



COMMISSION OF THE EUROPEAN COMMUNITIES

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

on the implementation of macro-financial assistance to third countries in 2005

{SEC(2006)938}

1. INTRODUCTION

The report on implementation of EC macro-financial assistance 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 review (working document of the Commission services SEC(2006)938) providing economic and financial information regarding the beneficiary countries is released in parallel. As for the present Communication it provides a general overview of the EC macro-financial assistance to third countries with historical background, a summary of the operations in 2005 and a synthesis of the economic situation of the beneficiary countries.

Special attention is paid in part 3 to a summary of relevant aspects of the economic stabilisation process and to 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. More details, at country level, are available in the accompanying working document of the services.

Moreover, as regards the recommendation of the Court of Auditors in the special report of March 2002 on improvement of financial management in the beneficiary countries, the Commission has carried out in 2005, with the assistance of an audit firm, operational assessments of the financial circuits and controls organisation related to macro-financial assistance in every beneficiary country prior to the disbursement of the assistance. The conclusions of these assessments concern mainly budget process, treasury organisation and control of public expenses (further details are provided in the working document). They entail recommendations that are being duly taken into account in the elaboration of the policy conditions attached to the implementation of this assistance.

The ex-post evaluation carried out in order to measure the impact of MFA in Armenia has been completed in 2005. In addition, two new ex-post evaluations are being conducted with the assistance of a specialised firm in Romania and fYRoM. Their final reports should be made available at the end of 2006.

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. It has continued to incorporate 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 (IFI's) and its macroeconomic conditionality. In particular, Community MFA has supported efforts by recipient countries to bring about 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 2005

During the period 2000-2005, the Balkans countries (Former Yugoslav Republic of Macedonia, Kosovo, Bosnia y Herzegovina, Serbia and Montenegro and Albania) have benefited from twelve assistances 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 733 million.

2.2.1. New decisions

No new decision has been adopted by the Council in 2005.

It has however to be noted that Commission adopted on 14 November 2005 a proposal to provide macro-financial assistance to Georgia of up to EUR 33.5 million (grant only). This proposal has been adopted by the Council in January 2006.

2.2.2. Disbursements

Disbursements of Macro-financial assistance amounted to a total of EUR 66.5 million of which EUR 51.5 million in the form of grants; EUR 3 million for Albania, EUR 1.5 million for Armenia, EUR 15 million for Bosnia y Herzegovina, EUR 25 million for Serbia and Montenegro, EUR 7 million for Tajikistan.

Assistance disbursed in the form of loans, amounted to EUR 15 million to Serbia and Montenegro.

2.3. Trends and geographical distribution of macro-financial assistance

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. Over the years, the number of countries to which it was appropriate for the Community to extend such support expanded, as a growing number of countries neighbouring the EU faced balance of payments difficulties and committed themselves to rigorous 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. As a result of the conflicts in the Western Balkans, in particular the Kosovo conflict of 1999 and of the political changes in Serbia and Montenegro (formerly, the FRY), a clear tendency for a relative increase in MFA to the countries of the Balkans developed through the 2000-2005 Council Decisions.

A specificity of the decisions of the 2000-2005 period is indeed the substantial share of grant support in the total amount decided: 41 % instead of 6 % over the 1990-1999 period. The new grant/loan proportion of the assistance packages reflects the assessment made by the EU bodies of the relative degree of poverty of the recipient countries and of their limited debt servicing capacity. As observed already in previous years, MFA is aimed not only at promoting macroeconomic stabilisation but also at supporting the recipient governments' programmes of structural reform. Consistently, MFA has been effectively combined with assistance from the PHARE/ISPA, TACIS or CARDS programmes with a view to strengthening the institutional capacity that was essential to the success of the structural reform process.

Tables 1 and 2, and their accompanying Graphs 1a and 2a underline the exceptional character of the EC MFA. The highest volumes of MFA operations were decided and disbursed in the years immediately after the changes in the political and economic systems of the countries of Central and Eastern Europe. Since then, the fluctuations in the amounts of MFA reflect decisions taken on a case-by-case basis after an assessment of the macro-economic situation and residual external financing needs of the potential beneficiary countries. Graph 1a - for net amounts of operations decided over the whole period from 1990 to 2005 (totalling around EUR 6.1 billion) - and Graph 2a - for actual amounts disbursed (totalling over EUR 5.1 billion) - show the important concentration of the assistance in the Central and East European Countries (around 54 % of total macro-financial assistance decided over the last 14 years). However, MFA to these countries was progressively phased out in parallel with their progress in macroeconomic adjustment and reform. More recently, MFA has been mainly provided to the Western Balkans (63.5 % of the operations decided from 1999 to 2002 and 84 % for 2000-2005) and some low income NIS. The relatively low amounts for the Mediterranean countries (13 % of the overall amounts authorised, but no new authorisation since 1996) should be considered against the background of other forms of macroeconomic support made available to these countries (notably, the MEDA Structural Adjustment Facilities).

3. SYNTHESIS OF THE ECONOMIC SITUATION AND REFORM IN BENEFICIARY COUNTRIES

3.1. Western Balkans

Economic growth was sustained in 2005 in the Western Balkans with an average 5.2 % GDP growth, except in Kosovo where growth was according to IMF estimates negative (-1.5 % of GDP). Inflation was moderate, except in Serbia where price tensions resumed. Fiscal consolidation progressed with General Government deficits reduced by 1 % of GDP and on average brought close to balance, but however remained in Albania and Kosovo in the range of 3.5 % to 4 % of GDP. As in previous years, external imbalances were still a challenge to macroeconomic stability. For the region as a whole, the trade deficit was high at around 27 % of GDP. The average current account deficit is estimated to have come down to around 12 % of GDP in 2005 (from 12.5 % in 2004). The size of this deficit is particular element of vulnerability in Bosnia and Herzegovina, where it is estimated around 20 % of GDP. Wage levels in Western Balkan countries remained a concern to competitiveness, particularly in fully euroised economies such as Montenegro and Kosovo, and call for a flexible interplay of market adjustment mechanisms.

The process of privatisation, which is at a different stage of progress in the countries, has overall progressed at an uneven pace in the Western Balkans. While a number of large sales took place, it has encountered significant delays in some countries, notably Albania and Serbia. Enterprise restructuring, notably as regards loss making public-owned enterprises, was as in the previous years again delayed by protracted decisions and poor management. Enforcement of property rights and contracts continued to encounter considerable difficulties throughout the region owing to weaknesses in the judiciary. The latter continued to have wide ranging economic consequences and to hinder business decisions, notably investment, and market exit. The large informal sector remained a source of uneven competition and tax evasion.

However, the conditionality linked to ongoing MFA operations was fully met and allowed for disbursements in Albania, Bosnia and Herzegovina and Serbia and Montenegro. In these countries, progress in reforms took place in the public administration, notably in the field of financial control and audit. More generally, a strengthening of tax collection has been observed through measures such as the introduction of a VAT system as well as an anti corruption strategy and the fight against tax-evasion. Finally, the banking sector has been subject to structural reforms through a wide privatisation process while the presence of foreign banks has become preponderant.

3.2. New Independent States

Economic growth in most of the New Independent States (NIS) remained very strong in 2005, making the area the second fastest growing region in the world, behind East Asia. The aggregate output increase in the NIS was close to 7 %. The most common factors behind growth are high commodity prices and domestic demand fuelled by private transfers, in particular workers' remittances.

Growth in Russia, by far the region's largest economy, remained strong, albeit showing signs of deceleration. In 2005 real GDP increased by 6.4 %, after 7.2 % a year before. The somewhat weakening growth performance despite continuing high prices of Russia's main export resources (Russia is the world's second oil exporter and the world's first gas exporter) is explained by more rapid increase in production costs than in productivity and by low investment and capacity constraints. Nevertheless, during the second half of 2005, the slowdown in investment (domestic and foreign) was reverted. In Ukraine, a negative terms of trade shock (import prices of energy increasing while world market prices on metal exports tumbled), combined with sluggish investment under an uncertain government policy environment led to a hard landing, after an exceptional 2004 performance. In 2005, real GDP growth rate was just 2.4 %, down from 12.1 % in 2004.

Among the other countries of the region, the most impressive growth performance in 2005 was registered by the resource-rich Azerbaijan, where, following the development of the oil production (largely due to foreign investments) and the start of the operation of the new pipeline to the Turkish Mediterranean port of Ceyhan, GDP increased by more than 26 %. Impressive growth was also registered in Armenia (+13.9 % in 2005) where the economic expansion is driven mainly by domestic demand, buoyed by foreign investments, remittances and private transfers. Growth performance in nearly all the other countries of the region exceeded that of Russia: at least 9 % in Kazakhstan, Belarus and Georgia; Moldova, Tajikistan and probably Turkmenistan (where the official statistics indicating a 20 % growth are widely believed to be grossly inflated).

Fiscal policies remained tight in the majority of the countries of the region and inflation pressures were generally kept under control. Several countries registered substantial fiscal surpluses on the back of strong tax revenue from exports of energy or imports of consumer goods. Current account developments have been mixed. Resource-rich countries have generally registered strong growth in trade surpluses, compensated sometimes by increasing deficits of the incomes and services accounts. At the same time, energy-importing countries have seen their trade deficits widen; yet this has not translated into the worsening of the current accounts since growth in trade deficits was generally compensated by increases in either private or public transfers or, more often, remittances. The only exception is Ukraine whose current account surplus was cut from a record 10.5 % of GDP in 2004 to about 5 % in 2005. External debt ratios were reduced in most of the NIS reflecting growth of nominal GDP. Also, one country (the Kyrgyz Republic) was granted debt reduction by the Paris Club of official creditors. Several NIS are still critically dependent on external financing by multilateral or bilateral donors to approach financial sustainability.

Progress in transition has been uneven across the region and the implementation of second-phase institutional reforms supporting markets and private enterprise is still at its early stages in several NIS. Among the beneficiaries of the Community macro-financial assistance, Moldova was probably the one to progress most in implementing structural reforms in the context of a comprehensive economic growth and poverty reduction strategy. Although much remains to be done to catch up with the most advanced countries of the region, this was a welcome change after several years of widespread state interference and poor governance. In Ukraine, the genuine reform commitment of the new political authorities who came to power in early 2005 could not be fully translated into action owing to political uncertainties. Armenia, Georgia and Tajikistan continued the implementation of adjustment and reform programmes supported by the International Financial Institutions.

TECHNICAL ANNEX

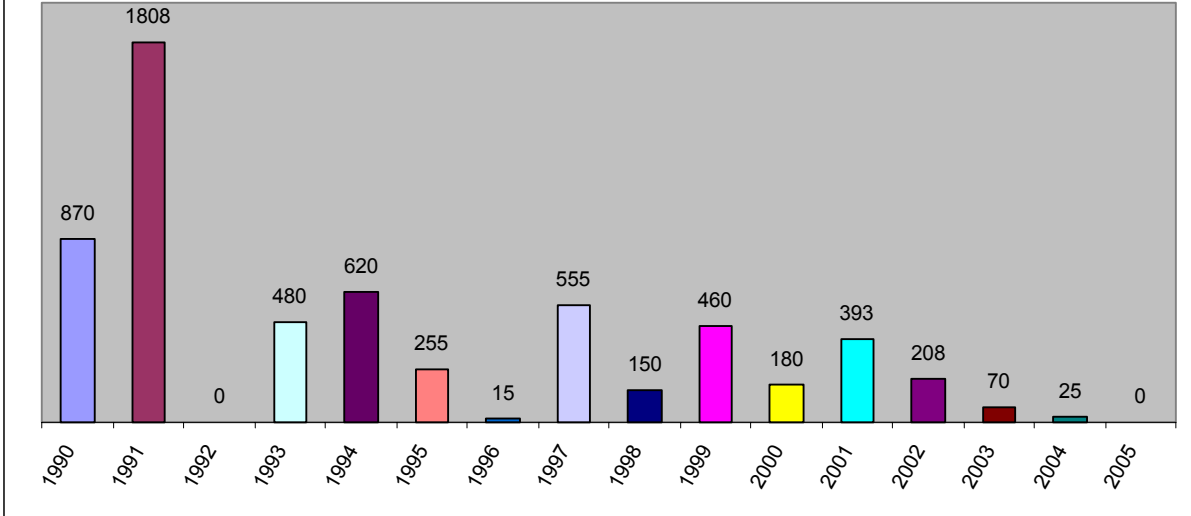
Table 1. Macro-financial assistance, 1990-2004 Maximum amounts authorised, millions euro

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Totals
By region																	
Central European Candidate Countries	870	1.220	410		255			250		300							3.305
Western Balkans			70		35			40		160	55	393	190	70	25		1.038
NIS					130	255	15	265	150		125		18(a)				958
Mediterranean		588			200												788
Total amounts disbursed decided	870	1.808	480	0	620	255	15	555	150	460	180	393	208	70	25	0	6.089
Out of which, straight grants		28	70		35			95		70	90	168	130	45	16		747
													Serbia & Montenegro (35)				
										Kosovo (35) Montenegro (20)							
												fyRoM (18) Serbia & Montenegro (120)		Bosnia (40)			
										Bosnia (40)	Tajikistan (35)			Serbia & Montenegro (45)	Albania(16)		
	Interest subsidies to Israel	Albania			Albania			Armenia and Georgia (95)		fyRoM (30)	Moldova (15)	Kosovo (30)	Moldova (15)				
													(b)				

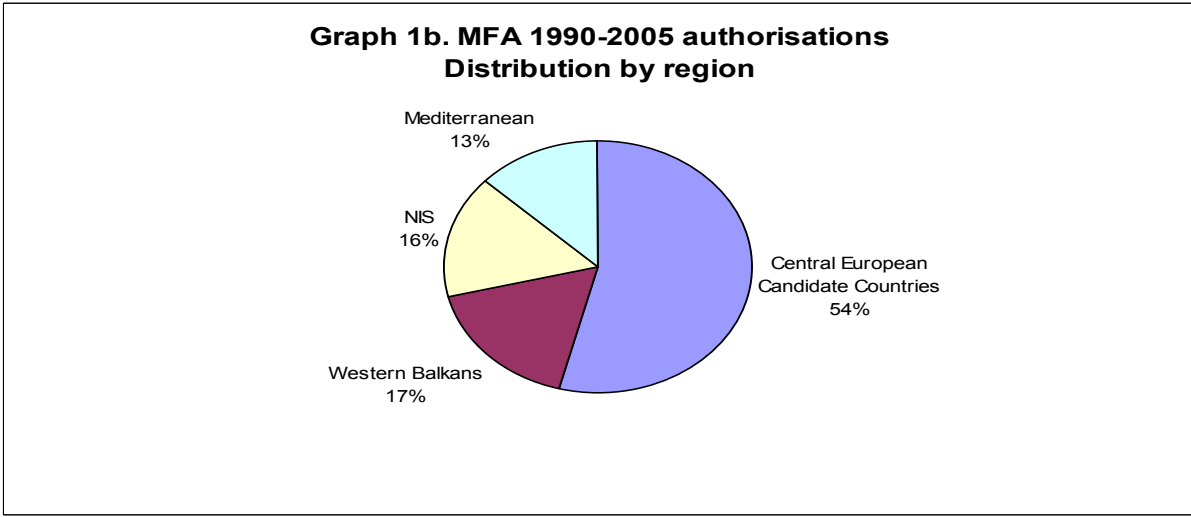
(a) net amount taking into account (b) and , for Ukraine, new loan of EUR 110 million together with simultaneous cancellation of EUR 150 million loan decided in 1998.

(b) grant of EUR 15 million and simultaneous cancellation of the EUR 15 million loan decided in 2000.

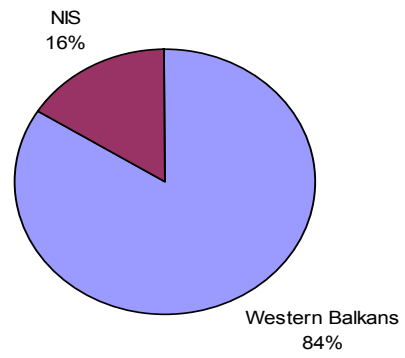
Graph 1a. Maximum amounts authorised by year, in EUR million



Graph 1b. MFA 1990-2005 authorisations Distribution by region



**Graph 1c. MFA 2000-2005, authorisations
Distribution by region**



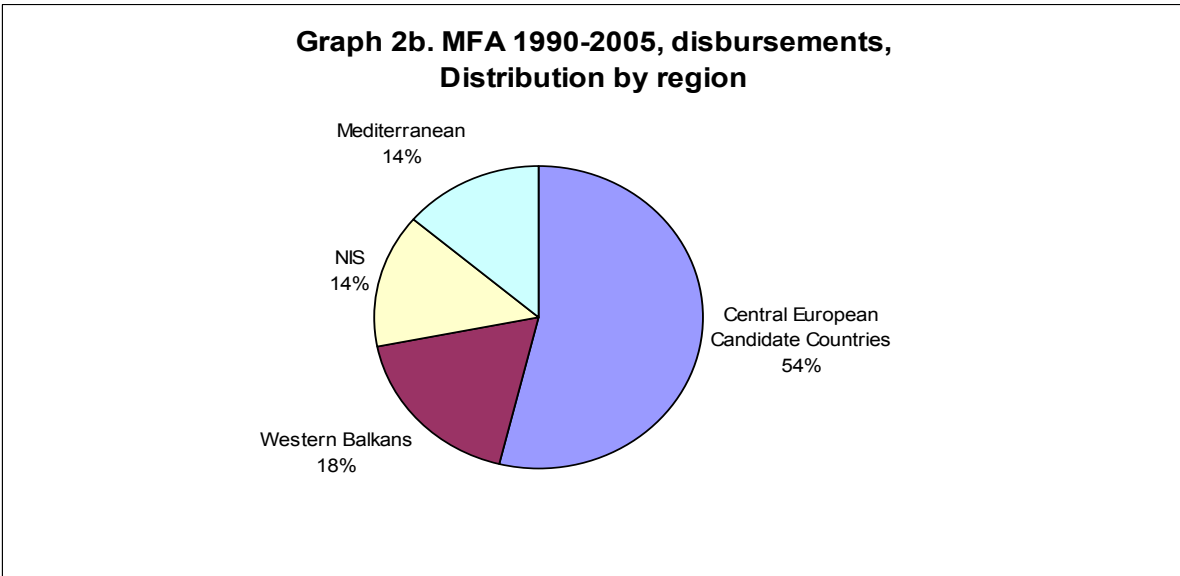
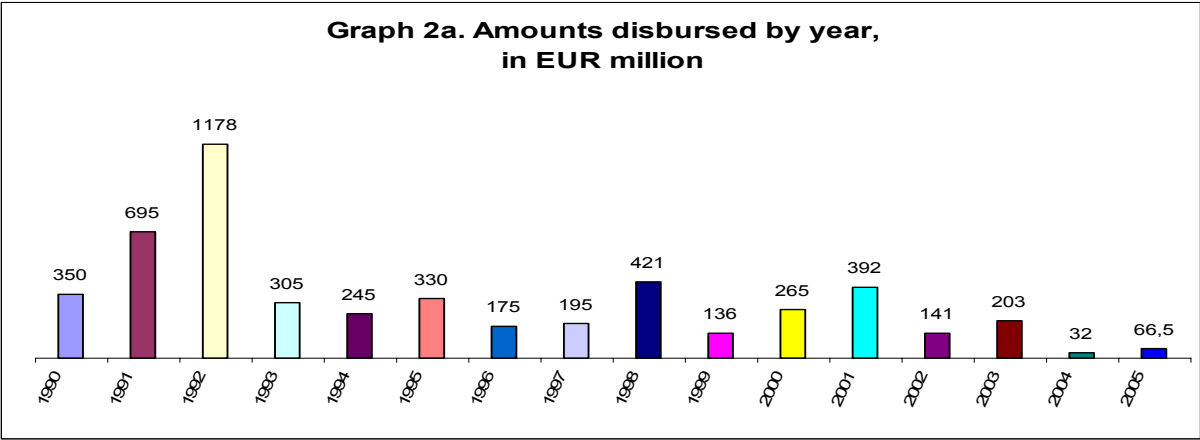
Disbursements, millions euro

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	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	941
NIS					25	135	115	100	156	71		80	11	7	12	8,5	720,5
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	5129,5
Out of which, straight grants			63	35		15	20		18	28	85	105	141	85	22	51,5	668,5
												Bosnia (15)					Serbia Montenegro (25)
												fyRoM (10)		Bosnia (25)			
										Armenia (4)	Bosnia (10)		Armenia (11)	Serbia & Montenegro (35)			
									Armenia (8)		fyRoM (20)	Kosovo (15)	Kosovo (15)		Serbia & Montenegro (10)		
												Serbia & Montenegro (ex FRY)(35)	Serbia & Montenegro (115)				
		Israel (28) Albania (35)	Albania		Albania	Albania				Georgia (9)	Kosovo (35)						
								Georgia (10)						fyRoM (18)		Bosnia (15)	
									Bosnia (15)	Montenegro (20)					Armenia (5,5) Georgia (6,5)		
												Georgia (6) Tajikistan (14)		Tajikistan (7)			
																	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 disbursement in favour of fyRoM and Tajikistan which, for technical reasons, took place in early January 2002.

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



**Graph 2c. MFA 2000-2005, disturbances,
Distribution by region**

