COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

COUNCIL DECISION

providing macro-financial assistance

for the Former Yugoslav Republic of Macedonia

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

Since 1995, the Former Yugoslav Republic of Macedonia, which became independent in 1991, is continuously improving its external relations. Important steps in this process were the Dayton/Paris peace agreements in late 1995 and the lifting of international economic sanctions against the Federal Republic of Yugoslavia in 1996. The relations between the Former Yugoslav Republic of Macedonia and the European Union in particular have also improved substantially during the last two years as the bilateral relations with Greece normalized in October 1995. These improved relations find their reflection in the Cooperation and Transport Agreements between the Former Yugoslav Republic of Macedonia and the European Community which was signed on 29 April 1997 at the General Affairs Council.

In November 1996, the Government of the Former Yugoslav Republic of Macedonia addressed to the Commission a request for Community complementary assistance in support of the medium-term stabilization and reform programme for 1997-1999 which is backed by the IMF Enhanced Structural Adjustment Facility (ESAF) adopted on 11 April 1997. In February 1997, a G-24/Consultative Group Meeting was jointly organized by the World Bank and the European Commission to review the Former Yugoslav Republic of Macedonia's past and future stabilization and reform path and to help easing the country's external financing constraints for 1997. The Commission announced at this meeting its intention to propose Community macro-financial assistance of up to ECU 40 million in favour of the Yugoslav Republic of Macedonia and other bilateral donors have given preliminary indications of support.

2. ECONOMIC SITUATION AND PROGRESS WITH STABILIZATION AND REFORM

From the beginning of its statehood, the Former Yugoslav Republic of Macedonia has striven to establish a market-based open economy. The country, however, had to face formidable obstacles as the inherent difficulties of the transition process were compounded by adverse external developments such as the dissolution of the Comecon, the break-up of Former Yugoslavia and the imposition of trade and transit sanctions.

Soon after independence, the Former Yugoslav Republic of Macedonia was plunged into a severe economic crisis: near-hyperinflationary conditions developed, fiscal control was lost and the budget deficit reached 13.6% in 1993. In the meantime, precarious balance of payments and reserves position, as well as the difficulties in allocating external liabilities of former Yugoslavia among the individual republics, forced the authorities to suspend foreign debt servicing temporarily. Between 1990 and 1995, GDP fell by almost 40%, total investment by more than 50%, real consumption declined by 25%, while registered unemployment increased above 24%.

In the past two years, however, the situation has improved considerably. The prudent macroeconomic policies and structural reforms, initiated in 1994 in the framework of the IMF Systemic Transformation Facility and since May 1995 with a stand-by arrangement, began to pay off. GDP started to expand in 1996 (at an estimated 1.1%) supported by consumption and investment increases of some 5%. Consumer prices fell by 0.7% in the year to December 1996, from an inflation rate of 241.8% in 1993. This was achieved by a sharp reduction in the budget deficit from 13.6% in 1993 to 0.4% in 1996 and a cautious monetary policy while keeping the exchange rate of the denar stable with the Deutsche Mark. But, at the same time, the current account deficit widened considerably as imports surged and exports fell sharply following the lifting of economic sanctions against Serbia/Montenegro.

In 1993, first steps were taken to promote the economy's structural adjustment when basic laws were enacted to allow the dismantling of the inefficient state-owned enterprise and financial sectors and reforming the social safety net. Starting from 1994, reforms in these areas were implemented with the support of the World Bank and other multilateral and bilateral institutions and donors. Substantial progress was made in the privatization or liquidation of enterprises and more recently in the restructuring of large loss-making enterprises. First steps were also taken to restructure the banking system. Recently the authorities took swift action to close a savings house (TAT) when the Central Bank discovered deposits that earned above market interest and were not fully covered by assets. Prudential regulations and capital adequacy requirements were also brought up to international standards

3. THE MEDIUM-TERM ECONOMIC PROGRAMME OF THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

In order to consolidate the stabilization and promote growth of the economy, the Government of the Former Yugoslav Republic of Macedonia has agreed with the IMF and the World Bank on a coherent economic strategy for 1997-99 to be supported by an ESAF loan and a Structural Adjustment Loan and Credit (SALC), respectively. It is expected that real GDP growth in the coming years would be in the order of 5%, with a substantial stimulus coming from the external side and consumption expected to pick up to some 3% in 1998.

To obtain this result, the authorities of the Former Yugoslav Republic of Macedonia intend to continue the mutually reinforcing cautious monetary and fiscal policies. Monetary expansion will remain under tight control. The authorities also intend to move towards indirect instruments of monetary control from direct controls.

The Government of the Former Yugoslav Republic of Macedonia aims at stabilizing the general government fiscal balance at a surplus of 1.5% . Tax compliance in the private sector will be strengthened in order also to lower income and social security tax rates. Furthermore, it is planned to replace the sales tax by a VAT. On the expenditure side agricultural and export subsidies (some 2% of public expenditures in 1995 and 1996) are intended to be phased out. The Government also intends to reintroduce a public sector wage freeze and review social spending in order to find possibilities for savings. At the same time, investment expenditure will be increased by 5%.

The Government of the Former Yugoslav Republic of Macedonia plans to continue and enhance the reforms in the area of trade, enterprise, financial and social sector as well as agriculture.

Regarding the trade regime, the new tariff law following the harmonized system was adopted in 1996 and most quantitative trade restrictions were eliminated. The Government will now increase transparency in tariff setting and exemptions and further eliminate discretionary exemptions.

The authorities intend to continue and intensify the restructuring of the enterprise sector. To encourage effective enterprise ownership, they plan to sell government-owned shares to outside investors and eliminate restrictions on trading of shares. The privatization or liquidation of the largest politically sensitive enterprises placed under the Special Restructuring Programme shall be continued and the privatization of the other enterprises shall be completed by the end of 1997.

In the financial sector, the authorities will further strengthen the supervision over banks and savings houses and pursue the restructuring or liquidation of institutions in financial difficulties. The government will encourage joint ventures with and a greater representation of foreign banks.

The Government plans to improve the social protection programme and the long-run solvency of the pension system, as well as the quality of health and education systems and to make further progress in providing for a more flexible and competitive labour market.

Finally, in the area of agriculture, the authorities of the Former Yugoslav Republic of Macedonia undertake to reduce further the interventions in output prices and end input subsidies. The Agricultural Privatization Law of April 1996, requiring enterprises to present privatization and, if appropriate, restructuring plans has prepared the ground for privatization in this sector. The Government is now also preparing a new Law on Land use, and intends to strengthen the Land Cadastre Office.

4. BALANCE OF PAYMENTS DEVELOPMENTS AND FINANCING NEEDS

Despite the persistently critical balance of payments situation, the financial relations of the Former Yugoslav Republic of Macedonia with its external creditors have been progressively normalized since 1993. Arrears with the Bretton Woods Institutions were eliminated in 1993 (IMF), 1994 (World Bank) and 1995 (IFC). Rescheduling agreements were reached with the Paris Club of official creditors in July 1995 (covering US$ 340 million) as well as with the London Club in mid-October 1996 (covering about US$ 200 million). In October 1995, the country resumed the payment of interest and some principal to the European Investment Bank (EIB). The Former Yugoslav Republic of Macedonia also committed in early 1997 to settle in the context of the new medium-term IMF programme all its outstanding financial liabilities to the Community and the EIB stemming from earlier EIB loans.

Last year, the external situation of the Former Yugoslav Republic of Macedonia deteriorated sharply as imports surged and the high exports stimulated by the regional conflict disappeared. Excluding official transfers, the current account deficit is estimated to have increased from US$ 259 million (6.9% of GDP) in 1995 to US$ 483 million (13.2% of GDP) in 1996, with the trade deficit more than doubling from US$ 235 million to US$ 523 million.

For 1997, the IMF programme foresees that exports will expand by 10%, stimulated by the 12% decline of the real effective exchange rate in 1996 which is likely to continue in 1997. Given the foreseen restrictive fiscal policy stance, imports are projected to increase by only 4%, reducing the trade deficit to an expected US$ 467 million. Assuming a modest improvement in the services balance and an increase in private transfers, it is projected that the current account deficit will fall to US$ 367 million in 1997 (9.5% of GDP). It should, however, be underlined that this forecast does not take into account any possible spillover effects (in particular border control) of the Albanian crisis that could lead to the need for higher fiscal expenditures and, as a result, some effect on the current account.

Under the programme, the Former Yugoslav Republic of Macedonia will require external financing of US$ 587 million to also ensure capital repayments on external debt of US$ 48 million and to clear all remaining external arrears (including some ECU 27 million owed to the Community and the EIB on previous EIB loans). At the same time, this allows for a build up in reserves by US$ 35 million to a level covering 2.3 months of imports. Once public and private capital inflows and rescheduling by the Paris Club of official donors have been accounted for, the external financing gap of the Former Yugoslav Republic of Macedonia in 1997 is estimated at US$ 120 million.

In order to support the Government's reform programme, the Fund has decided to grant to the Former Yugoslav Republic of Macedonia a three-year ESAF loan (1997-99) set at roughly US$ 80 million. In addition, the World Bank has committed a Structural Adjustment Loan and Credit of some US$ 45 million focusing on trade and agriculture reforms. Taking into account the contributions of these institutions for the first year of the programme (some US$ 50 million), the remaining residual financing gap for 1997 is now estimated at US$ 70 million.

Unless this remaining gap can be closed, the Former Yugoslav Republic of Macedonia's ability to secure stable import supplies and to meet its external financial commitments would be put into question. Hence, the success of the whole stabilization and reform programme to which the Government and the Central Bank are committed could be undermined before its expected positive effects on the balance of payments, including the revival of exports and the pick up in foreign direct investment, could be realized.

5. PROPOSED FURTHER MACRO-FINANCIAL ASSISTANCE AND MAIN FEATURES OF THE LOAN

The Commission is proposing that the Community would make available to the Former Yugoslav Republic of Macedonia a balance of payments loan of up to ECU 40 million with a maximum duration of fifteen years. The proposed duration of the loan is consistent with the medium and long-term balance of payments outlook for the Former Yugoslav Republic of Macedonia, which is expected to face substantial financing needs for the years to come.

The assistance would be granted in the context of the present ESAF and would complement resources made available by the International Financial Institutions and bilateral donors.

The assistance would be released in two tranches subject to a satisfactory track record of the country's macro-economic programme agreed with the IMF and progress with respect to structural reforms (including observance of a number of performance criteria). Its effective implementation would take place only after the Former Yugoslav Republic of Macedonia has fully discharged its outstanding financial obligations towards the Community and the EIB, stemming from previous EIB loans.

As in the case of similar operations in favour of other partner countries, the Community would provide the funds through market borrowing with a guarantee by the general budget. The Former Yugoslav Republic of Macedonia would subsequently borrow from the Community. The borrowing and lending operations would be perfectly matched and without any commercial risk for the Community.

In accordance with the Guarantee Fund mechanism, the budgetary implications of a decision to make available assistance of up to ECU 40 million to the Former Yugoslav Republic of Macedonia would imply an ECU 6 million provisioning of the Fund.

Proposal for a

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal of the Commission,

Having regard to the opinion of the European Parliament[1],

Whereas the Commission has consulted the Monetary Committee before submitting its proposal;

Whereas the Former Yugoslav Republic of Macedonia is undertaking fundamental political and economic reforms and is making substantial efforts to establish an open market economy;

Whereas the Former Yugoslav Republic of Macedonia and the European Community have signed on a Cooperation Agreement and a Transport Agreement which will help the development of a full cooperation relationship;

Whereas the Former Yugoslav Republic of Macedonia has agreed with the International Monetary Fund (IMF) on a comprehensive set of stabilization and policy reform measures to be supported by a loan under the Enhanced Structural Adjustment Facility (ESAF);

Whereas the Former Yugoslav Republic of Macedonia has agreed with the World Bank on a comprehensive set of structural adjustment measures to be backed by a Structural Adjustment Loan and Credit;

Whereas the authorities of the Former Yugoslav Republic of Macedonia have requested financial assistance from the international financial institutions, the Community and other bilateral donors; whereas, over and above the estimated financing which could be provided by the IMF and the World Bank, an important residual financing gap remains to be covered in the remainder of 1997 in order to strengthen the country's reserve position and support the policy objectives attached to the government's reform effort;

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Whereas the authorities of the Former Yugoslav Republic of Macedonia have committed to fully discharge their outstanding financial obligations towards the European Community and the European Investment Bank;

Whereas a Community long-term loan to the Former Yugoslav Republic of Macedonia is an appropriate measure to help ease the country' external financial constraints, supporting the balance of payments and strengthening the reserve position;

Whereas the Community loan should be managed by the Commission;

Whereas the Treaty does not provide, for the adoption of this Decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall make available to the Former Yugoslav Republic of Macedonia a long-term loan facility of a maximum principal amount of ECU 40 million with a maximum maturity of fifteen years, with a view to ensuring a sustainable balance-of-payments situation and strengthening the country's reserve position.

2. To this end, the Commission is empowered to borrow, on behalf of the European Community, the necessary resources that will be placed at the disposal of the Former Yugoslav Republic of Macedonia in the form of a loan.

3. This loan will be managed by the Commission in close consultation with the Monetary Committee and in a manner consistent with any agreement reached between the IMF and the Former Yugoslav Republic of Macedonia.

Article 2

1. The Commission is empowered to agree with the authorities of the Former Yugoslav Republic of Macedonia, after consultation with the Monetary Committee, the economic policy conditions attached to the loan. These conditions shall be consistent with the agreements referred to in Article 1(3).

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in co-ordination with the IMF, that the economic policy in the Former Yugoslav Republic of Macedonia is in accordance with the objectives of this loan and that its conditions are being fulfilled.

Article 3

1. The loan shall be made available to the Former Yugoslav Republic of Macedonia in two tranches. The first tranche is to be released subject to the provisions of Article 2 and after the full settlement of the oustanding financial obligations of the Former Yugoslav Republic of Macedonia towards the Community and the European Investment Bank.

2. Subject to the provisions of Article 2, the second tranche shall be released on the basis of a satisfactory track record in the implementation of the ESAF programme and not before one quarter after the disbursement of the first tranche.

3. The funds shall be paid to the National Bank of the Former Yugoslav Republic of Macedonia.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest rate risk, or in any other commercial risk.

2. The Commission shall take the necessary steps, if the Former Yugoslav Republic of Macedonia so requests, to ensure that an early repayment clause is included in the loan terms and conditions and that it may be exercised.

3. At the request of the Former Yugoslav Republic of Macedonia, and where circumstances permit an improvement in the interest rate on the loans, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average maturity of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by the Former Yugoslav Republic of Macedonia.

5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

At least once a year the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

Done at ....,

For the Council
The President

FINANCIAL RECORD

1. Title of Operation

Macro-financial assistance to the Former Yugoslav Republic of Macedonia.

2. Budget heading involved

Heading B0 2173 reflecting the budget guarantee for the Community loan facility (to be created through an amending and/or supplementary Budget).

3. Legal basis

Article 235 of the Treaty

4. Description and Justification for the action

a) *Description of the action*
Provision of Community loans (to be financed by Community borrowings in the international capital markets), in the amount of up to ECU 40 million, to the beneficiary country with a view to supporting its government's reform efforts and alleviating the social hardship of the austerity measures.

b) *Justification for the action*
The sustainability of the beneficiary country's economic reforms depends on external financial assistance from official sources.

5. Classification of the Expenditure

Obligatory

6. Nature of the expenditure

Potential activation of budget guarantee for the Community borrowing aimed to fund the loans.

7. Financial impact

a) *Method of calculation*

The evaluation of the amounts of the assistance deemed necessary is based on the present estimates of the beneficiary country's residual external financing needs.

A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that the budget guarantee will not be called.

b) *Effect of the action on intervention credits*

Activated only in the case of an effective call on the guarantee.

c) *Financing of intervention expenditure*

In case of call on the budget guarantee:

- Recourse to the Guarantee Fund established by Council Regulation (EC, EURATOM) n° 2728 of 31 October 1994.
- In case the Guarantee Fund did not contain sufficient resources, additional payments would be called up from the budget by transfer:
  - of any margin remaining in the Reserve for guarantees;
  - of any late payments to the budget for which the budget guarantee has been activated (under article 27(3) of the Financial Regulation);
  - of any margin available under the ceiling of category 4 of the financial perspectives or redeployment therein.
- In order to fulfil its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 of the Council Regulation (EEC, Euratom) n° 1552/89 of 29.5.1989 will apply.

8. <u>Fraud prevention measures</u>

The funds will be paid directly to the Central Bank of the beneficiary country only after verification by the Commission Services, in consultation of the Monetary Committee and in liaison with the IMF and World Bank Services, that the macro-economic policies implemented in these countries are satisfactory and that the specific conditions attached to this assistance are fulfilled.

9. <u>Elements of cost-effectiveness analysis</u>

a) *Grounds for the operation and specific objectives*

By supporting the beneficiary country's macro-economic reform efforts and complementing financing by the International Community provided to this country in the context of the IMF agreed programme, this assistance would not only underpin this transition towards a market economy but also help it with fully servicing its outstanding financial obligations towards the Community and the European Investment Bank. These outstanding obligations amount at present to some ECU 27 million (arrears including late interest).

The present assistance will only be mobilized on the proviso that the Former Yugoslav Republic of Macedonia fully discharges its outstanding financial obligations towards the Community and the European Investment Bank.

b) *Monitoring and evaluation*

This assistance is of macro-economic nature and its monitoring and evaluation is undertaken in the framework of the IMF supported adjustment and reform programme that the Former Yugoslav Republic of Macedonia is implementing.

The Commission services will monitor the action on the basis of a genuine system of macro-economic and structural policy indicators to be agreed with the authorities of the beneficiary country. They will also remain in close contact with the IMF and World Bank services and will benefit from their assessment of stabilization and reform achievements in the Former Yugoslav Republic of Macedonia.

An annual report to the European Parliament and to the Council is foreseen in the proposed Council decision, which will include an evaluation of the implementation of this operation.

10. Administrative expenditure

This action is exceptional in nature and will not involve an increase in the number of Commission staff.

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1997 AND MARGIN UNDER THE RESERVE FOR LOANS AND LOANS GUARANTEE IN FAVOUR OF THIRD COUNTRIES

(IN ECU MILLION)

Operations	Basis of the Calculation	Provisioning of the Fund [1]	Reserve Margin
			329.0 [2]
Decided operations [3]			
Project-related assistance			
EIB/MED	-14	-1.71	330.7
EIB/PVDALA	-38	-5.32	336.0
EIB/SOUTH AFR.	55	8.25	327.8
EIB/Renewal of mandates [4]	1536.5	230.48	97.3
Macro-financial assistance			
Slovakia (Cancellation)	-130	-18.20	115.5
Belarus (Suspension)	-25	-3.75	119.3
Proposed operations			
Project-related assistance			
EIB/Turkey [5]	105	15.75	103.5
EIB/FYROM [6]	35	5.25	98.3
EIB/ Croatia [7]	49	7.35	90.9
Macro-financial assistance			
Georgia, Armenia and, if appropriate, Tajikistan [8]	170	25.50	65.4
FYROM [9]	40	6.00	59.4
Bulgaria [9]	250	37.50	21.9

1 According to the provisioning rules provided in the Council regulation (EC, Euratom) n° 2728/94 of 31 October 1994. After a first drawing of the Guarantee Fund, and in compliance with Article 5 of the Regulation, the rate of provisioning for new operations has been increased from 14 % to 15% in 1995. New macro-financial assistance operations have been provisioned with a 15% rate.

2 Reserve amount in 1997 under the financial perspective.

3 Corrections of the amounts to be transfered to the Fund in compliance with annex to Council regulation n° 2728/94.

4 Council Decision of 14 April 1997.

5 Proposal for a Council regulation relative to a special action of financial cooperation in favour of Turkey (COM(95) 389 final).

6 Proposal for a Council decision concerning the conclusion of a cooperation agreement with FYROM (COM(96) 533 final) of 25 November 1996.

7 Cooperation agreement EC/Croatia (SEC(95) 180/final). Negotiations suspended since Summer 1995. It is therefore unlikely that this operation would be implemented in 1997.

8 Commission proposal for a Council decision (COM(97) 24 final) of 3 February 1997.

9 Commission proposal.

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