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REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget Situation at 30 June 2008

{SEC(2009) 159}

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1. INTRODUCTION AND TYPES OF COVERED OPERATIONS

This report is submitted pursuant to Article 130 of the Financial Regulation which requires the Commission *to report to the European Parliament and to the Council twice a year on budgetary guarantees and the corresponding risks*[1]. It is completed by a Commission Staff Working Document with a set of detailed tables and explanatory notes (the "Annex")[2].

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[3] ("MFA") loans to third countries and in conjunction with the Bretton Woods institutions, balance-of-payments loans granting support to non-EMU Member States grappling with transitional difficulties; and

– loans with microeconomic objectives (Euratom loans and most importantly European Investment Bank ("EIB") external financing[4]). These operations have been covered since 1994 by the Guarantee Fund for external financing ("the Fund")[5] 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 a country has become a Member State the risk is directly born by the Budget). If there are insufficient resources in the Fund, recourse will be made to the Budget.

The Council Regulation establishing the Fund (the "Fund Regulation"[6]), which was adopted in 1994, was first amended in 1999. Following a second amendment of the Council Regulation in 2004, the Fund's coverage is withdrawn if third countries become Member States. The Budget directly covers loans to Member States granted or guaranteed by the Community.

2. EVENTS SINCE THE LAST REPORT AT 31 DECEMBER 2007

There were no disbursements under macro financial assistance and Euratom loans during the first half of 2008.
A new disbursement of USD 22 million Euratom loan took place in October 2008.

Regarding EIB financing operations, a total amount of EUR 1 884 million had been signed by the EIB under the general mandate 2007-2013 (Council Decision 2006/1016/EC). Concerning the disbursement volume, an amount of EUR 911 million was disbursed of which EUR 286 million was disbursed under the new general mandate 2007-2013.

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1 COM(2008)451 and SEC(2008)2249 make up the previous report on the guarantees covered by the Budget at 31 December 2007.

2 SEC(2008)[…].

3 MFA may also take the form of grants to third countries. For more information on MFA, see the Commission report COM(2008)590 and SEC(2008)2504.

4 The figures concerning the EIB mandates are displayed in Table A1 and references to legal bases are listed in Table A4 of the Annex.

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

6 Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 establishing a Guarantee Fund for external actions, (OJ L 293, 12.11.1994, p.1).

It should be noted that, following an action undertaken by the Parliament, on 6 November 2008 the Court of Justice annulled Council Decision 2006/1016/EC since it was not adopted under the correct legal basis. The Court, while annulling the Decision, ordered "*that its effects be maintained for EIB financing arrangements entered into before the entry into force, within a period of 12 months from the date of delivery of this judgment, of a new decision adopted on the appropriate legal basis, namely Articles 179 EC and 181a EC together*". The Commission is currently preparing a proposal to the European Parliament and the Council to this effect.

3. DATA ON RISKS COVERED BY THE BUDGET

3.1. 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 (73% of the total outstanding amount guaranteed as of 30 June 2008) 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 27% 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 (either directly or indirectly via the Fund):

– The method of calculating the total amount of capital outstanding for the operations concerned on a given date including accrued interest. 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[7].

[7] 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).

Table 1: Total outstanding amounts covered as of 30 June 2008 in EUR million

	Outstanding Capital	Accrued Interest	Total	%
Member States*				
MFA	196	5	201	1%
Euratom	435	9	444	3%
EIB	3 976	36	4 012	23%
Sub-total Member States*	4 606	51	4 657	27%
Third Countries				
MFA	534	13	547	3%
Euratom	39	1	40	<1%
EIB	11 729	128	11 857	69%
Sub-total third countries	12 302	142	12 444	73%
Total	**16 908**	**193**	**17 101**	**100%**

* This risk is directly covered by the Budget and includes Bulgaria and Romania as they have joined the EU on 01.01.2007.

Tables A1, A2, A3 and A4 of the Annex provide more detailed information on these outstanding amounts, in particular in terms of ceiling, disbursed amounts or guarantee rates.

The total outstanding amount of capital and interest covered by the budget slightly decreased by EUR 122 million to EUR 17 101 million compared with the situation at 31 December 2007.

3.2. Risk linked to Member States

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

In the second half of 2008, the Budget will bear a risk linked to Member States of EUR 378 million. Table 2 shows that Bulgaria and Romania are ranked first and second among Member States 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 the 2nd half 2008 (EUR million)			
Ranking	**Country**	**2008**	**%**
1	Romania	116.7	30.8%
2	Bulgaria	91.9	24.3%
3	Czech Republic	45.2	11.9%
4	Poland	42.3	11.2%
5	Slovakia	32.5	8.6%
6	Slovenia	19.1	5.0%
7	Hungary	18.1	4.8%
8	Cyprus	4.8	1.3%
9	Latvia	3.7	1.0%
10	Lithuania	3.3	0.9%
11	Estonia	0.6	0.1%
12	Malta	0.3	0.1%
	Total	378.3	100.0%

The risk on Member States concerns all Members States involved in the last two enlargements with maturities ending 2031.

3.3. Risk linked to third countries

In the second half of 2008, the Fund will bear a maximum risk related to third countries of EUR 571 million. The top ten countries according to their total outstanding are listed below. They account for 79% of the risk borne by the Fund in 2008. The economic situation of these countries is analysed and commented in Section 6 below.

Table 3: Ranking of the 10 most important third countries according to the exposure with regard to the maximum risk borne by the Fund in the 2nd half 2008 (EUR million)			
Ranking	**Country**	**2008**	**% of the total maximum risk**
1	Turkey	158.4	21.8%
2	Egypt	91.7	12.6%
3	Tunisia	64.6	8.9%
4	Morocco	64.4	8.9%
5	Lebanon	55.0	7.6%
6	South Africa	46.8	6.4%
7	Serbia	29.4	4.0%
8	Mexico	20.5	2.8%
9	Jordan	20.4	2.8%
10	Croatia	20.3	2.8%
Total of the 10		571.3	78.7%

The Fund covers the guaranteed loans of 57 countries with maturities ending 2038. Details by country are provided in Table A2 of the Annex.

3.4. Global risk covered by the Budget

In total, the Budget will cover for the second half 2008 an amount of EUR 1 104 million representing the amounts due during this period, of which 34% are due by Member States (see Table A2 in the Annex).

3.5. Evolution of risk

The risk towards Member States should decrease in future for the loans to Member States under Euratom, MFA or EIB guaranteed financing which are reimbursed (see Graph A1 in Section 1.3 of the Annex).

However, the total risk towards Member States will increase with the activation of the Community medium-term financial assistance facility (balance-of-payments facility, BoP). This financial facility enables loans to be granted to one or more Member States which have not yet adopted the euro and which are experiencing, or are seriously threatened with, difficulties in their balance of current payments. A loan agreement with Hungary of EUR 6 500 million to Hungary was signed in the second semester 2008[8].

MFA loans to third countries are subject to individual decisions by the Council. The financial assistance granted under Council Decision 2007/860/EC of 10 December 2007 providing macro-financial assistance to Lebanon consists of EUR 50 million in loans and up to EUR 30 million in grants. The intention is now to disburse the loan part in two equal tranches in 2009. The Euratom lending to Member States or in certain eligible non-member countries (Russian Federation, 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 existing loan agreement of 2004 to K2R4 in Ukraine (EUR equivalent of USD 83 million Loan Facility Agreement), EUR 39 million was disbursed in 2007. As explained in Section 2, a new tranche of USD 22 million was disbursed on 10 October 2008.

The previous general mandate to the EIB expired on 31 July 2007. At this date, contracts corresponding to a total 98% of the overall ceiling under this mandate (EUR 20 060 million – see Table A5 of the Annex) had been signed. A total amount of EUR 6 774 million remains to be disbursed under previous EIB mandates, of which 97% relate to the previous general mandate[9] and should be disbursed within 10 years from the end of this mandate, as the guarantee of the Community lapses at the end of this period[10].

The most important item that will impact the risk for the Budget in future is the Community guarantee granted to the EIB under the general mandate 2007-2013. 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[11]. A total amount of EUR 3 761 million was signed at 30 June 2008 under this mandate, of which EUR 3 352 million is undisbursed at this date (see Table A6 of the Annex).

In Section 1.3 of the Annex, Graph A2 presents simulations of some scenarios of disbursements under the mandates preceding the general mandate 2007-2013, as well as under the general mandate 2007-2013, as those disbursements have a strong impact on the provisioning of the Fund.

4. DEFAULTS, ACTIVATION OF BUDGET GUARANTEES AND ARREARS

4.1. 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[12].

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8 In November 2008, Latvia has approached the EU for an assistance under the BoP facility.

9 See Section 1.3 of the Annex.

10 See Article 1.06 of the Restated and Amended Guarantee Agreement signed between the EC and the EIB on 30 August/2 September 2005.

11 Broken down into a basic ceiling of a fixed maximum amount of EUR 25 800 million and an optional mandate of EUR 2 000 million to be decided upon by the Council.

12 See 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.

4.2. 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 first half of 2008.

4.3. Activation of the Guarantee Fund for external actions

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.[13]

During the first half of 2008, the Fund was not called.

The total arrears at 30 June 2008 i.e. penalty interests with the Republic of Argentina, amount to USD 1 718 493.12; thereof USD 1 448 433.44 (EUR equivalent 918 823.54) 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.

5. GUARANTEE FUND FOR EXTERNAL ACTIONS

5.1. Recoveries

No recovery occurred in the first half 2008. However, a recovery of USD 1 448 433.44 penalty interests from the Republic of Argentina took place on 12 December 2008.

5.2. Assets

At 30 June 2008, the net assets of the Fund amounted to EUR 1 029 656 202.33.

5.3. 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 1 029 656 202.33) and outstanding capital liabilities[14] (EUR 12 443 426 701.62) within the meaning of the Fund Regulation has slightly improved from 8.26% at 31 December 2007 to 8.29% at 30 June 2008. The ratio will approach the 9% target rate after the transfer of EUR 91.60 million inserted in the Preliminary Draft Budget of 2009 at year-end 2007 will be executed in January 2009.

At year-end 2007, the Fund resources were lower than the target amount. According to the new provisioning rules adopted by the Council on 30 January 2007[15], a provisioning of EUR 91.60 million was inserted in the Preliminary Draft Budget of 2009 together with an amount of EUR 500 000.00 for the external evaluation under the mid-term review of the EIB external mandate pursuant to Council Decision 2006/1016/EC[16].

[13] For more details, see Section 1.4.3 of the Annex.
[14] Including accrued interests.
[15] Council Regulation (EC, Euratom) No 89/2007 of 30 January 2007 (OJ L 22, 31.1.2007, p. 1).
[16] OJ L 414, 30.12.2006, p. 102.

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

6.1. 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 3.3 above) should also be assessed. Tables on the country risk evaluation are presented separately in the Commission Staff Working Document. A summary of this analysis is provided in the report and the annex for the ten countries having the highest risk to the Budget in the second half of 2008 (see Section 3.3 above) and the countries having a direct exposure with the Community budget (MFA and Euratom Loans). The analysis related the candidate countries and the potential candidate countries is provided below.

6.2. Candidate countries

In **Croatia,** real GDP (Gross Domestic Product) growth rose by 5.6% in 2007, up from 4.8% in 2006. Growth was mainly driven by an acceleration of private and public consumption growth, fuelled by strong, but decelerating credit growth, one-off payments to pensioners, and pre-election spending. Economic growth slowed to 4.3% year-on year in the first quarter of 2008 with some rebalancing, as consumption moderated amid stronger investment activity, in particular private investment, partially reflecting some improvements in the overall business environment. The current account deficit widened from 7.9% of GDP in 2006 to 8.7% in 2007 and further to 9.6% in the twelve months to March 2008, mainly due to a higher trade deficit. The latter was fuelled by strong domestic demand, higher world commodity and energy prices and lower export growth. Net inflows of FDI (Foreign Direct Investments) increased by 33% in 2007 and reached 9.1% of GDP, and thus more than off-set the current account deficit. Gross external debt continued to increase, driven by an acceleration of direct borrowing of the corporate sector while the general government as well as the banking sector reduced their outstanding foreign liabilities. The gross external debt ratio increased from 85.5% of GDP at end-2006 to 88.9% at end-2007.

In the **former Yugoslav Republic of Macedonia,** output growth accelerated markedly to about 5% (in real terms) in 2007, compared to 4% in 2006. Important sources for growth were exports of steel products and private consumption. The current account deteriorated during the last months of the year, reaching a deficit of nearly 3% of GDP end-2007. Gross FDI inflows came back to 4.8% of GDP end-2007, after a single privatisation project in the energy sector had raised FDI inflows to nearly 6% of GDP in 2006. Early debt repayments reduced the external debt of the country to some 50% of GDP.

In **Turkey,** annual GDP growth amounted to 4.5% in 2007, down from 6.9% in 2006. Higher inflation and a severe monetary policy tightening by the Central Bank in mid-2006 dampened domestic demand growth. The current account deficit remained constant at almost 6% of GDP. Gross FDI inflows reached 3% of GDP in 2007, and about two thirds targeted the financial sector. In the previous year, the external debt of the country fell by about 2 percentage points to 37% of GDP by end-2007. At the same time, public debt fell to 39% of GDP from 46% of GDP in 2006. Turkish banks frequently borrow internationally to finance lending domestically, so they are expected gradually to feel the effect of the global credit squeeze.

6.3. Potential candidate countries

In **Bosnia and Herzegovina** real GDP growth decelerated from 6.7% in 2006 to 6% in 2007. In 2007 the widening of the trade deficit contributed to an increase of the current account deficit from 8.4% of GDP in 2006 to 13.1% of GDP in 2007. The current account deficit was fully financed by net FDI as large privatisations in the Republika Srpska (Република Српска) together with a relatively better performance of greenfield investments led to a surge in FDI to 13.8% of GDP. External public debt declined to 18.5% of GDP at the end of 2007, while the total external debt is estimated below 50% of GDP.

In **Serbia** real GDP grew by 7.5% during 2007. The current account deficit widened to 16% of GDP, driven by a growing trade deficit and a decline in net current transfers. Net FDI inflow declined to 5.1% of GDP while foreign borrowing grew to 10.3% of GDP. As a result of the slowdown in capital inflows, foreign exchange accumulation of the National Bank of Serbia fell to 3% of GDP. Foreign exchange reserves of the National Bank of Serbia stood at 7.5 months worth of imports of goods and services at the end of the year. External debt remained at 62% of GDP while private and public sector external debt by the end of 2007 accounted for 41% and 21% of GDP, respectively.

In **Montenegro**, GDP estimates points to a robust expansion of the economy by 8% in the first half of 2008 fuelled mainly by services on the production side and by private consumption on the demand side. The current account deficit strongly deteriorated to 39% of GDP driven by the sizeable trade deficit and notably stagnating exports. Yet, FDI inflows decreased moderately during the first half of 2008, bringing net FDI down to 22% of GDP. The public debt increased to 33.6% of GDP due to the surge in domestic indebtedness. By contrast, the share of external public debt decreased to 17.5% of GDP, following repayments to multilateral creditors facilitated by the good fiscal outcome.