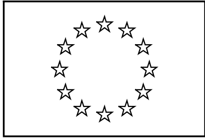

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 15.1.2004
COM(2004) 12 final

REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget - situation at 30 June 2003

[SEC(2004) 33]

TABLE OF CONTENTS

Part One: Events Since The Report At 31 December 2002, The Risk Situation And Activation Of Budget Guarantees 4

1. Introduction: types of operation 4

1.1. Operations with macroeconomic objectives 4

1.2. Operations with microeconomic objectives 4

2. Events since the report at 31 December 2002 4

3. Risk situation 5

3.1. Amount outstanding at 30 June 2003 (Table 1) 5

3.2. Maximum annual risk borne by the Community budget: operations disbursed at 30 June 2003 6

3.3. Maximum theoretical annual risk borne by the Community budget 6

4. Activation of budget guarantees 7

4.1. Payments from cash resources 7

4.2. Activation of the Guarantee Fund 7

5. Analysis of the Community's theoretical lending and guarantee capacity in respect of non-member countries (Table 2) 7

6. Situation of the Guarantee Fund at 30 June 2003 9

7. Relative solidity 9

Part Two: Evaluation Of Potential Risks: Economic And Financial Situation Of The Non-Member Countries Benefiting From The Most Important Loan Operations 10

1. Introduction 10

2. Candidate countries 10

2.1. Bulgaria 10

2.2. Romania 11

2.3. Turkey 12

3. Western Balkans 12

3.1. Bosnia and Herzegovina (BiH) 12

3.2. Former Yugoslav Republic of Macedonia (fYRoM) 13

3.3. Serbia and Montenegro 14

4. Newly Independent States 15

4.1. Armenia 15

4.2. Belarus ... 16
4.3. Georgia ... 17
4.4. Moldova ... 17
4.5. Tajikistan ... 18
4.6. Ukraine ... 19
5. Other Non-member Countries ... 19
5.1. Algeria ... 20
5.2 Argentina ... 20
5.3 Brazil ... 21
5.4 Jordan ... 22
List of abbreviations ... 23

Part One:
Events since the Report at 31 December 2002, the risk situation and activation of Budget Guarantees[1]

1. Introduction: Types of Operation

The risks covered by the Community budget derive from a variety of lending and guarantee operations which can be divided into two categories: loans with macroeconomic objectives and loans with microeconomic objectives.

1.1. Operations with macroeconomic objectives

The first of these are the balance-of-payments loans for Member States or non-member countries, normally carrying strict economic policy conditions.

1.2. Operations with microeconomic objectives

These are loans to finance projects which are usually repaid over the long term from funds which these projects are expected to generate; as a rule, they are granted to companies, financial institutions or non-member countries and, in addition to the Community guarantee, are covered by the usual guarantees demanded by banks.

This covers Euratom and NCI[2] loans in Member States and Euratom and EIB loans outside the Community (Mediterranean countries, Central and Eastern Europe, countries of Asia and Latin America, Republic of South Africa).

2. Events since the report at 31 December 2002

Regarding macro-financial assistance provided to third countries, no new Council decision was adopted during the period whilst loan disbursements were carried out on the basis of existing decisions in favour of Serbia and Montenegro (EUR 10 Million) and FYROM (EUR 10 Million). Another loan in favour of Romania (EUR 50 million) will be disbursed in July 2003.

Regarding Euratom no new Council decision was adopted during the period whilst a loantranche disbursement was carried out on the basis of an existing decision in favour of Bulgaria (Kozloduy EUR 25 Million).

[1] A reference to “Annex” in this report is refering to the Commission Staff Working Paper, containing an annex with a set of detailed tables and explicatory notes to this report.

[2] No disbursements since 1995

3. RISK SITUATION

There are two methods for evaluating the risks borne by the Community budget:

– The method, often used by bankers, of the total amount of capital outstanding for the operations concerned on a given date (situation described in Annex Table A1);

– The more budgetary approach of calculating the maximum amount which the Community could have to pay out in each financial year in case of a default of all debtors.

The second approach itself has been applied in two different ways:

– By reference only to actual disbursements at the date of the report, assuming that there are no early repayments (see Annex Table A2 below showing the lower limit of this maximum risk to the Community budget);

– On a more forward-looking basis, by reference to all the operations decided by the Council or proposed by the Commission in order to estimate the impact on future budgets, assuming that the Commission's proposals are accepted assuming that there are no early repayments (see Annex Table A3 below showing the upper limit of this maximum risk borne by the Community budget).

The latter exercise gives some idea of the future level of risks connected with the proposals made. However, a number of assumptions have to be made about dates of disbursement and terms of repayment (details are given in the Annex) as well as interest[3] and exchange rates[4].

The results are shown in Annex Tables A1 to A3, which make separate assessments of the risks relating to countries inside the Community and countries outside the Community.

The overall figures quoted cover risks of different types; loans to a country in the case of macro-financial assistance and loans for projects guaranteed by the borrowers in the case of NCI and EIB operations, for example.

The following analysis distinguishes between total risk, the risk in respect of Member States and the risk in respect of non-member countries.

3.1. Amount outstanding at 30 June 2003

The total risk at 30 June 2003 came to € 15.067 million, as against € 15.216 million at 31 December 2002. Details are shown in Annex Table A1.

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

---

3 An interest rate of 5,49% p.a. has been applied for the new operations in Table A3.
4 The exchange rates used for loans in currencies other than the euro are those of 30 June 2003.

Table 1: Changes of capital outstanding during the last 6 month*	€ million
Amount outstanding at 31 December 2002	**15.216**
Loan repayments	
Euratom	0
NIC	0
Financial assistance	-8
EIB	-566
Loans disbursed	
Euratom	25
NIC	0
Financial assistance	20
EIB	321
Exchange rate differences between Euro and other currencies	59
Amount outstanding at 30 June 2003	**15.067**

*all guaranteed loans (Member States, non Member States) confounded

The capital outstanding in respect of operations in the Member States was € 32 million at 30 June 2003, compared with € 39 million at 31 December 2002.

The capital outstanding from non-member countries at 30 June 2003 was € 15.035 million, compared with € 15.177 million at 31 December 2002.

3.2. Maximum annual risk borne by the Community budget: operations disbursed at 30 June 2003

– For 2003 the total risk amounts to € 984 million.

– The risk in respect of the Member States comes to € 8 million.

– The risk in respect of non-member countries comes to € 976 million.

Details of the maximum annual risk are set out in Annex Table A2.

3.3. Maximum theoretical annual risk borne by the Community budget

For 2003 the maximum theoretical risk amounts to € 1.106 million. It will increase from 2004 onwards and reach €3.709 million in 2011.

– The trend in the maximum theoretical risk in respect of Member States is the same as in Table A2.

– For the non-member countries it amounts to €1.092 million for 2003. The risk will increase from 2004 onwards to reach € 3.709 million by 2011.

Details of the maximum theoretical annual risk is set out in Annex Table A3.

4. ACTIVATION OF BUDGET GUARANTEES

4.1. Payments from cash resources

The Commission draws on its cash resources, under Article 12 of Council Regulation (EC, Euratom) No. 1150/2000 of 22 May 2000, implementing Decision 94/728/EC, Euratom, on the system of the Communities' own resources, in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying.

4.2. Activation of the Guarantee Fund

Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 (amended by Council Regulation 1149/99 of May 25, 1999) established a Guarantee Fund for external action. In the event of late payment by a recipient of a loan granted by the Community, the Guarantee Fund is called on to cover the default within three months of the date on which payment is due. If a borrower defaults on an EIB loan guaranteed by the Community budget, the Community will act within three months of receiving a letter from the Bank calling for the guarantee to be activated. The Commission will then authorise the Bank to take the corresponding amounts from the Guarantee Fund.

Default interest for the time between the date on which cash resources are made available and the date of activation of the Fund is drawn from the Fund and repaid to the cash resources.

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

In practice, the Guarantee Fund mechanism limits the Community's lending and guarantee capacity to non-member countries, since the appropriations available for provisioning the Fund are limited by the amount entered for the guarantee reserve in the Financial Perspective[5]. At any given time, the lending capacity is related to the margin remaining in the guarantee reserve. This margin is equal to the difference between the reserve and the estimated amount needed to provision the Guarantee Fund for operations which have already been adopted and which are in preparation.

Annex Table A4 shows an estimate of the Community's lending capacity in respect of non-EU countries over the period 2003-2006 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.

On the basis of the decisions adopted by the Council or the Commission and decisions proposed and in preparation (see Annex Table A4), €168,48 million is expected to be used from the guarantee reserve in 2003, leaving € 48,52 million available at the end of the year.

[5] The annual figure entered in the 2000-2006 Financial Perspective is €200 million at 1999 prices.

If account is taken of the effect on the Guarantee reserve of the provisioning of the Fund in respect of loans already decided and loans proposed and in preparation for 2003, the annual capacity available for loans is as follows:

– € 539,11 million for loans with a 100% guarantee under the Community budget, or

– € 829,40 million for loans with a 65% guarantee (in accordance with Council Decision 2000/24/EC of 22 December 1999).

At **30 June 2003**, outstanding lending and loan guarantee operations for non-member countries totalled € 17.542 million.

Table 2: Outstanding lending and loan guarantee operations for non-member countries as of 30 June 2003

	€ million
1. Capital outstanding, borrowing and lending, Macro financial assistance and Euratom	1.478
2. Capital outstanding, EIB	13.557
3. Capital outstanding, payment defaults	0
4. Default interest	2.360
Unpaid interest due*	147
TOTAL	**17.542**

* unpaid interest due within the meaning of the Regulation establishing the Guarantee Fund

6. SITUATION OF THE GUARANTEE FUND AT 30 JUNE 2003

At 30 June 2003, the Guarantee Fund amounted to € 1.679,65 million.

The ratio between the Fund's resources and outstanding capital liabilities, within the meaning of the Regulation establishing the Fund, was 11,1 %, 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 Communities.

The following movements were recorded in the first half of 2003:

– on February 22, 2003 the fund was called as a result of a default on a loan to the Republic of Argentina for an amount of USD 2.528.800,19 (€ equivalent 2.359.615,74);

– the Commission was informed from the EIB about arrears on another loan to the Republic of Argentina for an amount of USD 2.529.527,79, which could lead to a call on the fund in the second half of 2003;

– net revenue of € 32,7 million on investments from the Fund's assets.

– The first payment for 2003 from the reserve (EUR 145,67 Mio) and the surplus of the fund as of 31 December 2002 (EUR 263,33 Mio) will be executed in the second half of 2003. The remaining cash balance of EUR 117,66 Mio will be reimbursed from the fund to the budget of the Commission.

7. RELATIVE SOLIDITY

The ratio between the amount in the Fund at 30 June 2003 (€ 1.679,65 million) and the maximum annual risk for loans to non-member countries (defined as the total amount falling due) shown for 2003 in Annex Table A3 (€ 1.106 million) is 152%, i.e. the fund could under the assumption of a worst case scenario cover all obligations for more than a year.

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, these 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. Recent events, which may influence the portfolio country risk, are analysed below.

As in the previous reports, the country risk evaluation presented in Part Two comprises a table of risk indicators (see Annexes) for each non-member country that has received EC macro-financial assistance and still has outstanding debts to the EC and EURATOM. Moreover, other third countries each representing more than 2% of the total outstanding debt to the EC (notably through guarantees of EIB project related lending) and either categorised as "severely indebted" according to criteria set by the World Bank or facing notorious imbalances in their external or debt situation are also included in the risk evaluation.

To complement this, textual analysis is provided for all the countries studied in order to take into account new information influencing the risk evaluation.

Altogether, the country analysis is covering 48,6% of the total outstanding debt owned by the EC or guaranteed through its budget, thus providing a meaningful assessment of the risk

2. CANDIDATE COUNTRIES

Robust growth rates and decrease in inflation improve the perspectives of economic stabilisation for all candidate countries.

2.1. Bulgaria

In spite of the difficult global economic situation, Bulgaria continued to benefit from high growth and stability. Real GDP growth was 4,8% in 2002 and 4,1% in the first half of 2003. Growth is sustained by strong domestic demand arising from private consumption and investment as a consequence of increases in employment, net incomes and bank credits. Inflation is on a downward path due to low food prices and low import prices following the depreciation of the US dollar. Unemployment has decreased rapidly to 13,2% of the labour force until July 2003, and was more than 4 percentage point lower compared to one year earlier due to jobs created in both the private sector and government employment schemes. The privatisation programme is advancing slower than expected, with major difficulties for the sales of the telecom and tobacco monopolies.

The currency board arrangement (EUR 1 = BGN 1,95583) is being maintained and continues to be supported by high foreign reserves. It has not led to a remarkable deterioration of external competitiveness given that real exchange rate appreciation was broadly matched by higher productivity growth.

The current account deficit was lower than in previous years, also because of higher revenues from tourism, lower interest payments and higher current transfers, but has been higher again in the first half of 2003 as a consequence of higher deficits in the trade and income balances. Net inflows of foreign direct investment did not fully cover the current account deficit in 2002 when they were about the same size as in the first half of 2003 alone. The foreign reserves of the central bank continue to increase and amount to almost 6 months of imports of goods and non-factor services.

Fiscal discipline has been maintained and contributes to internal and external stabilisation. Similar to previous years, the general government sector had a (cash) deficit of 0,7% of GDP in 2002. In the first half of 2003, a budget (cash) surplus of about 1,8% of GDP was accumulated. Public debt is falling rapidly, from well above 100% of GDP in 1997 to 56% of GDP at the end of 2002. Total external debt has decreased to well below 70% of GDP. The government is conducting an active debt management with the objective of reducing risks by gradually shifting from a denomination in US dollar towards a denomination in €, from short-term to long-term maturity, from floating into fixed interest rate bonds and from foreign to domestic financing. This is reflected in slightly improved credit ratings for the country.

2.2 Romania

During the first half of 2003, macroeconomic trends remained positive with robust growth and declining inflation. However, macroeconomic risks increased as the external account began to widen again on the back of sharp rises in real wages and booming credit.

Despite a less favourable international environment, economic growth remained robust. After growing by 4,9% in 2002, GDP rose by 4,3% year-on-year during the first semester of 2003. However, contrary to 2002 when net exports had positively contributed to the economic expansion, the recovery became increasingly unbalanced in 2003. Sharply rising net wages and booming consumer credit boosted household consumption growth which accelerated to 7,4% year-on-year in the second quarter. With investment spending also continuing to increase apace, at 7,9%, import growth remained sustained at 12,1%. At 5,4% year-on-year in the second quarter, export growth decelerated sharply causing the contribution of net exports to growth to turn negative again.

As a result, while in 2002 economic growth was accompanied by greater domestic and external stabilisation, in 2003 inflation continued to decline (reaching 14,2% year-on-year in August) but the current account deficit began widening after falling sharply to 3,4% of GDP in 2002. Starting from the second quarter of 2003, in fact, rising outlays for the import of goods and the payment abroad of non-labour income pushed the current account deficit accumulated over the last twelve months to an estimated 4,1% of GDP.

Romania, however, continued to successfully tap the international financial markets as its sovereign paper was repeatedly upgraded. After rising to EUR 14,9 billion (or 34,4% of GDP) at end-2002, foreign debt declined to EUR 14,4 billion over the first five months of 2003 but this was only due to the appreciation of the Euro. Also, in July 2003, the debt stock increased as a result of a new 7-year EUR 700 million bond issue. Largely thanks to the latter, after weakening somewhat during the first half of 2003, international reserves increased to EUR 6,6 billion by August 2003, providing coverage for more than four months of imports.

In an attempt to address the weakening of the external accounts, in late August, the authorities agreed to tighten the policy stance by raising interest rates and increasing energy prices in the context of the last review of the IMF SBA.

While it is too early to assess the impact of these measures, prudent fiscal and wage policies coupled with a continued reduction in the quasi-fiscal deficit will be needed to preserve the momentum towards greater macroeconomic stability.

2.3 Turkey

During the second quarter of 2003, real GDP growth slowed down to 3,9%, after 8,1% in the first quarter. On average, real output nevertheless expanded by 5,8%, compared to the same period a year ago. However, economic growth still is mainly driven by exports and restocking, while the contribution of private consumption remains limited. As a result of import-intensive restocking, import growth is rather strong, leading to a rapidly increasing external imbalance. So far, the economic impact of the crisis in neighbouring Iraq has remained very limited. In particular with respect to financial markets, this can be seen as an indication of strengthened market confidence and a improved shock resilience of the Turkish economy. The strength of the Turkish lira contributes to the current account deficit, by lowering the costs of imported commodities while impeding competitiveness of Turkish exports. So far, Turkish exporters managed to maintain market shares and profit margins, by increasing productivity and containing wage growth.

Inflationary pressures have continued to decline with reaching a 12-month consumer price inflation of 25% in August. In view of the development during the recent months, reaching the end-year CPI target of 20% appears to be possible. However, the impressive decline in inflationary pressures is supported by weak domestic demand, impeding the pass-through of price increases of primary commodities to consumers, and the strength of the Turkish currency, lowering the price of imports, such as oil products.

Public finances are largely on track with IMF targets, envisaging a primary surplus of the general government of 6,5% of GDP in the period 2003-2004. After some fiscal slippage and higher costs of the social security system in the first half of the year, the government announced in July additional measures (amounting to about 0,75% of GDP) in order to safeguard the achievement of the primary surplus target. Based on substantial primary surpluses, strong growth and the expectation of declining interest rates, the debt ratio is expected to fall markedly in the near future. In April 2003, the Turkish authorities notified a 2002 general government deficit of 10% of GDP and a debt ratio of 95% of GDP. In 2003, the Turkish authorities expect a deficit of 7,2% of GDP and a debt ratio of 86,3% of GDP.

3. WESTERN BALKANS

Public and external debts remain at high level in all countries except FYROM where, in the medium term, the major risk remains the persistent ethnic divisions.

3.1 Bosnia and Herzegovina (BiH)

Under the current IMF programme (fully on-track), BiH maintained macro-economic stability, low inflation, and continued efforts with fiscal consolidation. However, the growth prospects for 2003 have been revised downwards, at 3,3% of real GDP growth, down from nearly 4% in 2002, as they are negatively affected by the external environment. In the light of declining official aid, BiH still faces the challenge of a sustained domestically generated economic growth. Strict adherence to the currency board has kept inflation under control, which in the first three months of 2003 was 0,5% on average.

Moreover, the BiH authorities have nominated in May the members of the new Governing Board of the Central Bank, in advance of the new mandate starting in August, hence ensuring continuity of this successful institution.

Although the size of public expenditure remains high, it is estimated to decline at 53% of GDP in 2003, against 56% in 2002. After the improved revenue performance recorded in 2002, with an estimated consolidated budget deficit revised downwards at 9,6% of GDP (4,3% after grants), for 2003 the authorities target a level of 6,4% of GDP (2,2% after grants). By adding external and internal debt (frozen foreign currency deposits and domestic arrears) total public debt reaches 80% of GDP, and war damage liabilities may add a potential risk.

Contrary to previous estimates, data revisions showed in 2002 a sharp deterioration in the current account deficit (at 20% of GDP excluding official transfers), mostly explained by the effect on imports of a credit boom and improved border controls. On a positive note, a larger part of the capital account was financed by FDI, which nearly doubled. In the first quarter of 2003, some improvement is visible, with a current account deficit reduction of 5,5% relative to the first quarter of 2002. The deteriorated current account deficit has started showing its effects on gross official reserves, which in the first quarter of 2003 have declined to 3,5 months of imports cover (against 4,7 months at end-2002).

External debt reached 47% of GDP at the end of 2002 (revised downwards from the projected 52%) and is expected to decline slightly over the medium-term. The ratio of debt service to exports, which started to pick up in 2002 (8,5%), will continue to increase in 2003 (9,3%) – mostly due to repayments to the IMF and the World Bank - before going down in the coming years. BiH is not rated by the credit rating agencies. EBRD transition indicators, which reflect progress in reforms in Central and Eastern European countries, place BiH towards the low end of the scale, even though some progress has been recorded.

Overall, over the first semester of 2003, although BiH remained current on its external debt service obligations, the balance of payments and external debtor situation continued to be vulnerable due to large external deficits, declining foreign assistance, and high internal and external public sector indebtedness.

3.2 Former Yugoslav Republic of Macedonia (FYRoM)

Economic data for the first months of 2003 show some positive signs after a modest 0,7% annual growth in 2002. According to preliminary unofficial estimates, GDP growth reached 2,2% in the first quarter of 2003. Both real GDP growth and average inflation are expected to reach about 3% by year-end. In April 2003, the IMF Executive Board approved a new 14-month Stand-By Arrangement of SDR 20 million (around € 25 million), in favour of the fYRoM. The 2003 budget agreed with the IMF foresees the general government deficit at 2% of GDP, which represents a significant fiscal adjustment of more than 3% with respect to 2002. Central government budget execution was satisfactory in the first five months of 2003, recording a surplus of 0,1% of GDP against a projected deficit of 1,2%.

Foreign trade increased by 27% in the first five months of 2003 compared to the same period of the previous year. The rise in imports was well above the projections, contributing to the worsening of the trade deficit which amounted to almost USD 400 million in the first five months of 2003. The 2003 current account deficit is forecasted at around 7% of GDP. Significant foreign financial assistance, amounting to more than USD 130 million is expected to finance the balance of payments needs.

In the first half of the year, foreign exchange reserves had been maintained to a level equivalent to four months of imports, which is the target set by the IMF programme. The external debt reached almost 40% of GDP at the end of 2002, a rather moderate level compared to other countries in the region, and is expected to decline by around three percentage points in the course of 2003.

In the short-term, there seem to be no major risks, apart from an expected increase in public expenditure in the second half of the year, which could increase cash flows in the economy and put some pressure on the fixed exchange rate, in case these flows were directed towards foreign goods. In the medium-term, the main risks remain associated with the persistent ethnic tensions within the country.

Overall, over the first semester of 2003, the risk profile of the country improved thanks to the signature of the new IMF agreement, which provided a sound medium-term macroeconomic framework for the country and allowed the release of frozen foreign assistance. This shows in the ratings given by the main credit agencies.

3.3 Serbia and Montenegro

In the first half of 2003, macro-economic policies in Serbia and Montenegro continued to be geared towards sustaining macro-economic stability in line with the current IMF programme, a three-year Extended Arrangement approved in May 2002. Structural reforms continued, although at a somewhat slower pace compared to the previous year, in particular with respect to the restructuring of large enterprises. A 4% real GDP growth is projected for 2003.

Actual external developments so far in 2003 present a mixed picture. The current account seemed to have improved somewhat owing mainly to a lower import demand, but the capital account came under pressure during the first quarter, as a result of a number of factors, such as the re-purchase of Serbian Telecom shares from Telecom Italia, some delays in obtaining external assistance, and a general temporary decline in confidence following the assassination of the Serbian Prime Minister in March. This led to a temporary loss in official foreign exchange reserves, which was overcompensated during the second quarter. For the first half of 2003 as a whole, official reserves increased by some USD 250 million. The exchange rate of the Dinar depreciated by some 5-6% vis-à-vis the euro and remained broadly unchanged in real effective terms, in line with the authorities' objective to use exchange rate policies to anchor inflation expectation while taking into account export competitiveness.

Overall, following the assassination of Prime Minister Djinjic in March 2003, the external outlook of the country, and in particular the prospects for private capital inflows, including FDI, appear to be less certain. Against this background, the IMF has revised its balance of payments projections for the current year in the context of the second programme review that was successfully concluded by the Board in end-July 2003. The revised projections point to additional balance of payments needs, also as a result of lower than earlier projected net inflows of FDI (USD 623 million instead of USD 731 million).

Following a debt restructuring agreement with the Paris Club reached in November 2001, substantial debt relief is being provided by official creditors while negotiations with the London Club of private creditors have not yet been concluded. The external debt stood at USD 11,8 billion or 76% of GDP (end-2002) and the country remains one of the most highly indebted countries in the region, particularly in comparison to its level of exports.

Debt service obligations are projected to rise considerably from around USD 183 million in 2002 (5,7% of exports of goods and services) to USD 466 million (10,7%) in 2003 and USD 761 million (14,8%) in 2004.

This ratio will deteriorate further over the rest of the decade, as a result of the expiration of grace periods of restructured debt or of the greater reliance of shorter-term debt.

4. NEWLY INDEPENDENT STATES

Save for the Ukraine, debt sustainability remains a major issue in the region and calls for further progress in structural reform.

4.1 Armenia

The Armenian economy continued to experience strong growth also in the first half of 2003 with real GDP growing at 14,8% year-on-year. In 2002 real GDP growth had reached 12,9%. Economic growth is driven by the diamond polishing, construction, mining and metal sectors. The present construction boom is financed to a large extent by private transfers from abroad while the mining and metals sectors have benefited from foreign direct investment. The Central Bank's target is to keep inflation below 3%. In mid-2003 the consumer price inflation picked up to 4% year-on-year due to temporary shortages in food supplies and increases in utility prices.

The government managed to narrow the fiscal deficit significantly in 2002. The central government deficit for 2002 was lower than expected at 0,6% of GDP (down from a deficit of 3,8% in 2001, on commitments basis). Expenditures were lower than budgeted and revenue collection targets were met comfortably. Reflecting both strong growth in domestic demand and better tax administration, VAT was the main factor contributing to the improved tax revenue to GDP ratio (up from 14,4% in 2001 to 14,6% in 2002). According to preliminary information, tax revenues continued to grow in the first half of 2003 at about 12% in nominal terms.

The current account deficit was narrowed further during 2002 to about 6,5% of GDP (9,5% in 2001). In the first half of 2003, growth in import spending has outpaced that of export revenues but owing to projected official and private transfers, it is expected that the deficit will deteriorate only moderately from last year. Armenia formally joined the WTO in February 2003.

Armenia's external public and publicly guaranteed debt stock was USD 1,03 billion at the end of March 2003 i.e. remains unchanged in nominal terms from the level at the end 2002 when the external debt amounted to 43,3% of GDP. Nearly 80% of the debt is contracted on concessional terms. The NPV of the external debt stock is estimated to have decreased from 129% of exports in 2001 to about 120% in 2002. Debt service amounted to about 10% of exports of goods and services. It is projected that as a result of the agreed debt-to-equity swap with Russia, the NPV of the external debt will be reduced to 91% of 2003 exports when the swap takes place. The Central Bank's gross international reserves increased in 2002 and they are at a comfortable level equivalent to about 4,5 months of imports.

4.2 Belarus

The marked slowdown in economic growth recorded in recent years (from over 10% y-o-y five years ago to about 3,5% in the year to 2003) underlines the limits inherent in the Belarusian economic model. Indeed, whereas Belarus produced the highest growth rates in the Commonwealth of Independent States during the late 1990s, since 2001 it has lagged behind several countries that shared similar economic circumstances during the Soviet era.

Belarus's ability to sustain even weak economic growth depends on its continuing ties with Russia, as the latter absorbs a substantial portion of Belarus's manufactured exports. However, excessive reliance on the Russian market has created a volatile environment for Belarusian manufacturers, as seen after the collapse of the Russian rouble in August 1998, when a drop in Russian demand for Belarusian manufactured goods sparked a sharp dip in Belarusian growth.

The Belarusian state-centred economic model is designed to perpetuate the administration's tight control over the country's political and economic space, and to prevent social unrest. The government ensures high employment levels, widespread subsidies and rising real wages. However, economic collapse has been prevented only through a ready supply of cheap credit to agriculture, construction and selected manufacturing industries. This has been achieved by infringing on the independence of the National Bank of Belarus and by forcing commercial banks to provide soft loans at the cost of spiralling inflation, widespread shortages and the collapse of the national currency. The high inflation is a direct consequence of the expansionary monetary policies needed to keep outmoded and inefficient economic structures in place. Although administration officials are aware of the dangers of inflation and the consequences of insufficient foreign-currency inflows, they have been unwilling to abandon the economic model that underpins their political control and continued legitimacy. This stance has consistently blocked the resumption of any financing by the IMF.

Nevertheless, since the start of 2000 the government has grudgingly accepted the need to unify the currency's various exchange rates, has replaced all quasi-fiscal operations by the central bank with subsidies through the government budget and has promised to curb pressure on the commercial banks to issue credit to key sectors. The government's exchange-rate liberalisation and the proposed currency union with Russia could be a major improvement, when underpinned by comprehensive structural reforms. The Belarusian authorities, unable to meet this demand and in desperate need of foreign currency to reduce inflation, have increasingly turned to Russia. The latter has provided loans to help stabilise the Belarusian rubel, and is likely to continue to do so in advance of the planned currency union between the two countries. Since late 2001 the government has been negotiating the sales of petrochemical enterprises to Russian companies - in the hope that this might provide the additional financing needed to preserve economic growth and low unemployment without needing to change current policies. The country's fiscal situation is a bright spot against the background of an otherwise dismal economic performance, thus explaining some improvement in the credit rating of the country.

4.3 Georgia

Preliminary data for the first half of 2003 give a higher than expected real GDP growth rate of 8,6% year-on-year (real GDP growth reached 5,4% in 2002 as a whole).

The construction of a new oil pipeline from Azerbaijan to Turkey through Georgia is having a strong effect on the Georgian economy in 2003 and 2004. There are spill over effects to other sectors of the economy, notably transportation and other services. Industrial production and agriculture have also registered fairly strong growth recently. Interruptions in the energy supply continue to plague production, however. Owing to a good harvest and relatively tight monetary policy, consumer price inflation has slowed down somewhat during the first half of 2003 compared to 2002 when the average inflation rate was 5,6%.

Some measures were taken in 2002 to improve tax revenue collection but the overall implementation record still remained weak in the first half of 2003.

The government's proposal for a more comprehensive reform of the tax code has been blocked by the parliament. Due to over optimistic expectations concerning non-tax revenues, notably privatisation proceeds and grants, the government is under strong pressure to restrain expenditures in 2003. In order to resume financing from the IMF, the government was requested in March 2003 to implement fiscal adjustment measures which would have corresponded to about 1,5% of GDP. Since these measures were not approved by the parliament, Georgia's PRGF arrangement with the IMF is effectively off-track.

Georgia's current account deficit for 2002 is estimated at about 7% of GDP. Owing to a rapid increase in imports during the construction of the Baku-Tbilisi-Ceyhan oil pipeline and a parallel gas pipeline, the current account deficit is projected to deteriorate to between 12-17% of GDP in 2003-2004. Foreign direct investment will cover these increases in the deficit. The National Bank's gross international reserves increased during 2002, but they still amount to no more than the equivalent of 1,7 months of imports.

Georgia's public and publicly guaranteed external debt stock was USD 1,75 billion (about 52% of GDP) at the end of 2002, and its net present value amounts to over 300% of central government revenues. Because of the projected increase in the external debt service from 2003 onwards, Georgia is expected to seek an additional rescheduling of its bilateral debts. In the absence of a working arrangement with the IMF, Georgia will not be able to approach the Paris Club to request an extension of the consolidation period to take into account the year 2003 maturity as originally provided for in the agreement with the Paris Club creditors in March 2001. Therefore, debt sustainability still remains a serious concern in the short and medium term.

4.4 Moldova

A generally sound policy mix is expected to ensure moderately strong growth at around 4-5%, and to contain significant price and currency instability. However, reforms continue to proceed slowly, and the economy remains narrowly based. This brings significant risk, which is exacerbated by Moldova's structurally high current-account deficit. Even with oil prices easing relatively quickly by 2004, and a 4% cumulative rise in food and beverage export prices in 2003-04, Moldova is expected to record annual trade deficits equivalent to roughly 25% of GDP, and annual current-account deficits ranging between 7% and 8% of GDP in the coming years.

The risks created by Moldova's narrow export base are mitigated to some extent by the likelihood that transfers (primarily technical aid and humanitarian assistance) will continue to record a large surplus, and that inflows of remittances from abroad (which are recorded as income rather than transfers) will remain large. These remain of crucial importance for Moldova, which will continue to struggle to access external financing or attract investment. Inflows of foreign direct investment (FDI) will remain low and the Eurobond market out of reach.

The government is unlikely to reverse the fiscal improvements achieved since 1999, but has little room for manoeuvre, given the limited financing options. It has failed to secure IMF and World Bank financing in 2003, except small sums for targeted projects, and its Lei 685 million (USD 48 million) privatisation target remains unrealistic. Faced with a financing shortfall and sizeable debt-repayment obligations, the government has therefore had to revise its 2003 budget in order to target a surplus. A new boost in government domestic borrowing is likely, since the Parliament has already authorised the government to borrow almost Lei 600 million from the National Bank of Moldova.

In 2004 problems with budget planning and implementation are unlikely to diminish, as a result of poor administrative capacity, of the continued risk that parliament might force through populist measures, as well as of additional delays to multilateral and bilateral financing inflows. In particular in the first quarter of 2004, debt servicing needs are huge, which could become highly problematic.

4.5 Tajikistan

Tajikistan experienced high economic growth also in the first half of 2003 when real GDP growth reached about 8,5% year-on-year according to preliminary data. For the year 2002 as a whole the growth rate was 9,1%. The aluminium sector still dominates industrial production with about 60% of total industrial output but in the first half of 2003 there have been positive signs of recovery in the light industry as well. Relatively strong growth is also continuing in the agricultural sector driven by the cotton production. Consumer price inflation is persistent at an annual average of about 15% owing partly to exogenous factors (severe winter, energy prices) but also because of occasional lapses in the monetary policy.

The overall fiscal balance for the year 2002 came out better than expected since the authorities directed higher than expected revenues to debt reduction rather than to increases in expenditures. Therefore, general government finances were close to balance with a small deficit of 0,1% (excluding public investment projects of about 2,5 % of GDP). Due to high economic growth and better tax collection, the tax to GDP ratio increased from 14,1% in 2001 to 14,7% in 2002. In 2003 fiscal revenues have so far exceeded targets, and the government continues to exercise prudent fiscal policy with a view to creating room for increases in much needed social and health expenditures in line with the Poverty Reduction Strategy Paper which was adopted last year.

The current account position improved in 2002 when the deficit was reduced to about 2,8% of GDP (7,2% in 2001). Excluding transfers, the current account deficit is estimated at about 18% of GDP. In 2003 the deficit will likely widen again partly due to an expected decline in humanitarian assistance and other transfers. A recovery in export prices of cotton and aluminium combined with an increase in export volumes mitigates the deterioration, however.

The bilateral debt rescheduling agreements with Russia and Uzbekistan contributed to a reduction in Tajikistan's external debt from USD 1.017 million (98% of GDP) at the end of 2001 to USD 976 million (82% of GDP) at the end of last year. Debt service was a high burden on the country corresponding to over 40% of fiscal revenues and about 23% of exports. Reaching USD 96 million at the end of 2002, the National Bank's gross international reserves did not increase in pace with the increase in imports. Therefore, international reserves corresponded to only 1,8 months of imports in early 2003.

4.6 Ukraine

Ukraine's GDP growth accelerated from 4,1% in 2002 to 7,5% in the first half of 2003 (year-on-year), amply exceeding expectations. GDP is projected to expand at rates in the 5-6 % range throughout the forecasting period. This high rate of economic expansion, combined with the effect of the poor harvest on food prices, has rekindled inflationary pressures (after last year's unprecedented deflation) but inflation is expected to remain in single digits in 2003. Reflecting the faster than expected economic growth, fiscal performance in the first half of the year was much stronger than budgeted (the consolidated government posted a cash surplus equivalent to 1% of annual GDP). The government has to clear however an important stock of arrears on VAT refunds, estimated at about USD 2,5 billion at end-June 2003.

For 2004, the authorities have informally agreed with the IMF on a consolidated budget deficit target of 1,4% of GDP.

The balance of payments remains in a relatively comfortable position. The current account continues to show a large surplus. The surplus is projected to reach about 8 % of GDP in 2003 but to shrink during 2004-06 as domestic demand gradually replaces net exports as the main source of growth. The Hryvnya has been remarkably stable in nominal terms and the real exchange rate remains at a competitive level. Official foreign exchange reserves have continued to increase and stood in August 2003 at a level equivalent of 3¼ months of imports. In December 2002, Ukraine regained access to the international capital markets with the issuance of a USD 350 million eurobond, which was followed in early June 2003 by the successful placement of a 10-year, USD 800 million eurobond. Secondary market yield spreads on Ukraine eurobonds have narrowed very substantially since mid-2001 and Ukraine's international ratings are being upgraded.

Progress with structural reforms, which slowed down significantly in 2001-02, remains the country's key economic challenge. Since the beginning of the 2003, encouraging measures have been taken, including tax reform and the adoption of new pension legislation, but progress in other areas, notably the energy sector, remains very disappointing.

Ukraine is currently negotiating a pre-cautionary stand-by arrangement with the IMF and intends to repay ahead of schedule all its debts to the IMF. It is also discussing with the European Commission the possible policy conditions to be attached to the disbursement of a new macro-financial assistance of up to EUR 110 million approved by the Council in July 2002.

5. OTHER NON-MEMBER COUNTRIES

Vulnerability to external shocks remains high in these economies despite some improvement in their fundamentals.

5.1 Algeria

Overall, the May 21 earthquake is not expected to have had a major immediate impact on growth and the fiscal and external position in 2003. Supported by continued expansionary fiscal policies and relatively high oil prices growth is expected to increase to around 6% of GDP. The Algerian parliament has approved a supplementary budget allowing for a spending increase of 3,5% of GDP to provide for the construction of housing and assistance for the affected population.

The fiscal stimulus stemming from the supplementary budgetary law is expected to result in a pick-up in non-hydrocarbon and non-agricultural production, largely surpassing the negative growth consequences of the destruction in capital stock linked to the earthquake. As a consequence of the additional public spending, the fiscal accounts are expected to turn from a near-balanced position in 2002 to a 0,4% deficit of GDP in 2003 (1,2% deficit of GDP in 2004).

Algeria continued to considerably strengthen its external position in 2003. High hydrocarbon prices coupled with the maintenance of relatively prudent macroeconomic policies have lifted gross official reserves to USD 27 billion in June 2003. Moreover, Algeria is expected to achieve another substantial current account surplus in 2003 (8,1% of GDP) reducing its foreign debt level to around USD 21,4 billion (around 35% of GDP) at the end of this year, while the debt-servicing ratio is heading below the 20% level.

However, the IMF points to Algeria's persisting economic and financial vulnerability vis-à-vis a lasting decline in oil prices, which has increased due to the financing needs of post-earthquake reconstruction. Oil revenues currently account for 95% of export revenues and 60% of budgetary revenues.

Should oil prices drop to USD 15 per barrel from 2004 on, the stock of external reserves would be reduced to less than 4 months of imports by end-2008. Altogether, the credit ratings of the country are however improving.

5.2 Argentina

Argentina continues to recover from its worst economic and financial crisis ever. The authorities and the IMF have recently raised their GDP growth projections for 2003 to 6 % and 4,75 %, respectively, which compares with a GDP drop of nearly 11 % last year. At about 18 %, the unemployment rate remains high, however. Inflation has decelerated further, with the CPI increasing by only 2,5 % in the first seven months of 2003.

Fiscal performance in the first half of 2003 was better than expected, reflecting buoyant collections from the income tax, the VAT and trade taxes and continued tight control over spending. This allowed Argentina to outperform the IMF fiscal targets both at federal and provincial levels. These trends are consistent with the programme target of a consolidated primary surplus above 2,5 % of GDP for 2003 as a whole.

Despite the announcement of the lifting of the corralón (remaining restrictions on deposits withdrawals) in April 2003, private bank deposits have continued to show a slight upward trend, while the exchange rate has been moving, most of the time, within a relatively narrow range after recovering strongly between June 2002 and June 2003. The current account remains in comfortable surplus but the surplus is shrinking due to the recovery of domestic

demand. The IMF is now projecting a current account surplus of 6,3 % of GDP for 2003 as a whole, down from last year's 9,5 % of GDP.

Progress with structural reforms since the IMF approved a transitional stand-by arrangement (SBA) last January has been disappointing, partly reflecting the interim nature of the previous government. While there has been some progress with the redemption of provincial and federal quasi-moneys and the reform of the tax administration, progress in other areas, in particular the banking system, the adjustment of utility tariffs and the discussions with private bondholders on the restructuring of the debt, has been limited. Moreover, in July, the government took a structural step backward by introducing certain capital controls.

In September 2003, the IMF Board is to approve a new 3-year SBA for Argentina that would effectively refinance its repurchases to the IMF during that period. The approval of the new arrangement should come after more than a month of difficult negotiations, at one stage of which Argentina failed to make a USD 2,9 billion repurchase to the IMF. Given Argentina's still very difficult debt service profile and the uncertainties over the amount of fiscal consolidation Argentina will undertake in the coming years, Argentina's risk of default remains high and is reflected in deteriorated credit ratings.

5.3 Brazil

The improvement of Brazil's financial indicators that began to be observed at the end of last year, following the turmoil associated with the October presidential election, continued during the first half of 2003. The orthodox and responsible policies adopted by the new administration have undoubtedly contributed to this improvement.

The exchange rate stands now at a considerably stronger level, yield spreads on Brazil's eurobonds have narrowed significantly, and the country's access to the international capital has improved, with the government having been able to place a number of bond issues and to successfully conclude a Brady Bond exchange.

Inflation is on a downward trend and is now projected to fall below 10 % by end-2003. This has allowed the central bank to cut interest rates rather aggressively in recent months. The fiscal targets agreed under the IMF programme were outperformed in the first half of 2003, leaving within reach the primary surplus target of 4,25 % of GDP defined for the year as a whole.

The still competitive level of the exchange rate continues to support export growth. But despite strong export performance, GDP growth remains sluggish due to the persistent weakness of domestic demand. GDP growth is now projected to reach 1,5 % this year (the same rate as last year). The current account has continued to improve, posting a small surplus in the first half of the year. This compares with a deficit of 4,5 % of GDP in 2001. At the same time, however, FDI inflows have dropped dramatically, reflecting adverse external conditions and the virtual completion of Brazil's privatisation programme.

Despite this strengthening of Brazil's financial situation, the country remains vulnerable to financial turmoil. A burdensome debt service profile, weak economic growth, lingering market doubts about the government's political ability to push forward its structural reform agenda (notably in areas such as pension and tax reform), and the contagion risks stemming from a still convalescent Argentinean economy, tend to keep Brazil's credit risk relatively high.

5.4 Jordan

Growth performance was strong up to 2003, reaching 5% in 2002. However the impact of the war in Iraq adversely affected performance in the first quarter of 2003 but growth is likely to reach 3% for the year as a whole. Inflation remained subdued in the first half of 2003, with the end of period CPI likely to be around 2%. Strong export growth continued into 2003 despite the conflict in Iraq (a major trade partner) and tourism has appeared to recover fairly quickly after the conflict. The current account will remain in surplus, particularly due to additional donor assistance, which has resulted in reserves building to over USD 4,5 billion by the end of July 2003 or over 10 months of imports.

Jordan's external vulnerability has been lowered in recent years due to improved policy performance and structural reforms including privatisation. This is reflected in stronger economic indicators and a higher level of reserves, which increases Jordan’s resilience to external shocks. Although its debt level can be still regarded as high, expected continued sound policy performance and reforms will lead to further improvements in external accounts and the debt situation in 2003 and beyond. Government external debt has been reduced from 95% of GDP in 1998 to around 80% in 2003 and the authorities are aiming to reduce the debt stock to less than 60% of GDP by 2007 using privatisation proceeds and by increasing fiscal revenues to reduce deficits. Importantly, the debt service ratio has also decreased substantially from around 34% ten years ago to 21% in 2003, reducing the risk of external default.

Nevertheless, Jordan’s external debt level remains very high with virtually all external liabilities denominated in foreign currency, reflecting external creditors unwillingness to expose themselves to the risk of a devaluation. These factors, as well as the difficult regional environment, constrain Jordan’s credit rating to speculative grade.

List of abbreviations

CPI	Consumer Price Index
EC	European Community
EIB	European Investment Bank
EU	European Union
€	Euro
FDI	Foreign Direct Investment
PRGF	Poverty Reduction and Growth Facility
GDP	Gross Domestic Product
IMF	International Monetary Fund
SBA	Stand-By Arrangement
USD	Dollar of the United States of America