



COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

COUNCIL DECISION

**providing exceptional financial assistance
to Armenia, Georgia and, if appropriate, Tajikistan**

(presented by the Commission)

EXPLANATORY MEMORANDUM

General economic situation of Armenia, Georgia and Tajikistan

Armenia, Georgia and Tajikistan were severely hit by the economic collapse resulting from the breaking up of the command economy and the disintegration of the Former Soviet Union. The crisis reached its height in 1993 when inter-republican payments and trade virtually ceased, arrears accumulated, and prices increased at hyper-inflationary rates. Additionally, civil hostilities in Georgia and Tajikistan, as well as war between Armenia and Azerbaijan in Nagorno Karabakh, have destroyed infrastructure, disrupted trade, and led to hundreds of thousands of refugees displaced to other regions. In Armenia, these shocks were compounded with the not yet overcome consequences of the 1988 earthquake which had destroyed a large share of the manufacturing base and housing stock. Under such critical circumstances, output dropped sharply between 1990 and mid-1994, by about two-thirds in all three countries, and living standards of the average population fell below poverty levels.

Out of the three countries, Armenia was the first to implement stabilisation policies and structural reforms. After a tightening of monetary policies in the second half of 1994 and last year, inflation fell to 30% in 1995. The budget deficit was contained below 10% of GDP in 1995, down from 50% in 1993. The economy began to grow again in 1994 and 1995 at an estimated 5% annual rate. The external account remains heavily constrained and the country, with hard currency resources in the amount of roughly 1.7 months of imports, has merely the means to cover core import needs.

Georgia started implementing in early 1995 strict monetary policies, and succeeded in bringing inflation down to an average 4% monthly in 1995, compared with a 66% monthly rate in 1994. The budget deficit was contained at 7% of GDP. Output continued however to decline by an estimated 5% of GDP. The country's external position remains highly uncertain. Last year's current account deficit, at about 16% of GDP, and important debt repayment obligations falling due could not be properly financed, thus leading to an accumulation of arrears towards the country's main suppliers and creditors. The situation improved somewhat over the last quarter following the successful introduction of a new currency which triggered hard currency inflows and an increase of the reserves position, from a very low level, to up to 150 million US\$, or almost three months of imports, by end-December 1995.

Tajikistan was the last among the three countries to initiate reforms. In early 1995 prices were partially adjusted, and a new currency, the Tajik rouble, was introduced. The current account improved dramatically from a considerable deficit in 1994 to overall balance in 1995. However, reforms were timid, monetary growth continued at a high pace, inflation increased over 600% in 1995 and GDP continued to decline, by about 12%. In early 1996 the authorities launched a more ambitious package of stabilization and structural reforms. Tajikistan, which has no hard currency reserves, is in a situation of arrears towards its main creditors and, given the high relative burden of its external debt (150% of GDP), heavily relies on rescheduling arrangements or new official grants, to meet its external financing needs in 1996 and 1997.

In order to cover their basic needs over the last three years Armenia, Georgia and Tajikistan have had recourse to international humanitarian assistance, out of which the Community has provided the biggest share, (under ECHO and exceptional food aid programmes).

Armenia, Georgia and Tajikistan, owing to their external financing needs and lack of hard currency reserves, have accumulated substantial arrears vis-à-vis their creditors and suppliers, including vis-à-vis the Community (for a global outstanding amount in arrears of some ECU 223 million including late interest) on commercial credits to finance food and medical imports allocated in 1992. However the Armenian and Georgian authorities have recently undertaken formally to fully service their outstanding debts (some ECU 61 million for Armenia and ECU 128 million for Georgia including arrears) towards the Community in the context of the new arrangements with the IMF.

Status of IMF programmes on Armenia, Georgia and Tajikistan

On 28 June, 1995, the IMF Board approved stand-by' arrangements in favour of Armenia and Georgia, to support both countries' ambitious programmes of stabilisation and structural reforms. The IMF programmes were approved despite remaining financing needs of the balance of payments, leading to arrears accumulation. The first reviews were completed in September, with both countries remaining on-track.

The IMF Board approved on 14 February 1996 an Enhanced Structural Adjustment Facility (ESAF) programme on Armenia in the amount of the equivalent of US\$ 150 million over three years. A similar ESAF programme on Georgia was approved by the IMF Board on 28 February 1996, for the equivalent of US\$ 245 million over three years.

On 8 May 1996, the IMF board approved a 7-month US\$ 22 million equivalent first credit tranche arrangement in favour of Tajikistan. An upper credit tranche arrangement and a multi-year ESAF programme are expected to follow, provided the authorities agree to implement further key stabilization and structural adjustment measures.

The proposed exceptional assistance

The Commission considers the Armenian and Georgian macro-economic programmes as being comprehensive and ambitious. These programmes, if fully implemented, should ensure the necessary macro-economic stabilisation and, by the means of structural reforms, establish the core frame of market economies. An improved economic and financial situation would also be an important element of political and social stability in the region.

However, without additional external assistance, these countries will not be able to meet their international financial obligations, and current programmes of reforms would be put in jeopardy. Furthermore, any further tightening of the authorities' programmes would put a strain on the already very difficult social situation.

Armenia, Georgia and Tajikistan, as low income countries, are eligible for World Bank lending at highly concessional IDA (International Development Association) conditions, as well as for IMF ESAF lending, the concessional facility of the Fund. Owing to their dire economic situation and to their extremely vulnerable balances of payments, these countries should be supported with highly concessional assistance. This view is shared by the Monetary Committee.

Throughout the 1993 - early 1996 period, the bulk of the Community assistance to these countries was provided in the form of grants under humanitarian programmes, in particular in the context of the two important food aid operations of the Winter periods 1994-1995 and 1995-1996. In November 1995 the Ecofin Council had an exchange of views on the situation of Armenia, Georgia and Tajikistan, and invited the Commission to make the necessary proposals.

Owing to the exceptionally harsh conditions presently faced by Armenia and Georgia, the Commission considered that exceptional assistance in the form of straight grants was required to support the implementation of the stabilisation and structural reform programmes of these countries as agreed with the IMF. The Commission considered furthermore that Tajikistan should also be made eligible to this assistance but only on the proviso that the authorities formally undertake to fully servicing their outstanding debt obligations towards the Community, and that they implement a comprehensive adjustment and reform programme in the context of upper-credit tranche and ESAF arrangements with the IMF¹.

Consequently, and on account of the constraints established by Category 4 of the present financial perspective, the Commission proposed on 28 March 1996 a revision of this financial perspective to make room for the financing of this action for an amount of up to ECU 170 million. However, owing to constraints in the Community budget, the budgetary authority could not go along with this proposal or with any adjustment of the ceiling of Category 4 of the present financial perspective.

In the circumstances, the Commission is now proposing that consistent with the present ceiling of Category 4 the financial perspective, the Community makes available to the beneficiary countries exceptional financial assistance in the form of:

- long-term loans for a maximum amount of ECU 170 million with a maximum maturity of fifteen years;
- straight grants of up to ECU 50 millions to be financed by the general budget.

The loan component of this assistance would be funded through Community market borrowing with a guarantee by the general budget. The beneficiary countries 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 loans of up to ECU 170 million to the beneficiary countries would be a ECU 25.5 million provisioning of the Fund to be drawn from the 1996 reserve for guarantees relating to external actions.

As for the grant component of this assistance and without prejudice to the competences of the budgetary authority, the Commission considers that given the constraints established by the present financial perspective, this part of the exceptional assistance cannot be financed in 1996 and would have to be implemented in five equal annual instalments of ECU 10

¹ It should be noted in this respect however that the political situation in Tajikistan remains very fragile, with persistence of civil hostilities, and that it is therefore highly uncertain, whether the country will actually be able to implement the necessary economic reforms, for which a peaceful settlement of internal conflicts is essential.

million, from 1997 onwards by redeployment, within the existing limits of Category 4 of the financial perspective for the 1997-1999 period.

The Commission accordingly requests the Council to adopt the attached proposal.

Proposal for a
COUNCIL DECISION
providing exceptional financial assistance
for Armenia, Georgia and, if appropriate, Tajikistan

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 Commission¹,

Having regard to the opinion of the European Parliament²,

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

Whereas Armenia and Georgia are undertaking fundamental political and economic reforms and are making substantial efforts to implement a market economy model; whereas Tajikistan is expected to implement similar stabilisation and structural change policies;

Whereas trade, commercial and economic links will develop between the Community, Armenia and Georgia within the framework of the Partnership and Cooperation Agreements signed on April 22, 1995;

Whereas Armenia and Georgia agreed with the International Monetary Fund (IMF) in 1994 on a first set of stabilisation and policy reform measures which was supported by the IMF's Systemic Transformation Facility, and whereas the IMF Board approved in June 1995 Stand-by Arrangements in support of further ambitious stabilisation and structural adjustment reforms, for the period July 1995 - June 1996;

Whereas the IMF board approved in February 1996 a three-year Enhanced Structural Adjustment Facility (ESAF) at concessional terms for Armenia and Georgia, in replacement of the current stand-by arrangements;

Whereas the Armenian and Georgian authorities have formally undertaken to fully service their outstanding financial obligations towards the Community;

Whereas the authorities of Armenia and Georgia have requested exceptional financial support from the Community;

¹ OJ n° ...

² OJ n° ...

Whereas Tajikistan implemented in 1995 and early 1996 important budgetary and monetary stabilisation measures and whereas a first credit tranche arrangement with this country was approved by the IMF Board in May 1996; whereas, subject to a peaceful settlement of internal conflicts, further policy discussions of the IMF and the World Bank with the Tajik authorities, and complementary financing assurances from the international donor community, the IMF management is expected to recommend the conclusion with Tajikistan of a multi-year programme of adjustment and reform to be supported by an upper credit tranche stand-by and concessional facilities under an ESAF arrangement;

Whereas Armenia, Georgia and Tajikistan are low income countries and are facing particularly critical economic and social circumstances; and whereas these countries are eligible to highly concessional loans from the World Bank and the IMF;

Whereas concessional financial assistance from the Community in the form of long-term loans and straight grants is an appropriate measure to help the beneficiary countries at this critical juncture by supporting the policy objectives attached to their governments' reform efforts and alleviating the social cost of adjustment measures;

Whereas this assistance is exceptional and only justified on account of the particularly harsh economic and social conditions presently faced by the beneficiary countries;

Whereas the inclusion of a grant component in this assistance is without prejudice to the competences of the budgetary authority;

Whereas this assistance 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 Armenia and Georgia exceptional financial assistance, in the form of long-term loans and straight grants, with a view to supporting the governments' reform efforts and alleviating the social hardship of the accompanying austerity measures.
2. Tajikistan will be made eligible to this assistance on the condition that: (i) the Tajik authorities have formally undertaken to fully service their outstanding financial obligations towards the Community; and (ii) the Board of the IMF has agreed on an upper-credit tranche arrangement with Tajikistan.

3. The loan component of this assistance shall amount to a maximum principal of ECU 170 million, with a maximum maturity of 15 years. 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 beneficiary countries in the form of loans.
4. The grant component of this assistance will consist of an annual amount of up to ECU 10 million for the 1997-2001 period.
5. The Community financial assistance shall be managed by the Commission in close consultation with the Monetary Committee and taking into account the provisions of any agreement reached between the IMF and the beneficiary countries.
6. The implementation of this assistance is conditional upon full servicing by the recipient countries of their outstanding financial obligations towards the Community.

Article 2

1. Subject to the provisions of Article 1, the Commission is empowered to agree with the authorities of the beneficiary countries the specific amounts and terms, and the conditions attached to this assistance.
2. The Commission shall verify, in consultation with the Monetary Committee, that the policies in the recipient countries are in accordance with the objectives of this assistance and that its conditions are being fulfilled.

Article 3

1. Subject to the provisions of Article 2, the loans and the grants shall be made available in successive instalments.
2. The funds shall be paid to the central banks of the recipient countries.

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 a beneficiary country 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 beneficiary countries, 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 operations under this Decision shall be borne by the beneficiary countries.
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

Exceptional financial assistance to Armenia, Georgia and, if appropriate, Tajikistan.

2. Budget heading involved

- *Grant component of the assistance*

Article (...) Exceptional financial assistance to Armenia, Georgia and if appropriate Tajikistan. (to be created through an amending and/or supplementary Budget).

- *Loan component of the assistance :*

Article (...) 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

Proposal for a Council Decision providing exceptional financial assistance to Armenia, Georgia and, if appropriate, Tajikistan.

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 170 million and grants of up to ECU 50 million (to be financed by the General Budget), to the beneficiary countries with a view to supporting their governments' reform efforts and alleviating the social hardship of austerity measures.

b) *Justification for the action*

The sustainability of the beneficiary countries' economic reforms heavily depends on external financial assistance from official sources, at concessional terms.

5. Classification of the Expenditure

- *Grant component* : non obligatory, differentiated.

- *Loan component* : obligatory

6. Nature of the expenditure

- Straight grants (100% subsidy), which would be released in successive instalments, possibly in the form of interest rate subsidies.
- 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 countries' residual external financing needs
- For the loan component of the assistance, 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*

The budget entry corresponding to the grant component of the assistance will be activated subject to compliance with a number of policy conditions to be agreed with the authorities of the beneficiary countries.

The budget entry reflecting the budget guarantee for the loan component of the assistance will be activated only in the case of an effective call on the guarantee.

c) *Financing of intervention expenditure*

(i) *Grants*

The financing of the expenditure will be secured in five equal annual instalments from 1997 onwards through redeployment within the limits of Category 4 of the present Financial Perspective for the 1997-1999 period.

The following schedule of appropriations is proposed (in current ECU):

	1997	1998	1999	2000	2001
Commitment appropriations	10	10	10	10	10
Payment appropriations	10	10	10	10	10

(ii) *Eventual 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, by reutilisation of reimbursed amounts (Article 27(3) of the Financial Regulation of 1977), or by amending and/or supplementary Budget.
- 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. Fraud prevention measures

The funds will be paid directly to the Central Banks of the beneficiary countries 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. Elements of cost-effectiveness analysis

a) *Grounds for the operation and specific objectives*

By supporting the beneficiary countries' macro-economic reform efforts and complementing financing by the International Community provided to these countries in the context of IMF agreed programmes, this assistance would not only underpin their transition towards market economy but also help them fully servicing their outstanding financial obligations towards the Community. These outstanding obligations are presently as follows:

Armenia: ECU 60.7 million (arrears including late interest);

Georgia: ECU 127.4 million (including 1997 maturities, arrears and late interest);

Tajikistan: ECU 67.9 million (arrears and late interest)

Total: ECU 256 million

The present assistance will only be mobilized on the proviso that the beneficiary countries fully discharge their outstanding financial obligations towards the country.

b) *Monitoring and evaluation*

This exceptional assistance is of macro-economic nature and its monitoring and evaluation are based on a satisfactory track record of the IMF supported adjustment and reform programmes that the beneficiary countries are implementing.

The monitoring of the action by the Commission services will take place on the basis of a genuine system of macro-economic and structural policy indicators to be agreed with the authorities of the beneficiary countries. The Commission services will also remain in close contact with the IMF and World Bank services and to benefit from their assessment of the recipient countries' stabilization and reform achievements.

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 1996 AND MARGIN UNDER THE RESERVE FOR GUARANTEES**

(IN ECU MILLION)

<u>Operations</u>	<u>Basis of the Calculation</u>	<u>Provisioning of the Fund(1)</u>	<u>Reserve Margin</u>	<u>Residual lending capacity (3)</u>
			326	(2) 2173
<u>Decided operations</u>				
Project-related assistance				
EIB/CEEC	1114	156.0	170.0	1134
EIB/MED	36	5.4	164.7	1098
EIB/PVDALA	111	15.5	149.1	994
EIB/SOUTH AFR.	120	18.0	131.1	874
EURATOM	0	0.0	131.1	874
Macro-financial assistance				
Moldova-II	15	2.3	128.9	859
Biélorussie	-20	-3.0	131.9	879
<u>Proposed operations</u>				
Project-related assistance				
EIB/Turkey	112.5	16.9	115.0	767
EIB/Croatia	52.5	7.9	107.1	714
EIB/PVDALA	410	61.5	45.6	304
Exceptional financial assistance				
Armenia, Georgia and, if appropriate, Tajikistan	170	25.5	20.1	134

- (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. For 1996, all EIB and EURATOM operations approved in 1993 and 1994 have been provisioned with a 14% rate. New macro-financial assistance operations have been provisioned with a 15% rate.
- (2) Reserve amount in 1996 under the financial perspective.
- (3) For 100% guarantee loans.

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