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COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget Situation at 30 June 2007

{SEC(2008) 18}

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1. INTRODUCTION AND TYPES OF COVERED OPERATIONS

This report is submitted pursuant to Article 130 of the Financial Regulation which requires the Commission *to report to the European Parliament and to the Council twice a year on budgetary guarantees and the corresponding risks*[1]. It is completed by a Commission Staff Working Paper with a set of detailed tables and explanatory notes (the "Annex")[2].

The risks covered by the budget of the European Union ("the Budget") derive from a variety of lending and guarantee operations which can be divided into two categories: loans granted by the European Communities with macroeconomic objectives, i.e. macro-financial assistance ("MFA") loans to third countries, and loans with microeconomic objectives (Euratom loans and most importantly European Investment Bank ("EIB") external lending[3]). These operations have been covered since 1994 by the Guarantee Fund for external actions ("the Fund")[4] which was set up, among other things, to limit the budgetary impact stemming from calls on guarantees given by the Budget for lending operations in third countries. If there are insufficient resources in the Fund, recourse will be made to the Budget.

The Council Regulation establishing the Fund (the "Fund Regulation"[5]), which was adopted in 1994, was first amended in 1999. Following a second amendment of the Council Regulation which was adopted in 2004 by the Council, the Fund's coverage is withdrawn if third countries become Member States. The Budget directly covers loans or guaranteed loans to Member States.

2. NEW LEGAL BASES

In the framework of the 2006 Council Decision[6] to grant a renewed Community guarantee to the EIB against losses under loans and loan guarantees for projects outside the Community (EIB external mandate 2007-2013, hereinafter the "new general mandate"), the Commission and the EIB signed a Guarantee Agreement and a Recovery Agreement in August 2007[7], laying down the detailed provisions and procedures relating to the Community Guarantee and the recovery of claims following a call on the Guarantee. The Guarantee Agreement covers EIB financing operations signed after 17 April 2007, the date of approval of the new general mandate by the EIB Board of Governors.

There were no new decisions on MFA loans or Euratom loans in the first half of 2007.

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1 COM(2007)454 and SEC(2007)1050 make up the previous report on the guarantees covered by the Budget at 31 December 2006.

2 SEC(2007)[…].

3 The figures concerning the EIB mandates are displayed in Table A1 and references to legal bases are listed in Table A4 of the Annex.

4 For the most recent report on the Fund, see COM(2006)695 "Comprehensive Report on the functioning of the Guarantee Fund" and the annexed staff working document (SEC(2006)1460).

5 Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994 establishing a Guarantee Fund for external actions, OJ L 293, 12.11.1994, p.1, as amended by Council Regulation (EC, Euratom) No 1149/1999 of 25 May 1999, OJ L 139, 2.6.1999, p. 1, Council Regulation (EC, Euratom) No 2273/2004 of 22 December 2004, OJ L 396, 31.12.2004, p. 28, and Council Regulation (EC, Euratom) No 89/2007 of 30 January 2007, OJ L 22, 31.1.2007, p. 1.

6 Council Decision (EC) No 1016/2006 of 19 December 2006, OJ L 414, 30.12.2006, p. 95.

7 C/2007/3592.

3. EVENTS SINCE THE LAST REPORT AT 31 DECEMBER 2006

There were no disbursements under MFA loans during the first half of 2007.

Regarding Euratom loans, disbursement of a first tranche of EUR 39 million took place in March 2007 for the financing of a safety upgrade of Unit 2 of the Khmelnitsky and Unit 4 of the Rovno Ukrainian nuclear power plants (K2R4) under the loan agreement of 2004 (EUR equivalent of USD 83 million Loan Facility Agreement).

During the first half of 2007, the EIB pursued its activity under the general mandate decided in the framework of the 2000-2006 Financial Perspective, (hereinafter "the current general mandate"). Moreover, on 28 June 2007, the EIB signed a first loan contract of EUR 30 million with the Republic of Moldova under the Council Decision No 2005/48 of 22 December 2004 granting a Community guarantee to the EIB against losses under loans for certain types of projects in Russia, Ukraine, Republic of Moldova and Belarus (hereinafter the "Russia, Ukraine, Republic of Moldova and Belarus mandate").

As mentioned under Section 2 above, the new Guarantee Agreement with the EIB covers financing operations signed after 17 April 2007. However, no operations had been signed by the EIB under the new general mandate as of 30 June 2007.

4. DATA ON RISKS COVERED BY THE BUDGET

4.1. Definition of risk

The risks borne by the Budget derive from the outstanding amount of capital and interest in respect of guaranteed operations.

Defaulting operations will be covered by the Fund when they are linked to third countries (70% of the total outstanding amount guaranteed as of 30 June 2007) and directly by the Budget where Member States are involved (loans to or for the benefit of projects in Member States account for the remaining 30% of the total outstanding amount). The large proportion of guaranteed loans linked to Member States is the result of the recent enlargement rounds. According to Article 1, third paragraph of the Fund Regulation, once a country becomes a Member State, the risk on the loans is transferred from the Fund to the Budget.

For the purpose of this report, two methods are used for evaluating the risks borne by the Budget (either directly or indirectly via the Fund):

– The method of calculating the total amount of capital outstanding for the operations concerned on a given date including accrued interest. This methodology gives the level of risk supported by the Budget on a given date.

– The budgetary approach defined as "the annual risk borne by the Budget" is based on the calculation of the maximum amount which the Community would have to pay out in a financial year assuming that all guaranteed loans are in default[8].

8 For the purpose of this calculation, it is assumed that defaulting loans are not accelerated, i.e. only due payments are taken into account (see also Section 1 of the Annex).

Table 1: Total outstanding amounts covered as of 30 June 2007 in EUR million				
	Outstanding Capital	**Accrued Interest**	**Total**	**%**
<u>Member States</u>*				
MFA	309	2	311	2%
Euratom	436	5	441	3%
EIB	4 224	38	4 262	26%
<u>Sub-total Member States*</u>	4 969	46	5 014	30%
<u>Third Countries</u>				
MFA	568	7	575	3%
Euratom	39	0	39	0%
EIB	10 901	116	11 018	66%
<u>Sub-total third countries</u>	11 508	124	11 632	70%
Total	**16 477**	**170**	**16 647**	**100%**

* This risk is directly covered by the Budget and includes Bulgaria and Romania as they have joined the EU on 01.01.2007.

Tables A1, A2, A3 and A4 of the Annex provide more detailed information on these outstanding amounts, in particular in terms of ceiling, disbursed amounts or guarantee rates.

4.2. Risk linked to Member States

Current risks on Member States result from loans granted prior to accession.

In the second half of 2007, the Budget will bear a risk linked to Member States of EUR 398 million including Bulgaria and Romania as they have joined the Union on 1 January 2007. Table 2 shows that these two states are ranked first and second in terms of their outstanding amount.

Table 2: Ranking of the Member States according to the exposure with regard to the maximum risk borne by the budget in the second half of 2007 (EUR million)			
Ranking	**Country**	**2nd Half of 2007**	**%**
1	Romania	119.7	30.1%
2	Bulgaria	90.4	22.7%
3	Poland	48.7	12.2%
4	Czech Republic	45.7	11.5%
5	Slovakia	35.1	8.8%
6	Hungary	19.7	5.0%
7	Slovenia	19.6	4.9%
8	Cyprus	7.8	2.0%
9	Latvia	4.7	1.2%
10	Lithuania	3.6	0.9%
11	Estonia	2.4	0.6%
12	Malta	0.5	0.1%
	Total	398.0	100.0%

The risk on Member States concerns all Members States involved in the last two enlargements with maturities ending 2031.

4.3. Risk linked to third countries

In the second half of 2007, the Fund will bear a maximum risk related to third countries of EUR 714 million. The top ten countries according to their total outstanding are listed below. They account for 82% of the risk borne by the Fund in the second half of 2007. The economic situation of these countries is analyzed and commented in Section 7 below.

Table 3: Ranking of the 10 most important third countries according to the exposure with regard to the maximum risk borne by the Fund in the second half of 2007 (EUR million)			
Ranking	**Country**	**2nd Half of 2007**	**% of the total maximum risk**
1	Turkey	100.9	14.1%
2	Brazil	82.7	11.6%
3	Egypt	75.2	10.5%
4	South Africa	69.0	9.7%
5	Morocco	61.0	8.5%
6	Tunisia	58.5	8.2%
7	Lebanon	54.2	7.6%
8	Ukraine	36.6	5.1%
9	Serbia and Montenegro[9]	24.5	3.4%
10	Jordan	21.8	3.1%
Total of the 10		584.3	81.8%

The Fund covers the guaranteed loans of 40 countries and 2 regional entities with maturities ending 2037. Details by country are provided in Table A2 of the Annex.

4.4. Global risk covered by the Budget

In total, the Budget will cover in the second half of 2007 an amount of EUR 1 112 million representing the amounts due during this period, where 36% are due by Member States (see Table A2 in the Annex).

4.5. Evolution of risk

The risk towards Member States should decrease in future as the loans to Member States under Euratom, MFA or EIB guaranteed lending are reimbursed (see Graph A1 in Section 1.3 of the Annex).

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9 Now the Republic of Serbia and the Republic of Montenegro.

MFA loans to third countries are subject to individual decisions by the Council. A proposal by the Commission for granting an MFA loan of EUR 50 million and a grant of EUR 30 million to Lebanon was adopted on 20 August 2007 and has been forwarded to the European Parliament for consultation and to the Council for decision.

The Euratom lending to Member States or in certain eligible non-member countries (Russian Federation, Armenia, Ukraine) has a ceiling of EUR 4 billion of which around 85% have already been used. The remaining margin is about EUR 600 million. Under the existing loan agreement of 2004 to K2R4 in Ukraine (EUR equivalent of USD 83 million Loan Facility Agreement), two further tranches may be disbursed in 2008 (see Section 3 above).

Under the existing EIB mandates preceding the new general mandate, an amount of EUR 8 067 million remains to be disbursed under signed loans. This amount will mostly be linked to the current general mandate[10]. At the end of July, the EIB signed a loan agreement of EUR 200 million with Ukraine under the Russia, Ukraine, Republic of Moldova and Belarus mandate. This mandate and the current general mandate expired on 31 July 2007[11].

The most important item that will impact the risk for the Budget in future is the recent Community guarantee granted to the EIB under the new general mandate. The Community guarantee is restricted to 65% of the aggregate amount of credit disbursed and guarantees provided under EIB Financing Operations, less amounts reimbursed and plus all related sums, with a maximum ceiling of EUR 27 800 million[12].

In Section 1.3 of the Annex, Graph A2 presents simulations of some scenarios of disbursements under the mandates preceding the new general mandate, as well as the new general mandate, as those disbursements have a strong impact on the provisioning of the Fund.

5. DEFAULTS, ACTIVATION OF BUDGET GUARANTEES AND ARREARS

5.1. Payments from cash resources

The Commission draws on its cash resources in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying the Commission[13].

5.2. Payments from the Budget

No appropriation was requested under Budget Article 01 04 01, "European Community guarantees for lending operations", as no default was recorded in the first half of 2007.

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[10] See Section 1.3 of the Annex.

[11] The next report (situation at 31 December 2007) will focus on the state of play with detailed figures at the date of expiration.

[12] Broken down into a basic ceiling of a fixed maximum amount of EUR 25 800 million and an optional mandate of EUR 2 000 million.

[13] See Article 12 of Council Regulation (EC, Euratom) No. 1150/2000 of 22 May 2000, as amended, implementing Decision 94/728/EC, Euratom, on the system of the Communities' own resources.

5.3. Activation of the Guarantee Fund for external actions

In the event of late payment by the beneficiary of a loan (third countries) granted or guaranteed by the Community, the Fund is called on to cover the default within three months of the date on which payment is due.[14]

During the first half of 2007, the Fund was not called.

The total arrears at 30 June 2007, i.e. penalty interests with the Republic of Argentina, amount to USD 1 718 493.12; thereof USD 1 448 433.44 (EUR equivalent 1 072 516.43) are still to be recovered by the Fund. As the Fund was not called for the remaining difference, this amount is due to the EIB. The Commission and the EIB have on several occasions reminded the Argentinean authorities of the need to fully clear these arrears before the resumption of new EIB lending operations in the country. Discussions on this issue will continue in the framework of the next meeting of the EU-Argentina macroeconomic dialogue.

6. GUARANTEE FUND FOR EXTERNAL ACTIONS[15]

6.1. Recoveries

No recovery occurred in the first half of 2007.

6.2. Assets

At 30 June 2007, the net assets of the Fund amounted to EUR 1 119 961 441.29.

6.3. Target amount

The Fund has to reach an appropriate level (target amount) set at 9% of the total outstanding capital liabilities arising from each operation, plus accrued interest. The ratio between the Fund's resources (EUR 1 119 961 441.29) and outstanding capital liabilities (EUR 11 632 230 697.97) within the meaning of the Fund Regulation was 9.6%.

At year-end 2006, the Fund resources were already higher than the target amount. According to the new provisioning rules adopted by the Council on 30 January 2007[16], a surplus of EUR 125.75 million was inserted in the Preliminary Draft Budget of 2008.

7. EVALUATION OF RISKS: ECONOMIC AND FINANCIAL SITUATION OF THE THIRD COUNTRIES BENEFITING FROM THE MOST IMPORTANT EU LOAN OPERATIONS

7.1. Introduction

Previous sections of the report provide information on quantitative aspects of the risk borne by the Budget. However, the quality of the risks which depend on the type of operation and the standing of the borrowers (see Section 4.3 above) should also be assessed. Tables on the

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[14] For more details, see Section 1.4.3 of the Annex.

[15] Annual Report from the Commission on the Guarantee Fund and its Management in 2006: COM(2007)362 and SEC(2007)869.

[16] Council Regulation (EC, Euratom) No 89/2007 of 30 January 2007, OJ L 22, 31.1.2007, p. 1.

country risk evaluation are presented separately in the Commission Staff Working Paper. A summary of this analysis is provided below for the ten countries having the highest annual risk to the Budget in the second half of 2007. Section 2 of the Annex provides an analysis of five further countries.

7.2. Turkey

In **Turkey**, annual GDP growth amounted to 5.3% in the first half of 2007, down from 6.1% in 2006. The current account deficit narrowed slightly to 7.8% of GDP from 7.9% of GDP in 2006. Gross FDI inflows reached 5% of GDP in 2007, and about two thirds targeted the financial sector. In the previous year, the external debt of the country increased by about 5 percentage points to roughly 45% of GDP by mid-2007. At the same time, public debt fell to 61% of GDP from 68% of GDP in mid-2006.

7.3. Brazil

Brazil's economy continues to pick up. After accelerating to 3.7% in 2006, annual economic growth is expected to reach about 4¾% in 2007. The main driver of growth is domestic demand, which continues to benefit from the substantial monetary easing. Private investment is notably growing rapidly. While remaining below the central bank's target of 4.5%, inflation pressures have risen somewhat recently as a result of a spike in food prices and some weakening of the currency in connection to the recent turbulence in the financial markets. While strong domestic demand has led to surging import growth and previous currency appreciation has dampened export growth, the current account has remained in surplus thanks to improving terms-of-trade (due to rising commodity prices) and solid volume expansion in commodity exports. The current account remains in surplus. Brazil's external vulnerability has eased with its external debt ratios declining significantly. The external debt-over-GDP ratio, in particular, has decreased from 40.8% in 2002 to currently around 16%. Efforts to reduce public external indebtedness are paying off: credit-rating agencies have upgraded Brazil's sovereign credit and interest spreads are at historically low levels. Despite recent progress public debt remains high at around 45% of GDP and current public expenditure is rising fast.

7.4. Egypt

The economic growth of **Egypt** accelerated from 4.5% in fiscal year 2005 to 7.1% in fiscal year 2007 underpinned by foreign direct investments and exports of goods and services (especially tourism). Inflation surged again to double digits in fiscal year 2007, after having been reduced to a single digit in the fiscal year 2006. A positive sign was the slowdown of unemployment in the recent year. But unemployment remains relatively high as a percentage of the labour force. Despite the strong economic growth and the sale of (semi-)state owned enterprises the general government deficit hardly narrowed (9.2% in fiscal year 2007 compared with 7.7% for fiscal year 2006). Consequently, the gross government debt remained above 100% of GDP. Reforms in the financial sector are progressing. Sound fiscal policy combined with adequate monetary policy will have positive effects on job creation.

7.5. South Africa

Real GDP of **South Africa** grew by 4.75 % and 4.5 % in the first two quarters of 2007, indicating that conditions for business remained favourable, in particular for construction, agriculture, financial services and transport. Growing disposable income and wealth effects from rising asset prices also boosted private consumption. In 2006 the Central Bank has increased the refinancing rate (REPO) from 7.0% to 9.0% to keep inflation within a 3% to 6% range. The current account deficit expanded to 7 % and 6.5% in the first two quarters of 2007, largely driven by strong domestic demand leading to stronger volume growth in imports than exports. The deficit was more than covered by large portfolio inflows, mainly equity. International reserves have increased to above USD 28 billion in mid 2007 accounting for 3.4 months of imports of goods and services.

The fiscal balance of the national government has turned into a surplus of 0.6% bringing government debt down to about 31% of GDP. On the external side, the economy could be adversely affected by weaker appetite for emerging market assets, a global slowdown, or a sharp deterioration in the terms of trade. However, the country's strong fundamentals should limit the adverse impact of these shocks on the economy. Internal pressures might arise from high unemployment, high inequality, high HIV/AIDS prevalence, and high crime rates.

7.6. Morocco

Morocco's ambitious economic reform program is beginning to bear fruit. The economic fundamentals have strengthened, and macroeconomic conditions remain solid. End-2006 real GDP growth is 8.1%, mainly resulting from a bumper crop but due to bad weather conditions in 2007 the GDP growth rate will slow down to 2.5%. A number of important budget and fiscal reforms have shown encouraging results. The forecast fiscal deficit (excluding privatisation receipts) for 2007 stands at 2.5% of GDP (up from 2.1% in 2006). Continuous expenditure pressures related to high oil and food subsidies (2.5% of GDP) are key reasons for a raising public deficit in 2007. The public debt-to-GDP ratio is expected to reach 58.0% of GDP end-2007. Gross official reserves are expected to keep increasing to reach over USD 23 billion in 2007 (over 8 months of imports), up from close to USD 20 billion in 2006. Morocco had a series of nine arrangements with IMF between 1980 and 1993, but has not had an IMF-supported program since then and completed repaying its borrowing from the IMF in 1997.

7.7. Tunisia

The economic growth of Tunisia accelerated from 4.0% in 2005 to 6.0% in 2007, originating from the agricultural, the non-textile manufacturing and the service sector. Despite the higher economic growth, unemployment remained high at around 14%. Remarkably, a significant part of the unemployed people has a university degree. The central public deficit, excluding privatisations, stabilized around 3%. The prudent fiscal policy along with a tightening monetary policy has been beneficial for the Tunisian economy because inflation remained moderate in 2007, at 3.0%. The higher oil prices did not lead to higher subsidies thanks to the phasing out of subsidies. Due to the higher economic growth the central government debt has regressed and is expected to continue this trend in the near future. Debt is currently however still above 50% of GDP, where the majority concerns foreign debt. Tunisia seems nonetheless quite resilient to external shocks or confidence crises due to the long-term structure of the external debt. The expectations are that the prosperous short term economic outlook will make the debt stock regress even to far below 50% of GDP soon. New privatization receipts are envisaged to be mainly used for debt amortization.

7.8. Lebanon

Lebanon remains one of the most indebted countries in the world while being confronted with immediate reconstruction needs following the 2006 July war. The military conflict put an additional pressure on the already vulnerable public finances and current account. As a result, the economy is estimated to have contracted in 2006 by 5% in real terms, the public deficit almost doubled compared to 2005 reaching 11% of GDP, and the government debt remained basically unchanged at 178% of GDP. The government adopted in January 2007 an ambitious and comprehensive medium-term programme of socio-economic reforms. The authorities presented the programme at the International Donors' Conference in Support for Lebanon (Paris III) in January 2007. The recently agreed IMF financing under the Emergency Post-Conflict Assistance (EPCA) reinforces the credibility of the programme, provides a means for close monitoring of its implementation particularly budget support. Yet, 2007 is a very difficult year as political instability and recurrent outbreaks of violence continue ahead of the presidential election in the period between September-November.

7.9. Ukraine

In **Ukraine**, strong domestic demand drives robust economic growth while net exports have been negative for two years now. Real GDP growth reached 8.4% in the first half of 2007 (7.1% in 2006 as a whole), supported by a strong credit growth and increases in real incomes. The current account turned negative at about 1.5% of GDP against a surplus of 3% the year before, driven by strong import demand and higher energy import prices. In 2007 the current account deficit is projected to increase to about 3.5% of GDP driven by imports' growth, surpassing exports which nevertheless have benefited from high world steel prices (Ukraine's main export sector accounting for 40% of total exports). Ukraine's public external debt declined to about 12% of GDP (15% in 2005), while the private sector's better access to foreign capital markets edged the total external debt to about 50% of GDP. The main risks still relate to the turbulent political situation, culminating in the pre-term parliamentary elections of September 2007. Standard & Poor's confirmed, however, Ukraine's sovereign long-term credit rating at BB-, supported in particular by the low level of indebtedness.

7.10.1 Serbia

In **Serbia** annual GDP growth amounted to around 8% (in real terms) for the first half of 2007. The current account deficit widened to about 16% of GDP in the first half of the year. Net FDI inflows declined to about 4% of GDP in the same period and the external debt of the country amounted to about 60% of GDP at end-July 2007. Public debt declined to about 35% of GDP at the same time, due to debt write-offs and early repayments to international financial institutions.

7.10.2 Montenegro

In **Montenegro** annual GDP growth accelerated to 6.9% in the second quarter of 2007. The current account deficit further widened to 31% of GDP in the same period, driven by an increasing trade deficit. Net FDI inflows reached 28.2% of GDP in the second half of 2007. Public debt continued to decline to 35.6% of GDP, while the public external debt of the country amounted to 23.7% of GDP at the end of June 2007.

7.11. Jordan

The economy of **Jordan** continues to grow strongly in 2007, with real GDP growth estimated at 6%. After successfully completing a series of IMF supported programmes, Jordan has maintained close relations with the Fund under the terms of Post-Program Monitoring. Policies have been consistent with the authorities' stated goals of promoting growth while consolidating the fiscal position in order to reduce the public debt/GDP ratio. The fiscal adjustment in 2005 and 2006 under a strategy centred on eliminating fuel subsidies and maintaining expenditure restraint brought the budget deficit (including grants) down to 2.7% of GDP in 2006 from 5% in 2005. On the account of prudent fiscal policies, Jordan's debt burden is also falling. In October 2007, the government signed an agreement with the Paris Club to buy back USD 3.3 billion of its debts. The current account deficit for 2007 is expected to narrow slightly from 13.6% in 2006 to 13.4% of GDP (and compared to 17.8% in 2005). It continues to be more than financed by exceptionally high capital inflows, including foreign direct investments, remittances and portfolio inflows primarily from the region.