Insurance Supervisors' (IAIS) core principles and EU directives. It establishes an independent agency to supervise the sector, which until now was de facto unsupervised.

4.4. Implementation of macro-financial assistance

An assistance programme to the State Union of Serbia and Montenegro was in operation until 30 June 2006. Montenegro became an independent country in June 2006, a few days before the expiry date of that operation. The description of that operation can be found in paragraph 5.4 within the chapter on Serbia.

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. In 2006, energy prices were adjusted several times to reflect price changes in world markets.

2. Trade liberalisation

Trade liberalisation is on going as part of the preparation for WTO accession. Montenegro became member of CEFTA in 2006.

3. Exchange regime

Montenegro continued to use the Euro as sole legal tender.

4. Foreign Direct Investment

The combined effect of macroeconomic stability, liberal economic regime, low corporate profit tax rate and the national treatment of foreign investors are attracting stronger inflows of net FDI than expected (25.9% of GDP). The investment flows linked to privatization represent only around 16% of total inflows in 2006, while the rest is being originated by greenfield investments. In 2006 more than half of FDI went into real estate.

5. Monetary policy

In Montenegro, the monetary framework remained anchored on the use of the Euro as sole legal tender.

6. Public Finance

Montenegro registered a preliminary surplus of 1.2% of GDP in 2006, due to substantially higher than expected revenues while expenditures increased at a lower pace. This provided also fiscal space for building up reserves of 1.7% of GDP and redeeming around 3.4% of GDP in public debt. Public debt amounted to EUR 701.1 million or 38.3% of GDP at the end of 2006, compared to 41.4% in 2005.

7. Privatisation and Enterprise Restructuring

The privatisation process is well advanced. At present, some 85% of the capital of former publicly-owned enterprises is already privatised.

8. Financial Sector Reform

Bank privatisation was completed in November 2006 with the sale of the state-owned stake in Niksicka Banka. The surge in domestic credit, and in particular consumer lending might enhance the credit risk in the banking sector and might lead to a deterioration of asset quality without proper prudential and supervision measures. The new banking law, to be adopted by mid-2007, intends to reinforce bank corporate governance and risk management in line with Basel II core principles as well as to mitigate vulnerabilities.

5. SERBIA

5.1. Executive summary

In Serbia, GDP grew by 5.4% year-on-year during the first nine months of 2006. Consumer price inflation declined to 12.8%. Employment fell by 2.8%. Average real wages grew at 10.1%, in line with labour productivity gains. On the external side, the current account deficit widened to 11.6%, the financing of which has improved. Foreign direct investment and foreign borrowing exceeded the current account deficit and, as a result of strong capital inflows, foreign exchange reserves increased substantially. The general government budget recorded a surplus of 1.6% of GDP and public debt fell to 38.8% of GDP. The privatisation of socially-owned companies and previously state-controlled banks advanced well. However, the process of restructuring the large insolvent companies selected by the government progressed slowly. The share of the private sector in GDP is estimated at 55%, whereas state and social ownership still governs a large part of Serbia's output.

5.2. Macroeconomic performance

In 2006, GDP grew by 5.4% year-on-year during the first nine months of 2006. Growth was particularly strong in transportation (27%), financial intermediation (14.6%) and commerce (8.4%). The manufacturing sector grew by 4.5% while hotels and restaurants as well as other services declined by 3% and 2.9%, respectively. Industrial production expanded by 4.6% year-on-year during the first eleven months of 2006, compared to 6.5% year-on-year during the first half of the year. Consumer price inflation declined in 2006, reaching an annual average of 12.8%, following an upwards spike to 16.5% in 2005. This moderation of inflation was supported by the appreciation of the dinar, the decline of global oil prices in the second half of the year as well as delays in the adjustment of some utility prices and a more restrictive monetary policy stance. Employment fell by 2.8% in 2006, compared to a moderate increase of 0.9% a year earlier. Labour productivity increased by 10.1% in 2006, compared to 5.6% in 2005. Average real wage growth has remained broadly in line with productivity gains. The investment ratio reached 19.8% of GDP compared to 15.8% a year earlier.

In 2006, the general government budget reached an estimated surplus of 1.6% of GDP, compared to a surplus of 1.9% in 2005. Total expenditure to GDP grew by 0.2 percentage points to 38.4%, driven by increase in capital investment, expenditures for social welfare and expenditures for employees. However, expenditures for social insurance benefits, subsidies and interest payments declined. Total revenues declined by 0.2 percentage points to 39.9% of GDP in 2006, driven by a reduction of revenues from value added tax, caused by strong export gains, resulting in higher VAT refunding, and a decline in revenues from customs duties related to the trend of appreciation of the dinar and the resulting impact on import values. However, revenues from personal and corporate income tax increased, due to the continued robust rise in economic activity. Non-tax revenues grew on license income for the second mobile operator as well as higher revenues related to fines, administrative and court taxes. The primary surplus declined from 3.0% of GDP in 2005 to 2.5% in 2006.

Public debt declined substantially to 38.8% of GDP in 2006, compared to 52.9% in 2005, driven by the Paris Club debt write-off related to the positive conclusion of the IMF programme in February 2006, early repayment of debt owed to the IMF and World Bank, as well as the clearing of pension arrears. In addition, robust GDP growth and the appreciation of the dinar have helped reduce the public debt level.

Following the substantial increase of reserve requirements in 2006 and the gradual withdrawal of the National Bank of Serbia from interventions in the foreign exchange market, growth of monetary aggregates slowed down during 2006. In the course of the year, the NBS reduced foreign exchange interventions and allowed for greater market flexibility. As a result, and against the backdrop of strong foreign currency inflows, the dinar appreciated by 7.6% vis-à-vis the Euro between January and December 2006. In September 2006, the National Bank of Serbia announced the changed of its monetary policy framework to inflation targeting. The 2006 policy target, which was defined as core inflation to stay within a range of 7-9% at year end, was not met as core inflation stood at 5.9% in December 2006.

On the external side, the current account deficit widened to 11.6% of GDP in 2006, compared to 9.8% in 2005, as the trade balance widened by 12.4% year-on-year. However, exports and imports expanded by 36% and 23%, respectively, pointing to some improvement in trade dynamics. Financing of the external deficit improved and foreign direct investment – having grown by 42.5% year-on-year – almost covered completely the current account deficit of 2006. Foreign financing in the form of loans to the private sector grew by 15.3% in 2006 compared to a year earlier. As a result of the strong increase in capital inflows, foreign exchange reserves grew by 54% to about EUR 8.1 billion at end 2006. External debt declined to about 55% of GDP compared to 61% in 2005.

5.3. Structural reforms

The share of the private sector in GDP remains at 55%, whereas state and social ownership still governs a large part of Serbia's output. The privatisation of socially-owned companies advanced in 2006, helped by amendments to several key laws in 2005 (laws on privatisation, share fund and financial markets). However, the process of restructuring the large insolvent companies selected by the Government has progressed slowly. The government still needs to resolve, through sale or bankruptcy, the core assets problem of Zastava and RTB Bor, which are two problematic socially-owned enterprises from a social and fiscal standpoint. A tender for sale was launched in September 2006 for RTB Bor. Progress has been made in the areas of company registration and bankruptcy and competition legislation. The operation of commercial courts has improved in terms of number of cases handled and the average number of days needed to complete court procedures. The law on arbitration was adopted in May 2006.

During 2006, several state-controlled banks were successfully sold to strategic foreign investors. Foreign ownership in the banking sector accounts for about 77% of assets. The five largest banks account for about 50% of the market. However, in an environment of strongly expanding credit to the household and enterprise sectors, the ratio of non-performing loans stood at 21% at end-September 2006. In addition, the large share of bank lending effectively denominated in foreign currency pose a

potential threat to financial stability. To strengthen its regulation and supervisory practices the National Bank of Serbia has increased the minimum capital adequacy ratio from 10% to 12%. A new banking law, aligning current practices towards the Basel Core Principles, was adopted. However, effective implementation remains an issue, as witnessed by the slow progress in the implementation of a plan to enhance supervision. The degree of currency substitution remained high and foreign currency deposits accounted for 71% of total deposits.

5.4. Implementation of macro-financial assistance

An assistance to, then, Serbia and Montenegro of up to EUR 200 million (EUR 120 million grant and EUR 80 million loan), which the Council of Minister had approved on 5 November 2002 and 25 November 2003, expired on 30 June 2006. Of this assistance, EUR 155 million (EUR 100 million grant and EUR 55 million loan) had been disbursed in four tranches prior to 2006. The loan element of the fourth tranche of EUR 15 million could not be paid in the first half of 2006 as intended, as the authorities did not complete before the expiry date on 30 June 2006 legal conditions required for the loan disbursement. Montenegro became an independent country in June 2006, a few days before the expiry date of the MFA operation on 30.6.2006. In July the authorities were also formally notified by the Commission of its decision not to disburse the fifth and final tranche of this assistance, due to the profound improvements of the external financing situation in Serbia and Montenegro in 2006.

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. In 2006, energy prices were adjusted several times to reflect price changes in world markets.

2. Trade liberalisation

Trade liberalisation is on going as part of the preparation for WTO accession. Serbia became member of CEFTA in 2006.

3. Exchange regime

In 2006, the National Bank of Serbia started to gradually withdraw from foreign exchange market interventions, which allowed for a gradual appreciation of the dinar by 7.6%.

4. Foreign Direct Investment

In Serbia, appropriate legislation as well as a foreign investment promotion agency is in place. FDI is largely related to large privatisation deals, while greenfield and portfolio investments remain negligible. In 2006, FDI reached a record EUR 2.7 billion or about 10% of GDP.

5. Monetary policy

The National Bank of Serbia announced in September to move to a monetary policy framework of inflation targeting, as the execution of a stability-oriented monetary policy under a highly managed monetary regime was undermined by strong capital inflows. The 2006 policy target, which was defined as core inflation to stay within a range of 7-9% at year end, was undershoot as core inflation stood at 5.9% in December 2006.

6. Public Finance

In Serbia, the primary surplus declined from 3.0% of GDP in 2005 to 2.5% in 2006. The general government budget recorded a surplus of 1.6% of GDP, partly driven by rising revenues from personal and corporate income tax increased, due to the continued robust increase in economic activity. Public debt declined substantially to 38.8% of GDP in 2006, compared to 52.9% in 2005.

7. Privatisation and Enterprise Restructuring

Privatisation process continued in 2006, in particular in the banking and telecommunication sector. However, the restructuring of large socially-owned enterprises and public utilities progressed only slowly.

8. Financial Sector Reform

Bank restructuring and privatisation continued in 2006 and several previously state-owned banks have been successfully privatised, boosting the share of foreign ownership to 77% of assets. Banking regulation and supervision have been further strengthened as the National Bank of Serbia has increased the minimum capital adequacy ratio from 10% to 12% and a new banking law, aligning current practices towards the Basel Core Principles, was adopted.

6. Kosovo (UNSC 1244)

6.1. Executive summary

Kosovo has a per-capita GDP of around EUR 1100, one of the lowest in Europe. Growth has been rather subdued over the recent years and insufficient in view of the territory's considerable development needs. After a sharp increase of GDP in the immediate post-war period, boosted by foreign reconstruction assistance, economic activity has been slowed down by declining donor support. A continuous and rapid shift from donor-financed investment to investment financed from the budget has created substantial pressure on both fiscal and external sustainability. The budget remained the main macro-economic variable of adjustment under the current monetary situation with the Euro as legal tender.

6.2. Macroeconomic performance

The decline in donors' support and the downsizing of the international community's presence continue to affect economic developments in Kosovo. However, there are signs of increasing dynamics and resilience of private sector activity in 2006, partially compensating the continuous decline in foreign assistance. Significant increases in the number of new businesses registered, tax revenues, and trade, as well as steady growth in credits provided to businesses are underlying this trend. GDP is estimated to have grown by around 3% in 2006.

Official statistics point to an unemployment rate of 42-44%, even though the real unemployment level is most probably lower due to a sizeable informal economy. The number of registered job seekers increased by 3% year-on-year to around 325,000 in November 2006, approximately by 5,000 more than in the beginning of the year. Labour costs in Kosovo remained in regional terms excessively high, dampening private sector development and export competitiveness.

The external situation of Kosovo remains precarious. The trade deficit over the first three quarters 2006 reached 39% of GDP, an increase by 2% of GDP compared with the same period of 2005. While Kosovo exports increased by 1.5% of GDP (on an annual basis), imports registered an increase of 3.5% of GDP. In September 2006, the Central Banking Authority of Kosovo released its first Bulletin on the 2004-2005 Balance of Payments Statistics of Kosovo, which was prepared with significant technical assistance by the IMF. According to the Bulletin, the trade deficit was close to 50% of GDP. The coverage ratio of regular imports by exports was at an extremely low level of 4% in 2005, mainly due to lacking export capacity and competitiveness. Given the absence of sizeable foreign direct investment (FDI) inflows, the financing of the current account deficit continued to rely heavily on foreign assistance in the form of project support (however decreasing from 20.8% of GDP in 2005 to 16.8% in 2006) and, to a lesser extent, on private capital transfers (estimated at around 15% of GDP in 2006). A modest increase in FDI inflows has been recorded recently, in the wake of acceleration of the privatisation process. The IMF estimates FDI, including privatisation proceeds, at around 10% in 2006.

Kosovo currently does not have any sovereign debt servicing obligations. This situation may however change if -following status negotiations under the auspices of

UN special envoy Mr Ahtisaari, and subject to their outcome- the servicing of a notional share of sovereign loans attributable to Kosovo which are currently being serviced by Serbia is transferred to Kosovo.

Inflation has been very moderate, to some extent owing to the weakness in economic activity and downwards adjustments in the context of downsizing of the international community's presence which had boosted prices in the early years of UNMIK's mandate. After two years of deflation, for 2006 the IMF estimates CPI inflation at 0.9%. According to national sources, consumer prices decreased by 0.2% over the first eleven months of 2006⁴.

The monetary framework in Kosovo is anchored on the use of the Euro as sole legal tender. Given the absence of autonomous monetary policy, the budget is the core policy tool for macroeconomic adjustment. The CBAK is in charge of regulating foreign exchange operations, providing payments services and supervising banks and other financial institutions. The CBAK closely monitors liquidity in the banking sector and credit expansion, with liquidity ratios and reserve requirements respectively as main tools of intervention.

Notwithstanding the conservative lending policies and prudential requirements, the annual credit growth continued to be substantial (38% in 2005 and 27% year-on-year as of October 2006). For loans with maturity over 1 year, it reached an annual growth of around 50%. The banking sector appeared to remain sound, profitable and well capitalised. The capital adequacy ratio of commercial banks in Kosovo was equal to 14.7% at the end of 2005. Local banks remain very liquid, with the loan-to-deposit ratio standing at around 61% at the end of 2005 and 70% in October 2006, partly as a result of high prudential requirements set by the CBAK. The available financial indicators should be interpreted with caution.

In March 2006, the CBAK revoked a license and ordered a closure of an ailing bank, Credit Bank of Pristina, with little detrimental impact on credibility and liquidity of the overall financial sector. Since then, there remain six commercial banks operating in Kosovo. As a result, the degree of concentration of the three largest banks further increased by 6% in terms of assets, reaching 80% of total banking sector deposits.

Latest developments point to a turnaround of the budget results. The budget turnout for 2006 was much more favourable than foreseen, with according to preliminary estimates a surplus of around EUR 75-80 million, instead of a deficit initially estimated around EUR 76 million. This is apparently due both to under spending –in particular, the rate of execution of capital expenditure was very low, below 75%- and better than foreseen revenue. Total budget revenues were EUR 712 million in 2006, an increase of EUR 83 million (13%) on the previous year (preliminary data). Much of the strength in revenues in 2006 appears to have been due to changes in tax rates and compliance, plus special payments by the telecom incumbent, rather than rapid growth in the underlying tax bases.

⁴ Source: Statistical Office of Kosovo (SOK). In 2006, the SOK changed the methodology for calculating the CPI. The historical data were however not revised. Thus, the reliability of annual inflation estimate for November 2006 was limited.

Considerable fiscal risks however remain, mainly due to the vulnerability of the energy sector, additional fiscal costs arising from the upcoming status settlement - notably debt servicing- and other possible contingent liabilities (currently not reflected in the proposed budget).

6.3. Structural reforms

Privatisation of the socially-owned enterprises progressed markedly in 2006: the 21st privatisation wave was launched in December 2006 by the Kosovo Trust Agency (KTA). The KTA aimed at privatising 90% of total assets and 50% of the total number of socially-owned enterprises by the end of 2006. While good progress continued in incorporating publicly-owned enterprises, their restructuring needs to be considerably accelerated. Infrastructure remained insufficient and often of poor quality. In particular, the situation in the energy sector is critical - the power supply infrastructure remained unreliable, with frequent power cuts, affecting economic activity at large. Furthermore, the efficiency of the judiciary system and law implementation remained low and only little progress was made in enforcement of court rulings and the establishment of property rights.

6.4. Implementation of macro-financial assistance

On 30 November 2006 the Council adopted a decision providing Kosovo with new macro-financial assistance, as proposed by the Commission, in the form of budget support (grants, up to EUR 50 million). This followed a needs assessment exercise, prepared by UNMIK and the Provisional Institutions of Self Government (PISG), coordinated with the Commission, the IMF and the World Bank. This assessment (the so-called "Medium-Term Expenditure Framework" – MTEF) foresaw that, by the end of 2006 or early 2007, the budgetary situation would warrant international donors' support, as cash reserves currently financing the deficit were expected to dry up. This assistance was thus conceived as *bridge support*, to be topped up by a more ambitious package from the EC and the international donor community, upon status settlement.

Budget execution in 2006 however showed a more favourable outcome, due to underspending – in particular, there have been backlogs in investment spending as the rate of execution of capital expenditure was below 75% - and better than foreseen tax revenue. Therefore, while the outstanding EC support remains available in view of possible substantial needs upon status settlement, there was no case in late 2006 for proceeding with the release of this assistance. Negotiations on a Memorandum of Understanding that would stipulate the conditionality attached to this assistance were accordingly delayed, pending clarifications of Kosovo's financing needs and the economic and fiscal framework on which to base the provision of this assistance.

External financing needs in 2007 and beyond will crucially depend on a possible status settlement for Kosovo. Such a settlement would lead to additional considerable government expenditure, mainly in the form of administration building and debt service. Needs for international financial assistance would accordingly augment under this scenario.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

The price setting mechanism is fully free. The authorities do not intervene, even in the case of housing or utilities' prices. Current governance arrangements as regards publicly-owned enterprises, which remain under the authority of UNMIK – Pillar IV, further ensure the absence of government interference in the price setting mechanism of their services.

2. Trade liberalisation

The process of trade liberalisation with neighbouring countries continued: as of December 2006, four free trade agreements with Albania, the former Yugoslav Republic of Macedonia, Bosnia and Herzegovina and Croatia were already in force.

3. Exchange regime

Kosovo continued to use the Euro as sole legal tender. The Central Banking Authority of Kosovo (CBAK) is in charge of regulating foreign exchange operations, providing payments services and supervising banks and other financial institutions.

4. Foreign Direct Investment

An increase in FDI inflows was recorded in 2006, mainly in the wake of acceleration of the privatisation process. Foreign direct investment inflows, including privatisation proceeds, are estimated to have reached 10% of GDP in 2006.

5. Monetary policy

The monetary framework remained anchored on the use of the Euro as sole legal tender.

6. Public Finance

The authorities finalised the first Medium-Term Expenditure Framework in March 2006. A medium-term economic policy framework was defined with the support of the IMF by a Letter of Intent and a Memorandum on Economic and Financial Policies, which aims to ensure a sustainable fiscal path. It was then signed by UNMIK and Provisional Institutions of Self Government (PISG) in November 2005. However, substantial weaknesses in compliance with the agreed policies and commitments surfaced throughout 2006 as their implementation lacked guidance and monitoring. The budget turnout for 2006 was considerably more favourable than foreseen: according to preliminary estimates it recorded a surplus of around € 75-80 million, instead of a deficit initially estimated at around € 76 million. This was due to under spending – in particular, the rate of execution of capital expenditure was below 75% - and better than foreseen tax revenue.

Kosovo has currently no sovereign debt. This situation will likely change if -following status negotiations and their outcome- the servicing of a notional share of sovereign loans attributable to Kosovo, which are currently being serviced by Serbia, is transferred to Kosovo.

7. Privatisation and Enterprise Restructuring

Privatisation of the socially-owned enterprises progressed markedly in 2006: the 21st wave was launched in December 2006. The Kosovo Trust Agency aimed at privatising 90% of total assets and 50% of the total number of socially-owned enterprises by the end of 2006. While good progress continued in incorporation of publicly-owned enterprises, their continuing restructuring need to be considerably accelerated.

8. Financial Sector Reform

The banking sector in Kosovo appeared to be sound, profitable and well capitalised, even if available financial indicators should be interpreted with caution. Competition in the banking sector remained limited. In March 2006, the CBAK revoked the licence and ordered the closure of the Credit Bank of Pristina, with little detrimental impact on the credibility and liquidity of the overall financial sector.

The Credit Register of Kosovo was established to improve the efficiency of the banking sector.

HORIZONTAL SECTION

7. NEW INDEPENDENT STATES

Economic growth in the New Independent States (NIS), which is for some years now the second fastest growing region in the world (behind East Asia), accelerated in 2006 from about 6.5% to nearly 8%. The most common factors behind growth are high commodity prices and domestic demand fuelled by private transfers.

As in 2005, fiscal policies remained tight in the majority of the countries of the region and inflation pressures were generally kept under control, even if inflation accelerated somewhat in some countries towards the end of the year reflecting delayed pass-through of higher gas import prices to consumers. Resource-rich countries have generally registered strong growth in trade surpluses, compensated sometimes by increasing deficits of the incomes and services accounts. At the same time, energy-importing countries have seen their trade deficits widen; yet this was partly compensated by increases in remittances and other public or private transfers. External debt ratios were reduced in most of the NIS reflecting growth of nominal GDP and debt cancellation (like in Tajikistan). Yet, several countries of the region are still critically dependent on external multilateral or bilateral financing.

Progress in structural reforms has been uneven across the region and the implementation of second-phase institutional reforms supporting markets and private enterprise is still little advanced in most NIS. Among the current and past beneficiaries of the Community macro-financial assistance, Moldova was probably the one to advance most. Progress in strengthening macroeconomic management and implementing structural reforms in the context of a comprehensive EU-Moldova Action Plan (under the European Neighbourhood Policy – ENP) and the country's economic growth and poverty reduction strategy, allowed Moldova to conclude a financing arrangement with the IMF, after several years of interruption. The European Neighbourhood Policy is expected to lead to more progress in reforms also in Armenia and Georgia, who have agreed on ENP Action Plans with the EU at the end of 2006. Tajikistan continued the implementation of adjustment and reform programmes supported by the International Financial Institutions.

COUNTRY SECTION

8. GEORGIA

8.1. Executive summary

Inflows of remittances and foreign capital helped Georgia in overcoming the impact of worsening trade relations with Russia, keeping economic growth resilient at about 9%, supported by on-going deregulation and legalisation of the economy.

Georgia's IMF-supported economic program is on-track backed by the government's adherence to macroeconomic stability in a difficult external environment and timely

structural reforms in the fiscal and monetary policy areas. In 2006, the IMF Board completed the third and fourth reviews under the PRGF (Poverty Reduction and Growth Facility) arrangement, which was approved in June 2004.

Following the Council Decision of January 2006 on Community macro-financial assistance to Georgia, the EC disbursed two grant instalments to Georgia in a total amount of EUR 22 million. A final grant instalment of EUR 11.5 million is planned for 2007.

In November 2006, an EU-Georgia Action Plan was adopted under the European Neighbourhood Policy, providing the basis for the deepening of the political and economic relations as well as closer cooperation in many sectors.

8.2. Macroeconomic performance

The Georgian economy continued to perform vigorously throughout 2006, despite the gas import price shock and the trade and transport blockades imposed by Russia, as the relations between the two countries deteriorated amidst the protracted conflicts in South Ossetia and Abkhazia. According to preliminary estimates, real GDP has increased by about 9% (9.6% in 2005). While the already deeply negative net exports further deteriorated, domestic demand remained robust, owing to brisk public spending and rapid credit expansion by commercial banks. Construction, manufacturing and services all performed well while agricultural production was negative due to harsh weather. Tourism is a new area of growth, and starting to attract investors.

Consumer price inflation accelerated in mid-2006 to 14.5% year-on-year partly related to higher import prices of energy but also fuelled by fiscal loosening and monetary growth. The National Bank of Georgia intervened in the foreign exchange market to curb rapid lari appreciation underpinned by inflows of foreign transfers and capital. In the second half of the year, the NBG tightened monetary policies. Inflation decelerated to 8.8% in December year-on-year.

Tax revenues continued to grow in line with the legalisation of economic activities and strong enforcement measures by the authorities. The tax revenues to GDP ratio is estimated to have reached 21½% (19.8% in 2005). The state budget was amended in May and July to increase defence and capital spending, financed by privatisation receipts. As a result, the fiscal deficit (on commitment basis) increased to an estimated 2.9% of GDP (1.5% in 2005). On cash basis, the deficit was slightly lower at about 2.3%.

The trade deficit is estimated to have widened to around 21% of GDP in 2006 (14.5% in 2005). Despite the closure of the Russian market for Georgian goods, exports as a whole increased by over 10% in 2006. Imports from Russia, apart from natural gas, were replaced quickly by imports from other countries and imports demand continued to grow rapidly (also related to strong investment activity in Georgia). According to the NBG, remittances, including those from Russia, increased in 2006, reaching USD 413 million in total (about 5% of GDP). Russia was the source for nearly 70% of the remittances. The current account deficit is estimated at around 9½% of GDP (5.4% in 2005), financed by foreign direct investment (including privatisation receipts).

Gross international reserves of the NBG increased to USD 880 million at end-2006, covering 2.2 months of imports. Georgia's public external debt is on a sustainable path, having decreased further from 27% of GDP in 2005 to around 22% last year (USD 1.7 billion in nominal terms). According to the IMF/World Bank debt sustainability study of 2006, Georgia's debt distress risk is low. The composition of the external public debt has changed favourably over the past few years so that the share of bilateral debt has decreased from 80% to about 40%, while Georgia has had access to multilateral, more concessional debt. The grant element of the borrowing as of 2005 is estimated at around one third. The repayments of Georgia's outstanding debt to the European Community continued over 2006 as had agreed with the authorities. The debt amounted to EUR 57.5 million at the end of the year.

In November 2006, Standard & Poor's revised the outlook for Georgia's sovereign credit rating (B+) from positive to stable owing to increased geopolitical risks in the region that may impair positive trends in Georgia's external liquidity, investor sentiment and economic growth. Apart from the geopolitical tensions, Georgia's rating is also constrained relatively high inflation, a comparatively undeveloped financial sector and a narrow economic structure.

So far, private external debt has been negligible. Now the largest of Georgian commercial banks have plans to access international capital markets for either equity or debt financing, following the initial public offering of Bank of Georgia shares in London last year.

8.3. Structural reform

The government's sweeping reform efforts over the past three years to tackle corruption and to deregulate the economy are showing tangible results in several areas, as reflected in the World Bank's 2006 Doing Business Report. The World Bank ranks Georgia's business environment at 37th place in the world, an impressive improvement from 112th place just one year before. Equally, according to the Transparency International and the World Bank's 2006 Anti-Corruption in Transition Report, a significant reduction in corruption has taken place.

Georgia presented in the autumn a Progress Report to the World Bank and the IMF on the Economic Development and Poverty Reduction Program (EDPRP). The methodology for estimating the poverty level has been changed in cooperation with the World Bank to bring it more in line with international practice. The poverty rate increased from 35.7% of the population in 2004 to 39.4% in 2005. This was largely due to the downsizing of the public sector and the restructuring of privatised firms and the increase in unemployment that followed. The data for early 2006 indicated that poverty has started to decline, however. The increase in utility tariffs may still have a negative impact, although the government has established life-line tariffs which mitigate the impact on the most vulnerable households. In compensation, transfers were made from the state budget to the energy companies.

Following the large-scale reforms in the education sector, the government is currently moving attention also to the health sector where a primary healthcare reform is underway and a large hospital investment programme has been announced. A medical insurance scheme for the poor began to be implemented in July 2006. A new poverty benefit scheme was launched in the capital Tbilisi in August 2006 and

rolled over to the whole country in September. The government has also been paying out the last expenditure arrears (salaries, pensions and social benefits) that the previous administration had accumulated until 2003.

After the completion of the oil and gas transit pipelines, foreign direct investment was largely driven by privatisation in 2006. The large privatisation deals from last year comprise ferroalloys and manganese production, hydropower generation, electricity and gas distribution as well as port management (Batumi) and telecommunications. A new law on electronic communication was adopted in 2006, facilitating investment in network development.

The new customs code, effective since January 2007, simplifies and harmonises customs legislation in line with EU standards. Modernisation of the tax administration also continues. A restructuring of the Ministry of Finance is underway to improve the enforcement, including the functioning of the financial police.

The banking sector has started to attract foreign capital which is expected to underpin continued strong credit expansion, albeit starting from a very low level. While the government has a liberal approach to developing financial services, this policy ought to be firmly complemented by appropriate supervision of the banking and non-banking financial sectors in line with international best practices. The establishment of a deposit insurance scheme has been under discussion.

Reforms in public finance management have continued with a particular focus on improving the medium-term expenditure framework and budget preparation. The first steps in the implementation of the accounting reform strategy have started in the treasury. In 2006 the government submitted to the parliament a draft law on the Chamber of Control which would reinforce its oversight function as a supreme auditing institution in line with international standards (INTOSAI). The adoption of the law has been delayed till 2007, pending the nomination of a new chairman.

The EU and Georgia reached agreement on a European Neighbourhood Policy Action Plan which was endorsed by the EU-Georgia Cooperation Council on 14 November 2006. In the economic area, the ENP Action Plan pays particular attention to the improvement of the business and investment climate, progress in the fight against corruption, the enhancement of bilateral trade relations and cooperation in the fields of transport and energy.

8.4. Implementation of macro-financial assistance

On 24 January 2006 the EU Council decided to provide macro-assistance to Georgia up to EUR 33.5 million over a two-year period (Decision 2006/41/EC, published in the Official Journal of 28 January 2006). The payment of the first grant instalment (EUR 11 million) was conditional on the completion of the third review under the IMF-supported economic programme (IMF Board meeting of March 31) and an early principal repayment of EUR 13 million by Georgia to the Community on the outstanding debt of EUR 85.5 million (as of end-2005). The Commission and the Georgian authorities agreed that before the release of the second grant instalment further progress should be made by the government in public finance management reforms. The Commission has cooperated closely with the World Bank which is also supporting the reform process set out under its Poverty Reduction Support Operation

(PRSO). Specific measures to be monitored by the Commission in the context of the macrofinancial assistance were defined in the areas of budget planning, budget execution and external audit. Following a review mission in mid-2006, the Commission services concluded that all agreed policy conditions attached to the release of the second grant instalment of the macrofinancial assistance were met. The Georgian authorities then proceeded with an early principal repayment of EUR 15 million to the Community, made possible by proceeds from privatisation. Since the IMF Board had completed on 29 September 2006 also the fourth review under the Fund-supported program, the conditions were met for the release of the second grant instalment of EUR 11 million also in the fiscal year 2006.

SUMMARY STATUS OF ECONOMIC REFORM

1. Price liberalisation

No administratively set prices exist outside the utilities sector. Administered prices account for about 5% of the CPI basket.

2. Trade liberalisation

Liberal trade policy. Georgia has been member of the WTO since June 2002. In September 2006, the number of tariff bands on imported goods was reduced from 16 to three (0%, 5%, and 12%). The maximum tariff of 12% is applied to those agricultural products and building materials which compete with domestic goods. The average weighted tariff is estimated to be 1½%. Non-tariff barriers allowed for environmental, security and health reasons only (in line with the Partnership and Cooperation Agreement with the EU).

3. Foreign exchange regime

Floating exchange rate of the lari with limited official intervention by the National Bank of Georgia. No restrictions on 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 inflows of FDI about 8% of GDP (2005).

5. Monetary policy

Prudent monetary policy has contributed to the stabilisation of the inflation in single digits. The NBG has developed monetary policy instruments, e.g. by introducing in 2006 certificates of deposits. The securitisation of government debt held by the NBG also introduced marketable securities for the NBG's open market operations. Dollarisation of the economy has decreased in the past few years but still remains high at 69% of total deposits.

6. Public finances

Total fiscal revenues (including grants) estimated at 26% of GDP (2006), of which tax revenues 21.5% of GDP. Total expenditure and net lending estimated at about 29% of GDP (2006) implying a fiscal deficit of 3% on commitment basis. Under the Budget System Law, which became effective on January 1, 2004, the treasury system is being reformed, with a fully functioning Single Treasury Account as of January 2006. A medium-term expenditure framework is in place and further developed with stronger policy content. A new liberal tax code is effective as of January 1, 2005.

7. Privatisation and enterprise restructuring

The private sector accounts for about 70% of GDP. Small scale privatisation largely completed while large scale privatisation has also accelerated since 2004 under the present government. New legislation adopted in 2005 on land privatisation.

8. Financial sector reform

There are 17 operating banks (of which 10 foreign-owned). Further consolidation is expected as the minimum capital requirement will be increased to GEL 12 million (approx. EUR 4.5 million) by 2008. Banking supervision has been strengthened in the past few years. The areas still to be addressed include "fit and proper" criteria for bank owners and managers, identification of "true" owners, monitoring of connected lending and consolidated supervision.

9. MOLDOVA

9.1. Executive summary

In 2006 Moldova faced strong external shocks – doubling of the price charged by Russia on natural gas imports and a ban on wine and other food exports to Russia – that resulted in a slowdown in growth. While industrial production contracted, as domestic demand, fuelled by remittances, remained strong, growth in the non-tradables sectors (e.g. construction) compensated for the drop in the industrial output and allowed GDP to grow by 4%. Trade and current account deficits widened, reflecting buoyant domestic demand, high energy prices and lower exports of food and beverages.

After two years of general government surplus, Moldova fiscal account moved to a moderate deficit (0.3% of GDP). The emergence of a small fiscal deficit reflects the cost of the Paris Club agreement to restructure Moldova's official debt (reached in May 2006) and of additional spending related to the need to cushion the effects of increases in utilities tariffs resulting from the gas prices.

Inflation accelerated in 2006 reflecting the relaxation of the monetary policy in response to pressures to provide liquidity to the food processing industry and exporters. Towards the end of the year, inflationary pressures moderated again.

Implementation of structural reforms contemplated in the Economic Growth and Poverty Reduction Strategy and the EU-Moldova European Neighbourhood Policy Action Plan continued. Moldova made some progress in the areas of corporate governance, regulation and enterprise restructuring, public finance management and public administration reform. Also, the financial sector restructuring continued and the government has launched, among other areas, a reform of the social protection. Yet, more reforms are needed to improve the business climate and the governance.

In May 2006, Moldova concluded a financing arrangement with the IMF under the Fund's Poverty Reduction and Growth Facility (PRGF). In support to the implementation of the government's economic programme backed by the PRGF arrangement, the Commission prepared a proposal for a new EC-macro-financial assistance (MFA) to Moldova. Under the new MFA, approved by the Council in early 2007, Moldova will receive in 2007-2008 up to EUR 45 million, in the form of three grant instalments.

9.2. Macroeconomic performance

In 2006, after five years of real *GDP growth* averaging 7% per annum, Moldova's economy slowed down to 4%. This weakening of growth was the result of external shocks faced by Moldova in 2006: doubling of the price of natural gas imports from Russia and closing down of the Russian market for Moldova's exports of wine and some other agricultural or food products. Industrial production contracted by almost 7% (it had increased by 6.4% in 2005), but this decrease was more than offset by double-digit growth in the sectors producing non-tradable services such as construction, transport and telecommunications. The performance of the construction and services sectors reflects the strength of household demand fuelled by the rising

real income of the population and the increasing flow of remittances by Moldavians working abroad.

The gas price shock created *inflationary expectations* already in the very beginning of 2006. Later, with the Russian ban on Moldova's food exports, the National Bank of Moldova (NBM) was put under strong pressure to provide liquidity to a large number of food processing enterprises. The resulting monetary expansion led to a surge in inflation – to 14.5% by November 2007, against 10% in 2005 – and to a downward pressure on the exchange rate. The NBM, through its interventions on the foreign exchange market, limited the nominal depreciation of the leu against the dollar to less than 4%, but fell substantially short of its target of reserve accumulation set in the agreement with the International Monetary Fund under the PRGF (Poverty Reduction and Growth Facility) approved in May 2006. Towards the end of the year, the NBM tightened again its monetary policy. Helped by a surge in remittances (beyond expectations), this resulted in a recovery of the nominal exchange rate to its level of the beginning of 2006, in an increase in international reserves to 2.8 months of imports (close to the target of the PRGF programme) and in a reduction of inflation to 14.1% (inflation has gone down further in early 2007).

In 2005, Moldova registered a *fiscal surplus* of 1.5% of GDP. For 2006, the PRGF programme allowed for substantial fiscal expansion, which was to translate in a moderate general government deficit of about 0.5% of GDP. In the course of the year, the policy makers feared that the fiscal impact of the external shocks would derail the fiscal programme of the government. However, the additional spending related to the need to cushion the effects of increases in utilities tariffs resulting from the gas prices could be contained and the revenue shortfall due to the wine ban was more than compensated by increasing revenue in other sectors of the economy (e.g. VAT on increasing imports). As a result, the State budget posted a small surplus, and the general government deficit was limited to around 0.3% of GDP.

Moldova's imports continued to grow in 2006, although at a slower pace than in 2005 (some 15%, against 29% in 2005). The import surge reflects the increase by one-third in the value of the energy imports and sustained domestic demand. At the same time, *exports* remained essentially stable. As a result, the trade deficit surged to nearly 49% of GDP, up from 41% in 2005, and the *current account* deficit to more than 12% of GDP, despite rising remittances.

Foreign direct investments (FDI) increased by about 10% in nominal dollar terms and reached some USD 223 million. In 2006, Moldova's balance of payments needs included, in addition to the needs to finance the current account and build up international reserves, a substantial amount for clearance of arrears on Moldova's debt to official bilateral creditors in the context of the agreement with the Paris Club concluded in May 2006, shortly after the IMF Board approved the PRGF arrangement.

The Paris Club deal did not provide for any debt cancellation. Yet, Moldova continued the gradual reduction of its *external indebtedness* through regular principal repayments, not matched by new disbursements. So, in 2006, Moldova fully repaid the loan provided by the EU under the macro-financial assistance programme in the 1990s. At the same time, part of the interest arrears owed to the Paris Club was capitalised and thus was added to the stock of Moldova's official debt. The

capitalisation of part of the Paris Club arrears and new IMF disbursements resulted in an increase of Moldova's public and publicly guaranteed debt in 2006 by some USD 100 million, to about 27% of GDP (from 26% in 2005).

9.3. Structural reform

Moldova's structural reform agenda was governed in 2006 by the implementation of the Economic Growth and Poverty Reduction Strategy (adopted in 2004) and of the EU-Moldova Action Plan in the context of the European Neighbourhood Policy (adopted in early 2005).

The government's economic strategy foresees several specific measures in the area of *corporate governance, regulation and enterprise restructuring and privatisation*. Some of these measures have already been or are being implemented. A new strategy to strengthen bankruptcy procedures and a new law on management of state property and privatisation were prepared in 2006 in order to be submitted to the Parliament in 2007. The government also changed the rules regarding debt cancellation for enterprises: the Credit Council was abolished and the State Tax Inspection was given the responsibility for monitoring tax debts. The implementation of the National Strategy of Regulatory Reform also progressed in 2006. After the completion of the comprehensive review of more than 1,000 business regulations that resulted in a substantial streamlining of licensing and business registration procedures (the first stage of the so-called "guillotine approach"), the Parliament adopted in July 2006 a law on the basic principles of regulation of entrepreneurial activity. Under this law, all regulatory authorities are required to conduct regulatory impact assessment of all existing laws and regulations.

The restructuring and the consolidation of the *financial sector* progressed further, with the sale of two Moldovan banks, including one in the top five of the sector, to foreign banks. One more Western European bank operates in Moldova through its Romanian subsidiary and another one has opened a representative office and is considering either an acquisition or a greenfield investment. Yet, the financial sector remains fragile – this was demonstrated in the second quarter of 2007, when Moldova's banks came under strong pressure due to a near liquidity crisis of the food processing industry – and needs further restructuring. A new decisive step in the restructuring of the banking sector is expected to be made with the sale to a strategic banking investor of a majority stake in Moldova's state-controlled Savings Bank, the country's largest retail bank. The partial privatisation of the Savings Bank is under preparation.

The recent progress in governance and business regulation is already reflected in the World Bank governance indicators. Yet, this progress is still fairly modest and it is being achieved from a very low point – due to the persistence of significant barriers related to regulation, arbitrary tax administration and heavy state interference, the business environment in Moldova is perceived as one of the worst in the region.

In the area of *public finance management*, several important results were achieved by the authorities in 2006:

The development of the Medium-term expenditure framework (MTEF) continued, with improved coverage of government spending. Also, the 2007 budget

consolidation progressed further through integrating six extra-budgetary funds (previously covered by separate budget annexes).

The Central Treasury made further moves towards the establishment of the Single Treasury Account. This resulted in the improvement of the control over collection and use of the budget funds and in better cash management.

Similar changes (use of special treasury accounts) with similar results (better control over public funds and more effective cash management) were implemented for the management of the revenues of the social insurance and health insurance budgets.

In October 2006, the government approved the new tax administration strategy, aimed in particular at strengthening the tax collection and control systems.

Also in October 2006, the government adopted a strategy for the development of the system of Public Internal Financial Control (PFIC).

At the same time, despite an increased use of competitive procedures for the award of public procurement (PP) contracts, little progress was achieved to improve the institutional framework for PP, in particular in establishing a truly independent PP agency.

In the framework of the reform of *the central public administration*, in 2006 and early 2007 the government completed the functional review of key central public administration authorities and of the decision-making processes in the administration authorities. A new law on public sector remuneration was also adopted in 2006. The new law increases the basic salaries of civil servants and establishes salary grades. It is the first step on the way to addressing the issue of low pay in the civil service, one of the factors of corruption, which remains a serious concern.

In the area of *social protection*, the main government's priority was the reform of income support, in particular of the scheme compensating for utility tariff increases. The government recognises that the scheme needs to be reformed in order to improve its currently very low targeting efficiency and is planning to replace the current system targeting specific categories of population by the one based on actual income.

9.4. Implementation of macro-financial assistance

In October 2006, the Commission prepared a proposal for a Council Decision on macro-financial assistance (MFA) to Moldova. The proposed assistance is aimed at contributing to covering Moldova's external financing needs in 2007-2008 identified by the IMF in the context of the PRGF arrangement approved in May 2006.

Under the proposal, finally adopted by the Council on 16 April 2007, Moldova will receive grants of a total amount of EUR 45 million, in three instalments. It will complement support from the Bretton Woods Institutions, Moldova's official creditors (who agreed recently to restructure Moldova's Paris Club debt) and bilateral donors, as well as support from the EU under the Food Security Programme. The disbursements are expected to take place in 2007 and 2008.

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, mostly, informal restrictions still exist on some key commodities. Moldova became a member of the WTO in June 2000.

3. Exchange regime

The leu 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. A new investment law introducing equal treatment of domestic and foreign investors adopted in 2004. Administrative interference on foreign investors is still widespread, notably in the energy sector. FDI, after having declined in 2002-2003, is now growing but is still modest.

5. Monetary policy

After acceleration in inflation during most of 2006 reflecting relaxation of monetary policy to support liquidity of the food processing sector, the National Bank stepped up sterilisation since the end of last year. As a result, inflation moderated gradually. The National Bank expected to pursue a tighter policy course aimed at increasingly privileging control of inflation over exchange rate stability while still continuing to accumulate forex reserves.

6. Public finances

Budget revenue continued increasing in 2006 reflecting rising revenue from taxation of consumption. As expenditure increase was higher to accommodate the settlement of debt arrears to the Paris Club and fiscal compensations for utility tariff increases (following the rise of gas prices), the general government budget switched to a moderate deficit (0.3% of GDP, from a surplus of 1.5% in 2005). Public external debt increased to about 27% of GDP as a result of capitalisation of part of arrears and new disbursements by the IMF. Reform of Public Finance Management continued, with progress achieved in particular in developing the Medium-Term Expenditure Framework, in moving towards the single Treasury account, in strengthening tax administration and in developing the system of Public Internal Financial Control.

7. Privatisation and enterprise restructuring

Structural reforms are being implemented in the framework of the EGPRSP and the EU-Moldova ENP Action Plan. Progress is being achieved in strengthening bankruptcy procedures, management of state property and simplification and streamlining of the regulatory environment of the enterprises. Yet enforcement remains a serious concern and business environment suffers from state intervention and formal and informal business restrictions. Also, little progress was achieved in privatisation. Other key areas of structural

reforms – public administration and social protection reforms – progressed. A crucial reform of the income support is under preparation.

8. Financial sector reform

Restructuring and consolidation of the financial sector progressed, with significant foreign investments. Further strengthening is crucial to mobilize savings and promote investment.

10. TAJIKISTAN

10.1. Executive summary

Tajikistan's economy has continued to grow strongly in 2006, recording an estimated 8.0% real GDP growth. The government budget deficit has been estimated at 4.5% in 2006 and Tajik external debt has fallen to less than 35% of GDP by the end of that year. Annual average inflation in 2006 is estimated to have increased to about 8%. The current account deficit in 2006 is estimated to have widened from 3.4% of GDP in 2005 to 4.2% in 2006.

Limited results are noted in the area of structural reforms. Land reform is proceeding slowly, and the indebtedness issue of cotton farmers remains unsettled. The sale of TadAZ, the sole aluminium smelter accounting for half of the country's industrial output has been put on hold in 2006. However implementation of the new simplified Tax and Customs Code, an improved VAT administration and the increase in VAT collection on imports - following a switch to the destination principle in intra-CIS trade – have contributed to a rise in tax collection. Also the minimum capital requirement for banks has been raised from US\$ 1.5 million to US\$ 5 million. Non-complying banks are closed down or merged with other banks.

A final (fifth) grant instalment of € 7 million under the Exceptional Financial Assistance (EFA) to Tajikistan was disbursed late 2006. An external evaluation of the programme is being conducted.

10.2. Macroeconomic performance

Tajikistan's economy has continued to grow strongly in 2006. Continued robust inflows of workers' remittances have boosted retail trade. Growth increased from 6.7% of GDP in 2005 to an expected 8.0% of GDP in 2006 mainly due to major foreign-investment projects and strong domestic demand. Cotton and aluminium remain the traditional pillars of the economy.

Tax collection as a ratio to GDP has increased from 15.2% in 2004 to 16.0% in 2005 and a further increase to 16.4 is estimated for 2006. A key factor contributing to this upward trend is the improved VAT administration and the increase in VAT collection on imports following a switch to the destination principle in intra-CIS trade. The government budget worsened from a deficit of -2.9% of GDP in 2005 to an expected deficit of -4.5% in 2006, mainly due to increased public sector wages. Total expenditures increased from 23.0 % of GDP in 2005 to an expected 24.1 % in 2006. Good progress was made however in reprioritizing expenditures towards social sectors such as education and health care, in line with the government's commitment under the Poverty Reduction Strategy Paper (PRSP).

Average annual inflation was brought down from 38.6% in 2001 to 7.1% in 2005, even as the economy expanded rapidly. In 2006 inflation was pushed up moderately to 7.8% by rises in domestic utility tariffs, increases in public sector salaries, pensions and the minimum wage, ongoing robust inflows of workers' remittances that contribute to growth in domestic demand, high fuel prices and a possible

shortfall in the grain harvest. Also temporary disruptions to border trade with Uzbekistan, and exchange rate depreciation contributed to price increases.

In October 2004 Tajikistan signed a bilateral agreement with Russia, its largest creditor, writing off \$242 million out of the country's bilateral debt towards Russia. Tajikistan would settle the remainder of the debt by 31 December 2008 through a debt-to-equity swap (by giving Russia a share in a major hydropower plant under construction). In the framework of the MDRI (The Multilateral Debt Relief Initiative) the outstanding debt of SDR 69 million (US\$ 100 million) with the IMF at the end of 2005 resulting from disbursements made prior to 2005 was cancelled as of September 2006. Following this debt relief complemented with similar bilateral debt agreements with other creditors (e.g. Pakistan), external debt has fallen from 66.3% of GDP in 2003 down to 34.5% in 2006. There is however a growing concern over the failure to reduce private debt among farmers in the cotton sector.

The current account deficit increased from 3.4% of GDP in 2005 to 4.2% in 2006 according to IMF estimates. Continued flows of development assistance and remittances financed most of the current account deficit. Gross official reserves remained around \$200 million in 2006, providing only about 2 months of import cover.

10.3. Structural reforms

There has been limited progress in the liberalisation of the Tajik economy in 2006. The small-scale framework of the privatisation strategy for 2003-07 was largely completed in January 2006, and few attempts have since been made to extend the privatisation process to large entities. The sale of TadAZ, the sole aluminium smelter accounting for half of the country's industrial output, had been expected by 2007, but the government announced in May 2006 that privatisation was no longer an option. The main progress is expected from ongoing reforms of the tax administration, including a new tax code aimed at raising compliance and attract more revenue from the shadow economy. Measures to improve payment collection rates should begin to reduce the quasi-fiscal deficit in the electricity sector. Land reform is proceeding slowly, and the indebtedness of cotton farmers remains unsettled. Progress in farm privatisation has been hindered by the indebtedness of state-owned farms. The level of debt is now estimated to reach US\$ 400 million (representing over 200 per cent of cotton exports in 2005).

Good progress has been made in the consolidation of the banking sector, which has developed rapidly in the past couple of years. Remittances from the large number of Tajiks working abroad have increasingly been directed through the banking system since 2003, and banking sector indicators are improving strongly, although from a very low base. The banking sector has been open to foreign investors since 2005, allowing foreign banks to establish subsidiaries. By mid- 2006 a number of foreign banks were reported to be in the process of opening their subsidiaries in Tajikistan. Also in 2005 the minimum capital requirement for large banks has been raised to US\$ 5 million. Small banks have to meet the requirement since end-2005. The National Bank of Tajikistan (NBT) has become stricter on banks that do not comply with regulations. They are closed down or merged with other banks. Commercial

bank's compliance with International Accounting Standards (IAS) is considered to be satisfactory.

An engagement under the PSI programme (IMF Policy Support Instrument), and a surveillance relationship as a successor for the PRGF (IMF Poverty Reduction and Growth Facility) arrangement that ended in 2006 is currently being discussed. The authorities share the IMF's view that a successor program should focus on deepening reforms in the areas of tax administration and public expenditure management, strengthening the financial relations between the MoF and the central bank as well as the need to speed up agriculture reforms.

10.4. Implementation of macro-financial assistance

Tajikistan has benefited from an assistance package consisting 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 instalments.

As Tajikistan has made satisfactory progress in macroeconomic policies and in structural reform, the total amount of the grant instalments was disbursed. The last annual payment of €7 million was made in October 2006. On the other hand, the EC has not pushed for the maximum annual debt repayments which the MoU between the Commission and the Tajik authorities would have allowed. In 2001, 2002, 2005 and 2006, Tajikistan was asked to repay € 8 million only each time, whereas the MoU would have allowed requesting € 12 million. Tajikistan's outstanding debt to the EC is now € 28 million. An independent examination on the implementation of the programme is expected to be concluded in 2007.

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. Tajikistan has applied for membership in the WTO (observer status since 2001). A Factual Summary of Points Raised (summarizing the discussions of the Working Party) was circulated informally in April 2005 and subsequently revised in May 2006. Bilateral market access negotiations are underway on the basis of revised offers in goods and services. 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 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 Tajikistan's small market, lack of regional integration, slow pace of privatisation, limited access to financing, weakness of public administration and corruption. FDI inflows were around 1.5% in 2005. FDI inflows in 2006, mainly into hydropower slightly increased to just over 2% over GDP.

5. Monetary policy

A Monetary Policy Committee was set up in 2003, which should lead to a more effective monetary policy and a decree was issued the same year, withdrawing lending authority from all National Bank branch managers, department heads and deputy chairpersons. Average annual inflation was brought down from 38.6% in 2001 to 7.8% in 2006, even as the economy expanded rapidly.

6. Public finances

Total tax collection of the general government has increased from 15.2% in 2004 to 16.0% in 2005 and an estimated 16.4% in 2006. 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

A privatisation strategy for 2003-07 covered that State-owned enterprises, with a few exceptions, to be privatised, restructured (if direct privatisation is not feasible) or liquidated. The sale of TadAZ, the sole aluminium smelter accounting for half of the country's industrial output, had been expected by 2007, but the government announced in May 2006 that privatisation was no longer an option.

8. Financial sector reform

The banking sector is open to foreign investors since 2005, allowing foreign banks to establish subsidiaries. Also in 2005 a reduction in transfer fees was decided and progress has been made in improving banking regulation and supervision. This has encouraged more Tajik workers to use the banking system to remit wages earned abroad. The minimum capital requirement for commercial banks has been raised from US\$ 1.5 million to US\$ 5 million. Non-complying banks are closed down or merged with other banks. Compliance with IAS is considered to be satisfactory.

**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 2005 (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 (1) (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	
RYRoM 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			294,5	80,5
Armenia			(58)	Dec. 1998 (loan) Dec. 1998 (grant) Dec. 1999 (grant) Feb. 2002 (grant) Dec. 2002 (grant) June 2004 (grant) Dec 2005 (grant)	28 8 4 5,5 5,5 5,5 1,5	58	0
Georgia			447,5	Jul. 1998 (loan) Aug. 1998 (grant) Sep. 1999 (grant) Dec. 2001 (grant) Dec 2004 (grant)	110 10 9 6 6,5	141,5	33,5

Tajikistan			(95)	Mar. 2001 (loan)	60	95	
				Mar. 2001 (grant)	7		
				Dec. 2001 (grant)	7		
				Feb. 2003 (grant)	7		
				May 2005 (grant)	7		
				Oct 2006 (grant)	7		
Ukraine III (BoP loan)	15.10.98	98/592/EC	150	Jul. 1999	58	58	92
	12.07.02	02/639/EC					(Cancelled)
Albania III (BOP loan)	22.04.99	99/282/EC	20				20
Bosnia I (3) (BOP loan and grant)	10.05.99	99/325/EC	60	Dec. 1999 (grant)	15	60	
		modified by		Dec. 1999 (loan)	10		
	10.12.01	01/899/EC		Dec. 2000 (grant)	10		
				Dec. 2000 (loan)	10		
				Dec. 2001 (grant)	15		
Bulgaria IV (BOP loan)	08.11.99	99/731/EC	100	Dec. 1999	40	100	
				Sep. 2000	60		
fYRoM II (4) (BOP loan and grant)	08.11.99	99/733/EC	80	Dec. 2000 (grant)	20	98	
		modified by	18	Dec. 2000 (loan)	10		
	10.12.01	01/900/EC		Dec. 2001 (loan)	12		
				Dec. 2001 (grant)	10		
				May 2003 (grant)	10		
				June 2003 (loan)	10		
				Dec. 2003 (loan)	18		
				Dec. 2003 (grant)	8		
Romania IV (BOP loan)	08.11.99	99/732/EC	200	Jun. 2000	100	150	50
				July 2003 (loan)	50		
Kosovo I (5) (Grant budgetary support)	19.02.00	00/140/EC	35	Mar. 2000	20	35	
				Aug. 2000	15		
Montenegro (5) (Grant budgetary support)	22.05.00	00/355/EC	20	Aug. 2000	7	20	
				Dec. 2000	13		
Moldova III (BOP loan)	10.07.00	00/452/EC	15				15
	19.12.02	02/1006/EC					(Cancelled)
Kosovo II (3) (Grant budgetary support)	27.06.01	01/511/EC	30	Sep. 2001	15	30	
				Dec. 2002	15		
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	Dec. 2002 (grant)	30	105	25
				Feb. 2003 (loan)	10		
				Aug. 2003 (grant)	35		
				Aug. 2003 (loan)	30		
		modified by					
	25.11.03	03/825/EC	70	Dec 2004 (grant)	10	50	20
	07.12.2004	04/862/EC					
				April 2005 (loan)	15		
				Dec 2005 (grant)	25		
Bosnia II (8)	05.11.02	02/883/EC	60	Feb. 2003 (grant)	15	60	
		modified by		Dec. 2003 (grant)	10		
	7/12/2004	04/861/EC					
				Dec 2004 (loan)	10		
				Jun 2005 (grant)	15		
				Feb 2006 (loan)	10		
Moldova IV	19.12.02	02/1006/EC	15				15
							(expired)
Albania IV (9)	29.04.04	04/580/EC	25	Nov 2005 (grant)	3	25	
				March 2006 (loan)	9		
				July 2006 (grant)	13		
Georgia II	24.01.06	06/41/EC	33,5	August 2006 (grant)	11	22	11,5
				Dec 2006 (grant)	11		
Kosovo	30.11.06	06/880/EC	50				50
TOTAL			6279,0			5190,0	1089,0

(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) Includes a loan principal amount of € 9million and grants of € 16 million

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

Status of effective disbursements as of end-December 2005 (in millions of euro)

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>		<u>Totals</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>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 (Suspended)
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 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	
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 10.12.2001	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	
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 10.12.2001	01/549/EC modified by 01/901/EC	345	Oct. 2001 (grant) Oct. 2001 (loan) Jan. 2002 (grant) Aug. 2002 (grant)	35 225 40 45	345	
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	03/825/EC (7)	70	Dec 2004 (grant)	10	50	20
	07.12.04	04/862/EC		April 2005 (loan) Dec 2005 (grant)	15 25		
Bosnia II (6) (BOP loan and grant)	05.11.02 07.12.04	02/883/EC modified by 04/861/EC	60	Fev. 2003 (grant) Dec. 2003 (grant) Dec 2004 (loan) June 2005 (grant) Feb 2006 (loan)	15 10 10 15 10	60	
Albania IV (8) (loan and grant)	29.04.04	04/580/EC	25	Nov 2005 (grant) Mar 2006 (loan) Jul 2006 (grant)	3 9 13	25	
Kosovo	30.11.06	2006/880/EC	50				50
TOTAL B			1088			973	115

(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

(8) Includes a loan principal amount of € 9 million and grants of € 16 million

C. New Independent States (NIS)

Armenia, Georgia and Tajikistan (9) (Structural adjustment loans and grants)	17.11.97	97/787/EC	375			294,5	80,5
of which	28.3.00	00/244/EC					
Armenia			(58)	Dec. 1998 (loan)	28	(58)	0
				Dec. 1998 (grant)	8		
				Dec. 1999 (grant)	4		
				Feb. 2002 (grant)	5,5		
				Dec. 2002 (grant)	5,5		
				Jun 2004(grant)	5,5		
				Dec 2005(grant)	1,5		
Georgia			(175)	Jul. 1998 (loan)	110	(141,5)	(33,5)
				Aug. 1998 (grant)	10		
				Sep. 1999 (grant)	9		
				Dec. 2001 (grant)	6		
				Dec. 2004 (grant)	6,5		
Tajikistan			(95)	Mar. 2001 (loan)	60	(95)	
				Mar. 2001 (grant)	7		
				Dec. 2001 (grant)	7		
				Feb 2003 (grant)	7		
				May 2005 (grant)	7		
				Oct 2006 (grant)	7		
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	25	45	
				Aug. 1995	20		
Moldova II (BOP loan)	25.03.96	96/242/EC	15	Dec. 1996	15	15	
Moldova III (BOP loan)	10.07.00	00/452/EC	15				15 (cancelled)
	19.12.02	02/1006 EC					
Moldova IV (BOP grant)	19.12.02	02/1006/EC	15 <i>(15)</i>				15 (expired)
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	50	200	
				Oct. 1996	50		
				Sep. 1997	100		
Ukraine III (BoP loan)	15.10.98	98/592/EC	150	Jul. 1999	58	58	92 (cancelled)
	12.07.02	02/639/EC					
Ukraine IV (BOP loan)	12.07.02	02/639/EC	110 <i>(15)</i>				110 (Suspended)
Georgia II	21.01.06	06/41/EC	33,5	Aug 2006	11	22	11,5
				Dec 2006	11		
TOTAL C			1098,5			749,5	349
D. Mediterranean countries							
Israel (10) (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	250	400	
				Aug. 1994	150		
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			6279,0			5190,0	1089,0

9) 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

(10) 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.