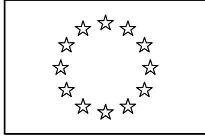

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.7.2007
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REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget
Situation at 31 December 2006

{SEC(2007)1050}

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1. INTRODUCTION[1] AND TYPES OF COVERED OPERATIONS

The risks covered by the budget of the European Union ("the 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, i.e. macro-financial assistance ("MFA") loans to third countries, and loans with microeconomic objectives (Euratom loans and European Investment Bank ("EIB") external lending[2]). These operations have been covered since 1994 by the Guarantee Fund for external actions ("the Fund")[3] which was set up, among other things, to limit the budgetary impact stemming from calls on guarantees given by the Budget for lending operations in third countries. If there are insufficient resources in the Fund, recourse will be made to the Budget.

The Council Regulation establishing the Fund (the "Fund Regulation"[4]), which was adopted in 1994, was first amended in 1999. Following a second amendment of the Council Regulation which was adopted in 2004 by the Council, the Fund's coverage is withdrawn if third countries become Member States. The Budget directly covers loans or guaranteed loans to Member States.

2. NEW LEGAL BASES

Under the new Financial Framework, the Interinstitutional Agreement of 17 May 2006 between the European Parliament, the Council and the Commission on budgetary discipline and sound financial management[5] has entered into force on 1 January 2007. According to this agreement, the provisioning of the Fund is carried out through a Budget line under Heading 4 (EU as a global player) and not, as before, through a dedicated Reserve.

In line with the Interinstitutional Agreement, the Fund Regulation had to be amended in order to reflect the cancellation of the Reserve. Consequently, a new Council Regulation was adopted on 30 January 2007[6], which in addition has provided the Fund with a new, more efficient provisioning mechanism in terms of the use made of budgetary means. Moreover, the transparency and programming of budgetary transactions have been enhanced.[7] The content of this report has been adapted in consequence thereof.

The Council decided on 19 December 2006[8] to grant a renewed Community guarantee to the EIB against losses under loans and loan guarantees for projects outside the Community. This Community guarantee is restricted to 65% of the aggregate amount of credit disbursed and

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[1] COM(2007)66 and SEC(2007)241 make up the previous report on the guarantees covered by the Budget at 30 June 2006.

[2] The details concerning the EIB mandates are displayed in Table A1 of the Annex.

[3] For the most recent report on the Fund, see COM(2006)695 "Comprehensive Report on the functioning of the Guarantee Fund" and the annexed staff working document (SEC(2006)1460).

[4] Council Regulation (EC, Euratom) No 2728/94 establishing a Guarantee Fund for external actions, OJ L 293, 12.11.1994, p.1, as amended by Council Regulation (EC, Euratom) No 1149/1999, OJ L 139, 2.6.1999, p. 1, Council Regulation (EC, Euratom) No 2273/2004, OJ L 396, 31.12.2004, p. 28, and Council Regulation (EC, Euratom) No 89/2007, OJ L 22, 31.1.2007, p. 1.

[5] OJ C 139, 14.6.06, p.1.

[6] Council Regulation (EC, Euratom) No 89/2007, OJ L 22, 31.1.2007, p. 1.

[7] For information on the old provisioning mechanism, see the report mentioned supra, footnote 1.

[8] Council Decision 2006/1016/EC of 19 December 2006, OJ L 414, 30.12.2006, p. 95.

guarantees provided under EIB Financing Operations, less amounts reimbursed and plus all related sums, with a maximum ceiling of EUR 27,800 million throughout the 2007 – 2013 period. This decision also stipulates that the Commission and the EIB shall enter into a guarantee agreement laying down the detailed provisions and procedures relating to the Community guarantee as well as a recovery agreement laying down the provisions and procedures in relation to the EIB's obligation to seek to recover amounts paid by the Community pursuant to a call on the Community guarantees.

There were no new decisions on MFA loans or Euratom loans in 2006.

3. EVENTS SINCE THE LAST REPORT AT 30 JUNE 2006

There were no disbursements under MFA loans during the second half of 2006.[9]

Regarding Euratom loans, there were no disbursements in the second half of 2006. Disbursement of a first tranche of EUR 39 million has taken place in March 2007 for the financing of a safety upgrade of Unit 2 of the Khmelnitsky and Unit 4 of the Rovno nuclear power plants (K2R4) under the loan agreement of 2004 (EUR equivalent of USD 83,000,000 Loan Facility Agreement).

4. DATA ON RISKS COVERED BY THE BUDGET

4.1. Definition of risk

The risks borne by the Budget derive from the outstanding amount of capital and interest in respect of guaranteed operations.

Defaulting operations will be covered by the Fund when they are linked to third countries (67% of the total outstanding amount guaranteed) and directly by the Budget where Member States are involved (loans to or for the benefit of projects in Member States account for the remaining 33% of the total outstanding amount). The large proportion of guaranteed loans linked to Member States is the result of the recent enlargement rounds. According to Article 1, third paragraph of the Fund Regulation, once a country becomes a Member State, the risk on the loans is transferred from the Fund to the Budget.

For the purpose of this report, two methods are used for evaluating the risks borne by the Budget:

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[9] MFA may also take the form of grants to third countries. For more information on MFA, see the annual report from the Commission to the Council and the European Parliament on the implementation of macro-financial assistance to third countries in 2006.
First and second payments of grant (EUR 11 million each) were paid to Georgia in August and December 2006 under the 2006 Council Decision.
Under MFA programmes of 1997 and 2000, the last grant disbursement to Tajikistan (EUR 7 million) was made in October 2006.
Albania also received a grant of EUR 13 million corresponding to the last instalment of a 2004 Council Decision.

– The method of calculating the total amount of capital outstanding for the operations concerned on a given date. This methodology gives the level of risk supported by the Budget on a given date.

– The budgetary approach defined as "the annual risk borne by the Budget" is based on the calculation of the maximum amount which the Community would have to pay out in a financial year assuming that all guaranteed loans are in default[10].

Table 1: Total outstanding amounts covered as of 31.12.2006 in EUR million

	Outstanding Capital	Accrued Interest	Total	%
Member States*				
MFA	365	2	367	2%
Euratom	436	6	442	3%
EIB	4,482	42	4,524	28%
Sub-total Member States*	**5,283**	**50**	**5,333**	**33%**
Third Countries				
MFA	604	6	610	4%
Euratom	-	-	-	
EIB	10,311	103	10,415	64%
Sub-total third countries	**10,915**	**110**	**11,025**	**67%**
Total	**16,198**	**159**	**16,358**	**100%**

* Including Bulgaria and Romania as they have joined the EU on 01.01.2007.

Tables A1, A2, A3 and A4 of the Staff working document[11] annexed to this report (the "Annex") provide other information on these outstanding amounts, in particular in terms of ceiling, disbursed amounts or guarantee rates.

[10] For the purpose of this calculation, it is assumed that defaulting loans are not accelerated, i.e. only due payments are taken into account (see also section 1 of the Annex).

[11] SEC(2007).

4.2. Risk linked to Member States

Current risks on Member States result from loans disbursed prior to accession.

In 2007, the Budget will bear a risk linked to Member States of EUR 812 million including Bulgaria and Romania as they have joined the Union on 1 January 2007. Table 2 shows that these two states are ranked first and second in terms of their outstanding amount.

Table 2: Ranking of the Member States according to the exposure with regard to the maximum risk borne by the budget in 2007 (EUR million)

Ranking	Country	2007	%
1	Romania*	263.4	32.4%
2	Bulgaria*	155.7	19.2%
3	Czech Republic	102.2	12.6%
4	Poland	98.4	12.1%
5	Slovakia	72.8	9.0%
6	Slovenia	39.2	4.8%
7	Hungary	35.6	4.4%
8	Cyprus	15.7	1.9%
9	Lithuania	14.8	1.8%
10	Latvia	8.5	1.0%
11	Estonia	4.7	0.6%
12	Malta	1.0	0.1%
	Total	812.1	100%

* Member States as of 01.01.2007

4.3. Risk linked to third countries

In 2007, the Fund will bear a maximum risk related to third countries of EUR 1,203 million. The top ten countries according to their total outstanding are listed below. They account for 78% of the risk borne by the Fund in 2007. The economic situation of these countries is analyzed and commented in Section 7 below.

Table 3: Ranking of the 10 most important third countries according to the exposure with regard to the maximum risk borne by the budget in 2007 (EUR million)

Ranking	Country	2007	% of the total maximum risk
1	Egypt	152.9	12.7%
2	Turkey	151.0	12.6%
3	Brazil	130.3	10.8%
4	Morocco	117.4	9.8%
5	Tunisia	112.2	9.3%
6	South Africa	93.6	7.8%
7	Lebanon	56.4	4.7%
8	Jordan	44.8	3.7%
9	Serbia and Montenegro[12]	43.5	3.6%
10	Ukraine	36.8	3.1%
Total of the 10		939.0	78.0%

The Fund covers the guaranteed loans of 38 countries and 2 regional entities with maturities ending 2035. Details by country are provided in Table A2 of the Annex.

4.4. Global risk covered by the budget

In total, the Budget will cover in 2007 a global amount of EUR 2,015 million representing the amounts due during the year, where 40% are represented by Member States (see Table A2 in the Annex).

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[12] Now the Republic of Serbia and the Republic of Montenegro.

4.5. Evolution of risk

The risk towards Member States should decrease in future as the loans are reimbursed and no new loans will be signed with Member States under Euratom, MFA or EIB guaranteed lending (see Graph A1 in Section 1.3 of the Annex).

MFA loans to third countries are subject to individual decisions by the Council. At present, there are no new proposals from the Commission concerning the grant of loans. However, a proposal for granting an MFA loan of EUR 50 million and a grant of EUR 30 million to Lebanon may be launched in 2007 by the Commission.

The Euratom lending to Member States or in certain eligible non-member countries (Russian Federation, Republic of Armenia, Ukraine) has a ceiling of EUR 4 billion of which around 85% have already been used. The remaining margin is about EUR 600 million.

Under the 2000-2007 EIB mandates, an amount of EUR 9,830 million remains to be disbursed. Moreover, at the end of 2006 the EIB has not signed any loan agreements under the Council decision concerning a special lending action for certain types of projects in Russia, Belarus, Moldova and Ukraine[13]. This decision has a ceiling of EUR 500 million with a guarantee rate of 100% and expires on 31 July 2007.

The most important item that will impact the risk for the budget in future is the recent Community guarantee granted to the EIB[14] during the period beginning on 1 February 2007 and ending on 31 December 2013 (with the possibility of an extension by six months). The Community guarantee is restricted to 65% of the aggregate amount of credit disbursed and guarantees provided under EIB Financing Operations, less amounts reimbursed and plus all related sums, with a maximum ceiling of EUR 27,800 million. This maximum ceiling is broken down into two parts: a basic ceiling of EUR 25,800 million and an optional mandate of EUR 2,000 million. The use of the optional amount will depend on the result of the mid-term review due in 2010. The basic ceiling is split into the following binding regional ceilings:

- Pre-Accession countries: EUR 8,700 million;
- Neighbourhood and Partnership countries: EUR 12,400 million;
- Asia and Latin America: EUR 3,800 million;
- Republic of South Africa: EUR 900 million.

In Section 1.3 of the Annex, Graph A2 simulates some scenarios of disbursements under the current mandates as well as the new mandate and their effect on the Fund provisioning.

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[13] Council Decision 2005/48/EC of 22 December 2004, OJ L 21, 25.1.2005, p. 11.

[14] See also Section 2 of this report.

5. DEFAULTS, ACTIVATION OF BUDGET GUARANTEES AND ARREARS

5.1. Payments from cash resources

The Commission draws on its cash resources in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying the Commission[15].

5.2. Payments from the Budget

No appropriation was requested under Budget Article 01 04 01, "European Community guarantees for lending operations", as no default was recorded in the second half of 2006.

5.3. Activation of the Guarantee Fund

In the event of late payment by the beneficiary of a loan (third countries) granted or guaranteed by the Community, the Fund is called on to cover the default within three months of the date on which payment is due.[16]

During the second half of 2006, the Fund was not called.

The total arrears at 31 December 2006, i.e. penalty interests with the Republic of Argentina, amount to USD 1,718,493.12. USD 1,448,433.44 thereof (EUR equivalent 1,099,797.60) are still to be recovered by the Fund. As the Fund was not called for the remaining difference, this amount is due to the EIB. The Commission and the EIB have on several occasions reminded the Argentinean authorities the need to fully clear these arrears before the resumption of new EIB lending operations in the country. Discussions on this issue will continue in the framework of the next meeting of the EU-Argentina macroeconomic dialogue.

6. GUARANTEE FUND FOR EXTERNAL ACTIONS[17]

6.1. Recoveries

No recovery occurred in the second half of 2006.

6.2. Assets at year-end

At 31 December 2006, the net assets of the Fund amounted to EUR 1,378,954,442.51.

At 31 December 2006, outstanding lending and loan guarantee operations plus accrued interest for Bulgaria and Romania amounted to EUR 2,899,334,719.06. As these countries became members of the European Union on 1 January 2007, an amount of EUR 260,940,124.72 was repaid to the Budget on 14 February 2007.

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15 Cf. 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.

16 For more details, see Section 1.4.3. of the Annex.

17 Annual Report from the Commission on the Guarantee Fund and its Management in 2006: COM(2007)362 and SEC(2007)869.

6.3. Target amount

The Fund has to reach an appropriate level (target amount) set at 9% of the total outstanding capital liabilities arising from each operation, plus accrued interest. The ratio between the Fund's resources (EUR 1,118,014,317.79) and outstanding capital liabilities (EUR 11,025,065,532.58) within the meaning of the Fund Regulation was 10.1%. Since this is higher than the target amount, a repayment from the Fund to the Budget has to be made, as provided for in the third paragraph of Article 3 of the Fund Regulation.

According to the new provisioning rules, this surplus of EUR 125,750,000.00 will be inserted in 2007 in the Preliminary Draft Budget of 2008.

7. EVALUATION OF RISKS: ECONOMIC AND FINANCIAL SITUATION OF THE THIRD COUNTRIES BENEFITING FROM THE MOST IMPORTANT EU LOAN OPERATIONS

7.1. Introduction

Previous sections of the report provide information on quantitative aspects of the risk borne by the Budget. However, the quality of the risks which depend on the type of operation and the standing of the borrowers (See Section 4.3) should also be assessed. Tables on the country risk evaluation are presented separately in the Commission Staff Working Paper. A summary of this analysis is provided below for the ten countries having the highest annual risk to the Budget in 2007. Section 2 of the Annex provides an analysis of eight further countries.

7.2. Egypt

The economic growth of **Egypt** increased from 4.6% in 2005 to 6.8% in 2006 due to the investment policy (especially FDI) and strong exports of goods and services. Inflation has been reduced to single digit but inflationary tendencies still exist. Unemployment remains persistently high at more than 10% of the labour force. Despite the improvement of economic situation and the sale of (semi-)state owned enterprises the general public deficit hardly narrowed (7.9% in 2006 compared with 9.6% for 2005). Reforms in the financial sector are progressing. The banking system is still largely dominated by the State despite the recent privatisation of one major bank. The reform of the financial sector should take two or three years before completion. Sound fiscal policy combined with adequate monetary policy should have positive effects on job creation.

7.3. Turkey

For **Turkey,** annual GDP growth amounted to 6.1% in 2006, as compared to 7.4% in 2005. Domestic demand grew faster than total output which caused the current account deficit to widen in 2006 to 7.9% of GDP compared with 6.3% in 2005. Private consumption slowed down in the second half of the year as a result of the monetary policy tightening that followed the volatility of May-June 2006. The reduction in growth is expected to continue in 2007 and the resulting stabilization of the current account deficit makes a soft-landing scenario a likely outcome. Although the current account has been comfortably financed, vulnerabilities remain as a reversal of flows could be triggered by domestic factors or an external shock. A comparatively high level of external debt (almost 50% of GDP) makes Turkey vulnerable to significant depreciation of the currency. Factors making the economy more resilient to shocks include, in contrast to the pre-2001 crisis situation, flexible exchanges rate regime and a

credible and independent Central bank. The official reserves of the Central bank amount to about EUR 45 billion in 2006 or over 5 months of imports.

7.4. Brazil

Brazil's growth, after slowing in 2005, recovered in 2006 to about 2.9% on the back of robust consumer spending and a recovery in private investment. Disinflation continued in 2006 to its lowest level since the adoption of the inflation targeting regime in 1998. While export growth slowed substantially in 2006 as a result of previous currency appreciation, improving terms-of-trade allowed the country to run a comfortable current account surplus in 2006 (estimated at 0.6% of GDP). Brazil's external vulnerability has eased with its external debt ratios declining significantly after the country fully repaid its debt to the IMF ahead of schedule at the end of 2005, and to the Paris Club in the first half of 2006. The country has also redeemed all its Brady Bonds. The external debt-over-GDP ratio has decreased from 36.4% in 2004 to 18.9% at the end of 2006. Efforts to reduce public external indebtedness are paying off: Brazil's sovereign credit has been upgraded by the leading credit-rating agencies. Significant vulnerabilities remain, however, despite recent progress with public debt management. Public debt remains above 50% and is highly exposed to interest rate variations as it has a relatively short average maturity.

7.5. Morocco

The economy of **Morocco** has registered a real GDP growth of 8.1% in 2006. This situation is due mainly to the exceptional harvest in agriculture and, more generally, to the dynamism of the different economic sectors. Inflation is still low with an annual rate of 3.3%. The public deficit has been reduced at 2.1% of GDP (compared with 5.3% for 2005). Public debt amounted to 57% of GDP. Unemployment is still at a rate of 9.7% while poverty (15% of the population under 2 USD per day) and high adult illiteracy (47.7%) still remain key challenges for Moroccan authorities.

7.6. Tunisia

Growth of the **Tunisian** GDP reached 5.8% in 2006 compared with 4% in the previous year (6% expected for 2007). Inflation accelerated from 2% to an annual rate of 4.7% for the first ten months of 2006 mainly due to the increase in international prices of oil. In order to curb this tendency the Central bank was forced to raise its key interest rate in 2006 (first adjustment in three years). The current account deficit reached 2.6% of GDP and the debt of the country amounted to 54.8 % of GDP. Unemployment is still high with an average of 13.4% of the labour force.

7.7. South Africa

South Africa annual GDP growth amounted to 5.0% (in real terms) in 2006 after 5.1% in 2005. Growth is expected to nearly reach the 5% level in 2007. In 2006 the Central Bank has increased the refinancing rate from 7.0% to 9.0% to keep inflation within a 3% to 6% range. The current account deficit widened to 5.6% of GDP in 2006 from 3.8% in 2005. It is expected to stay at around 5.0% in 2007. FDI and other capital inflows (portfolio investments) more than outweigh the current account deficit. This leads to increased net gold and foreign exchange reserves reaching 3 to 4 months of total imports. External debt to official creditors fell to 2.0% of GDP in 2006 - the lowest level in Sub-Saharan Africa (average 16%) - and is expected to fall to 1.9% in 2007. The fiscal deficit stayed at 0.4% of GDP in past two years

and is expected to turn to a slight surplus in 2007 (0.3%). South Africa is a middle-income, emerging market economy where services account for nearly two thirds of South Africa's economy, while most exports are based on mining. The major risks are volatilities in capital inflows (portfolio investments), export commodity price shocks, and internal pressures arising from high unemployment, high inequality, high HIV/AIDS prevalence, and high crime rates.

7.8. Lebanon

The military conflict caused a very serious shock for the economy of **Lebanon**. In 2006 the national GDP decreased by 5% in real terms, the public deficit nearly doubled compared to 2005 reaching 14% of GDP and the GDP and the government debt increased to a record-high 190% of GDP. No statistical data regarding unemployment are available for the moment. Inflation is moderate with an annual rate of 5%. Lebanon remains one of the most indebted countries in the world. Debt sustainability is at serious risk due to the immediate reconstruction needs following the 2006 war and the political instability caused by the lack of consensus on the necessary reforms.

7.9. Jordan

The **Jordan's** economy continued to grow strongly in 2006; real GDP growth is estimated at 6% (2005: 7.2%). High levels of remittances and strong activity in the services sector boosted private consumption. The unemployment rate decreased from 14.8% in 2005 to 13.9% in 2006. The inflation rate picked up in 2006 to 6.3% (2005: 3.8%) following the cuts in oil price subsidies. The authorities have intensified fiscal adjustment in 2005 and 2006 under a strategy centred on eliminating fuel subsidies and maintaining expenditure restraint. These efforts brought the budget deficit (excl. grants) down to 7.5% of GDP from 10% in 2005. External current account deficit (incl. grants) for 2006 decreased slightly from 17.8% in 2005 to 16% of GDP (and compared to a surplus of 11.6% in 2003). Merchandise export growth remained robust. The trade deficit decreased from 47% of GDP in 2005 to 37.1% in 2006. The current account deficit continued, however, to be financed by exceptionally high capital inflows, including foreign direct investments, remittances and portfolio inflows.

7.10. Serbia and Montenegro

In **Serbia** annual GDP growth amounted to 6.3% (in real terms) in 2005. Growth continued at 6.3% in the first quarter of 2006. The current account deficit reached 9.8% of GDP in 2005. It widened further in the course of 2006. Gross FDI inflows reached 6.1% of GDP in 2005 and the external debt of the country amounted to 66% of GDP at end-July 2006. Public debt has declined following the EUR 600 million Paris Club debt write-off, which was linked to the successful completion of the recent IMF programme in February 2006.

In **Montenegro** annual GDP growth amounted to 4.1% (in real terms) in 2005. Growth accelerated to 6.5% in the first semester of 2006. The current account deficit reached 12.2% of GDP in 2005. It further widened in the course of 2006. Gross FDI inflows reached 22.8% of GDP in 2005 and the external debt of the country amounted to 42.6% of GDP at the end of 2005.

In July 2006, following the declaration of independence of Montenegro, the Republic of Serbia and the Republic of Montenegro concluded an internal agreement on the division of financial rights and obligations following the succession of Serbia to the former state union.

7.11. Ukraine

Real GDP growth of **Ukraine** was about 7% (2.6% in 2005). The current account turned negative at about 1.5% of GDP against a surplus of 3% the year before, driven by strong import demand and higher energy import prices but also due to the fluctuations in steel markets (Ukraine's main export sector accounting for 40% of total exports). Ukraine's public external debt declined to about 12% of GDP (15.3% in 2005), while the private sector's better access to foreign capital markets edged the total external debt to nearly 50% of GDP. Inflation accelerated in December 2006 to 11.6% year-on-year, partly due to higher prices of energy imports. The main risks still relate to the turbulent political situation and the ensuing lack of coherence in policy-making. In August, Standard & Poor's confirmed, however, Ukraine's sovereign long-term credit rating at BB-, supported in particular by the low level of indebtedness.