COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 12.01.2005
COM(2004) 836 final

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REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget situation at 30 June 2004

SEC(2004) 1629

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Part One: Events since the Report at 31 December 2003, 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 EC with macroeconomic objectives (balance-of-payments loans to Member States and macro-financial assistance loans to non-member States) and loans with microeconomic objectives (Euratom and EC-NCI[2] loans in Member States and Euratom and European Investment Bank loans outside the Community[3]).

2. EVENTS SINCE THE REPORT AT 31 DECEMBER 2003

Regarding macro-financial assistance provided to third countries, Council decision (2004/580/EC) of 29 April 2004 granted exceptional macro-financial assistance to Albania for a total amount of EUR 25 million, of which EUR 9 million in loans. A loan disbursement of EUR 10 million was carried out on the basis of the existing decision in favour of Bosnia and Herzegovina.

Regarding Euratom, a new Commission decision (C(2004)891/2) was adopted on 30 March 2004 in relation with the Cernavodă plant in Romania. A loan disbursement was carried out on the basis of an existing decision in favour of Bulgaria (Kozloduy, EUR 35 million).

A new Commission decision amending decision (C(2000)3812) of 13 December 2000 will be adopted in the second half of 2004[4] in order to reduce the loan amount decided in favour of Ukraine for K2R4 plant.

With a view to the accession of ten new Member States on 1 May 2004, the Commission proposed an amendment to Council Regulation No 2728/94 establishing a Guarantee Fund for external actions, as amended. The amendment would withdraw the loans to the new Member States from the Guarantee Fund (while maintaining the Community guarantee coverage for those loans) as these countries are no longer "third countries". The amendment has not yet been adopted by the Council. Therefore, in the remainder of this report, unless otherwise stated, all figures are calculated including the new Member States that acceded in May 2004. Where

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1 Please note that the annex contains a Commission Staff Working Paper with a set of detailed tables and explicatory notes to this report.

2 New Community Instrument, not active since 1995. The last loan will be fully amortized by 17.12.2004.

3 The details concerning the EIB Mandates are displayed in Table A1 of the annex.

4 C(2004)2817/3 of 20.7.2004 (EUR equivalent of USD 83 000 000).

stated, key figures are reported excluding these countries as it is expected that the amendment will be adopted by the Council at the end of 2004 or early in 2005. The amount that would be freed from the Guarantee Fund and transferred back to the Union budget if the amendment is adopted is EUR 338 831 402.

According to the Commission Communication on Financial Perspectives 2007 - 2013[5], the amount of the Reserve will theoretically not 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 follows the established measures of capital outstanding, maximum annual risk and maximum theoretical annual risk borne by the Community budget (methodology 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 2004

The total risk at 30 June 2004 came to EUR 15 519 million, as against EUR 15 062 million at 31 December 2003.

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 2004*		**EUR million (rounded)**
Amount outstanding at 31 December 2003		15 062
Loan repayments		
	Euratom	
	NCI	
	macro-Financial assistance	- 7
	EIB	- 661
Loans disbursed		
	Euratom	35
	NCI	
	macro-Financial assistance	10
	EIB	1 217
Exchange rate differences between EUR and other currencies		- 138
Amount outstanding at 30 June 2004		15 519

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

The capital outstanding in respect of operations in the Member States was EUR 5 431 million at 30 June 2004, compared with EUR 24 million at 31 December 2003.

5 COM(2004) 487.

The capital outstanding from non-member States at 30 June 2004 was EUR 10 088 million, compared with EUR 15 037 million at 31 December 2003.

The major changes in these figures are due to the transfer of accession countries from the "third countries" section to the "Member States" section as of 1 May 2004 (See Section 2 "Events since the report at 31 December 2003").

3.2 Maximum annual risk borne by the Union budget: operations disbursed at 30 June 2004 (see Table A2 in Annex)

- For 2004 the total risk amounts to EUR 1 088 million.
- The risk in respect of the Member States comes to EUR 325 million.
- The risk in respect of non-member States comes to EUR 763 million.

3.3 Maximum theoretical annual risk borne by the Union budget: operations disbursed and decided at 30 June 2004 (see Table A3 in Annex)

- For 2004 the maximum theoretical risk amounts to EUR 1 194 million and is estimated to reach EUR 3 667 million in 2012.
- 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 869 million for 2004. The risk is estimated to reach EUR 3 404 million by 2012.

4. ACTIVATION OF BUDGET GUARANTEES

4.1. Payments from cash resources

The Commission draws on its cash resources[6] 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 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 Union budget, the Community guarantee is called upon at the earliest three months after the date on which payment has fallen due. The Community will act within three months of

[6] 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.

receiving such a letter from the EIB calling for the guarantee to be activated, authorising the EIB to take the corresponding amounts from the Guarantee Fund.

Default interest owed by loan beneficiaries for the time between the date on which cash resources are made available by the Union budget and the date of activation of the Fund is drawn from the Fund and repaid to the Union budget. For EIB loans, default interest is calculated during the period between the due date of a defaulted loan instalment and the date of receipt of the cash resources by the EIB from the Commission.

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 Financial Perspectives[7].

Table A4 shows an estimate of the Community's lending capacity in respect of non-member States over the period 2004-2006 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 forecasted (see in Annex Table A4), an amount of EUR 208.07 million is expected to be used from the Guarantee Reserve in 2004[8], leaving EUR 12.93 million available for further guaranteed lending operations.

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 forecasted for 2004, the annual capacity available for loans is as follows:

– EUR 143.71 million for loans with a 100% guarantee under the Union budget, or

– EUR 221.09 million for loans with a 65% guarantee (in accordance with Council Decision 2000/24/EC of 22 December 1999).

Table 2 shows outstanding lending and loan guarantee operations for non-member States totalled EUR 15 658 million (figure including the 10 new Member States), at 30 June 2004.

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7 The annual figure entered in the 2000-2006 Financial Perspectives is EUR 200 million at 1999 prices; in 2003, the amount was EUR 217 million and it is EUR 221 million in 2004.

8 At the moment of finalising this report (November 2004), no new decisions on macro-financial assistance had been taken or launched. The use of the reserve could therefore be about EUR 17 million less than expected in June 2004.

Table 2: Outstanding lending and loan guarantee operations for non-member States in EUR million (rounded)	
1. Capital outstanding, EC (MFA), Euratom	1 499
2. Capital outstanding, EIB[1]	14 003
3. Payments defaults	2
4. Default Interest	1
5. Unpaid interest due[2]	153
Amount outstanding at 30 June 2004	15 658

[1] including the ten new Member States

[2] 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 10.34%, 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 2004

At 30 June 2004, the Guarantee Fund amounted to EUR 1 619.15 million. The following movements were recorded in the first half of 2004:

– The second transfer of 2003 was the subject of payment of EUR 2.25 million dated 2 January 2004;

– on 24 February 2004 a call was made on the Fund as a result of a default on a loan to the Republic of Argentina for an amount of USD 2 689 781.25 (EUR equivalent 2 140 523.04);

– at 30 June 2004, the total arrears (excluding default interest) with the Republic of Argentina amount to USD 7 907 132.83 (EUR equivalent 6 968 656.91);

– the Commission was informed by EIB about arrears on a loan to the Republic of Argentina for an amount of USD 2 687 444.26 which will lead to a call on the Fund in the second half of 2004;

– net revenue of EUR 29.2 million on investments from the Fund's assets as of 30 June 2004;

– the first annual transfer will amount to EUR 161.76 million from the Reserve into the Fund. A second transfer of EUR 20.115 million will be made at the same time as the Commission Decision (C(2004)891/2) allowing a new Euratom loan in Romania. The Fund's surplus of the year 2003 amounted to EUR 223.16 million. Those amounts will be netted under the mechanism for offsetting, resulting in a cash payment of EUR 41.285 million in the second half of 2004 from the Fund to the budget of the European Union.

7. RELATIVE SOLIDITY

The ratio between the amount in the Fund at 30 June 2004 (EUR 1 619.15 million) and the maximum theoretical annual risk for loans to non-member States in 2004 (EUR 869 million) is estimated to 93% (see Annex Table A3)[9]. The increase of the ratio to 93% compared with 78% at 31 December 2003, is mainly due to the change of status of the accession countries into Member States as of 1 May 2004. Assuming the Commission proposal on the withdrawal of the ten new Member States from the Guarantee Fund is adopted, the amount in the Guarantee Fund would come approximately to EUR 1 280 million and the ratio would be about 74%.

[9] Please note that the estimate for the maximum theoretical annual risk for the year 2004 reported in Table A3 refers to the 2nd half of 2004 only. For reasons of comparability, this amount has been normalised on a 12 month period 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. Unlike previous reports, the country risk evaluation is now presented separately in the Commission Staff Working Paper SEC(2004)1629). A brief summary of this analysis is provided below.

2. CANDIDATE COUNTRIES

General government debt and total external debt of **Bulgaria** have continued falling respectively to close to 40% and 55% of GDP, following the buy-back of some Brady bonds which reduced debt-to-GDP ratios by about 3 percentage points.

The outlook for the economy of **Romania** points to sustained economic growth, a further decline in inflation and a significant but stable current account deficit above 5.5% of GDP. The total foreign debt-to-GDP ratio remains low at around 34% of GDP.

Turkey remains vulnerable to external shocks and financial markets sentiment, in particular because of the sheer size of its rising public sector borrowing requirements, public debt and gross foreign debt (estimated at respectively 20%, 80% and 53% of GDP in 2004). The debt servicing to exports of goods and services ratio is projected at about 40% in 2004.

3. WESTERN BALKANS

The external debt of **Bosnia and Herzegovina** has been declining and is currently equivalent to 34% of GDP. The debt service ratio has also had a downward trend in the last two years and is expected to be 7% of GDP for 2004, while international reserves cover a comfortable 4.5 months of imports. However, a settlement concerning old claims on the government is expected to be reached in the near future and will increase public debt by at least 10% of GDP.

In 2003, the external debt of **Former Yugoslav Republic of Macedonia** as a share of GDP declined by 3 percentage points to 38%, and is expected to stay at the same level in 2004. Debt servicing obligations decreased to 14% of exports of goods and services in 2003 and are projected around the same level in 2004.

The external sector of **Serbia and Montenegro** remains vulnerable given weak export performance and uncertain medium-term prospects for private capital inflows. In 2004, the current account deficit is projected at 11% of GDP and the external debt-to-GDP ratio at 54%.

Financing requirements continue to be high, caused by rising debt servicing as grace periods run out.

4. NEW INDEPENDENT STATES

The gross international reserves of the Central Bank of **Armenia** are comfortably high, covering nearly four months of imports. In nominal terms the public external debt is about USD 1.1 billion, while as a ratio to GDP it is projected to decline further from about 39 percent in 2003.

In the first half of 2004, GDP growth in **Belarus** has reached an annual rate of 10.3%. Despite the improvement, however, the economy remains constrained on a number of counts; in particular, foreign exchange reserves are very low at less than one month of imports, while the country is now facing higher prices for gas supplies from Russia.

The gross international reserves of the National Bank of **Georgia** remain equivalent to only 1.5 months of imports. Georgia's public external debt increased in 2003, reaching about USD 1.8 billion (about 49.5% of GDP). In July 2004, Paris Club creditors agreed to a restructuring of Georgia's external debt expected to reduce debt service due to those creditors from USD 169.2 million to USD 46.4 million.

Moldova's economy has not made clear progress in tackling long-standing structural problems, such as an unsatisfactory business climate and reliance on a narrow range of traditional products. Macro stability remains elusive given the public sector's continuing inability to fully service foreign debt, high inflation and a constrained balance of payments situation.

Last June, an agreement was reached between **Tajikistan** and the Russian authorities allowing the Tajik external debt to fall to USD 700 million or about 50% of GDP. However, after a sizeable improvement in 2003, the current account deficit is widening again in 2004, due to the continuing strong increase in imports whose coverage by gross official reserves is projected at 1.9 months at end-2004, identical to the year before.

The balance of payments of the **Ukraine** is in a comfortable position as the current account shows a large surplus, projected to reach a record high of about 10 percent in 2004 of GDP (5.8 percent in 2003). This has resulted in a rapid accumulation of foreign exchange reserves at the National Bank, equivalent to nearly four months of imports. The public external debt to GDP ratio is expected to decline from 22.5% in 2003 to about 19% in 2004.

5. OTHER NON-MEMBER COUNTRIES

Despite the improvement in the macroeconomic situation, the risk associated with lending to, or investing in, **Argentina** remains high. The lack of progress with some key structural reforms and the delays in reaching a debt restructuring agreement with private creditors has led to a postponement of the third review under the current SBA with the IMF while the country continues to run arrears on some of its payments to the EIB (see section 6 in part one).

Although the rise in foreign exchange reserves, the comfortable current account position and the recent steps taken by the authorities to improve the composition of public debt have increased the country's resilience, **Brazil** remains vulnerable to a change in investor sentiment towards emerging markets.

Despite broadly unchanged debt stocks (in USD terms), the foreign debt/GDP ratio of **Algeria** is expected to fall by 5 percentage points to 30.6% of GDP in 2004 and the foreign debt service ratio from 79.5% in 2003 to 62.2% in 2004. Foreign debt is almost exclusively public medium and long-term debt and there have been no payment arrears over recent years.

While further efforts of fiscal consolidation are called for, there are no immediate concerns of sustainability given **Jordan**'s recent strong external performance (notably the large current account surplus and building up of reserves), which is expected to continue in the near future.