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 31 December 2005

{SEC(2006) 1071}

TABLE OF CONTENTS

Part One: Events since the Report at 30 June 2005, 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 30 JUNE 2005

Regarding macro-financial assistance provided to third countries, no new Council Decision was adopted and no further loan disbursement occurred in the second half of 2005.

Disbursements in the form of grants amounted to a total of EUR 29.5 million: EUR 3 million for Albania, EUR 1.5 million for Armenia and EUR 25 million for Serbia and Montenegro.

Regarding Euratom, no loan disbursement was carried out on the basis of existing decisions.

According to the Commission Communication on the Financial Perspectives 2007 - 2013[3], the amount of financing of the Guarantee Fund will not be explicitly 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 31 December 2005

The total risk at 31 December 2005 came to EUR 16,521 million, as against EUR 16,333 million at 30 June 2005.

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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 COM(2004) 487 of 14.07.2004.

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 31 December 2005*		EUR million (rounded)
Amount outstanding at 30 June 2005		16,333
Loan repayments		
	Euratom	0
	Macro-financial assistance	-111
	EIB	-1,243
Loans disbursed		
	Euratom	0
	Macro-financial assistance	0
	EIB	1,580
Exchange rate differences between EUR and other currencies		-38
Amount outstanding at 31 December 2005		16,521

* 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 2,966 million at 31 December 2005, compared with EUR 3,214 million at 30 June 2005.

The capital outstanding in respect of operations in non-member States at 31 December 2005 was EUR 13,554 million, compared with EUR 13,119 million at 30 June 2005.

3.2. Maximum annual risk[4] borne by the Union budget: operations disbursed at 31 December 2005 (see Table A2 in Annex)

– For 2006, the total maximum annual risk amounts to EUR 2,139 million.

– The risk in respect of Member States comes to EUR 617 million.

– The risk in respect of non-member States comes to EUR 1,522 million.

3.3. Maximum theoretical annual risk[5] borne by the Union budget: operations disbursed and decided at 31 December 2005 (see Table A3 in Annex) [6]

– For 2006, the maximum theoretical risk amounts to EUR 2,213 million and is estimated to reach, under certain assumptions, EUR 2,782 million in 2014.

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4 The technical term "maximum annual risk" is explained under point 1 in the Annex.

5 The technical term "maximum theoretical annual risk" is explained under point 1 in the Annex.

6 The maximum annual risk takes into account the amounts of loans remaining to be disbursed for the current financial perspectives as the new EIB Mandate 2007 to 2013 has not yet been decided.

– The maximum theoretical risk in respect of Member States remains almost stable at EUR 618 million in 2006.

– For the non-member States it amounts to EUR 1,594 million. The risk is estimated to reach EUR 2,604 million by 2014.

4. ACTIVATION OF BUDGET GUARANTEES

4.1. Payments from cash resources

The Commission draws on its cash resources[7] 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 (third countries) 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.[8]

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

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[9].

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 13,680 million at 31 December 2005.

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[7] 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.

[8] For more details, see Section 2.5. of the Annex.

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

Table 2: Outstanding lending and loan guarantee operations for non-member States in EUR million (rounded)	
1. Capital outstanding, EC (MFA), Euratom	1,465
2. Capital outstanding, EIB	12,089
3. Unpaid interest due[1]	126
Amount outstanding[2] at 31 December 2005	13,680

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

2 Payments Defaults and Default Interest are not included in the outstanding amount to be covered by the Fund and are reported separately in Section 6.

The ratio between the Fund's resources and outstanding capital liabilities, within the meaning of the Regulation establishing the Fund, was 9.7%, 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 31 DECEMBER 2005

At 31 December 2005, the Guarantee Fund amounted to EUR 1,323.94 million. The following movements were recorded in the second half of 2005.

– The first transfer into the Fund of EUR 140.11 million.

– The Fund's surplus of the year 2004 of EUR 187.13 million back to Union budget in 2005.

– Net revenue of EUR 25.6 million from investment of the Fund's assets as of 31 December 2005.

No recovery occurred in the second half of 2005.

The total arrears, at 31 December 2005, i.e. penalties interests with the Republic of Argentina, amount to USD 1,718,493.12, thereof, USD 1,448,433.44 (EUR equivalent 1,227,798.12) are still to be recovered by the Fund. The balance is due to the EIB.

7. RELATIVE SOLIDITY

The ratio between the amount in the Fund at 31 December 2005 (EUR 1,323.94 million) and the maximum theoretical annual risk for loans to non-member States in 2006 (EUR 1,590 million) is estimated at 83% (see Annex Table A3).

Part Two: Evaluation of 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, the quality of the risks which depend on the type of operation and the standing of the borrower should also be assessed. Tables on the country risk evaluation are presented separately in the Commission Staff Working Paper[10]. 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

Bulgaria has experienced a very strong expansion in the first half of 2005 followed by a considerable slow down in the third quarter. Real GDP growth reached 5.5% for the whole year. The deceleration was largely due to the heavy floods during the summer months. The current account deficit increased to 11.8% of GDP. Net FDI inflows remained strong, but unlike in previous years, FDI inflows fell short of fully financing the current account deficit in 2005 and covered only about 75%.

In 2005, the real GDP growth of **Romania** growth slowed to 4.1% mainly due to the negative impact of massive floods and structural changes affecting the industrial activity. The current account deficit marginally widened to 8.7% of GDP in 2005 from 8.4% in 2004 of which more than 85% was covered by net FDI and portfolio investments. In 2005, external debt inched up by only 2 % points to 34.5% of GDP.

Real GDP of **Turkey** grew by 7.4% in 2005 following an increase of 8.9% in 2004. The main sources of growth have been investment and private consumption. The current account deficit widened less than anticipated from 5.1% in 2004 to 5.8% of GDP in 2005. Public finances performed favourably, benefiting from strong growth and low wage growth in the public sector. The general government deficit (fiscal notification 2006, using ESA 95) fell from 11.3% of GDP in 2003 to 5.7% of GDP in 2004 and 1.2% in 2005 (or about 2% in GFS terms).

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10 SEC(2006) 1071

3. WESTERN BALKANS

GDP growth of **Albania** remained high at 5.5% in 2005. Large imbalances persist in the external sector. While the trade deficit is estimated to have remained above 23% of GDP in 2005, substantial private transfers from abroad have contributed to finance a current account deficit of an estimated 7.0% of GDP. Some progress was achieved in the management of public expenditures and revenues; nevertheless the strengthening of the tax administration and public sector governance remain among the key challenges for the new government.

Bosnia and Herzegovina maintained a stable macroeconomic environment in 2005, with the economy growing at around 5% as in 2004. Structural reforms continued to be rather slow, although some achievements were noted in the fields of indirect taxation and privatisation. In the absence of official statistical data the current account deficit can be estimated at 23% of GDP.

Economic growth of **The Former Yugoslav Republic of Macedonia** remained strong. In 2005, real GDP growth was 4.0%, largely unchanged from 4.1% in 2004. The current account improved significantly during 2005, with a decline in the deficit from nearly 8% of GDP in 2004 to about 1½% in 2005. About half of the improvement is due to higher exports. At the end of December 2005, official reserve assets of the National Bank stood at a level of EUR 1.1 billion, equivalent to slightly less than approximately 4 months of 2005 imports of goods and services. End-December gross external debt stood at some 38 % of GDP.

The economic performance of **Serbia and Montenegro** has been robust in 2005, driven by strong gains in trade, transportation, financial services and construction. GDP in Serbia is estimated to have grown by 6.5% year-on-year for the whole year and in Montenegro by 3.8% in the first nine months of 2005. The current account deficit is estimated at 8.5% of GDP. Strong FDI inflows have somewhat eased financing requirements. In both Republics, the reform momentum has again been strong in 2005 and in Serbia, the share of the private sector is estimated to have increased to 55% of GDP, as a result of progress in privatisation and restructuring of enterprises.

4. NEW INDEPENDENT STATES

Georgia's economic growth accelerated in 2005 to around 8% (6.2% in 2004) owing to strong performance of both industry and agriculture. The privatisation process took off last year, bringing revenues equivalent to approximately 3% of GDP. The current account deficit is estimated to have widened to about 10% of GDP (7.6% in 2004) owing to large inflows of capital goods for oil/gas pipeline and other infrastructure investment. The deficit was largely financed by inflows of foreign direct investment. Georgia's external debt decreased slightly in nominal terms to USD 1.8 billion at the end of 2005, while as a ratio to GDP the external debt is estimated to have decreased from 36% (2004) to about 30% (2005).

In **Ukraine**, a negative terms of trade shock (import prices of energy increasing while world market prices on metal exports tumbled) combined with sluggish investment under an uncertain government policy environment led to a hard landing, with a real GDP growth rate of 2.4% in 2005 (12.1% in 2004). Ukraine's public external debt of USD 13 billion is, however, at a sustainable level of about 16 percent of GDP. The international reserves of the National Bank of Ukraine doubled in 2005 mainly as result of privatisation-related capital inflows in the last quarter of 2005. The political uncertainties continued until March 2006 parliamentary elections. The rating agencies, however, maintained Ukraine's sovereign rating at BB (with stable outlook) supported by low government debt and good external liquidity.

Moldova's GDP growth exceeded again 7% in 2005 reflecting strong domestic demand boosted by booming remittances. The current account deficit widened to 7% of GDP in 2005 even if most of the growing trade deficit is covered by equally growing remittances. The budget surplus increased in 2005 owing to higher taxes collected on imports. In 2006 the budget may well turn to a deficit reflecting higher spending for social programmes and the expected settlement of Moldova's debt to the Paris Club creditors. Already in 2005, as a result of the exchange rate appreciation and of the GDP growth, the stock of the public and publicly guaranteed external debt went down to just one-quarter of GDP. The international reserves of the National Bank of Moldova have increased to represent more than two months of imports.

The economy of **Tajikistan** has continued to grow strongly in 2005, recording 7.5% real GDP growth, compared to 10.6% in 2004. The government budget surplus has been estimated at 0.1% in 2005 (a surplus has been recorded for the third consecutive year). Thanks to the successful bilateral debt agreement with Russia – Tajikistan's largest creditor – external debt has fallen to less than 40% of GDP in 2005. As a result, the current account deficit is estimated to have narrowed from 4% of GDP in 2004 to 3.6% in 2005. Import coverage of gross official reserves has improved slightly from 1.8 months in 2004 to 1.9 months by end-2005.