COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget situation at 30 June 2005

{SEC(2005)1769}

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Part One: Events since the Report at 31 December 2004, the risk situation and activation of Budget Guarantees[1]

1. INTRODUCTION: TYPES OF OPERATION

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

2. EVENTS SINCE THE REPORT AT 31 DECEMBER 2004

Regarding macro-financial assistance provided to third countries, no new Council Decision was adopted. A loan disbursement of EUR 15 million was carried out on the basis of the existing decision in favour of Serbia and Montenegro.

Disbursements in the form of grants amounted to a total of EUR 22 million: EUR 15 million for Bosnia and Herzegovina and EUR 7 million for Tajikistan.

Regarding Euratom, a loan disbursement of EUR 25 million was carried out on the basis of an existing decision in favour of Bulgaria (Kozloduy). Moreover, two loan tranches were paid to Romania (Cernavodă, EUR 100 million and EUR 90 million) following a Commission decision[3].

Concerning the EIB's mandates, on 22 December 2004[4], the Council decided to grant a Community guarantee to the EIB against losses under loans for certain types of projects in Russia, Ukraine, Moldova and Belarus; the overall ceiling amounts to EUR 500 million. On 23 May 2005, the Commission decided that Russia and Ukraine were eligible under this Decision[5].

On 12 April 2005, the Commission adopted a Proposal for a Council Regulation amending Regulation (EC, Euratom) No 2728/94 establishing a Guarantee Fund for external actions[6] to change the Fund's provisioning mechanism. The main objective of this proposal is to improve the efficiency of the use of budgetary means. According to the proposal, the Fund would be provisioned ex-post on the basis of observed amounts of guaranteed loans outstanding.

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1 Please note that the annex contains a Commission Staff Working Paper with a set of detailed tables and explanatory notes to this report.
2 The details concerning the EIB Mandates are displayed in Table A1 of the annex.
3 C(2004)891/2 of 30 March 2004.
4 OJ L 21, 25.01.05, p.11.
5 C(2005)1499.
6 COM(2005)130.

According to the Commission Communication on the Financial Perspectives 2007 - 2013[7], the amount of financing of the Guarantee Fund will not, in theory, be limited in the future as the funding of the Guarantee Fund will be carried out through a budget line under Heading 4 (External Relations) and not, as at present, through a dedicated Reserve.

3. RISK SITUATION

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

3.1. Capital outstanding at 30 June 2005

The total risk at 30 June 2005 came to EUR 16,333 million, as against EUR 15,284 million at 31 December 2004.

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

Table 1: Capital outstanding at 30 June 2005*		**EUR million (rounded)**
Amount outstanding at 31 December 2004		15,284
Loan repayments		
	Euratom	0
	Macro-financial assistance	-38
	EIB	-561
Loans disbursed		
	Euratom	215
	Macro-financial assistance	15
	EIB	1,565
Exchange rate differences between EUR and other currencies		-147
Amount outstanding at 30 June 2005		16,333

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

The capital outstanding in respect of operations in the Member States was EUR 3,214 million at 30 June 2005, compared with EUR 3,360 million at 31 December 2004.

The capital outstanding in respect of operations in non-member States at 30 June 2005 was EUR 13,119 million, compared with EUR 11,924 million at 31 December 2004.

[7] COM(2004) 487 of 14.07.2004.

3.2. Maximum annual risk borne by the Union budget: operations disbursed at 30 June 2005 (see Table A2 in Annex)

– For the second half of 2005, the total maximum annual risk amounts to EUR 1,053 million.

– The risk in respect of Member States comes to EUR 265 million.

– The risk in respect of non-member States comes to EUR 789 million.

3.3. Maximum theoretical annual risk borne by the Union budget: operations disbursed and decided at 30 June 2005 (see Table A3 in Annex)

– For the second half of 2005, the maximum theoretical risk amounts to EUR 1,103 million and is estimated to reach, under certain assumptions, EUR 3,480 million in 2013.

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

– For the non-member States it amounts to EUR 839 million for second half of 2005. The risk is estimated to reach EUR 3,253 million by 2013.

4. ACTIVATION OF BUDGET GUARANTEES

4.1. Payments from cash resources

The Commission draws on its cash resources[8] in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying the Commission.

4.2. Activation of the Guarantee Fund

Council Regulation (EC, Euratom) No. 2728/94 of 31 October 1994, as amended, established a Guarantee Fund for external actions. In the event of late payment by a recipient of a loan granted or guaranteed by the Community, the Guarantee Fund is called on to cover the default within three months of the date on which payment is due.[9]

During the first half of 2005, the Guarantee Fund was not called as no default occurred on such loans.

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

9 For more details, see Section 2.5. of the Annex.

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

In practice, the Guarantee Fund mechanism limits the Community's lending and guarantee capacity to non-member States, since the appropriations available for provisioning the Fund are limited by the amount entered for the Guarantee Reserve in the current Financial Perspectives[10].

Table A4 in the Annex shows an estimate of the Community's lending capacity in respect of non-member States over the period 2005-2006 in line with the Guarantee Fund mechanism. The method of calculation and references to legal texts are set out in greater detail in the Annex.

Table 2 shows that outstanding lending and loan guarantee operations for non-member States totalled EUR 13,245 million at 30 June 2005.

Table 2: Outstanding lending and loan guarantee operations for non-member States in EUR million (rounded)

1. Capital outstanding, EC (MFA), Euratom	1,576
2. Capital outstanding, EIB	11,543
3. Payments defaults	0
4. Default Interest	1
5. Unpaid interest due*	125
Amount outstanding at 30 June 2005	13,245

* Unpaid interest due within the meaning of the Regulation establishing the Guarantee Fund.

The ratio between the Fund's resources and outstanding capital liabilities, within the meaning of the Regulation establishing the Fund, was 9.8%, which is higher than the target figure of 9% set in Regulation No. 1149/1999 amending Regulation No. 2728/94 establishing the Fund. The rules state that at the end of a year the surplus shall be paid back to a special heading in the statement of revenue in the general budget of the European Union.

6. SITUATION OF THE GUARANTEE FUND AT 30 JUNE 2005

At 30 June 2005, the Guarantee Fund amounted to EUR 1,298.35 million. The following movements were recorded in the first half of 2005.

10 The annual figure entered in the 2000-2006 Financial Perspectives is EUR 200 million at 1999 prices; in 2005, the amount is EUR 223 million.

– On 10 January 2005, an amount of EUR 338,831,402.07 was repaid to the budget, representing 9% of the outstanding operations granted to the new Member States at 1 May 2004 (EUR 3,764,793,356.32) following Regulation No 2273/2004[11].

– Net revenue of EUR 25.1 million from investment of the Fund's assets as of 30 June 2005.

The total arrears, at 30 June 2005, i.e. penalty interest with the Republic of Argentina, amount to USD 1,718,493.12 (EUR equivalent 1,261,649.75).

7. RELATIVE SOLIDITY

The ratio between the amount in the Fund at 30 June 2005 (EUR 1,298.35 million) and the maximum theoretical annual risk for loans to non-member States in 2005 (EUR 839 million) is estimated at 77% (see Annex Table A3)[12].

[11] JO L 396 of 31.12.2004.

[12] Please note that the estimate for the maximum theoretical annual risk for the year 2005 reported in Table A3 refers to the second half of 2005 only. For reasons of comparability, this amount has been normalised on a period of 12 months for the above comparison.

Part Two: Evaluation of potential risks: Economic and financial situation of the non-member countries benefiting from the most important loan operations

1. INTRODUCTION

The figures in Part One provide information on quantitative aspects of the risk borne by the general budget. However, this data should be accompanied by an assessment of the quality of the risk, which depends on the type of operation and the standing of the borrower. Tables on the country risk evaluation are presented separately in the Commission Staff Working Paper[13]. A brief summary of this analysis is provided below. A section analysing the situation of the other non-member countries can be found under point 3.1 of the Annex.

2. CANDIDATE COUNTRIES

The Commission forecast for **Bulgaria** predicts growth of 6.0% for 2005, driven mainly by strong domestic demand resulting from expansionary fiscal and wage policies. The current account deficit reached 7.4% of GDP in 2004 and is expected to widen to 8.5% in 2005, based on continuing strong import growth. FDI inflows reached 8.4% of GDP in 2004 whereas the external debt of the country increased slightly to 63.0% of GDP at the end of 2004.

For 2005-2006, the outlook of the **Romanian** economy points to sustained economic growth of 5-6% (after 5.3% in 2004) and a further widening of the current account deficit that reached 7.5% of the GDP in 2004, helped by large FDI inflows of 7.1% of GDP and a moderate increase in the foreign debt-ratio which reached 37% of GDP.

Turkey has seen real GDP growing by 8.9% in 2004. In the first quarter of 2005, growth speeded down to 4.8 %. The Commission forecast for 2005 foresees growth of 5%, driven mainly by investment and private consumption. The current account deficit reached 5.2% of GDP in 2004 and is expected to widen slightly to just below 6% in 2005, based on higher energy prices and increased import demand. FDI inflows reached 0.5% of GDP and contributed to a decrease of the external debt to 46% of GDP at the end of 2004.

3. WESTERN BALKANS

The real GDP of **Bosnia Herzegovina** is expected to grow by around 5%, similar to 2004. The current account deficit remained at 23% of GDP in 2004 and is expected to narrow slightly in 2005, based on strong export performance and slower import growth. FDI inflows reached 7% of GDP in 2004. The external debt of the country continued to fall to 30% of GDP at the end of 2004, but total domestic debt is likely to raise substantially in the near future due to a large settlement of claims.

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13 SEC(2005)…

In the **Former Yugoslav Republic of Macedonia** growth amounted to 3.7% in the first half of the year, thus being in line with the IMF forecast of 3.7% for 2005. Growth accelerated in the second quarter mainly due to increased output of the industry and the service sectors. The current account deficit reached 7.7% of GDP in 2004 and is expected to further narrow in 2005, based on exports increases. FDI inflows reached 2.8% of GDP in 2004. The external debt of the country fell to 38% of GDP at the end of 2004.

Serbia and Montenegro's real GDP grew by 7.2% in 2004 while the IMF forecasts 4.6% in 2005, mainly driven by buoyant domestic demand and an improving trade balance. The current account deficit reached 13% of GDP in 2004 and is expected to narrow to 9.5% in 2005, based on an improved export performance. FDI inflows reached 4.3% of GDP in 2004. The external debt of the country fell to 62% of GDP at end-2004.

4. NEW INDEPENDENT STATES

In **Armenia,** real GDP growth remained close to 10% in 2004-early 2005 while the government is increasing social and capital expenditure in 2005 in line with the poverty reduction strategy, budget deficit is projected to stay below 3% of GDP. The current account deficit narrowed to 4.7% of GDP in 2004 and the gross international reserves of the Central Bank of Armenia are covering nearly four months of imports. The public external debt represents about 29% of GDP in 2005 (down from about 33% in 2004).

In **Georgia,** the construction of oil and gas pipelines continues to drive growth but is also the cause of a substantial increase in the current account deficit (due to high import demand for the construction) – 11.8% of GDP in 2005 against 8.1% in 2004 – In 2005 the government has budgeted large increases in expenditure (social programs, defence, infrastructure) which will lead to a projected deficit of 4.8% of GDP. The gross international reserves increased in 2004 to cover nearly two months of imports. Georgia's public external debt as a ratio to GDP was at the end of 2004 equivalent to about 36% (46% in 2003).

In 2004, the GDP growth of **Belarus** was 11% and is expected to approach 9% in 2005 (resulting in an accumulated real GDP growth of above 80% since 1996). The General Government account turned again to a surplus, reaching 2.7% of GDP by mid-2005, up from 1.8% in 2004. External debt – mainly short-term – remained modest, with a debt-to-GDP ratio below 20%. Despite this improvement, the Belarus economy remains vulnerable in many areas; for instance foreign exchange reserves are very low, at below one month of imports.

Moldova's economic GDP growth, which exceeded 7% in 2004, is expected to go down to 6% in 2005. Inflation remains in the double-digit area. The budget is likely to return to a surplus in 2005 owing to higher taxes collected on imports. As a result of the exchange rate appreciation and of the GDP growth, external debt is expected to represent just one-third of GDP at the end of 2005.

After a record high rate of 12% in 2004, real GDP growth in **Ukraine** in 2005 is expected to be no more than 5.5-6%. The government's revenue collection targets in the first half of 2005 were met and therefore the targeted deficit of 2.5% of GDP seems realistic. The balance of payments is in a comfortable position as the current account is expected to show a large surplus also in 2005 (7% of GDP, after 10.5% in 2004). In the light of the de facto peg of the local currency to the US dollar, this results in a rapid accumulation of foreign exchange reserves equivalent to 3½ months of imports. The ratio of public external debt to GDP is projected to decrease further in 2005 to about 16% (from about 19% in 2004).

Tajikistan's economy has continued to grow strongly in 2005, despite dampening effects of a deteriorating external environment. Real GDP growth of 7% is expected for the full year, compared to 10.6% in 2004. For 2005, the fiscal deficit is foreseen to be limited to 0.5% of GDP. Thanks to successful bilateral debt agreements with Russia – Tajikistan's largest creditor – and Pakistan, external debt has fallen from 66.3% of GDP in 2003 to 41.1% in 2004 and to a projected 38.4% in 2005. After increasing to 4% of GDP in 2004, the current account deficit has widened further in the first quarter of 2005, this being driven by a large increase in the trade deficit.