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**REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN
PARLIAMENT**

**Report from the Commission to the Council and the European Parliament
on the implementation of the macro financial assistance to third countries in 2007**

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1. INTRODUCTION

This report provides a general overview of the EC macro-financial assistance to third countries including historical background, a summary of the operations in 2007, information regarding the most recent operations in the Western Balkans, the New Independent States and Mediterranean countries together with statistical tables of the different operations carried out since 1990.

The recent trends of EC macro-financial operations with the results of the evaluations that have been carried out in 2007 are also included in this report. The objective of these evaluations is to assess the impact on the relevant aspects of the economic stabilisation process and the implementation of structural reforms in the recipient countries. Progress in this respect also reflects the degree to which the corresponding economic policy conditions attached to the EC macro-financial assistance have been met.

Moreover, as regards the recommendation of the Court of Auditors in their special report of March 2002 on improvement of financial management in the beneficiary countries, the Commission has carried out since 2004, with the assistance of an audit firm, several operational assessments of the financial circuits and controls organisation related to macro-financial assistance in every beneficiary country. The conclusions of these assessments are being duly taken into account in the elaboration of the policy conditions attached to the implementation of this assistance.

This report is submitted in accordance with the Council decisions regarding Community macro-financial or exceptional financial assistance to third countries and follows on from the reports presented in previous years. A more detailed report (working document of the Commission services **SEC(2008) 2381**) providing economic and financial information regarding the beneficiary countries is released in parallel.

2. OVERVIEW

2.1. Background

Macro-financial assistance (MFA) supports the political and economic reform efforts of the beneficiary countries and is implemented in association with support programmes from the IMF and the World Bank. MFA incorporates a set of principles reaffirmed by the Council in its conclusions of 8 October 2002, which underline the exceptional character of this assistance, its complementarity to financing from the International Financial Institutions (IFIs) and its macroeconomic conditionality. In particular, Community MFA has supported efforts by recipient countries to implement economic reforms and structural changes. In close co-ordination with the IMF and the World Bank, it has promoted policies that are tailored to specific country needs with the overall objective of stabilising the financial situation and establishing market-oriented economies.

2.2. Macro-Financial Assistance in 2006

During the period 2000-2007, nineteen decisions have been approved for a total amount of EUR 1085 million. The Balkans countries (The former Yugoslav Republic of Macedonia, Bosnia and Herzegovina, Serbia and Montenegro including Kosovo and Albania) have benefited from thirteen assistance decisions of the Council. This

makes the Balkans countries the main beneficiaries of MFA with a total of assistance amounting to a maximum of EUR 783 million out of 1085 million.

2.2.1. *New decisions*

Two decisions have been adopted by the Council in 2007.

On 16th April, the Council decided (2007/259/EC) to provide macro-financial assistance to Moldova of up to EUR 45 million in the form of grants.

On 10th December, the Council decided (2007/860/EC) to provide macro-financial assistance to Lebanon of up to EUR 80 million (EUR 50 million in the form of loans and EUR 30 million in the form of grants).

2.2.2. *Disbursements*

Disbursements of macro-financial assistance amounted to EUR 20 million for Moldova.

2.3. **Synthesis of the most recent operations in the beneficiary countries**

2.3.1. *Western Balkans*

The Council adopted on 30 November 2006 a decision to provide a *Macro-financial assistance* (MFA) to **Kosovo** (UNCS 1244/1999), as proposed by the Commission, in form of budget support (grants, up to € 50 million). However, the budgetary situation turned out differently than initially foreseen. The signing of the Memorandum of Understanding and the Grant Agreement between the Commission and the Kosovar authorities, represented by UNMIK, was finalised in December 2007, so that the MFA can be disbursed during the course of 2008-2009 if conditions are met, as agreed, in two tranches of €30 million and €20 million, respectively. In September 2007, the authorities have produced a revised version of the MTEF¹ for the period 2008-2010. The disbursement is subject to the existence of a financing gap which did not materialise in 2007 and a number of specific conditions related to the framework of fiscal and economic policies, public financial management and control, privatization and liquidation of State-owned enterprises, and statistics.

According to the latest statistical data from the IMF and the Central Banking Authority of Kosovo, GDP growth was around 3.5% in 2007, in contrast to a 1% growth assumption adopted by the authorities for the budget 2007 planning. This situation is partly due to the delays in the status settlement with less adverse effect on domestic demand from the dismantling of UNMIK. Private sector consumption has had a positive impact on growth. Overall, growth seems to become more robust compared to previous years, but remains low compared to the other countries of the region.

Inflation jumped to an average annual rate of 4.5% in 2007. The sharp rise in CPI² was fuelled by the growth of food prices, which have a 42.5% share in the CPI basket.

Export growth increased in the second half of 2007. However, the export base remains very weak, so that the *trade deficit* has further widened in 2007 to around 60% of GDP. For 2007, a current account deficit (including foreign assistance) of

¹ Medium term expenditure framework

² Consumer price index

24% of GDP is expected. Kosovo currently does not assume any sovereign debt servicing obligations.

Kosovo's *budgetary situation* is marked by a high degree of volatility and unpredictability. The execution of the budget in 2007 was characterised by an opening cash balance taken over from 2006 at around €200 million, a one-off exceptional revenue of €75 million for the licence of a second mobile phone operator, an improved performance in revenue collection and a continuously weak spending record, especially on capital items. The annual budget surplus 2007 is estimated at €150 million. However, the budgetary position in Kosovo remains precarious and the surplus may turn out to be of a quite temporary nature and masks a weaker structural budgetary position as it half stems from one single one-off measure (see above) and is subject to substantial budgetary risks, related i. a. to status settlement, unresolved property rights, environmental issues, the precarious energy situation and possible liabilities stemming from the privatisation process. Additionally, Kosovo's development needs remain enormous.

2.3.2. *Eastern Neighbourhood Countries*

In 2007, the Commission implemented two programmes of macro-financial assistance in favour of the countries of the region.

Under the programme in favour of **Georgia** for an amount of EUR 33.5 million in grants, adopted in January 2006, the Commission conducted the review of the conditions for the disbursement of the third and last tranche (the disbursements of the first and the second tranche of a total amount of EUR 23 million had been made in 2006.) The review was not completed and no payment was made because one of the specific conditions for the release of the tranche was not met: the law regarding the organisation of the external audit was not passed as foreseen by the Parliament.

The Commission started the implementation of a new macro-financial assistance to **Moldova**, decided by the Council on 16 April 2007. The new MFA amounts to EUR 45 million in grants and is linked to Moldova's Poverty Reduction and Growth Facility (PRGF) arrangement with the IMF. The first tranche of the assistance amounting to EUR 20 million was disbursed in October 2007. The remaining two tranches are expected to be disbursed in 2008.

This programme is designed to help Moldova implementing its economic programme and contribute to cover the country's external financing needs linked to external shocks faced by Moldova's economy (primarily, the increase in prices for natural gas imported from Russia and restrictions on Moldova's exports of wine and several agricultural products). The Community macro-financial assistance complements financing from the IFIs and bilateral donors and budget support provided by the EU under the Food Security Programme and the European Neighbourhood and Partnership Instrument (ENPI).

2.3.3. *Mediterranean countries*

On 10 December 2007 the Council approved a programme of macro-financial assistance in favour of **Lebanon**; with a view to supporting Lebanon's domestic efforts of post-war reconstruction and sustainable economic recovery, and in this way, alleviating the financial constraints on the implementation of the government's economic programme. The Decision provides for a EUR 80 million package consisting of a EUR 30 million grant and a EUR 50 million loan.

In December 2007, the Commission and the Government of Lebanon decided that the assistance would be disbursed, at a later stage, in two tranches, of EUR 40 million each.

3. GEOGRAPHICAL DISTRIBUTION AND EVALUATIONS OF MACRO-FINANCIAL ASSISTANCE

3.1. Geographical distribution

The EC MFA is intended to support macroeconomic stabilisation of the beneficiary countries and ease their balance of payments (and budget) difficulties. It plays also a very useful role in promoting structural reform. The highest volumes of MFA operations were decided and disbursed in the years immediately after the changes in the countries of the Central and Eastern Europe.

Over the years, the number of countries to which the Community extended such support expanded, as a growing number of countries neighbouring the EU faced balance of payments difficulties and committed themselves to programmes of economic reform. This led to a change in the geographic balance of assistance from the early years, when most beneficiary countries were countries in Central and Eastern Europe. Hence, since 2000, MFA has been exclusively provided to the Western Balkans (83% of the decisions from 2000 to 2006) and to the NIS countries. The year 2007 shows an evolution in this trend with a Decision from the Council in favour of Lebanon.

3.2. Evaluations

According to the financial regulation, the Commission has implemented an evaluation programme in order to assess the impact of MFA in each of the beneficiary countries. The analyses are carried out by external consultants selected by open call for tenders under the supervision of a "Steering Committee". Since 2004, a total of 5 evaluations have been carried out. Two evaluations were completed in 2007 regarding Tajikistan and Bosnia & Herzegovina. The main observations are the following:

3.2.1. Tajikistan

The evaluation assessed the Macro-Financial Assistance (MFA) granted to Tajikistan by the European Commission (EC) as a specific part of the global MFA operation granted earlier to Armenia and Georgia. The MFA consisted of a loan of EUR 60 million and a grant of EUR 35 million that was intended for disbursement in five successive equal tranches (EUR 7 million each) during the period 2001-2004.

The net impact of the MFA operation on macroeconomic stabilization appears to have been rather limited. MFA brought a marginal improvement in economic growth and inflation over the period 2001-2006. The results of quantitative modeling suggest that MFA contributed approximately a cumulative 1.5 percentage point increase in GDP in this period. By decreasing the cost of foreign debt servicing it allowed budget expenditure to be shifted to domestic use.

The impact of MFA on long-term external sustainability is positive but small. The channels where it was relatively easy to identify the direct contribution of MFA appear to play a relatively small part in the long-term perspective. This applies to both the debt-relief element of the operation and slightly higher GDP resulting from MFA. In the long term, other issues related to improved economic governance appear more important.

Although the expected effects of the structural conditionalities of the MFA operation have been achieved, their effect remains relatively limited. The most evident and

strongest effect on structural reforms was observed in the case of the two EC-specific conditionalities, which had sizeable consequences on the implementation of reforms related to public finance management.

3.2.2. *Bosnia and Herzegovina*

The evaluation assessed Macro-Financial Assistance (MFA) provided to Bosnia and Herzegovina (BiH) in the period from November 2002 to February 2006. The MFA includes a loan element of up to € 20 million and a grant element of up to € 40 million. The MFA operation coincided with an IMF Stand-by Arrangement which was in place from August 2002 till February 2004. MFA was explicitly linked to this Stand-by Arrangement.

MFA has influenced medium-to-long-term external sustainability through various channels. The primary channel is via macroeconomic stability, and impact on economic growth. Another channel is through institution building, to which the structural conditionalities of MFA have contributed.

The overall package of structural conditions has influenced the sustainability of the reforms by improving the country's institutions, accelerating privatization and creating a treasury system and an effective custom and tax administration. The reforms in customs and tax policy and administration have contributed to further irreversible reforms like the introduction of valued-added tax (VAT) in 2006. As such, the structural component of MFA has improved the country's economic stability and growth potential in the short and medium term

In both Bosnia and Herzegovina and Tajikistan the decision of the Commission to release the funds instilled confidence in the economy of these countries and thus contributed to the improvement of their business environment.

Evaluations of Serbia - Montenegro and Albania are on-going and their final reports should be made available in the third quarter of 2008.

3.3. Improving financial management in beneficiary countries: the operational assessments

In 2007 two new operational assessments have been carried out in Moldova and Lebanon in addition to the seven former operational assessments completed between 2004 and 2006 in countries benefiting from macro-financial assistance (Albania, Armenia, Serbia-Montenegro, Bosnia-Herzegovina, Georgia and Kosovo). The work programme is elaborated in co-operation with the consulting firm Deloitte and includes information contained in available reports issued by other donors and notably the PEFA analyses. Follow up missions have been undertaken (Albania, Armenia, Tajikistan and Georgia) in order to assess the improvements implemented in the national administrations following the first missions.

The investigations focus on the one hand on the independence of the Central banks and on the functioning of their accounting departments. On the other hand, they examine the budget process, the treasury department, the internal audit, human resources and IT departments of the Ministries of Finance. The functioning of the external audit institutions is also reviewed in order to assess their control effectiveness.

The conclusions of the operational assessments are communicated to the national authorities who have the opportunity to comment the analysis contained in the reports.

For each country, the assessments concluded that "The framework for sound financial management is effective" based on the consultant's analyses who pointed out however the need for a number of improvements. The most serious weaknesses have been detected in the Ministries of Finance such as the absence of a single treasury accounts, appropriate accounting systems and written procedures or to improve the procurement procedures. The capacity of the internal control had, for every Ministry, to be strengthened with the recruitment of skilled auditors and the implementation of special training sessions. In some cases, macro-economic forecast departments appeared unable to fulfil their role and the independence of the external audit institutions was not considered as sufficient.

With a view to improving the public finance management of the beneficiary countries, recommendations have been addressed to the national authorities to correct weaknesses. Some of these recommendations are considered as prior actions that have to be fulfilled before disbursement can be made. This has been the case for the strengthening of the internal control department within the Ministry of Finance or the adoption of instructions containing minimal requirements regarding the segregation of duties as regards accounting, authorizing and payment functions.

Four years after the beginning of these operational assessments and despite delays in the implementation of some of the requested modifications, the Commission has noticed real improvements, at all level in the public finance management of the beneficiary countries.

Table 1. Macro-financial assistance, 1990-2007
Maximum amounts authorised, millions euro

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Totals	
By region																				
Central European Candidate Countries	870	1.220	410		255			250		300							50		3.305	
Western Balkans			70		35			40		160	55	393	190	70	25				1.088	
NIS					130	255	15	265	150		125		18 (a)				33,5	45	1.036,5	
Mediterranean		588			200													80	868	
Total amounts authorised	870	1.808	480	0	620	255	15	555	150	460	180	393	208	70	25	0	83,5	125	6.297,5	
out of which, straight grants		28	70		35			95		70	90	168	130	45	16		83,5	75	905,5	
											Kosovo (35)		Serbia and Montenegro (75)	Serbia and Montenegro (45)	Albania (16)		Kosovo (50)	Moldova (45)		
								Armenia and Georgia (95)		Bosnia (40) FYRoM (30)	(20) Serbia and Tajikistan Montenegro (15)	(18) FYRoM (120)	(18) Serbia and Montenegro (30)	(40) Bosnia (15)	(40) Moldova (b)			Georgia (33,5)	Lebanon (30)	
	Interest subsidies to Israel		Albania		Albania															

(a) net amount taking into account (b) and, for Ukraine, new loan of EUR 110 million together with simultaneous cancellation of EUR 92 million out of the EUR 150 million loan decided in 1998.
(b) grant of EUR 15 million and simultaneous cancellation of the EUR 15 million loan decided in 2000

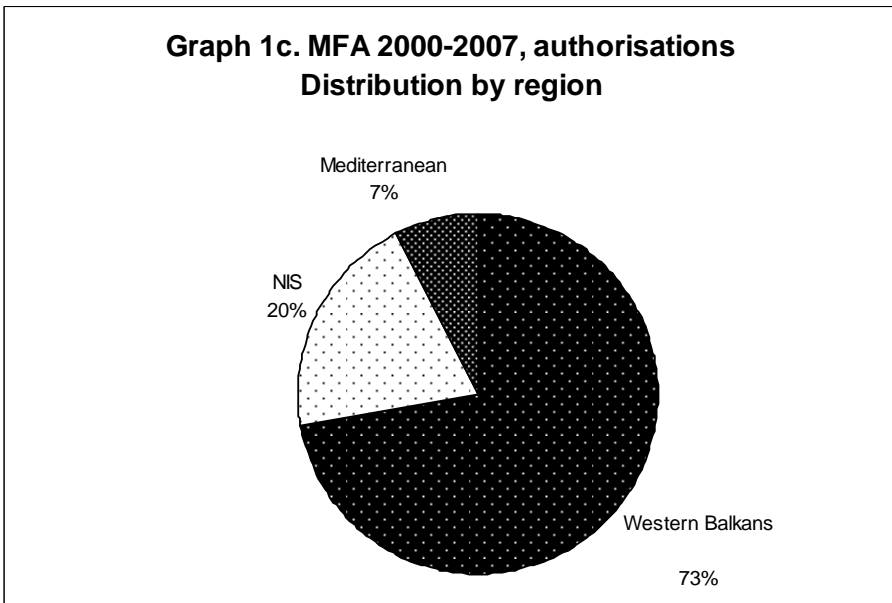
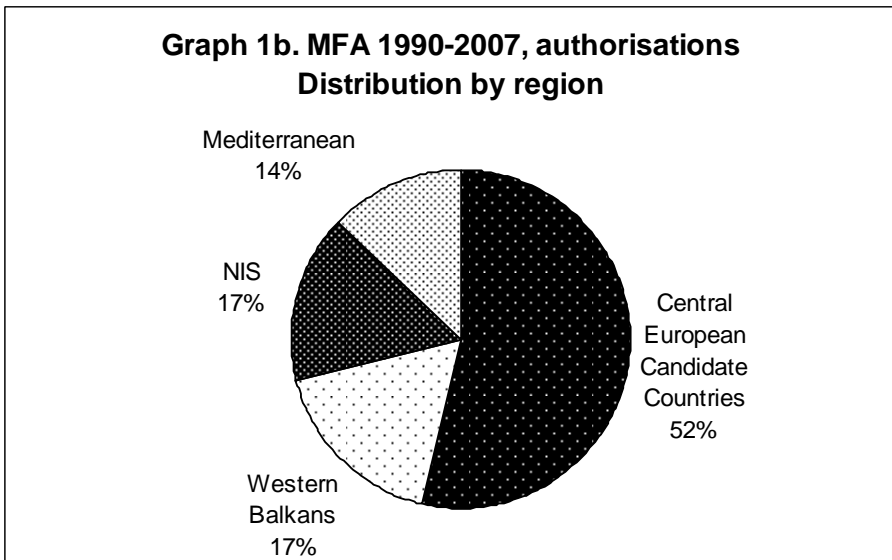
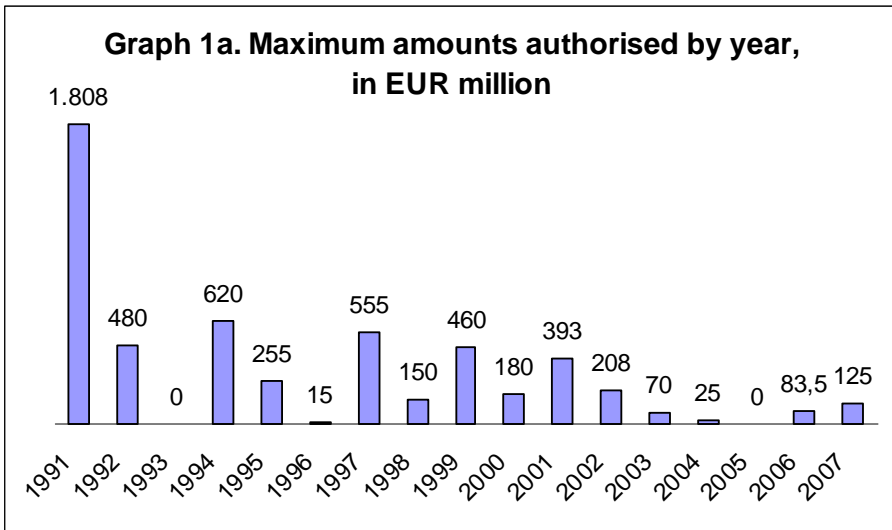


Table 2. Macro-financial assistance, 1990-2007
Disbursements, millions euro

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Totals	
By region																				
Central European Candidate Countries	350	695	705	270	70	80	40	70	250	40	160			50						2.780
Western Balkans			35	35		15	20	25	15	25	105	312	130	146	20	58	32			973
NIS					25	135	115	100	156	71		80	11	7	12	8,5	29	20		770
Mediterranean			438		150	100														688
Total amounts disbursed	350	695	1.178	305	245	330	175	195	421	136	265	392	141	203	32	66,5	61	20	5.210	
out of which, straight grants			63	35		15	20		18	28	85	105	141	85	22	51,5	42	20		730,5
													Bosnia (15) fYRoM (10) Kosovo (15) Serbia and Montenegro (115)	Armenia (11) Kosovo (15) Serbia and Montenegro (35), fYRoM (18), Tajikistan (7)	Bosnia (25, Serbia and Montenegro (10) Armenia (5,5) Georgia(6,5)	Serbia and Montenegro (25)	Albania (13) Tajikistan (7) Georgia (22)	Moldova (20)		
			Israel (28) Albania (35)	Albania		Albania	Albania		Armenia (8) Georgia (10)	Armenia (4), Kosovo (35) Georgia (6)	Kosovo (35) Montenegro (20)	Montenegro (ex FRY) (35) Georgia (6) Tajikistan (14)					Bosnia(15) Albania(3) Armenia (1,5) Tajikistan (7)			

NB: 2000 figures include disbursements in favour of Bosnia, fYRoM and Montenegro which, for technical reasons, took place in early January 2001.

2001 figures include disbursements in favour of fYRoM and Tajikistan which, for technical reasons, took place in early January 2002.

2002 figures include disbursements in favour of Bosnia and Tajikistan which, for technical reasons, took place in early 2003.

