

COMMISSION OF THE EUROPEAN COMMUNITIES

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Brussels, 04.10.1994

94/0218 (CNS)

**Proposal for a
COUNCIL DECISION
providing further macro-financial assistance
for Algeria**

(Presented by the Commission)

EXPLANATORY MEMORANDUM**Algeria's request for Community macro-financial assistance**

Algeria received Community macro-financial assistance for the first time in 1991, in the framework of a far-reaching economic stabilisation and reform programme which was supported by an IMF Stand-By arrangement. In September 1991, the Council approved complementary balance of payments assistance from the Community for an amount of ECU 400 million and the first tranche of ecu 250 million was disbursed in January 1992. As economic performance for the first quarter of 1992 did not meet the programme criteria, both IMF financial support and Community macro-financial assistance were suspended and the disbursement of the second tranche (ECU 150 million) of the Community loan was delayed.

In early April 1994, the Algerian authorities reached an understanding with the IMF on a new economic stabilisation and reform programme for the period April 1994 to March 1995. The Letter of Intent of the Algerian authorities and some US\$ 1 billion financial support for the programme were approved by the IMF Executive Board on 27 May.

On 30 April, the Algerian Prime Minister addressed a request to the Community for further macro-financial assistance in the framework of the new economic programme 1994-95. The request included the release of the remaining second tranche of ecu 150 million of the 1991 Decision as well as a new Community support.

Following this request, the Commission considered that it was appropriate to re-activate Community's macro-financial assistance to Algeria and announced to the Council its intention to release the remaining ECU 150 million second tranche and to propose a further ECU 200 million balance of payments loan after the adoption of the country's new macro-economic programme by the IMF Board. On 16 May the Council agreed on this approach and stated that it will consider favourably the Commission's proposal on the basis of a satisfactory track record of Algeria's macro-economic programme as agreed with the IMF.

The IMF Board approved the new programme on 27 May 1994, the ECU 150 million remaining tranche was disbursed in August 1994 and the present proposal is made as a follow-up to the Council's decision in principle.

Economic developments 1992-93

Algeria's economic situation deteriorated rapidly since the government abandoned, in early 1992, the targets of the 1991-92 economic programme. GDP growth remained moderate in 1992 at 2.2%, mainly due to a good agricultural season, but fell to -1.8% in 1993. Inflation reached nearly 32% in 1992, and remained at around 20% in 1993 despite the public sector wage freeze and continued price controls.

As the authorities maintained an administered exchange rate regime, the real exchange rate of the Dinar appreciated by 14% in 1992 and 25% in 1993. Stringent import controls and foreign currency allocation procedures were established towards the end of 1992, leading to a fall in imports from US\$ 9 billion in 1992 to US\$ 7.8 billion in 1993.

As a result of these measures, consumer hardship increased and industrial capacity utilisation declined as spare parts, investment goods, construction materials and other imported inputs were not available in sufficient quantities. Socio-political unrest intensified and the security situation deteriorated further against the background of high unemployment (over 20%) and an acute housing shortage.

The fiscal deficit increased from 1.3% of GDP in 1992 to 9.2% in 1993. Total central government revenue declined, mainly as a result of falling hydrocarbon revenue (which accounted for nearly two thirds of all government revenue in 1992) and total expenditure increased sharply against the background of the government's attempts to stem social unrest.

Towards the end of 1993, Algeria's external financial situation became unsustainable, due to a sharp decline in oil prices. By the end of the year, hydrocarbon exports, which account for nearly all export revenue, had fallen to US\$ 9.9 billion, down from US\$ 11 billion in 1992. At the same time, external debt service payments reached US\$ 9.4 billion. As export revenues fell below external debt service charges, Algeria started to accumulate arrears on external debt. By March 1994, they reached some US\$ 500 million. A rescheduling of the country's external debt thus became inevitable.

The government's economic programme for 1994-95

In early April 1994, the Algerian government reached a new understanding with the IMF on an economic programme for 1994-95. The programme is designed to speed up the transition to a market economy with a view to restoring growth and to reducing the external debt burden. It includes:

- The elimination of quantitative trade restrictions and the liberalisation of imports;
- The pegging of the Dinar to a basket of currencies during the first 6 months of the programme and the introduction of a market clearing exchange rate regime by the end of September 1994;
- Price increases for subsidised goods and further liberalisation of the domestic price regime;
- A review of the social security system, including a monthly allowance system for participants in public works projects;
- Fiscal measures to reduce the government deficit from 9.2% of GDP in 1993 to 3.3% in 1994
- A tightening of credit policy and an overall increase in various refinancing rates of the Bank of Algeria as well as banks' interest rates to positive levels in real terms;
- The acceleration of public enterprise and banking sector reforms;
- A review of rents for public housing and further structural reforms in the housing sector.

Prior actions foreseen in the programme, have been carried out in January and April 1994. These include a substantial devaluation of the national currency (from 25 to 36 Dinar per US\$), significant price increases for petrol and basic food items in order to reduce subsidies, increases in deposit and lending interest rates as well as central bank refinancing rates and a first package of measures to liberalise domestic prices and the imports regime. These measures are consistent with the structural reform performance

criteria that were attached to the release of the second tranche of the 1991 Community balance of payments loan.

The new programme makes allowance for a more than 20% increase in imports that is required to supply industries with vital spare parts, investment goods and other inputs, the absence of which has inhibited economic growth in the period 1992-93. The increase is designed to be compatible with a resumption of economic growth to 3% in 1994 and 6.2% in 1995, up from -1.8% in 1993.

Medium-term external financial prospects are expected to improve from 1995-96 onwards when additional hydrocarbon production and transport capacity will become operational. The resulting increases in import capacity and fiscal revenue will also stimulate activity in residential housing construction, agriculture and industries.

External outlook and financing needs

Under the programme, the current account is expected to deteriorate from a US\$ 1 billion surplus in 1993 to a US\$ 2.2 billion deficit in 1994. Export revenue is expected to further decrease from US\$ 10.3 in 1993 to US\$ 8.9 billion in 1994 and allowance is made for a significant rise in much needed imports of consumer goods and inputs for industries, from US\$ 7.8 billion in 1993 to some US\$ 9.4 billion in 1994. All projections are based on an oil price of US\$ 15/barrel throughout the programme period.

The global external financing gap, before debt rescheduling and including arrears on external debt service, is estimated at around US\$ 6.9 billion for the programme period from May 1994 to April 1995. It would only gradually decrease to zero by 1998.

In June 1994, Algeria obtained an agreement on a rescheduling of its official debt in the Paris Club. The Paris Club creditors agreed to reschedule debt service due during the consolidation period, including arrears, over a 15 years repayment period with 4 years grace. The cut-off date has been set at September 1993. These rescheduling terms are expected to reduce the financing gap by some US\$ 4.9 billion during the programme period. Algeria has also initiated negotiations with its commercial bank creditors on a similar rescheduling operation.

The residual financing gap for the programme period, after debt rescheduling, is estimated at around US\$ 2 billion. Financial support from the IMF, approved on 27 May 1994, amounts to some US\$ 1 billion, with a combination of a Stand-By arrangement (SDR 457.2 million) and a Complementary and Contingency Financing Facility (SDR 274.32 million).

The expected financial support from the World Bank would amount to some US\$ 435 million during the programme period. This includes the release of the US\$ 175 million second tranche of the Financial and Enterprise Sector Loan (FESAL), the disbursement of some US\$ 60 million under the existing housing sector loan and a new Structural Adjustment Loan for an amount in the range of US\$ 200 million. Japan is also expected to contribute some US\$ 150 million in co-financing the second tranche of the FESAL and various other donors may contribute some US\$ 100 million (Arab Monetary Fund, African Development Bank, Islamic Development Bank), thus leaving a financing gap in the order of US\$ 400 million.

Total Community macro-financial assistance during the programme period would amount to a maximum of ECU 350 million (US\$ 420 million), comprising the ECU 150 million of the second tranche released in August 1994 and the ECU 200 million new loan facility provided for by the present proposal.

The Algerian authorities have already announced their intention to start negotiations with the IMF in early 1995 on a successor 3-year economic programme, to be supported by an Extended Fund Facility. Financial projections by the IMF services show that Algeria will probably require further external financing facilities and debt rescheduling arrangements until the end of 1997.

Main features of the loan

The Commission is proposing that the Community grants Algeria a further balance of payments loan of up to Ecu 200 million, with a maximum maturity of seven years.

The assistance would complement resources made available by the IMF and the World Bank and would be disbursed in two tranches subject to a satisfactory track record of Algeria's macro-economic programme agreed with the IMF and progress with respect to structural reforms, including the observance of a number of performance criteria.

As in the case of similar operations in favour of third countries, the Community will provide the funds through market borrowing with a guarantee by the general budget. Algeria will subsequently borrow from the Community. The borrowing and lending operations will be perfectly matched and without any commercial risk for the Community.

On the assumption that the Guarantee Fund mechanism will be in place before the end of the year, the budgetary implications of a decision to grant further assistance of up to ECU 200 million to Algeria would imply an ECU 28 million provisioning of the Fund.

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**Proposal for a
COUNCIL DECISION
providing further macro-financial assistance
for Algeria**

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 submitted after consulting the Monetary Committee,

Having regard to the opinion of the European Parliament²,

Whereas Algeria has undertaken, since 1989, political and economic reforms and has decided to adopt a market economy model;

Whereas the Community and Algeria traditionally maintain close economic, political and cultural links which have been developed within the framework of the 1978 Cooperation Agreement;

Whereas, by Decision 91/510/EEC³, the Council decided to grant Algeria a medium-term loan for an amount of ECU 400 million in support of the government's adjustment and reform programme agreed with the International Monetary Fund (IMF) in 1991.

Whereas a first tranche of ECU 250 million of this loan was effectively disbursed in January 1992, and whereas the release of the second tranche of ECU 150 million has been delayed owing to slippages with respect to macro-economic performances and structural reform progress;

Whereas Algeria has reached an agreement with its Paris Club creditors on a comprehensive rescheduling of its official debt and whereas a similar agreement is under negotiation with Algeria's commercial bank creditors;

Whereas the Algerian authorities have requested complementary financial assistance from the European Union in support of the 1994-95 economic programme; whereas, after taking into account assistance which could be provided through debt rescheduling, IMF and World Bank financing and financial support from other donors, a residual financing gap of some US\$ 400 million remains to be covered during the programme period;

Whereas, in the context of this programme, the Commission has released the remaining tranche of ECU 150 million under the loan facility provided by Council decision,

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3 OJ n° L272, 28.9.91, p.90.

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91/510/EEC and whereas the grant by the European Community of a further loan facility to Algeria is an appropriate measure to ease the country's external financial constraints and support the policy objectives attached to the government's reform effort;

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 grant to Algeria a medium-term loan facility of a maximum amount of ECU 200 million in principal with a maximum maturity of seven years, with a view to ensuring a sustainable balance-of-payments situation and strengthening the 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 Algeria 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 Algeria.

Article 2

1. The Commission is empowered to negotiate with the Algerian authorities, 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 close coordination with the IMF, that Algeria's economic policy 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 Algeria in two installments. The first installment shall be released on the basis of a satisfactory progress in Algeria's application of the stand-by arrangement agreed with the IMF and subject to the provisions of Article 2(1).
2. The second installment shall be released at least one quarter after the release of the first instalment and subject to the provisions of Article 2 (2).
3. The funds shall be paid to the Bank of Algeria.



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 Algeria so wishes, 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 Algeria, 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 Algeria.
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 Brussels,

For the Council

The President

FINANCIAL RECORD

1. Budget line concerned

Article (...) loan guarantee for the Community loan to Algeria (to be created through an amending and/or a supplementary Budget).

2. References(legal base)

Article 235 of the Treaty

3. Classification of the Expenditure

Obligatory

4. Description and Justification for the actiona) Description of the action

The budget entry reflects the commitment of the budget guarantee associated with the Community loan to Algeria designed to ensure a sustainable balance-of-payments position and strengthening international reserves of this country.

b) Justification for the action

The viability of Algeria's external accounts heavily depends on external financial assistance from official sources.

5. Nature of the expenditure and method of calculationa) Nature of the expenditure

A guarantee for the Community loan to Algeria

b) Method of calculation

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 this budget guarantee will not be called.

6. Effect of the action on intervention credits

Only in the case of an effective call on the guarantee.

7. Financing of intervention expenditure

- Endowment of the line 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 fulfill 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) no. 1552/89 of 29.5.1989 will apply.

**BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF
THE GUARANTEE FUND IN 1994 AND NOTIONAL 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>
			318(2)
<u>Project related assistance</u>			
EIB/CEEC	765	107	211
EIB/MED	100(3)	14	197
EIB/PVDLA	500(4)	70	127
EURATOM	150	21	106
<u>Macro-financial assistance</u>			
Moldova	45	6	100
Bulgaria	40(5)	6	94
Romania	125	18	76
Algeria	200(6)	28	48
Slovakia	130(6)	18	30

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- (1) According to the provisioning rules agreed in the Council's common position of 13 September 1993
 - (2) Reserve amount in 1994 under the financial perspective
 - (3) Including amounts of estimated disbursements in 1993 and operations for Cyprus and Malta
 - (4) Including amounts of estimated disbursements in 1993
 - (5) Commission proposal to increase the amount of assistance (ECU 110 million) decided in 1992
 - (6) Commission proposal

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DOCUMENTS

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