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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 2010**

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## **LIST OF ABBREVIATIONS**

CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
DCFTA	Deep and Comprehensive Free Trade Area
EC	European Community
EFC	Economic and Financial Committee
EIB	European Investment Bank
EPCA	Emergency Post-Conflict Assistance
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GSP	Generalised System of Preferences
IMF	International Monetary Fund
IPA	Instrument for Pre-Accession
MFA	Macro-Financial Assistance
MoU	Memorandum of Understanding
PIFC	Public Internal Financial Control
SDR	Special Drawing Rights
SME	Small and Medium-sized Enterprises
USD	Dollar of the United States of America
VAT	Value Added Tax
WTO	World Trade Organisation

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## **INTRODUCTION**

This working document is published in parallel with the Report from the Commission to the Council and to the European Parliament on the implementation of macro-financial assistance (MFA) to third countries in 2010. It provides economic and financial information regarding the situation of the beneficiary countries as well as more detailed information on the implementation of MFA operations in those countries. Statistical data on the different macro-financial assistance decisions adopted since 1990, by date and by regions, are included in the annex.

## **WESTERN BALKANS**

### **1. BOSNIA AND HERZEGOVINA**

#### **1.1. Executive summary**

In 2010, the economy of Bosnia and Herzegovina was moderately recovering from the recession experienced in 2009, with a real GDP growth of 0.9%. The recovery was driven by exports, reflecting the strong economic growth of some of Bosnia and Herzegovina's main trading partners, in particular Germany. Preliminary estimates indicate that the consolidated 2010 budget deficit reached 3.8% of GDP, in line with the target agreed with the IMF. No agreement was reached on the Global Fiscal Framework 2011-2013 between the entities and the state level. Because of a political stalemate after the 3 October 2010 elections the Parliament and Government of the Federation were only constituted in mid-March 2011, while state government formation was still pending in the beginning of June 2011.

The authorities of all government levels concluded in early May 2009 negotiations with the IMF on a Stand-By Arrangement that comprised commitments to a number of structural reforms and fiscal adjustment measures. The Fund's Board approved a EUR 1.15 billion loan (13% of GDP; 600% of the quota) for a three-year period on 8 July 2009. The main policy condition under the programme is a reduction of current expenditure, especially wages and social transfers, reducing the structural fiscal deficit.

No funds were disbursed in 2010 under the current EU macro-financial assistance to Bosnia and Herzegovina (loan facility of up to EUR 100 million, Council Decision 2009/891/EC of 30 November 2009). In a pre-election environment, long internal discussions in Bosnia and Herzegovina during 2010 delayed the adoption of the Memorandum of Understanding establishing the conditionality of EU MFA, which was eventually signed on 8 November 2010. The corresponding Loan Agreement has not been ratified yet, reflecting the difficulties in setting up governments and parliaments after the October 2010 elections. Assuming a timely ratification of the Loan Agreement and the fulfilment of the MoU conditions, including good progress under the IMF programme, the EU MFA is planned to be disbursed in 2011.

#### **1.2. Macroeconomic performance**

After the recession experienced in 2009 with a drop in real GDP of 2.9%, the country only moderately recovered in 2010, recording a positive real growth rate of 0.9%, driven by external demand. Domestic demand also picked up, supported by a relatively stable

inflow of remittances. The growth of industrial production in 2010 was slightly positive, reaching 1.6%. When looking at the trade balance in 2010, the annual trend is still positive as the deficit decreased by 4.7%. Unlike in 2009, this development was driven by exports, which nominally soared by 28.3% year-on-year (in 2009 it was the shrink in imports that explained the lower deficit). Manufacturing, accounting for almost 90% of overall exports, recorded a 30.5% growth, while the export of agricultural products grew by 45%, accounting for a mere 2.3% of overall exports. The trend of an improving trade balance was reversed in the second half of 2010 when the increase of imports exceeded that of exports in volume, as import levels are much higher than export levels. Imports rose by 10.3% in 2010 (nominally). Dominated by trade developments, the current account deficit further decreased, reaching 5.2% of GDP in 2010. However, the current account also showed a reversed trend as of the third quarter 2010. Capital inflows, in particular FDI, remained low and below the already low level of 2009. Nevertheless, net FDI turned positive again in the third quarter 2010, after two quarters of negative volumes. Foreign exchange reserves remained stable, covering almost six months of imports. Due to the continued improvement of the current account and the comfortable level of foreign reserves, the external financing needs decreased throughout 2010.<sup>2</sup>

Unemployment was growing throughout the year, but at a decelerating pace. The high level of registered unemployment persisted during 2010, reaching 43.3% of the total labour force in December. Throughout 2010, employment fell most in construction, manufacturing and hotels and restaurants, while on the other hand, the highest growth of employment was registered in financial intermediation and transport. According to the Labour Force Survey following ILO methodology conducted annually in May, unemployment significantly increased to 27.2% in 2010 from 24.1% in 2009. After wage increases of previous years, in 2010 decrease in wages in real terms contributed to an increase of competitiveness of the Bosnian economy. Nominal gross wages grew by 2.2% in December compared to end-2009.

Annual inflation reached 2.1% in 2010, compared to an average annual deflation of 0.4% in 2009. The highest increase was registered in transport prices that grew by an average of 7.1%, after falling by 9.9% a year earlier. Moreover, food prices lowered their decline by 0.2 pps to 0.7%. Inflation in 2010 was also driven by a hike in excise duties on tobacco and alcohol, as well as telecommunication costs. The monetary policy of the Central Bank continued to be conducted under a currency board arrangement, with the euro as the anchor currency, enjoying a high level of confidence and credibility. Monetary policy settings remained unchanged throughout 2010 after minimum reserve requirements had been lowered in several steps between October 2008 and May 2009 in order to boost the liquidity of the banking sector during the financial turmoil.

The estimated budgetary outcome for 2010 of a consolidated deficit of 3.8% of GDP is below the previous year's outcome and the target of 4½% set under the IMF programme.<sup>3</sup> This is due to the faster than expected recovery of revenues and the adjustment measures on the expenditure side, in particular wage cuts in the public sector, which reduced the

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<sup>2</sup> The estimate by the IMF of external financing needs for 2010 decreased from 5.6% of GDP in the first programme review in March to 4.1% of GDP in the second and third reviews in October.

<sup>3</sup> It needs to be underlined, though, that in this estimate expenditure side GDP data are used, while the IMF uses production-side GDP data (not yet published), which are lower. Therefore, the budget deficit to GDP figure following the IMF methodology is likely to be higher.

consolidated wage bill by 1.5% in nominal terms. Consolidated revenues increased by 2.6% in 2010. 44% of the revenues originated from indirect taxes that increased by 8.3%, driven by the resuming economic activity, the development of imports and import prices and the increase of some road tolls and excise duties on tobacco, and despite the reduction of tariffs following the entry into force of the Interim Agreement on trade with the EU in mid-2008. Despite the positive development, the level of collected indirect taxes in 2010 was still lower than in 2008. Expenses increased by 6.6% year-on-year in 2010. Current spending dominates the budgets with wages accounting for 27% of overall expenditure and subsidies and transfers (mainly social benefits) for 37%, both marginally lower in relative terms than in the previous year. Temporary budgets have been in place in the first and second quarter 2011 at state level, and in the first quarter in the Federation. The Parliament of the Republika Srpska had adopted the 2011 budget in December 2010.

The sharp economic downturn of 2009 and the slow recovery of 2010 revealed the vulnerabilities of the country's growth model relying on externally financed consumption, thus creating large external imbalances. The current account improved over that period, but this trend is already reversing. The productive capacity and the competitiveness of the economy remain weak.

### **1.3. Structural reforms**

Commitment to fiscal adjustment and structural reform measures, as well as their implementation, was uneven across the country. Some fiscal and structural reform measures were enacted under the pressure of budgetary imbalances and the IMF programme. Nevertheless, budgets are still not self-sustaining and the quality of public finances remains weak with high shares of current expenditures to GDP. Some improvements in public financial management and control structures can be noted, partly linked to the MFA conditionality. Privatisation, restructuring of public enterprises and the liberalisation of network industries did not advance. Upgrading of infrastructure has proceeded, though at a slow pace. Structural rigidities such as high taxation of labour and low labour mobility continue to hamper job creation and labour market participation. The generous and poorly targeted social transfers reduce the propensity to work, further highlighting the need for reform of the social benefits system. The business environment is affected by administrative inefficiencies and the weak rule of law.

In the context of the IMF programme, substantial savings were envisaged in the public sector wage bill and in transfers, reflecting the elimination of special unemployment benefits for demobilised soldiers, the implementation of eligibility audits for civil and war benefit recipients and strict control over pensions provided on favourable terms. The State level froze wages in 2010. After initial delays, the Federation advanced the reform agenda over the summer: The parliament adopted a new civil service wage law at the end of July rationalising the wage bill by, inter alia, consolidating a large number of allowances into the base wage. The government approved a pension reform strategy which, however, was later withdrawn from parliamentary procedure. Eligibility audits of privileged pension and war disability benefit recipients started in July, albeit slowly. In Republika Srpska wages in public administration were frozen in 2010 after the cuts in 2009. As less hires than planned were effected, the wage bill decreased by 1.1%. An eligibility audit for social transfers was conducted in Republika Srpska, reducing the number of beneficiaries.

In Republika Srpska around 69% of the initial stock of state-owned capital intended for privatisation had been sold by May 2010, practically unchanged from a year earlier. After a series of failed privatisation deals the privatisation agency of the Federation developed a revised action plan for 2009-10, including the privatisation of the entire public share in eight companies. Progress in this area is very slow and several auctions have failed as they did not attract interested parties. The privatisation of an 88% share in the aluminium company Aluminij d.d. Mostar, one of the largest enterprises in the country and a key source of export revenue, which had been pending for more than three years, was declared to have failed.

The 'legislative guillotine' project to reduce administrative burdens has been completed in Republika Srpska. In the Federation, the parliament amended 34 laws in July 2010 initiating the second stage of this regulatory reform, simplifying and streamlining 35 priority administrative procedures. Businesses nevertheless continue to suffer from political instability, the high tax burden, and slow contract enforcement and business registration procedures. In the World Bank's 2011 Doing Business Report Bosnia and Herzegovina ranks 110<sup>th</sup> in the world (out of 183 countries), still lagging behind its neighbours. Moreover, complicated procedures for starting a business, dealings with construction permits, enforcement of contracts and difficult access to financing are further deteriorating the business environment.

#### **1.4. Implementation of macro-financial assistance**

The performance under the IMF Standby Arrangement, to which the EU's macro-financial assistance is linked, remained broadly satisfactory. In March 2010, the IMF Executive Board approved the first review of the programme which resulted in the release of the second and third tranche in the amount of approximately EUR 140 million. In October, the IMF Board approved the second and third reviews, making available some EUR 130 million. However, the central bank, in view of a comfortable level of its foreign exchange reserves, decided not to draw on the funds made available in October. Thus, only EUR 38 million of this tranche were drawn by the authorities, channelled completely as budget support to the entities. A total amount of around EUR 385 million has been disbursed under the programme so far, with 100% of these funds transferred to the entity budgets.

In November 2009, the EU Council approved a macro-financial assistance of up to EUR 100 million in the form of loans. The assistance aims at alleviating the impact that the economic crisis had on Bosnia and Herzegovina's stressed budgetary and external position and at contributing to fill the remainder of the external and budgetary financing gap as identified in the IMF programme.

In the course of 2010, the Commission agreed the economic policy conditions with the Bosnian authorities in a Memorandum of Understanding (MoU) that was finally signed in November 2010, after the state and the entities eventually agreed amongst themselves on all policy conditions negotiated with the Commission. The disbursement will be conditional upon a satisfactory track record in the implementation of the current Standby Arrangement with the IMF, as well as upon a positive evaluation by the European Commission of progress made with respect to a number of structural reforms. The MoU stipulates that the MFA will be disbursed in two tranches and that the proceeds may be transferred to the state and entity budgets according to the following distribution key: 10% to the state level, 60% to the Federation and 30% to Republika Srpska. The specific



policy conditions tackle public financial management issues, statistics and budgetary procedures. The detailed financial terms of the assistance were spelled out in the Loan Agreement which was signed in November. However, due to the non-establishment of governments and parliaments in Bosnia and Herzegovina after the October 2010 elections, it has not been ratified yet.

Given the delays in the signing of the MoU and the corresponding Loan Agreement caused by internal political disagreements in a pre-election environment and by the difficulties in government formation after the elections – the main stumbling blocks for the signing of the MoU were the distribution of funds available from the MFA between the different levels of government and one of the technical conditions related to the cooperation of the Statistical Institutes at state and entity level – no funds were disbursed during 2010. In addition, one of the two policy conditions agreed for the disbursement of the first tranche - the approval of the Global Framework of Fiscal Policies by the Fiscal Council of Bosnia and Herzegovina for the years 2011-2013 - was not met. This Framework is a key instrument for medium-term budgetary planning and an indispensable element of the annual budgetary process, of particular relevance in Bosnia and Herzegovina given the federal structure of the country. The Fiscal Council did not approve this Framework which by Law was due on 31 May 2010.

Some progress was, however, made on the fulfilment of policy conditions in the area of public financial management. These conditions were mostly derived from the findings of the operational assessment of financial circuits and procedures in Bosnia and Herzegovina carried out in November 2009, for example as regards the full functioning of the Central Harmonisation Unit and the management of public domestic debt.

The disbursement of the EU MFA is planned for 2011, assuming that the Loan Agreement can be ratified timely enough, that the IMF programme remains on track and that all policy conditions as laid down in the MoU for the first and second tranche are fulfilled.

<b>SUMMARY STATUS OF ECONOMIC REFORM BOSNIA AND HERZEGOVINA (BiH)</b>	
<b>1. Price liberalisation</b>	Most prices are liberalised even though a number of administered prices remains for some utilities and infrastructure as well as in some other areas.
<b>2. Trade liberalisation</b>	BiH started WTO accession negotiations in 1999. In July 2008, the Interim Agreement of the Stabilisation and Association Agreement with the EU entered into force. BiH is part of the CEFTA agreement.
<b>3. Exchange rate regime</b>	In 1997, the Central Bank of Bosnia and Herzegovina established a currency board with the Deutsche Mark as the anchor currency which has functioned smoothly since then. With the introduction of the euro the Bosnian Convertible Mark was pegged at 1.95583 to the euro and has remained unchanged since then.
<b>4. Foreign direct investment</b>	FDI inflows reached a peak in 2007 (when the telecommunications company of Republika Srpska was privatised), fell to a level in line with the years prior to 2007 in 2008 and then halved in 2009, falling to around 2½% of GDP. Net FDI became even negative in the first half of 2010 and turned positive again in the third quarter. FDI has been mainly related to privatisation transactions, as green-field investment is still hampered by weaknesses in the business environment.
<b>5. Monetary policy</b>	The Central Bank of Bosnia and Herzegovina (CBBH) is responsible for operating the currency board arrangement which limits the scope of monetary policy basically to minimum reserve requirement ratios.
<b>6. Public finances</b>	The quality of public finances in Bosnia and Herzegovina continues to be low. The ratio of general government expenditure to GDP continuously increased in recent years from 37.1% in 2005 to 43.4% in 2010. Expenditure was not shifted towards growth-enhancing areas but remained concentrated in current expenditure, in particular on wages and social benefits. The fiscal balance of the general government was positive until 2007, but in the following years increasing fiscal deficits materialised due to the economic crisis.
<b>7. Privatisation and enterprise restructuring</b>	While the privatisation and enterprise restructuring process is already advanced in the RS, progress has remained limited in the Federation.
<b>8. Financial sector reform</b>	The financial sector is dominated by banks. The sector remained overall sound and stable during the economic and financial crisis, but its profitability and the quality of the loan portfolio deteriorated throughout 2010. A Standing Committee for Financial Stability was established in 2010. The limit on guaranteed bank deposits was further increased to around EUR 18,000 (from around EUR 10,000) as of April 2010.

## 2. KOSOVO<sup>4</sup>

### 2.1. Executive summary

According to the latest national accounts data, real GDP grew by 2.9% in 2009, driven mainly by government consumption and investment. There are growing risks to this growth profile, which is likely to have been repeated in 2010, as recent fiscal expansion is reaching its limits. The labour market is stagnant with high level of unemployment. By end of March 2011 consumer price inflation reached a double-digit level, spurred by raising food and energy prices. Providing a reliable electricity supply remains a major challenge for private sector development.

In November 2006, the Council decided to make available to Kosovo exceptional financial assistance in the form of budget support grants of up to EUR 50 million. However, until end-2009 the assistance was not disbursed as key conditions, in particular an understanding with the IMF, as well as the confirmation of budgetary financing needs, were not met. The European Commission adopted in December 2009 a Decision to extend the availability period of the EU exceptional financial assistance to Kosovo by one additional year, until 11 December 2010.

Following the approval by the Executive Board of the IMF on 21 July 2010 of an 18-month Stand-By Arrangement (SBA), and upon satisfactory compliance with conditionality requirements agreed upon in 2007, the European Commission disbursed in September 2010 the first tranche (EUR 30 million) of the exceptional Community financial assistance to Kosovo. The money entered the budget as a grant.

In November 2010, after a non-confidence motion, the Parliament was dissolved and early parliamentary elections were held on 12 December. As a consequence of the dissolution of the Assembly, the 2011 budget was not approved. Thus, the IMF could not complete its review of the SBA by the end of November, as originally envisaged, and disburse the second tranche of the IMF loan. Under these circumstances, it was not possible to assess whether the agreement with the IMF remained on track, which was a key condition for the release of the second tranche of the EU MFA to Kosovo, thus preventing its disbursement before the assistance expired in December 2010. In mid-July 2011, the government entered into a new agreement with the IMF – a non-disbursing Staff Monitored Programme (SMP) to replace the SBA and run until the end of 2011.

### 2.2. Macroeconomic performance

In November 2010, the Statistical Office of Kosovo published revised GDP data for 2004-2009 and, for the first time, estimates about real GDP growth rates. Real GDP increased by 2.9% in 2009, mainly driven by public expenditure. Investments grew by 13.6%, households consumption rose moderately by 1.5%, while donor consumption shrunk by 14.8%. There are growing risks to the growth profile, as the fiscal expansion that has been underpinning it is reaching its limits.

In 2010 exports of goods (mainly base metals) increased, although from a very low level, by 78%. Imports increased as well, by 11%. However, even with the higher relative

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<sup>4</sup> UNSCR 1244

increase of exports, the trade deficit further increased to EUR 1,851 million compared to EUR 1,770 million a year earlier. According to balance-of-payments statistics, in the first three quarters of 2010 the current account deficit was EUR 512.2 million, increasing against a deficit of EUR 450.5 million in the corresponding period of 2009. This deterioration was mainly driven by increased payments for construction services in the second quarter of the year. The surplus on the capital and financial account (EUR 315.1 million) was not sufficient to cover the current account deficit. The European Union and the countries of CEFTA remain the main trading partners of Kosovo.

The monetary framework is anchored on the use of the euro as legal tender. The Central Bank of Kosovo, therefore, cannot implement an independent monetary or exchange rate policy. Its role lies in supervising the financial sector and monitoring liquidity in the banking sector and credit expansion, with liquidity ratios and reserve requirements as main policy tools. The banking system consists of eight banks which mainly engage in domestic deposit-taking and lending. The degree of concentration of the banking system remains high, with about 80% of the assets managed by three banks. More than 90% of the assets in the sector are handled by banks under foreign ownership. By end-February 2011, annual deposit growth stood at 8.1% and credit growth at 14.4%. The loans-to-deposit ratio was 77.2%, below the informal Central Bank benchmark according to which it should not exceed 80%. The net profit of the banking sector increased by 45% in 2010 (year-on-year) to EUR 36.6 million, mainly driven by higher interest income.

After accelerating in the summer of 2010, inflation continued rising steadily to reach a double-digit level of 10.8% (year-on-year) by the end of March 2011. The main drivers of the inflationary dynamic were food and fuel prices, contributing respectively 8.1 and 1.4 percentage points. The prices of basic goods, such as bread and cereals and oils and fats, increased by more than 40%, hitting disproportionately the poor segments of the population. By end-March, the goods and services with positive contribution to inflation had increased their weight to 95% of the whole CPI basket, pointing to a broad-based inflationary pressure. Average annual inflation in 2010 stood at 3.5%, after a deflation of 2.4% in 2009.

The unemployment rate in Kosovo is very high at above 40%. Most of the unemployment is long-term, pointing to very low dynamics in the labour market, even though the informal sector distorts the actual picture. In the last three quarters of 2010, the number of registered unemployed remained stable at around 335 thousand, though about 1% lower than a year ago. According to the Ministry of Labour and Social Welfare data, registered unemployed decreased slightly across all skill levels. Nevertheless, with a share of 60% of the total number of unemployed, unskilled unemployment is still dominant.

Budgetary developments in Kosovo have been quite volatile and hard to predict in recent years. The budget deficit increased from 0.1% of GDP in 2008 to 0.7% in 2009. The underlying deficit was, however, much higher, rising to about 5.8% of GDP in 2009, if a one-off EUR 200 million dividend payment received from Post and Telecommunications of Kosovo is deducted from total revenue. According to preliminary data from the Ministry of economy and finance, in 2010 the general government had a lower than expected deficit of EUR 115 million (2.8% of GDP). However, the underlying deficit (net of grants and dividends) remained broadly unchanged at 5.6% of GDP. By the end of December 2010 usable and readily available government bank balances were EUR 243 million, or slightly above its target according to the IMF programme.

Total revenue and grants stood at EUR 1,156 million by the end of December (including EUR 30 million of EU budget support). The underlying revenue growth of 10% (excluding dividends and grants) was underpinned by strong performance of almost all revenue components. Total expenditure reached EUR 1,272 million. Expenditure at central level grew by 3% and at municipal level by 14%. Capital outlays increased by 11% at central government level and by 23% at municipal level, followed by increased spending on wages and salaries – by 23% at central and 12% at local level.

Due to the early elections, the approval of the 2011 budget was delayed and the Assembly voted in on 31 March 2011. The budget includes a substantial increase of government sector employees' wages (by 30% to 50%) – a measure that deviates from commitments made in the current IMF programme and that is likely to lead to a deterioration of price competitiveness and external imbalances as well as to lower job creation incentives. Fiscal sustainability remains at risk, as expenditure pressures have not subsided.

### **2.3. Structural reforms**

Kosovo's enterprise sector remained dominated by micro-enterprises, with more than 90% of the enterprises employing less than four people. The economic structure is highly concentrated on the retail sector, with about half of all enterprises operating in this field. In 2010, a Law on Economic Zones was adopted and the procedure to establish six zones, one at central and five at municipal level, started. Information on registered companies became available online. Online registration of companies so far is only possible at the 'one stop shops' or municipal business centres that have been established in 22 municipalities. Fees for starting and closing a business are low, but the relatively large number of inactive firms in the business register suggests that the market exit regulations and implementation thereof could be improved further.

In the area of public finance and administration limited progress was recorded in 2010. In order to develop and strengthen its debt management capacity, in June 2010 the Treasury reorganised its Cash and Debt Management Division into two separate units dealing respectively with cash and debt management. In September 2010, the Statistical Office of Kosovo approved an action plan for compiling and publishing comprehensive statistics on national accounts and labour market.

The Privatisation Agency of Kosovo continued the privatisation of socially owned enterprises, albeit mainly small businesses, with limited macroeconomic impact. In 2010, the agency started liquidation of socially owned enterprises for which there is no investor interest in privatisation. Privatisation proceeds from the sale of socially owned enterprises have been kept, in accordance with existing legislation and MFA conditionality, in a single trust account at the Central Bank. The government hired transaction advisors for privatising the Post and Telecommunications of Kosovo and the distribution and supply functions of the public electricity company (Kosovo Energy Corporation, KEK). Both privatisation deals and the transaction for the development of a new Kosovo power plant were, however, significantly delayed and could not be concluded in 2010.

Providing a reliable electricity supply remains a challenge for private sector development. Despite some improvements in billing and collection in 2009, and establishment of annual targets for improving billing and bill collection rate in line with

MFA conditionality, about 42% of the energy entering the public electricity company network was not paid for. KEK continued to receive in 2010 substantial subsidies from the state budget for electricity imports and loans for financing its investment programme.

#### **2.4. Implementation of macro-financial assistance**

In November 2006, the Council decided to make available to Kosovo exceptional financial assistance in the form of budget support grants of up to EUR 50 million (Council Decision 2006/880/EC of 30 November 2006). This assistance was made available with a view to alleviating the financial situation in Kosovo, supporting the development of a sound economic and fiscal framework, facilitating the continuation and strengthening of essential administrative functions, and addressing public investment needs. In December 2007, a Memorandum of Understanding laying down the conditions for the release of the assistance was signed between the European Commission and the Kosovo authorities. However, the assistance was not disbursed by end-2009 as key conditions, in particular a financial arrangement with the IMF, as well as the confirmation of budgetary financing needs, were not met.

The availability period of the exceptional Community financial assistance to Kosovo was to expire two years after the signing of the Memorandum of Understanding laying down the conditions for the release of the assistance, i.e. on 11 December 2009, but was extended in December 2009 for an additional year by the Commission, after consulting the EFC (Decision 2009/918/EU of 7 December 2009). Subsequently, Addenda to the Memorandum of Understanding and to the Grant Agreement were signed by the Kosovo authorities and the Commission to that effect in early 2010.

Following the approval by the Executive Board of the IMF on 21 July 2010 of an 18-month Stand-By Arrangement, in early September 2010, and upon satisfactory compliance with other conditionality requirements, the Commission disbursed the first tranche (EUR 30 million) of the exceptional financial assistance to Kosovo. The policy conditions agreed with the EU included the adoption of a revised Medium-Term Expenditure framework in June 2010, enhancing the administrative capacity in the areas of internal audit and Treasury management, and maintaining the ring-fencing of privatisation proceeds in line with legislative requirements. The money was disbursed to the budget in the form of a grant.

In November 2010, after a non-confidence motion, the Kosovo Parliament was dissolved and early parliamentary elections were held on 12 December. As a consequence of the dissolution of the Assembly, the 2011 budget has not been approved. Thus, the IMF could not complete its review of the Stand-By Arrangement by the end of November, as originally envisaged, and disburse the second tranche of the IMF loan. Under these circumstances, the Commission could not assess whether the agreement with the IMF remained on track, which was a key condition for the release of the second tranche of the EU macro-financial assistance to Kosovo. The availability of the assistance expired in December 2010 and could not be renewed.

**SUMMARY STATUS OF ECONOMIC REFORM  
KOSOVO**

**1. Price liberalisation**

The price setting mechanism is basically free. Current governance arrangements as regards publicly-owned enterprises ensure the absence of government interference in the price setting mechanism of their services.

**2. Trade liberalisation**

Kosovo does not enjoy preferential access to the EU market following the expiration of the autonomous trade measures. It is part of CEFTA, however, three parties to this free trade agreement, namely Serbia, Bosnia and Herzegovina and Moldova, do not recognise its customs stamp and, as a result, prevent free flow of goods from Kosovo.

**3. Exchange rate regime**

Kosovo continued to use the euro as sole legal tender. The Central Bank of Kosovo is in charge of regulating foreign exchange operations, providing payments services and supervising banks and other financial institutions.

**4. Foreign direct investment**

Net FDI inflows are estimated to have reached EUR 191 million (4.6% of GDP) in the first three quarters of 2010, almost unchanged from EUR 195 million (5.0% of GDP) in the same period of 2009.

**5. Monetary policy**

The monetary framework remained anchored on the use of the euro as sole legal tender.

**6. Public finance**

The execution of the budget in 2010 was characterised by a strong revenue performance and a substantial increase in both current and capital spending. Preliminary data point to an annual 2010 budget deficit of 2.8% of GDP. Fiscal sustainability is at risk, as expenditure pressures have not subsided.

**7. Privatisation and enterprise restructuring**

In 2010, the Privatisation Agency of Kosovo started liquidating socially owned enterprises for which there is no investor interest in privatisation. The government hired transaction advisors for privatising the Post and Telecommunications of Kosovo and the distribution and supply functions of the public electricity company (Kosovo Energy Corporation). Both privatisation deals and the transaction for the development of the new Kosovo power plant have, however, been significantly delayed and could not be concluded in 2010.

**8. Financial sector reform**

The degree of concentration of the banking system remains high, with about 80% of the assets managed by three banks. More than 90% of the assets in the sector are handled by banks under foreign ownership. By the end-February 2011, the loans-to-deposit ratio was 77.2%, pointing to a conservative banking model. In 2010 banks' profits increased by 45% (year-on-year) to EUR 36.6 million, mainly driven by higher interest income.

### **3. SERBIA**

#### **3.1. Executive summary**

Following a 3.1% drop of output in real terms in 2009, Serbia's economy recovered in 2010 with GDP up by 1.8% driven by vigorous broad-based export growth. Macroeconomic stability was anchored by the economic programme supported by the IMF under the Stand-By Arrangement (SBA), which remained broadly on track throughout the implementation period between May 2009 and April 2011. The balance of payments position stayed solid thanks to the containment of the current account deficit at around 7% of GDP. However, public finances deteriorated as the supplementary budget allowed the fiscal deficit to widen to 4.7% of GDP against the provision of additional social assistance and subsidies. Considerable strides have been made in transforming Serbia towards a market economy over the past years, but the pace of reforms slowed down in the wake of the recession.

The Council decision of 30 November 2009 (2009/892/EC), which granted Serbia macro-financial assistance in the form of a loan facility of up to EUR 200 million, was followed by the signing of a Memorandum of Understanding on 5 July 2010 and of the Loan Agreement by the end of the year. The objective of this assistance was to help the government address residual external financing and budgetary needs that emerged as a consequence of the strong economic slowdown. This assistance from the EU is complementary to the resources provided by international financial institutions and bilateral donors. In light of the scaling down of the IMF assistance against lower foreign financing needs, the European Commission informed the Economic and Financial committee in July 2010 that it was planning to disburse only the first EUR 100 million tranche. Following the completion of the ratification procedures in Serbia in March 2011, the Commission is currently preparing the disbursement, which is planned to take place by July 2011.

#### **3.2. Macroeconomic performance**

Following a 3.5% drop of output in real terms in 2009 against the backdrop of the global crisis, the economy recovered in 2010. Up by 1.8%, GDP rebounded more than expected (1.5%, according to the IMF and national forecasts). After strengthening steadily over the first half of the year, economic activity accelerated vigorously in the third quarter but moderated again in the last three months of the year.

The economic upturn in 2010 was driven by export expansion as revival was gradually underway in Serbia's main trading partners, and the dinar continued to depreciate. Domestic consumption and investment began to pick up only slowly against the background of constrained disposable incomes.

Buoyant foreign demand stimulated a rebound of industrial activity, up by almost 3% compared to 2009, thanks especially to solid growth in manufacturing of basic metals and chemicals. However, services continued to provide the main stimulus to growth. Transport and financial intermediation expanded by almost 7% following some deceleration towards the end of the year as the economy hit a soft patch. By contrast, construction and agriculture shrunk compared to 2009 in face of the ongoing economic rebalancing toward more export-based growth and unfavourable market conditions. The



hospitality sector too contracted in spite of a strong acceleration in the fourth quarter on the back of a pick-up in private spending.

Contrary to expectations that the gradual recovery in activity and trade would impair Serbia's external position, the current account gap stayed contained well below the pre-crisis level thanks to vigorous broad-based export activity. The current account deficit narrowed further by a notch to about 7% of GDP as the merchandise trade deficit was some 7% lower than the year before. Exports rallied against the solid external demand, supported also by the steady dinar depreciation. By contrast, imports strengthened steadily over the year as manufacturing sustained the momentum driven by foreign demand. The current account deficit was smaller compared to 2009 despite the higher income account deficit (up by a third year-on-year) and the slightly lower surplus on the current transfers account (notwithstanding the sustained high inflow of remittances). Throughout 2010, financial and capital flows remained modest, with FDI markedly lower in comparison with 2009. At the same time, private sector's external liabilities decreased as companies and banks were repaying foreign loans. Foreign currency inflows have been largely insufficient to cover the current account deficit. During 2010, total external debt rose by almost EUR 1.3 billion to around EUR 23.8 billion, i.e. close to 80% of GDP.

In the context of the sixth SBA review at end-2010, the IMF re-estimated Serbia's 2010 gross external financing requirements to EUR 6.24 billion (against an earlier estimate of EUR 8.54 billion), due to a lower current account deficit and in view of the comfortable reserves position. After deducting available financing, the external financing gap stood at EUR 470 million in 2010 (against EUR 2.1 billion, expected previously).

In 2010, the foreign reserves held by the National Bank of Serbia (NBS) remained largely stable at about EUR 10 billion, i.e. more than a third of GDP, or sufficient to cover some 9 months' worth of imports, despite the NBS intervening regularly on the interbank market. A number of foreign exchange operations were undertaken throughout the year to smooth the exchange rate depreciation. Following some strengthening of the dinar towards the end of the year, the RSD/EUR exchange rate overall depreciated by around 10% during 2010. Pursuing exchange rate stability partly overshadowed inflation targeting, the main monetary policy objective. In view of the renewed inflationary tensions, the NBS reverted in August from the gradual easing of monetary conditions to a monetary tightening. By end-2010, the reference interest rate had been hiked in several steps from 8% to 11.5% (currently at 12.5%). Disinflation was interrupted in the middle of 2010 due to rising agricultural/food prices and the dinar depreciation. Tensions built up further based on the expected strengthening of domestic demand in step with the gradual pick-up of economic activity and higher bank lending. By the end of 2010, CPI inflation soared to 10.3% year-on-year (6.6% in 2009), overshooting the 4-8% target range set by the NBS.

In spite of the gradual economic recovery, the labour market situation remained strife throughout 2010. The LFS unemployment rate lingered at 20% and was one of the highest in the region. From the second half of the year, job losses were contained and the employment rate stabilised at some 47%. In 2010, wage moderation continued to prevail owing largely to the agreement to keep public sector wages frozen in nominal terms. Compared to 2009, the average net wage increased by 7.6% in nominal and 0.7% in real terms. Wage rises are expected to be more substantial from 2011 onwards as indexation

of public sector salaries is re-introduced, but are likely to remain subdued given the weak labour market.

In 2010, public finances remained under pressure in the face of a fragile economic recovery. In May, the revised agreement with the IMF allowed for the general government deficit to be widened by 0.3pp, to 4.8% of GDP, due to a revenue shortfall in face of a sluggish economic recovery. While revenue performance improved in the second half of the year as economic activity was picking up, a supplementary budget was nevertheless adopted in November. Additional social assistance and subsidies were provided in response to the weak labour market performance and poor living conditions. The outcome was broadly in line with the plans; at 4.7% of GDP the deficit was one of the highest in the past decade.

Compared to 2009, the share of expenditure as a percentage of GDP is estimated to have decreased by 0.3 percentage points, to 46.4%. Current expenditure (which accounts for more than 90% of total expenditure and almost 40% of GDP) remained constrained as a set of ad-hoc emergency measures agreed with the IMF under the SBA programme continued to be implemented. Since mid-2009, public savings were fostered by the nominal freeze of public administration salaries and pensions as well as restricted hiring in the public sector. However, these were partially offset by higher social assistance spending. Capital expenditure also increased in 2010 by around 13% in nominal terms.

The revenue ratio is estimated to have reached 41.7% of GDP, a drop of 0.6 percentage points compared to 2009. As the labour market was slow to improve and public sector salaries remained frozen, personal income tax revenue underperformed. Furthermore, corporate income tax revenue was constrained by the ongoing balance-sheets repair. On the other hand, indirect tax revenues began to recover as VAT strengthened in step with the gradual economic upturn and excise taxes increased as a consequence of the hike in excise duties on diesel and gasoline. In spite of the steady rise in imports, however, customs revenues continued to decrease due notably to the lowering of tariffs following the start of implementation of several free trade agreements, including the Interim Agreement of the Stabilisation and Association Agreement.

The budgetary gap spurred government borrowing but financing proved difficult given the lack of investors' interest in treasury bills with long-end maturities due to the significant exchange rate risk. In 2010, public debt rose by around 2 billion, amounting to 42.7% of GDP, an increase of around 8.5 percentage points compared to 2009.

### **3.3. Structural reforms**

Considerable strides have been made in transforming the economy over the past years; however, the pace of reforms slowed down in the wake of the crisis. Recently, the momentum took off again. Important challenges remain, especially related to creating a viable market economy and a business-friendly environment. Deficiencies in competition, the regulatory environment, administrative procedures, rule of law and infrastructure bottlenecks remain barriers to doing business.

With the aim to strengthen fiscal discipline, the government adopted amendments to the budget system law in late September 2010, which also constituted a required structural reform measure for disbursement of the first MFA instalment. A set of quantitative rules has been designed to underpin fiscal consolidation in the medium run. Improved

procedures and the setting-up of a fiscal council are deemed to anchor fiscal responsibility. Together with the new pension law, which extends the working period and age for assuming pension rights and adjusts the indexation mechanism, this may enhance the long-term sustainability of public finances.

Sluggish privatisation has been one of the weakest points of the reforms in Serbia. Privatisation of the socially-owned companies continued in 2009-2010, but at a slower pace. A number of sale contracts were again repealed due to non-compliance with the contracted obligations, which brought the number of privatisations annulled to almost one quarter of the firms initially scheduled for privatisation. The government once more extended the deadline for finalising privatisation of the socially-owned companies to 30 June 2011. Likewise, privatisation of the large state-owned companies was postponed given the economic circumstances. However, the government announced privatisation strategies for a number of companies as the situation in the global markets improved. Notably, a tender for the sale of the telecoms incumbent company was called in October. No progress has been made as regards stepping up the processes of denationalisation and restitution.

In spite of further steps in establishing legal predictability and removing red tape, the business environment continues to be constrained by the weak enforcement of the rule of law, especially with regard to property rights, which hampers market entry and exit. The reform of economic governance systems and regulatory institutions is slow, which further impedes competition.

There is political consensus on the need to advance structural reforms in the direction of developing industrial sectors at the high value-added part of the productive chain, which will bolster export expansion. An improved economic performance will further depend on the country's ability to attract foreign investment and to deal with structural rigidities on the labour market, reflected in the persistently high unemployment and a low participation rate, particularly of older workers.

### **3.4. Implementation of macro-financial assistance**

Given the tighter external financing conditions in the aftermath of the global crisis, the IMF granted Serbia a EUR 3 billion loan in the framework of an SBA programme to run between May 2009 and April 2011. By the end of 2010, Serbia had concluded successfully six of the reviews under the IMF SBA. The final review of the SBA was completed in April 2011. However, since March 2010 the Serbian authorities have been drawing upon the available amounts only partially given the country's ample foreign exchange reserves. The total disbursements under the SBA were about EUR 1.5 billion, i.e. roughly half of the programme's funds.

Over 2010, complementary financial assistance was provided by international financial institutions and bilateral donors to help the government address residual budgetary needs. The World Bank approved lending of USD 250 million through its Development Policy Loan programmes, part of which was turned into a guarantee for commercial borrowing worth USD 400 million. Additionally, the EU agreed to provide budget support of EUR 100 million under the Instrument for Pre-Accession (IPA). Two tranches of EUR 50 million each were disbursed at the end of 2009 and 2010, in light of the broadly satisfactory implementation of the economic policy programme, as assessed by the IMF, and fulfilment of specific conditions required for payment.

To top up the IMF and the World Bank funds, the EU also approved a macro-financial assistance of up to EUR 200 million in the form of a loan in November 2009. The objective of this assistance was to help the authorities address residual external financing and budgetary needs that emerged as a consequence of the global crisis.

In the spring of 2010, a Memorandum of Understanding and the Loan Agreement detailing a set of economic policy conditions and the terms for disbursement of assistance were negotiated with the Serbian authorities. After consulting the EFC, the Memorandum of Understanding was signed on 5 July 2010. It stipulates that a loan for a maximum amount of EUR 200 million would be released in two equal instalments of EUR 100 million each. Disbursements are conditional upon a satisfactory track record in the implementation of the current IMF SBA, as well as priority reforms of the public finance management. The latter priority reforms are due to take place in six major areas: fiscal responsibility within the budget process, accounting, internal control, internal and external audit, and public debt management.

The loan facility, while primarily geared towards covering balance-of-payments needs, might also be used to address budgetary needs. In light of the gradual economic recovery, lower foreign financing needs and the fact that Serbia had decided to draw on only 50% of the funds made available by the IMF under the SBA, the Commission informed in July 2010 the Economic and Financial Committee of its intention to scale down the planned assistance to half the original amount. Following the completion of all the internal ratification procedures in Serbia in March 2011, the Commission is currently preparing the disbursement of the EUR 100 million loan in one tranche. This disbursement is planned to take place by July 2011, subject to a satisfactory fulfilment of condition requirements.

## SUMMARY STATUS OF ECONOMIC REFORM - SERBIA

### 1. Price liberalisation

The share of administrative prices accounts for about a quarter in the CPI inflation basket. The government regulates prices of state-owned utilities in the area of fuel, electricity, telecommunication, communal and other public services. In the middle of 2010, the market formation of prices was challenged as the state intervened following the shortage of basic food items such as dairy and cooking oil.

### 2. Trade liberalisation

In December 2009, the EU unblocked the Interim Agreement which Serbia had been implementing unilaterally since January 2009. Since 2010, the ratification process of the Stabilisation and Association Agreement signed in April 2008 has been underway. By May 2011, 16 Member States had ratified the Agreement.

### 3. Exchange rate regime

The monetary policy setting fosters a managed float of the dinar. Nevertheless, the National Bank of Serbia (NBS) has been intervening in the interbank market. In 2010, the NBS sold more than EUR 2.5 billion over a number of FOREX operations.

### 4. Foreign direct investment

There are no controls on inward direct investment. By end-2010, net FDI inflows reached EUR 860 million (EUR 1.4 billion, i.e. 4.4% of GDP in 2009).

### 5. Monetary policy

The NBS has been committed to inflationary targeting since 2006. It sets a broad band around the targeted CPI inflation rate. The main policy instrument is the two-week repo interest rate. In August 2010, gradual relaxation of monetary conditions – pursued since early 2009 – was discontinued as inflationary pressures started building up. In a series of rate hikes the interest rate was raised from 8% to 12.5%, at present.

### 6. Public finance

In 2010, the slow and fragile economic recovery prompted adoption of a supplementary budget. Revenues remained constrained but continued implementation of a number of corrective expenditure measures helped to rein in current spending. Adoption by government of amendments to the budget system law and the pension law was an important step towards improving the quality of public finances and is in line with the MFA conditionality requirements.

### 7. Privatisation and enterprise restructuring

Privatisation of public enterprises remains the weakest point on the reform agenda. Privatisation of socially-owned enterprises back-paddled in 2010 while privatisation of state-owned companies continued to be delayed, partly due to the lack of political consensus about restructuring and privatisation strategies.

### 8. Financial sector reform

Serbia's financial sector has been relatively unscathed by the international financial crisis thanks to a set of timely administrative and regulatory repair measures, and also supported by the commercial banks commitments under the Vienna Initiative. The banking sector remained generally sound and profitable but the relatively high share of bad loans and considerable exposure to exchange rate risk are points to watch.

## **EASTERN NEIGHBOURHOOD COUNTRIES**

### **4. ARMENIA**

#### **4.1. Executive summary**

In 2010, the Armenian economy recovered from the sharp downturn of 14.2% in 2009 but the pace of recovery remained modest. Real GDP grew by 2.6% driven by recovery in services and industry. The fiscal deficit was narrowed to 4.9% of GDP from 7.9% of GDP in 2009. However, the recovery in investments and remittances remained fairly muted. Thus, despite a slight improvement in the current account deficit, from 16% in 2009 to 14.6%, a large part of the external financing needs continued to be covered by the international community.

In June 2010, the IMF Board agreed, following Armenia's request, to cancel the Stand-By Arrangement approved in March 2009 and to replace it with a new longer term programme under the Extended Fund Facility (EFF) and the concessional Extended Credit Facility (ECF).

In December 2010, the Commission and the Armenian authorities reached an agreement on the Memorandum of Understanding (MoU) and the related documents stipulating the policy conditions for the disbursement of the macro-financial assistance adopted by the Council of the European Union in November 2009 (Decision 2009/890/EC). The assistance, consisting of a loan of EUR 65 million and of a grant of EUR 35 million, will be released in two instalments over the course of 2011.

#### **4.2. Macroeconomic performance**

The Armenian economy experienced a very sharp downturn during the global crisis with GDP contracting by 14.2% in 2009. The widening current account deficit and the sharp fall in external financing sources, in particular FDI and remittances, exposed a severe external financing gap, which could only be filled with foreign assistance. As a result, in March 2009, Armenia reached an agreement with the IMF for a 28-month Stand-By Arrangement of about USD 532 million, with the total amount of access augmented to about USD 820 million in June 2009.

In 2010, the economic activity started recovering from the deep recession, although the pace of recovery was modest. Despite the gradual withdrawal of the fiscal stimulus and the unprecedented decline in agricultural output due to adverse weather conditions, GDP grew by around 2.6% driven by a recovery in services and industry. Nevertheless, growth prospects are still challenging, due to lack of diversification, low-competitiveness and the closed borders with two out of four neighbouring countries.

Despite the increase in metal prices, the trade deficit did not improve significantly and remained close to 24% of GDP. In addition, the recovery in investments and remittances was fairly muted as growth in Russia, Armenia's main trading partner and source of FDI and remittances, moderated compared to previous years. As the effects on the Armenian economy of the improvements in the country's external environment appeared to be limited, the current account deficit narrowed only to 14.6% of GDP in 2010, from 16% of GDP in 2009. Thus, a significant part of the external financing needs in 2010 was covered by the international community; a similar situation is expected for 2011.

In June 2010, the IMF Executive Board decided upon Armenia's request to cancel the Stand-By Arrangement, initially agreed in March 2009, and to replace it with a new longer term programme under the Extended Fund Facility (EFF) and the concessional Extended Credit Facility (ECF). Under this programme which runs until mid-2013, Armenia will get access to IMF funds of about USD 410 million; taking into account the disbursements made under the IMF Stand-By Arrangement before June 2010, total access of Armenia to IMF resources in 2009-2013 is estimated to reach around USD 950 million.

Domestic and external supply shocks, as well as a sharp decline of agricultural output, brought the inflation rate to 9.4% year-on-year in December 2010, from 7% in January 2010. The Central Bank of Armenia left the reference interest rate unchanged at 7.25% since May 2010, as the pace of recovery slowed down in the second semester of 2010 and the inflationary pressures were not demand driven. The Central Bank expects that in the second half of 2011, when shocks to food prices recede, inflation will revert to levels below 5.5%. In the meantime, it introduced measures to strengthen the effectiveness of monetary policy hampered by the high dollarization of the economy.

The fiscal easing of 2009 was reversed during 2010 on the back of the economic recovery. Reflecting government's increased focus on ensuring macroeconomic stability, fiscal policy was tightened in 2010. As a result, the fiscal deficit was reduced to 4.9% of GDP in 2010 compared to 7.9% of GDP in 2009. The reduction in the fiscal deficit was mainly driven by a substantial increase in tax revenues supported by the economic recovery, while on the expenditure side the government limited the increase of current expenditures and made efforts to achieve better targeting of the anti-poverty and social programmes. Nevertheless, the tax-to-GDP ratio deteriorated from 22.8% in January 2010 to 16.2% in December 2010, indicating high tax evasion and low tax collection rates.

The public debt-to-GDP ratio nearly tripled, from 16.1% of GDP in 2008 to 44% of GDP in 2010, as a result of the counter-cyclical measures and the financial assistance from the international community in the form of loans. The external debt represents around 90% of the total public debt, thus increasing the exchange rate vulnerability and the dependence on concessional financing in addressing future financing needs.

The exchange rate market is small and highly volatile, and the Central Bank of Armenia often undertakes foreign exchange interventions to limit the exchange rate volatility. Altogether in 2010, the Armenian Dram (AMD) appreciated by 4% against the USD and by around 12% against the EUR. Although foreign reserves in December 2010 were at a sufficient level (around USD 1.809 billion), a need for reserve built-up remains given the persisting high levels of the current account deficit (around 14.6% of GDP in 2010) and the weak stream of external inflows to the economy.

In 2010, the authorities took steps to improve the business climate by simplifying the taxpayer reporting system, reducing the discretionary authority of inspectors, introducing a legal restriction on public officials from engaging in commercial activities, strengthening the competition commission, and further reducing barriers to entry for new businesses, including a recent cabinet decree to create a one-stop shop for business registration. FDI is estimated to have decreased from 8.4% of GDP in 2009 to around 6.5% of GDP in 2010.

The banking sector is well capitalised and has exhibited resilience to stress-tests. The ratio of non-performing loans dropped in August 2010 to 5% from 10% in 2009 as a result of the economic recovery. Nevertheless, the financial intermediation remains low, with the private sector credit as a share of GDP at around 25%. Lending rates continue to be around 18%, partly due to the currency mismatch between deposits (around 68% of total deposits are foreign currency denominated) and assets (around 56% of total assets are foreign currency denominated).

### **4.3. Structural reforms**

Armenia had a good track record in implementing strong macroeconomic policies and structural reforms, which resulted in high growth rates for a series of years prior to the economic crisis. However, reform efforts should intensify as the economy remains fragile marked with close borders and high current account deficit, while new challenges emerge, like the accumulation of public debt and the moderated future growth prospects.

Structural reform process has gained momentum in the context of the financial assistance by the international community, often linked to reforms in certain areas like tax administration, social policy, public finances and debt sustainability and financial sector stability.

In the area of tax administration, measures have been taken to reduce corruption and increase tax compliance by simplifying and streamlining reporting requirements and by applying regulation consistently to all taxpayers through published normative acts approved by the Ministry of Finance. An appeal body dealing with legal and procedural disputes of taxpayers was also established. Processing time for VAT refund claims was brought below 90 days while, in preparation of a fully-functional risk based VAT refund processing system, only high-risk VAT refunds will be subject to review. Efforts for strengthening tax administration are expected to continue, also because they tax administration reform is part of the MFA conditionality.

In 2010, Armenia continued to tax more heavily the imported tobacco products than the domestically produced ones in a way that constitutes a breach of the WTO rules. Both IMF and EU MFA programmes are encouraging the removal of this discrimination. In October 2010, Armenia passed a law which provided only for gradual removal of this discrimination until 2014. In relation to the relevant MFA condition which foresees a more rapid removal of this discrimination, the Government adopted in December 2010 a Decree on the implementation of tax collection for imported tobacco products aiming at correcting this situation.

To ensure fiscal consolidation and place the debt on a downward path, the authorities re-introduced and strengthened the Medium Term Expenditure Framework in 2010 and adopted a new debt management strategy. The adoption of a new law on internal audit will also accelerate efforts for the implementation of a new Public Internal Financial Control strategy across the government. The MFA programme supports both these areas by three relevant conditions foreseeing the acquisition of a modern debt recording system, the improvement of internal functions in the debt management department and the methodological development and monitoring of financial management control and internal audit across the government.



The government improved the targeting of social spending while, in collaboration with the World Bank, it is working to improve the coverage of social programmes and develop an integrated system for the provision of social protection services. In the field of social policies, the reform of the pension system is addressed by the MFA programme.

Regarding the banking sector, the risk management and supervisory frameworks were enhanced, including through contingency planning. Prudential regulations to specifically address currency-induced credit risk were issued, including increased loan-loss provisioning requirements and higher risk weights in capital requirements for foreign currency loans. Progress was also made regarding the establishment of the Committee for Financial Stability and the coordination of crisis management banking policies among policy makers. Measures to encourage de-dollarisation had some positive results, while the new legal framework for insurance and private investment funds was submitted to the Parliament.

Efforts to improve the transmission channels of the monetary policy continued in 2010. To this end, preparations for the active management of liquidity and the development of transactions in dram-denominated securities advanced.

#### **4.4. Implementation of macro-financial assistance**

Despite the partial recovery of the economy in 2010, total private financing of the balance of payments left an external financing gap of around EUR 660 million for the period 2010-2011. The MFA programme, put in place in close coordination with IMF, is part of the external financing provided to cover Armenia's balance of payment needs in 2011. It will also support the economic adjustment and reform programme of the Armenian authorities designed to achieve sustainable medium-term growth. The assistance will consist of a loan of EUR 65 million and of a grant of EUR 35 million and will be released in two instalments. The first instalment is expected to be released in June/July 2011 following the ratification by the Armenian side of the documents pertaining to the assistance, signed in February 2011. The first instalment would amount to EUR 40 million (EUR 14 million in grants and EUR 26 million in loans). The second instalment, planned for release in autumn 2011, would amount to EUR 60 million (EUR 21 million in grants and EUR 39 million in loans).

In addition to the respect of the economic programme agreed between Armenia and the IMF, the economic policy conditions for the release of the assistance, also agreed upon in 2010 (the final agreement was reached in December 2010), comprise specific economic policy measures in the areas of public debt management, pension system, public internal financial control, external audit, public procurement, tax policy and tax administration, and customs policy.

Several agreed policy measures build on the results of the Operational Assessment (OA) that was carried out by the Commission (with the support of external consultants) in February 2010. The OA detected a real improvement compared to the situation observed during the previous OA, carried out in 2004-2005. An important programme of reforms in the area of Public Finance Management (PFM) has been put in place, including the implementation of the programme budgeting by all central level bodies and the enhancement of the budget preparation process. The external audit function has also been developed and the concept of Public Internal Financial Control has been introduced. At the same time, the OA formulated a number of recommendations for further actions such

us the completion of the re-organisation of the Ministry of Finance, the strengthening of the cash management and the debt management function, the implementation of public internal financial control strategy in the context of a new law on internal audit, the strengthening of custom administration, the adoption of a new public procurement system and the strengthening of the external audit function of the Chamber of Control.. These recommendations were indeed taken into account in negotiating the MoU with the Armenian authorities.

In the area of public debt management, the authorities will implement steps in developing a debt strategy and put in place a modern debt recording system. In the area of public internal financial control (PIFC) and internal audit, the MFA will support the broadening of the scope of public internal audits from cash flow controls to organisation, management and reporting, as well as the setting-up of a body within the Ministry of Finance responsible for methodological development and monitoring of financial management control and internal audit across the government. In the area of external audit, it will support the adoption by the Chamber of Control of an Action Plan aiming at bringing its working methods closer to international standards. The condition of the MFA programme in the area of public procurement foresees the harmonisation of Armenia's legislation with the EU directives and international standards.

In addition to Public Finance Management proper, several conditions refer to more structural questions in the broad area of public finances. They include an Action Plan for upgrading tax administration in several key areas accompanied by respective budget allocations and steps to enhance tax collection for fiscal consolidation and debt sustainability purposes, and the preparation of legislation reforming the pension system and introducing a privately funded pillar.

Finally, two trade-relevant measures support Armenia's efforts to create an open and transparent trading environment. The first condition refers to the need for Armenia to apply a non-discriminatory taxation to the domestically produced and imported tobacco products. The second condition reflects the need to reform the customs valuation system in a way that it is based on the transaction values and the proper application of the WTO rules. This condition entails the progressive development of risk-based post-clearance valuation controls.

## ARMENIA - SUMMARY STATUS OF ECONOMIC REFORM

### 1. Price liberalisation

Prices are largely free but there are fixed oligopolistic conditions in many sectors of the economy.

### 2. Trade regime

Armenia is a WTO member since 2003. Tariff structure is simple, all tariffs are bound and the applied average tariff is 2.7%. Customs procedures have improved but customs clearance remains slow and sometimes non-transparent due to the extensive use of 'reference' values in breach of WTO rules. Problems remain regarding technical barriers to trade and in the sanitary and phyto-sanitary regulations. A Decree was adopted aiming to lift the discriminatory tax treatment for tobacco products. Taxation of beverages was still in breach to WTO rules. Armenia qualified for the EU GSP+. EU is ready to discuss the launching of DCFTA negotiations with Armenia once the country meets a number of pre-conditions.

### 3. Exchange rate regime

After the March 2009 devaluation of the Armenian dram, the central bank announced the adoption of a free floating exchange rate regime. However, the exchange rate market is small and highly volatile, and the central bank often undertakes foreign exchange interventions to limit exchange rate volatility. In 2010, the Central Bank of Armenia committed to intervene without contradicting fundamental market trends while communicating clearly its intervention policy to avoid creating market misperceptions.

### 4. Foreign direct investment

Overall, Armenia has a liberal trade and investment regime. The country's land-locked geographical position with two closed borders and the oligarchic structure of the private sector hampers growth potential and competitiveness which deteriorated in 2010. Investors' protection, payment of taxes, access to finance and corruption appear as points of concern.

### 5. Monetary policy

The Central Bank of Armenia follows an inflation targeting regime. Efforts to improve the transmission channels of the monetary policy continued in 2010.

### 6. Public Finances and Taxation

While public expenditure management is strong there is considerable room for improvement in the field of public internal financial control (PIFC). To this end the authorities adopted a new PIFC strategy and a new law for Internal Audit. They also reverted to the Medium-Term Expenditure framework abandoned during the economic crisis. Revenue collection in 2010 did not benefit substantially from the economic recovery resulting to a low tax-to-GDP ratio of 16.2%.

### 7. Privatisation and Enterprise Restructuring

During the 1990's and early 2000's most of the small and medium-sized enterprises had been privatised. Also, the electric power distribution system was privatised and bought by a Russian company in 2005. Plans to privatise some remaining smaller enterprises seem to have been delayed as a result of the economic crisis.

### 8. Financial Sector

The banking sector in Armenia is relatively small (banking assets represent around 45% of GDP) but well capitalised and deposit-funded. It consists mainly of private banks. Nevertheless, financial intermediation remains low. The Central Bank of Armenia enhanced the risk management and supervisory frameworks in the banking sector, including contingency planning. Prudential regulations on higher capital and provisioning requirements on foreign currency loans were issued. Future efforts should focus not only on enhancing financial stability but also on facing obstacles to credit growth and financial intermediation.

## **5. GEORGIA**

### **5.1. Executive summary**

Following the double shock of the military conflict with Russia of August 2008 and the 2008-2009 global crisis, the Georgian economy entered a recovery path in 2010. In line with its commitments, the country has maintained a prudent fiscal and monetary policy stance, increased the flexibility of its exchange rate and continued to make progress with its structural reform agenda. However, due to a limited recovery in FDI inflows and a still very large current account deficit, Georgia's external position has remained vulnerable. The country has remained dependent on external official financing, including EU macro-financial assistance.

Since September 2008, Georgia has been implementing an economic adjustment programme agreed with the IMF and supported by IMF funding. The programme remained fully on track during 2010. In January 2011, the IMF Executive Board completed successfully the seventh and the eighth programme reviews. However, the authorities indicated that they did not intend to draw the instalment that became available. At the same time, the authorities plan to conclude a follow-up Stand-By Arrangement with the IMF after the current SBA expires in June 2011.

In 2010, the first macro-financial assistance (MFA) operation to Georgia approved by the Council in November 2009 was implemented successfully. The assistance, amounting to EUR 46 million in the form of grants, was part of a pledge of two possible EU funded MFA operations of the same amount made by the European Commission at the International Donors' Conference of October 2008. The approval of the second MFA was conditional on the continued existence of external financing needs over and above those covered by the IMF arrangement. After thorough assessment of external financing needs of Georgia, the Commission considered that the activation of the second part of the MFA pledged in 2008 was warranted and adopted a proposal for further MFA in the amount of EUR 46 million (half of it in grants and half of it in loans) on 13 January 2011. The joint European Parliament and Council Decision is expected for June-July 2011.

### **5.2. Macroeconomic performance**

Following the double shock of the military conflict with Russia of August 2008 and the 2008-2009 global crisis, the year 2010 saw a revival of economic activity. After a contraction of activity by 3.8% in 2009, real GDP grew by 6.3% in 2010. The labour market has profited only marginally from the economic recovery, however: the unemployment rate remained high: it decreased by only 2 percentage points from its 2009 height of almost 17%.

On the back of the economic recovery, the government tightened its budgetary and monetary policies. In line with the government commitment in the framework of the IMF Stand-By Arrangement and of the ENP Action Plan, the fiscal deficit was reduced from 9.2% of GDP in 2009 to 6.6% in 2010. Expenditure containment accompanied by a number of spending cuts has been the main means to achieve this fiscal consolidation, even if the recovering tax revenues were also an important factor. The tax revenue increased by almost 10% in comparison to 2009 thus more than compensating tax revenue fall-out of the previous year. The tightening of the monetary policy began in summer to keep inflation under control, with the key policy interest rate having been

increased by 3 percentage points between May 2010 and February 2011. The authorities also increased reserve requirements. However, while CPI inflation in 2010 was 7.1% on average, it picked up at the end of 2010 reaching 11.2%. One of the reasons for the strong increase in inflation is the fact that almost half of the CPI basket in Georgia consists of food items, so that increases in cereals prices, especially those of wheat, previously imported from Russia, feed into the higher CPI. To find a solution to high food prices and reduce Georgia's dependency on certain key agricultural exports, such as wheat, the authorities reviewed their agricultural policy announcing a greater political commitment to promote growth and jobs in the agricultural sector.

While the economic recovery has taken hold, the external economic situation remains vulnerable as the financing of the large current account deficit remains uncertain. By weakening domestic demand, the crisis contributed to a halving of the current account deficit in 2009. However, the deficit remains very large, at 9.9% of GDP in 2010, and it is expected to remain similarly high in 2011. The trade deficit, which reached 22.2% of GDP in 2010, has been the main driver of the large current account deficit. Georgia's exports continue to suffer from the trade embargo imposed by Russia in 2006 and extended in 2008. Georgia's exports to the EU countries have remained low and the possibilities offered by the GSP+ remain under-exploited. While a certain trade re-orientation and changes in export profile have recently taken place, Georgia's exports continue to lack diversification. Overall, the Georgian export performance remains far below its potential.

FDI inflows were negatively affected by the crisis and declined in 2010 in comparison to the previous year. Thus, FDI inflows reached USD 550 million thus remaining substantially below the 2009 figure of USD 750 million. This disappointing performance of FDI inflows puts at risk the financing of the current account and the build up of international currency reserves and shows that foreign investor confidence, which experienced a dramatic blow due to the conflict with Russia in 2008, has still not returned. It also reflects the loss of steam of the privatisation process, as many of the most attractive state companies and assets have already been sold. At the same time, much of the official donor financing agreed at the 2008 International Donors' Conference has already been disbursed as it was mostly frontloaded. A further vulnerability in the balance of payments relates to the fast increasing external public debt that represented in 2010 34.1% of GDP (up from 16.8% of GDP in 2007), and a significant need for a debt roll-over in the coming years. Substantial external debt repayment obligations are expected to become due in 2013-2015. A strong bunching of repayments foreseen for 2013 (USD 750 million) reflects the repayment of the Eurobond of USD 500 million issued in 2008 and substantial repurchases under the IMF's Stand-By Arrangement. To improve the amortisation profile and reduce the bunching of debt repayments in 2013, the authorities accessed the international capital markets in early April 2011. Georgia issued a Eurobond of USD 500 million with a ten-year maturity and in parallel redeemed USD 417 million of the existing Eurobond. Despite the improved creditworthiness in international capital markets, Georgia's balance of payments situation remains vulnerable.

In September 2008, the IMF approved an 18-month Stand-By Arrangement for Georgia, worth USD 750 million. In August 2009, the Stand-By Arrangement was extended until 14 June 2011 and the financing package increased, bringing the total Stand-By Arrangement programme to USD 1.17 billion. The programme remained fully on track during 2010. In January 2011, the IMF Executive Board completed successfully the

seventh and the eighth programme reviews. However, the authorities indicated that they did not intend to draw the instalment of around USD 153 million that became available. At the same time, the authorities have indicated their interest to conclude a follow-up Stand-By Arrangement with the IMF after the current SBA expires in June 2011.

Consistent with the commitment of the monetary authorities within the IMF Stand-By Arrangement to increase the exchange rate flexibility, the National Bank of Georgia continued its less interventionist exchange rate policy. The depreciation trend against the USD during the first half of the year reversed in June, with the appreciation against the USD allowing for a slight recovery in foreign reserves. However, although gross international reserves have recovered from a trough of USD 1.5 billion reached during the crisis to USD 2.7 billion by end March 2011, they remained at a suboptimal level, particularly since this recovery has partly been achieved by borrowing from the IMF. Despite a certain improvement at the end of 2010, net international reserves remained low, at USD 882 million in December 2010.

### **5.3. Structural reforms**

Since the 2003 Rose Revolution Georgia has made significant progress in a number of legal and regulatory reforms. The tax system has been simplified and public finance management brought closer to international practices. Customs regime has been liberalised, while important anti-corruption measures have been taken and the regulatory business environment has substantially improved. In 2010, the reform efforts were intensified in some areas, although others continued to lag behind the ambitious reform plans of the government.

One policy field that has been at the heart of government's reform efforts has been public finance management. In line with the policy conditionality of the macro-financial assistance, internal and external audit reforms continued, as well as reforms in the field of budget formulation and public procurement. Thus, the law on Internal Audit and Inspection introducing internal audit units in individual ministries was approved by the Parliament in March 2010, while the Action Plan on internal audit for 2010 was adopted by the government in May 2010. In April 2010, the Chamber of Control adopted a two-year capacity development plan that foresees the introduction of compliance audit manuals, quality control systems, staff-recruitment and targeted training. In the area of budget preparation, the Budget System Law was replaced by a more comprehensive Budget Code in January 2010. To advance the introduction of the programme-based budgeting, a decree outlining a three-year government plan was signed in March 2010. Pilot projects for programme-based budgeting were implemented in six line ministries. In public procurement, the law was amended to better reflect the introduction of the e-procurement mode in December 2010. Furthermore, a dispute review mechanism was established in December 2010. Georgia also made some progress in the area of public revenue management. A new, simplified Tax Code was approved in September 2010, electronic filing of tax returns and VAT invoices was implemented, while tax payment control and customs management systems have been reformed to reflect a more risk-based policy approach of the authorities.

In the area of trade and of trade-related regulatory reforms, progress was rather limited. A dialogue with the EU on the preparation for the start of negotiations on a deep and comprehensive free trade area continued but reforms in key trade-related regulatory and institutional reforms, such as sanitary and phyto-sanitary measures, technical regulations

and competition policy have remained insufficient to allow the launching of the negotiations.

In the area of prudential financial policy, the decision to merge the Financial Supervision Agency with the National Bank of Georgia in December 2009 and appointed the National Bank as the single regulator of financial sector was further implemented in 2010. The supervision is gradually moving towards a risk-based system.

In the field of statistics, a new law ensuring a higher independence of the National Statistical Office entered into force in February 2010. However, financial resources of the Statistical Office remained very limited putting at risk the quality of statistical data in the country.

Georgia's company law introduced an efficient registration system for new enterprises that allows a company to register within half a day. As far as business climate is concerned, according to the World Bank's 'Doing Business' indicators, Georgia ranked 12<sup>th</sup> globally, in particular due to improvement in access to credit and investor protection.

#### **5.4. Implementation of macro-financial assistance**

The EU Council Decision of 30 November 2009 provided macro-financial assistance (MFA) to Georgia amounting to EUR 46 million, in grants. This assistance was part of a pledge of two possible EU funded MFA operations of the same amount made by the European Commission at the International Donors' Conference of October 2008. This pledge was part of a comprehensive Community package of up to EUR 500 million to support Georgia's economic recovery in the aftermath of the August 2008 armed conflict with Russia. It supported the Stand-By Arrangement agreed by the Georgian government with the IMF to help the country through the global crisis. The Union's MFA contributed to covering Georgia's external financing needs in 2009-2010. The Commission disbursed the first tranche of the assistance of EUR 23 million in two parts amounting to EUR 15.3 million and EUR 7.7 million in December 2009 and in January 2010, respectively. The second tranche of EUR 23 million was disbursed in August 2010.

The approval of the second MFA operation was conditional on the continued existence of external financing needs over and above those covered by the IMF arrangement. In a letter from 10 May 2010, the Georgian Minister of Finance requested the activation of the second part of the EC pledge, amounting to EUR 46 million. After thorough assessment of external financing needs of Georgia the Commission considered that the activation of the second part of the MFA pledged in 2008 was warranted and adopted its proposal on 13 January 2011. The joint European Parliament and Council Decision is expected for June-July 2011.

The proposed assistance would be provided half in grants and half in loans. The new MFA will support the economic reform agenda of the government. It would promote policy measures to strengthen public finance management (building on those of the previous operation and of the EU's sectoral budgetary support operation), as well as measures to foster economic and financial integration with the EU, in particular by exploiting the potential offered by the future Association Agreement, which aims at concluding a Deep and Comprehensive Free Trade Agreement between the two parties.

In the context of the preparation of the new MFA operation, the Commission conducted at the end of 2010 an operational assessment of the financial procedures and circuits. The

OA is being finalised. Its initial findings suggest that significant efforts have been made in Georgia since the OA conducted in 2004-2005 to build a functional and transparent public finance management system, compliant with international standards. This reform, which was supported by the conditionality of the MFA operation implemented in 2009-2010, has translated in progress in the areas of public procurement, programme-based budgeting as well as external audit. Also, the customs and tax environment has been simplified. Yet, the OA report noted a need for further measures in areas including budget planning, debt management, public internal financial control, external audit and public procurement.



## GEORGIA - SUMMARY STATUS OF ECONOMIC REFORM

### 1. Price liberalisation

Prices are largely free.

### 2. Trade regime

Liberal trade policy. Import tariffs have been abolished on around 90% of products. In September 2006, the number of tariff bands on imported goods was reduced from 16 to three. The maximum tariff of 12% is applied to those agricultural products and building materials which compete with domestic goods. The average weighted tariff is estimated to be 1.5%. Non-tariff barriers allowed for environmental, security and health reasons only. There are no quantitative restrictions on imports and exports.

Since December 2005, under the EU Generalised System of Preferences (GSP), Georgia benefits from the generous tariff preferences of the special incentive arrangement for sustainable development and good governance covering 7200 items, the GSP+. Georgia's GSP+ utilisation rate has been declining. In May 2010, the mandate for the negotiations of the Association Agreement between the EU and Georgia was approved. In the area of trade, the new agreement would foresee the establishment of deep and comprehensive free trade area, once the necessary conditions are met.

### 3. Exchange regime

Floating exchange rate of the lari with limited official intervention by the National Bank of Georgia. There are no restrictions on current international transactions in conformity with Article VIII of the IMF's Articles of Agreement.

### 4. Foreign direct investment

Adequate overall legislation. Unlimited repatriation of capital and profits.

### 5. Monetary policy

Central Bank's main policy objective is the price stability. The stated inflation target of the monetary authorities is 6%. However, in practice, stability of the external value of the lari against the USD seems to take precedence over the aim of domestic inflation control.

### 6. Public finances and taxation

Public finance management system is largely appropriate. Significant reform efforts have been made allowing to build a solid foundation for a functional and transparent public finance management system. A new tax and customs code was introduced as well as a number of reforms in external and internal audit, programme-based budgeting and public procurement.

Georgia has double taxation agreements with 26 countries, including 19 EU Member States.

### 8. Privatisation and enterprise restructuring

The majority of state-owned enterprises have been privatised. Privatisation receipts amounted to 3.7% of GDP in 2008, to 2% in 2009 and 1.1% in 2010.

### 7. Financial Sector

There are 15 banks in Georgia with foreign investors holding significant stakes in the Georgian banking industry. The two largest foreign banks are Société Générale's subsidiary Bank Republic (holding around 11% of the market in terms of deposits) and HSBC. Russia's Vneshtorgbank, the German Procredit, the Kazakh Turan Alem Bank and the Armenian Cascade Bank are also present. The share of non-performing loans, defined as overdue by more than 90 days, has remained low reaching 5.4% in early 2011. Capital adequacy and provisioning rules in Georgia are more conservative than Basel standards. Since December 2009, the National Bank of Georgia is the single supervisor of Georgia's financial sector. It is currently introducing risk-based bank supervision in line with Basel II.

## **6. MOLDOVA**

### **6.1. Executive summary**

The global crisis hit the Moldovan economy hard. GDP contracted by 6 % in 2009, with investment and remittances falling by around 30%, which exposed a severe external financing gap. In 2010, the Moldovan economy started to recover at a rapid pace and real GDP grew by 6.9% of GDP. Private consumption and investment rose again, the latter at a double-digit growth rate, while the negative external demand subtracted from growth. The recovery was broad based, with agriculture, industry and services all growing after contractions in 2009. Although exports rebounded strongly they were outpaced by imports and together with the narrow export base meant that the persistently high trade deficit expanded as a share of GDP. The increase was however offset by a rise in remittances and labour income, and the current account deficit slightly decreased as a share of GDP. FDI inflows are estimated to have risen to about 3.5% of GDP in 2010. Long-term external borrowing also increased but was supported by the loan disbursements under the IMF programme. The uncertainty surrounding private external financing implies that international donor support remains important for maintaining macro-economic stability and supporting the government's reform agenda.

The incoming governments' structural reform priorities are broadly those of the previous administration but political uncertainty has somewhat hampered progress. The incoming government's main priorities are to consolidate and improve the efficiency and sustainability of public finances, partly by overhauling the civil service, improve the environment for businesses, in particular export oriented businesses, by reducing the number of business licences, permits and authorisations, to support small and medium-sized enterprises (SMEs), and to improve education and health.

In October 2010, the EU co-legislators adopted a decision to grant Moldova macro-financial assistance of EUR 90 million. The assistance, in the form of grants, is to be disbursed in three tranches in 2010 and 2011. The first tranche of EUR 40 million was disbursed at the end of December 2010. The disbursement of the first tranche was made possible by the agreement between the Commission and the authorities on the economic policy conditions of the assistance reached in December 2010. The second and third tranches, of EUR 20 million and EUR 30 million respectively, should be disbursed at the end of the second and fourth quarters of 2011.

### **6.2. Macroeconomic performance**

The global crisis hit the Moldovan economy hard. GDP contracted by 6% in 2009, with investment and remittances falling by around 30%. The sharp fall in external financing sources exposed a severe external financing gap. On 29 January 2010, the IMF agreed to provide financial assistance of SDR 369.6 million (EUR 420 million) spread over three years. The IMF financing is provided under the Fund's Extended Fund Facility (EFF) and the concessional Extended Credit Facility (ECF). On 16 July 2010, the IMF completed the first of a series of semi-annual reviews of the ECF-EFF arrangement. The review concluded that the lending programme is on track and that current policies will continue to stabilise the economy and support the recovery. All IMF performance criteria and indicative targets were met. The positive review triggered the second disbursement of SDR 60 million. The second IMF review was completed in April 2011 and the next tranche of SDR 50 million was disbursed.

In 2010, the Moldovan economy began to recover. Real GDP grew by 6.9% of GDP. Private consumption and investment started to rise again although the external negative demand subtracted from growth. On a sectoral basis, the recovery was broad based with agriculture, industry and services all growing after contractions in 2009. Although exports rebounded strongly they were outpaced by imports and together with narrow export base meant that the persistently high trade deficit expanded from 36% of GDP in 2009 to an estimated 38% of GDP in 2010. The increase was however offset by a rise in remittances and labour income and the current account deficit slightly declined from 8.5% of GDP in 2009 to 8.3% of GDP in 2010. FDI inflows are estimated to have risen to 3.5% of GDP from 1.5% in 2009. Long-term external borrowing increased although supported by the loan disbursements under the IMF programme. The uncertainty surrounding private external financing implies that international donor support remains important for maintaining macro-economic stability and supporting the government's reform agenda.

After decreasing rapidly in 2009, inflation edged up again through 2010 mainly due to cost push pressures as credit and domestic demand remained subdued. In particular, inflation was driven up by increases in food prices and energy tariffs, the depreciation of the leu, and higher excise rates. The CPI rose to 8.1% at the end of 2010. In response to mounting inflationary pressure, the National Bank of Moldova (NBM) reversed the trend of monetary easing by raising the base lending rate twice in the first quarter of 2010, to 7%. The NBM adopted a more explicit policy of inflation-targeting in 2010, with a target of 5%  $\pm$ 1.5 percentage point for the end of 2010. The NBM's policies have started to be gauged in quarterly monetary policy reports, the first of which was published in February 2010.

The banking system is well capitalised with a capital adequacy ratio of about 30% as of March 2011. The large amount of non-performing loans declined from 16.4% in 2009 to 10.7% in the first quarter of 2011, supported by the resumption in private credit growth. The growth rate of private credit turned positive to about 13% in 2010 and jumped to around 38% in January 2011 based on higher FX lending to the corporate sector and a reduction of leu lending rates. Lending rates remain high at above 15% p.a. while the spread between lending and deposit rates increased significantly in the crisis. In addition, a high proportion of foreign currency denominated loans (43%) and deposits (46%) heighten exchange rate vulnerability.

Unemployment has continued to rise compared to 2008 and 2009 and reached about 7.4% of the labour force (ILO definition) in 2010. The activity rate declined to less than 42% thus being very low on account of the large segment of the population working abroad. Job losses were reported in agriculture, industry, and catering, while there were increases in transport, communications, and construction. As Moldova is relatively poor, the recession affected heavily the living standards of the population. The impact was however alleviated by the multilateral and bilateral official financing which supported domestic demand and set the stage for the economic recovery. After having dropped by around 6% in euro terms in 2009, GDP per capita bounced back by about 12% in 2010. Still, it only reached a low level of about 1,230 euro.

The authorities have focused fiscal and monetary policy on ensuring macroeconomic stability and fiscal consolidation. Fiscal policy was significantly tightened in 2010. The government reduced the deficit in 2010 to 2.5% of GDP from 6.3% in 2009. The reduction was driven by cuts in general public services and reduced debt servicing costs,

as well as regulatory rises in taxation that contributed to an increase in revenue of 17% compared to 2009. The 2010 budget included increases in VAT on gas, and higher excise duty on tobacco products, luxury cars, alcoholic beverages and perfumes. Government debt remained stable at 25.2% of GDP.

In the context of efforts by international donors to put the economy on a reform path, the government has adopted a wide-ranging medium-term structural reform programme ("The Economic Stabilisation and Recovery Programme for 2009-2011") supported by multilateral and bilateral donors. In the medium term, the government aims at gradually narrowing the budget deficit, mainly through an adjustment of current expenditure on wages, goods and services, and subsidies. The government is also aiming at reforming the civil service and the judiciary; combating corruption; reducing and streamlining business administration; providing greater support to small and medium-sized enterprises, and improving education and health.

The major near-term challenge for Moldova is how to expand growth enhancing public spending and maintain basic living standards while at the same time consolidate public finances. In order to protect the most vulnerable groups from the measures to increase utility tariffs and reduce subsidies, the government has put in place targeted compensation schemes for heating costs for families receiving social assistance, low wage public sector workers, and for pensioners on low incomes. In line with the EU Action Plan objective of ensuring the sustainability of public finances, reforms were agreed to the social insurance systems which have tightened sick leave allowances and pulled back early retirement schemes. The authorities also adopted a strategy to improve tax collection, including risk-based auditing, targeting economic agents outside the formal economy, and combating tax evasion.

### **6.3. Structural reforms**

The incoming governments' structural reform priorities are broadly those of the previous administration but political uncertainty has somewhat hampered progress and expectations were not always met. As indicated already, the incoming government's main priorities are to consolidate and improve the efficiency and sustainability of public finances, partly by overhauling the civil service, to improve the environment for businesses, in particular export oriented businesses, by reducing the number of business licences, permits and authorisations, to support small and medium-sized enterprises (SMEs), and to improve education and health.

With respect to fiscal policy, the government is aiming to reduce the fiscal deficit, at a pace depending on the economy's speed of recovery. To achieve the consolidation, the government is aiming to cut the public sector wage bill, reduce non-essential current spending, and increase tax revenue by improving tax administration, i.e. broadening the tax base and reducing the level of fraud and tax evasion. In 2010, the government intensified efforts to reform public procurement and public internal financial control (PIFC), including through the introduction of internal audit units and approval of core PIFC legislation. These measures are in line with the structural reform criteria of the MFA. The government also introduced new legislation to improve the financial sustainability of the social insurance system, by making sick leave benefits more incentive-compatible by assigning the responsibility for the first day of sick leave to the employee and the second day to the employer, and by phasing out early retirement

privileges for civil servants, judges and prosecutors. In future, the government intends to introduce a performance-based salary system for all public sector employees.

The government has continued to take actions to create an investment- and export-friendly business environment, advance liberalization and deregulation, and prepare for further privatisations. The government is planning to privatise state owned assets in the telecommunications, rail and air sectors, and is working with the World Bank and the IMF on a restructuring plan for the energy sector. The National Agency for Energy Regulation (ANRE), in accordance with its mandate and methodology, has increased tariffs over the past few years to cost-recovery levels. The government also intends to deregulate wages in state run utility companies by removing indexation to the national minimum wage.

With respect to reforming the environment for businesses, a number of formal and informal export and import restrictions were removed in 2010. The government also simplified licensing requirements, and procedures for business registration and liquidation. The VAT regime was simplified by extending nationally the option to receive VAT refunds for purchases of investment goods effective from 2011. Business overhead costs were lowered by reducing the frequency of inspections of enterprises by state agencies and by simplifying access to digital signatures. In order to promote trade, one-stop-shop business services linked to customs administration were extended. The government continued to improve IT facilities to enable automated data exchange and electronic document processing. In order to stimulate private investment and strengthen the protection of investors' rights, the government intends to review investment-related legislation, including the laws on joint stock companies, entrepreneurship and capital markets. The government also intends to amend the Land Code and other related legislation to simplify the procedure of converting agricultural land for other business use.

In order to increase efficiency in the education sector, the government passed a decision to merge several schools. It is planning further consolidation and also intends to allow schools to generate revenue from their own assets. The proceeds from efficiency gains will be reinvested in order to raise the quality of the education sector.

#### **6.4. Implementation of macro-financial assistance**

A Legislative Decision (938/2010/EU) to provide EUR 90 million of macro-financial assistance in grant aid to Moldova was adopted on 20 October 2010. The EU MFA is to be disbursed in three tranches in 2010 and 2011. The first tranche of EUR 40 million was disbursed at the end of December 2010. The second and third tranches, of EUR 20 million and EUR 30 million respectively, should be disbursed at the end of the second and fourth quarters of 2011.

EU MFA is part of an international financing package put in place to support the Republic of Moldova's efforts to meet substantial external financing needs and cover a sharp deterioration in public finances in the context of the global economic crisis. EU MFA will complement financial resources provided by (i) the IMF; (ii) the World Bank (WB) which is undertaking additional operations aimed mainly at supporting growth-enhancing structural reforms; (iii) other multilateral creditors and official bilateral donors; and (iv) the EU, in the form of EIB loans and sectoral budget support programmes financed under the European Neighbourhood and Partnership Instrument.

The objective of EU MFA is to help bridge the external financing gap and to bring about structural reforms which will stabilise the Moldovan economy and raise potential growth. In this respect, EU MFA is tied to a number of structural reform criteria. The main criteria included in the Memorandum of Understanding, agreed with the authorities in December 2010, are public finances and public finance reforms, financial stability and financial sector reforms, and legislative and regulatory convergence with the EU.

EU MFA is mainly tied to a number of actions to reform public finance management and improve the efficiency and effectiveness of public spending. They include the preparation of a new law on public finances, the publication of a Medium-Term Budgetary Framework (MTBF) for the period 2012-2014 to improve budgetary planning, the preparation of a census of all public sector employees to improve control over public sector wage costs. Also, the Ministry of Finance will approve a new unified Chart of Accounts for the whole public sector, put in place a new Financial Management Information System (FMIS), and elaborate, approve, and publish a medium-term debt management strategy for the period 2012-2014, also covering the terms of settlement of outstanding government bonds held by the National Bank of Moldova. Finally, the Public Procurement Agency will receive new powers and put forward regulations and standards to bring public procurement closer to EU standards.

EU MFA is also tied to several actions to reform the financial sector. The government will introduce legislation to define the regulatory and supervisory responsibilities for leasing and micro-credit institutions. The Ministry of Finance and the National Bank of Moldova will jointly elaborate a medium-term action plan to ensure the sufficient capitalisation of the National Bank of Moldova. The government, in cooperation with the National Bank of Moldova, will modify Central Bank legislation to ensure its compliance with the Treaty on the Functioning of the European Union, in particular with respect to central bank independence and restriction on monetary financing.

## MOLDOVA – SUMMARY STATUS OF ECONOMIC REFORM

### 1. Price Liberalisation

Prices are regulated on utilities and some public services. There are price controls on electricity, natural gas, water supply and sanitation, housing and medical services, rail and urban passenger transport, and postal services.

### 2. Trade regime

Moldova (a WTO member since 2001) has a liberal trade regime. Since 2006, Moldova has been a member of the Central European Free Trade Agreement (CEFTA); it has also concluded bilateral free trade agreements with all CIS countries but Tajikistan. Since March 1, 2008 Moldova has benefited from Autonomous Trade Preferences (ATP+) with the EU as a result of implementation of sustainable development, good governance policies and customs administration. Moldova started negotiations with the EU on an Association Agreement in January 2010 including the establishment of a DCFTA. Moldova does not impose any taxes, quotas or other restrictions on exports while custom tariffs are applied to around 50% of imported products. No tariffs are applied to products originating from the EU and from CEFTA, up to quota limits agreed within CEFTA. The average weighted customs tariff is 4.3%. The average tariff on agricultural products is 12.7% and 3.9% on industrial products.

### 3. Exchange regime

The exchange rate regime has been a managed float since 2008. The NBM intervenes in the domestic foreign exchange interbank market in order to smooth out sharp fluctuations of the Moldovan leu against the US dollar. The NBM publishes information on its interventions.

### 4. Foreign Direct Investment

There are no controls on inward investment. Net FDI inflows amounted to an estimated 3.5% of GDP in 2010. Before the global economic crisis FDI inflows were considerably higher, at around 11.5% of GDP in 2008.

### 5. Monetary policy

The primary objective of monetary policy is price stability. The central bank adopts an annual inflation target and uses the base interest rate as the main policy instrument. In January 2010, the National Bank of Moldova (NBM) announced an inflation target of 5 percent with a narrow  $\pm 1.5$  percent deviation band.

### 6. Public Finances and Taxation

The Moldovan government is implementing several measures to consolidate public finances, in particular to increase tax revenue and to increase the efficiency of public expenditure, notably by improving public finance management and rationalising public sector employment. Moldova's tax rates have been significantly reduced in recent years. The 2008 budget simplified income tax by cutting the number of bands from three to two (with top rate of 22%); it also eliminated corporate income tax except for distributed profits and dividends. Tax revenue amounted to approximately 38% of GDP in 2010.

### 7. Privatisation and enterprise restructuring

Moldova has gradually sought to privatize state owned assets and enterprises. The private sector accounts for around 60% of GDP. Privatisation revenues rose to 0.5% of GDP in 2010 from 0.1% of GDP in 2009. One of the government's current priorities is energy sector reform.

### 8. Financial sector

Moldova's bank-based financial system remains generally sound. The sector was largely insulated from the global financial crisis due to limited access of local banks to international capital markets, but deposits fell and the asset quality deteriorated at the beginning of the crisis. Partly as a result of supportive measures from the NBM, commercial banks have remained liquid and adequately capitalized although lending to the economy has fallen significantly. Recently, lending to the private sector resumed its positive trend while the share of non-performing loans fell from around 17% in April 2010 to about 11% in March 2011.

## **7. UKRAINE**

### **7.1. Executive summary**

Ukraine's economy entered a phase of recovery in 2010. This, along with a new IMF Stand-By Arrangement concluded in July 2010, helped the newly formed executive to consolidate the general macroeconomic policy framework. Notably, 2010 saw a return to economic growth, lower domestic inflation, a stabilisation of the hryvnia against the US dollar and other foreign currencies, a reversal of the losses of foreign exchange reserves witnessed in 2009 and a narrowing of the public deficit. However, the rebound in domestic investment has remained timid, while the current account has swung back into deficit, raising some doubts about the medium-term sustainability of the recovery.

In terms of structural reforms, the government implemented a significant increase in retail energy prices, strengthened central bank independence and started working on a pension reform in 2010; all of these measures formed part of the IMF's conditionality. However, a key weakness in Ukraine remains the operating environment for businesses, which is hampered by non-transparent bureaucratic procedures, a lack of administrative implementation and enforcement capacity and continued constraints in companies' access to credit.

Against the backdrop of a persistent external financing gap and in order to support the economic reform process in the country, the European Commission started to negotiate with the Ukrainian authorities in July 2010 an MFA loan package of up to EUR 610 million, based on the Decisions of 2002 (EUR 110 million) and 2010 (EUR 500 million). Unfortunately, progress in these negotiations has been slow, reflecting reluctance on the part of the authorities to make clear commitments in some key reform areas, including external audit, VAT refund arrears and energy sector reform. Any disbursements of MFA in 2011 are conditional on the successful conclusions of these negotiations, as well as continued drawings on IMF support by Ukraine under its current Stand-By Arrangement on the basis of positive assessments by the IMF of the country's reform progress.

### **7.2. Macroeconomic performance**

Ukraine was among the EU neighbourhood countries hardest hit by the global economic and financial crisis. From late 2008, it suffered a parallel balance-of-payments and banking crisis, and output contracted by 15% in 2009. However, in 2010 Ukraine's economic fortunes improved in parallel with the rebound in much of the rest of the world and in the wake of a stabilisation in the domestic political situation following the presidential election early in the year and the subsequent formation of a majority government.

The Ukrainian recovery was initially export-led, but spread to domestic demand over the course of 2010. Official labour market figures reflect this upturn: unemployment (ILO methodology) declined from 9.6% in 2009 to 8.8% in 2010, while the number of jobs rose slightly (0.4%). As a consequence of an improved economic and labour market situation, household consumption, rising by 7.0% in real terms, turned into the mainstay of economic growth in 2010, which came to 4.2%.

Investment also recovered in 2010, albeit only in the second half of the year and relatively timidly (4.9% in 2010) considering the favourable base effect stemming from



its drastic contraction during the crisis (-50.5% in 2009). This hesitant recovery in investment may in part reflect severe problems in the operating environment for companies, along with persistent difficulties with access to financing. Loans by domestic banks to non-financial companies barely increased in real terms in 2010, as the Ukrainian banking system continued to grapple with a non-performing loan ratio in excess of 15% (compared with 3% before the crisis) and posted a consolidated net loss of UAH 13.0 billion (albeit down from UAH 38.3 billion in 2009).

More encouragingly, the National Bank of Ukraine (NBU) managed to control inflation relatively well by historical standards in 2010. Following three years of double-digit increases in consumer prices, the year-average headline inflation in 2010 came to 9.4%. Core inflation was even slightly lower, at 8.6%, reflecting the fact that part of the price pressure stemmed from increases in excise taxes and administered prices, notably for gas and communal heating services, in line with the IMF programme.

In its fiscal policy, Ukraine also broadly followed the consolidation course agreed with the IMF under the July 2010 SBA. At just over 5% of GDP, the general government deficit was even lower than the programme target of 5.5% in 2010, although this positive development was offset by the higher-than-mandated deficit of Naftogaz, which occurred despite the gas price hikes implemented under the programme. General government debt stood at approximately 36% of GDP, a notable deceleration of the steep increases seen during the crisis years of 2008 and 2009.

On the external front, the positive adjustment of the current account that had resulted from the crisis-related contraction of imports during 2009 continued through the first half of 2010, before starting to reverse as domestic demand picked up. The current account slipped back into deficit in Q3 2010, i.e. even before the start of the heating season, which traditionally entails higher gas imports for Ukraine.

Positively, the country was able to tap various sources of external financing. Notably, this included a return to capital markets with a combined USD 2.5 billion of Eurobonds issued in September and December 2010 and a further USD 1.5 billion issued in February 2011. The government also secured a USD 2 billion revolving loan from a Russian state-owned bank and, most importantly, a new Stand-By Arrangement (SBA) with the IMF in July 2010, worth USD 15 billion and running to end-2012 (following the stalling of the preceding SBA in November 2009 over Ukraine's lack of compliance with agreed programme parameters). Meanwhile, negotiations between Ukraine and the EU on a macro-financial assistance loan of EUR 610 million were launched, but not concluded, in 2010 (see below).

The combination of multilateral, bilateral and private external borrowing by the government, along with a gradual return of external lending to private borrowers in Ukraine, allowed the National Bank of Ukraine (NBU) to replenish its foreign exchange reserves from a low of USD 24.1 billion in February 2010 to USD 34.6 billion at year-end.

Thus, 2010 was overall a successful year for Ukraine in terms of external economic stabilisation. However, the relatively weak rebound in investment, along with persistent problems in the operating environment for businesses in Ukraine, calls into question the medium-term sustainability of the recovery. With the current account deficit widening again and debt roll-over requirements of around USD 43 billion, the country may continue to depend on official external financial support in 2011 if it is to avoid a

recurrence of a drain on its foreign currency reserves, as happened during the crisis in 2008-09.

This underlines the importance of continued cooperation with the IMF. Ukraine successfully concluded the first review of the IMF programme, triggering the release of its second tranche (of approximately USD 1.5 billion) in December 2010. However, the completion of the second review of the programme, initially scheduled for March 2011, has been delayed reflecting notably the postponement of parliamentary adoption of pension reform legislation.

### **7.3. Structural reforms**

The IMF programme was instrumental as an external anchor for structural reform progress in Ukraine in 2010. In particular, domestic gas prices were increased and are to be raised further in a gradual manner with a view to bringing retail energy prices to cost recovery levels, thereby reducing the need for state transfers to Naftogaz. As part of the IMF programme, Ukraine also started working on pension entitlement reform and committed to a reorientation of monetary policy towards domestic price stability as the primary objective, even if the resulting gradual relaxation of the de facto exchange rate peg to the US dollar did not become apparent over the course of 2010. Changes in the NBU law also strengthened the central bank's independence (a reform also contained in the EU-Ukraine Association Agenda).

In a separate development monitored closely both by the IMF and the EU, the Ukrainian government reduced the arrears on VAT refunds that had existed for many years and swollen to unprecedented levels during the crisis. In August 2010, the government issued VAT bonds with a face value of UAH 16.4 billion or 1.6% of GDP to companies with outstanding VAT refund claims. While this measure cleared a large part of the state's VAT refund debt, it was controversial in the business community, both domestically and abroad, as companies felt compelled to sign up (perceiving the bond scheme as the only way of being paid at all), even though the bonds offered a coupon inferior to market yields of comparable government bonds. Indeed, companies in need of cash for their operations had to sell the bonds at a discount of reportedly 20-30% of face value. There were also complaints about preferential treatment of companies with close ties to the authorities, while other enterprises reported that part of their VAT refund claims were not recognised and remained unpaid. Moreover, contrary to government claims that it has addressed the VAT refund problems in a durable manner, a renewed build-up of arrears was reported by companies in late 2010.

The controversy about the VAT bond scheme was part of a general picture of growing concern on the part of businesses about the operating and investment environment in Ukraine in the final part of 2010, in particular regarding red tape and a lack of transparency in dealings with the administration. In November-December 2010, divergences between the government and the business community came to a head when entrepreneurs protested publicly for several weeks against a planned overhaul of the Tax Code. However, the government ultimately managed to defuse the protests by offering some targeted concessions to SMEs and entrepreneurs, thus securing passage of one of its flagship reform projects before year-end.

Aside from the Tax Code, key pieces of legislation in the government's economic reform agenda of 2010 have been new laws on public procurement and the functioning of the

gas market (providing notably for the unbundling of Naftogaz and the end of its domestic monopoly), as well as the Budget Code, on the basis of which the authorities drew up a 2011 budget in line with the consolidation benchmarks agreed with the IMF. However, in many areas, there are problems or delays with the implementation and enforcement of new laws, which can therefore not unfold their desired positive impact on the business climate. For example, this has been the case for the public procurement law, as well as the Tax Code, while many businesses also still complain about arbitrary customs valuation procedures, despite the fact that WTO-compliant legislation is in place.

The policy programme that is associated with the EU's planned MFA operation and currently under negotiation between the European Commission and Ukraine therefore seeks to support further legislative developments, as well as the implementation side of the economic reform agenda in Ukraine. Meanwhile, recent and ongoing reforms in the area of public finance management will be assessed in a Public Expenditure and Financial Accountability (PEFA) study that is being conducted jointly by the World Bank and the European Commission. The results of this PEFA study that will be updating the one conducted by the World Bank in 2007 will be available in the second half of 2011.

#### **7.4. Implementation of macro-financial assistance**

Following the Commission proposal for MFA of EUR 500 million to Ukraine, adopted in late 2009 in response to a Ukrainian request of the same year, the co-legislators approved the package in July 2010 (as the first MFA Decision adopted under the ordinary legislative procedure as per the Lisbon Treaty). In addition, EUR 110 million of MFA stemming from a Council Decision of 2002 are still available to Ukraine. In parallel to the co-legislator's deliberations and in order to prepare the eventual implementation of the MFA, the Commission launched a new Operational Assessment of administrative procedures and financial circuits of public organisations involved in the management of MFA in Ukraine. The consultants submitted their final report in April 2010. Its general conclusion is that the framework for sound financial management is effective in Ukraine, despite several weaknesses detected during this mission, such as the absence of an efficient external audit function, deficiencies in the transparency of public procurement and difficulties in the financial management of state-owned enterprises.

As of end-2010, the assistance was still at the negotiation stage; no disbursement was made in the course of the year. The Commission organised a mission to Kiev in July 2010, immediately after the adoption of the aforementioned MFA Decision, to gather detailed information on the economic situation of the country following the crisis of 2008-09 and on the government's planned reforms. The IMF also sent a mission to Ukraine in July 2010, following which the Executive Board, on 28 July, approved a new Stand-By Arrangement worth up to SDR 10 billion and running to end-2012.

On this basis, the Commission proposed to combine the EU's MFA loan amounts of the 2002 and 2010 Decisions in a single package (covered by one Memorandum of Understanding and one Loan Agreement) of up to EUR 610 million. This is to be split into four tranches (of EUR 100 million, EUR 10 million, EUR 250 million and EUR 250 million), of which the second and third (a combined EUR 260 million) could be disbursed on the same date. First drafts of the Memorandum of Understanding and Loan Agreement were presented to the authorities at the end of the staff mission in July. The policy measures proposed therein take into account the shortcomings in public finance

management detected by the Operational Assessment (conducted in 2009), while also covering important structural reform priority areas, notably taxation and trade (including the VAT refund system and customs valuation practices), energy (unbundling and increased transparency in the gas sector), and finance (legislative approximation with the EU).

Bilateral consultations on the package took place over the following months; these talks were upgraded to negotiations by the Ukrainian side in November 2010, following the President's official authorisation of a negotiating mandate for the Ministry of Finance. However, progress in these negotiations has been slow, reflecting reluctance on the part of the authorities to make clear commitments in some key reform areas, including external audit, VAT refund arrears and energy sector reform.

Meanwhile, Ukraine successfully concluded the first review of the IMF programme, triggering the release of its second tranche (of approximately USD 1.5 billion) in December 2010. However, the completion of the second review of the programme, initially scheduled for March 2011, has been delayed reflecting notably the postponement of parliamentary adoption of pension reform legislation. Continued successful conclusions of IMF reviews under the current SBA, as well as an agreement between Ukraine and the EU on the pending Memorandum of Understanding and Loan Agreement, are pre-conditions for any disbursements of EU MFA in 2011.

## UKRAINE - SUMMARY STATUS OF ECONOMIC REFORM

### 1. Price liberalisation

Most prices are free, but regulated prices prevail for some utilities, notably gas, as well as in some other areas.

### 2. Trade liberalisation

Ukraine joined the WTO in May 2008. However, export duties and quotas on individual products remain in force, and complaints by importers about technical and administrative barriers to trade abound. Positively, in late 2010 legal changes were adopted that will facilitate the gradual replacement of obligatory pre-market certification of non-food products (which presently constitutes a trade barrier) with a system of market surveillance.

### 3. Exchange rate regime

While not officially operating a peg or band, the National Bank of Ukraine effectively manages the level of the hryvnia against the US dollar. Since the crisis-related devaluation in late 2008, the central bank has held the hryvnia at close to UAH 8:USD. A gradual reorientation of monetary policy towards domestic price stability has been agreed between Ukraine and the IMF.

### 4. Foreign direct investment

FDI-related flows are largely liberalised, and since May 2010 a registration of foreign investment is no longer compulsory. Meanwhile, some sectors remain closed to foreign ownership, notably the gas transmission system.

### 5. Monetary policy

The National Bank of Ukraine is responsible for controlling the domestic money supply. Amendments to the NBU law of 2010 aimed at strengthening the bank's political independence and its responsibility for price stability. However, in practice, exchange rate stability (against the US dollar) still takes precedence over domestic inflation control.

### 6. Public finances

General government expenditure made up an estimated 48.3% of GDP in 2010. Nearly three-quarters of Ukraine's government expenditure goes towards wages and social transfers (including over one-third on pensions). Gradual domestic gas price increases under the IMF programme are aimed at balancing Naftogaz' finances, thus relieving budgetary pressures. Ukraine has also undertaken some reforms in its public finance management systems (e.g. in public procurement), but many challenges remain (e.g. in tax and customs administration and the fight against corruption).

### 7. Privatisation and enterprise restructuring

State-owned companies continue to dominate certain sectors, in particular utilities; the gas sector holding Naftogaz remains largely unreformed; and the privatisation of strategic assets, including the gas transmission system, is prohibited by law. In December 2010 a ban on privatisation of several big companies in the power generation and mining sectors was lifted, and the privatisation of telecommunications company Ukrtelecom was launched.

### 8. Financial sector reform

At the end of 2010, 176 banks were operating in Ukraine, including 17 foreign-owned institutes. Before the crisis, Ukraine had two state-owned banks. In 2009 this number increased to five as the state became majority-owner in three troubled banks. An audit by the NBU in late 2010 revealed that these banks require further substantial injections of state resources. Aside from the consolidation and recapitalisation of the banking system, it is the authorities' declared objective to develop domestic private capital markets and to upgrade the independence and capacity of financial regulators.

## MEDITERRANEAN NEIGHBOURHOOD COUNTRIES

### 8. LEBANON

#### 8.1. Executive summary

Mediterranean Neighbourhood Countries are eligible for MFA under the Genval Criteria. Lebanon is the first country of this group benefiting from MFA since the balance of payments loan granted in 1994 to Algeria (Decision 1994/933/EC).

Lebanon's economy continued to grow at a remarkable – although slightly lower – rate during 2010, aided by the prudent macroeconomic policies of the past years and a well functioning banking system. The formation of a new national unity government in late 2009 helped to restore confidence and enabled a marked acceleration in capital inflows, including a steady stream of foreign deposits in the banking sector during 2010. The fiscal position, as well as the balance of payments position, deteriorated moderately mainly due to rises in government expenditures and oil prices. The sizeable debt-to-GDP ratio improved, prolonging the declining trend of the previous years. On the back of the unfolding political and social crisis, the Banque du Liban (BdL) has become an effective regulator and the central pillar of economic management in the country

While macroeconomic management and performance was broadly satisfactory in 2010, the country continued to fail to make progress with structural reforms reflecting the lack of consensus within the coalition government. Political instability remains in 2011 a main destabilisation factor of the Lebanese economy, with the Prime Minister designate, Najib Mikati, struggling to form a cabinet.

In December 2007, the Council adopted a decision on a MFA to Lebanon amounting to EUR 80 million – a combination of medium-term loans (EUR 50 million) and grants (EUR 30 million), to be disbursed in two tranches. The first tranches of grants and loans were disbursed in December 2008 and June 2009 respectively. At the end of 2009, the Commission proposed a one-year extension of the period of availability of the assistance to 21 December 2010, to be formalised through an addendum to the Memorandum of Understanding. However, this addendum was never signed by the authorities. This, as well as the lack of progress with implementing the MFA conditions and the lack of a successor IMF arrangement thwarted the disbursement of the second tranche of the MFA, which has now expired.

#### 8.2. Macroeconomic performance

The Lebanese economy showed great resilience to the global financial crisis despite the politically uncertain environment. Buoyant economic activity led to an estimated real GDP growth of almost 8% in 2010 from almost 9% in the previous year. This remarkable performance was partly attributed to low degree of exposure to international financial markets and the implementation of prudent banking regulations and supervision. Inflation pressures stemming mainly from fuel and food price increases intensified during 2010; average inflation reached 5% during the year after the sharp drop to 1.2% in 2009 in the context of the global crisis and the associated decline in international commodity prices.

The government budget deficit (including grants) is estimated to have widened to 8.7% of GDP in 2010 from 8.1% in 2009, partly reflecting capital expenditures increases, including substantial investments in electricity generation, and other government expenses, that more than outweighed buoyant fiscal revenues. Despite its steady declining trend during the last years, public debt remains at extremely high levels (139% of GDP in 2010) and almost half of it is denominated in foreign currency, underlying the country's external vulnerability and fiscal consolidation challenges. A combination of expenditure rationalization and socially balanced tax measures is necessary for lowering the debt burden, while maintaining permanently higher investment and social spending.

On the back of increases in oil prices and the rebound of real import growth, the current account balance (including official grants) deteriorated to -11.1% of GDP from -9.5% in 2009. On a more positive note, the external debt-to-GDP ratio declined to 160% by the end in 2010 (from 171% in end 2009), continuing the moderate downward trend witnessed in previous years.

In order to reduce the vulnerability to external shocks, the Banque du Liban has endeavoured to retain a comfortable level of international reserves. Abundant capital inflows enabled the accumulation of foreign currency reserves during the last years, reaching the record level of EUR 32.2 billion in 2010 (corresponding to 10.3 months of next year's imports of goods and services), as compared to EUR 26.8 billion in 2009.

Despite the overall resilience of the Lebanese economy to global headwinds in 2010, the economic situation remains vulnerable. Substantial imbalances in the public finances and external accounts could affect the credibility of the exchange rate peg in the longer term. The economy is currently directly affected by the political and social unrest in the Arab world, given that some of its main trading and financial partners are the countries of the Middle East and North Africa. In particular, Lebanon depends significantly on worker remittances and investments from Gulf Cooperation Council countries. It is also highly dependent on imported hydrocarbons for almost all its energy needs, making the country particularly vulnerable to international oil price increases. Apart from political risks and the slow global upswing, economic vulnerability stems from the high public and external debt, the reliance on just a few sectors to provide the bulk of growth, uncertainty about the persistence of foreign inflows in a situation where banks continue to have maturity mismatches, and possible inflation risks also in view of rising commodity prices.

### **8.3. Structural reforms**

Implementation of the ambitious programme of structural reforms adopted in the aftermath of the Paris agreements stalled as a consequence of the political stalemate, which paralysed progress in legislative activity in the run-up to the June 2009 parliamentary elections and during the protracted subsequent negotiations on forming a new government.

During 2010, while macroeconomic policies were relatively prudent, progress in growth-enhancing structural reforms was rather poor. The implementation of key structural reform measures set by the Paris III donor conference and the two IMF's Emergency Post-Conflict Assistance (EPCA) programmes, including raising the value added tax (VAT) rate, eliminating extra-budgetary funds, and strengthening public finance management (including overhauling the budget process), was clearly below expectations. Changing the heavily subsidised electricity system is another urgent priority in phase of

the frequent power shortages. In addition, modernizing tax administration and reforming the water and telecommunications sectors remain key elements of Lebanon's reform agenda.

Fiscal reforms, including expanding revenue collection, are necessary to reduce the large public debt stock. However, the adoption of fiscal reforms was thwarted by the lack of political consensus within the coalition government. The draft 2010 budget entailed an increase in capital spending of 2.4% of GDP, including substantial investments in electricity generation, but an increase in VAT rate was not feasible due to lack of political support. Privatization of the two state-owned mobile-phone operators and restructuring of the heavily subsidised state-owned electricity provider, Electricité du Liban (EDL), have been put on ice, reflecting ongoing uncertainty about market conditions, and are not expected before 2012. Nevertheless, a 20% cut in subsidies to EDL was achieved in 2010, due to the substitution of the provider's imported fuel oil by Egyptian gas. A 25% stake in the national air carrier MEA, held by the central bank, was announced to be floated in 2010 thus delaying the time path for full privatisation.

In the field of public finance management, progress with improving budgetary planning and control has been limited. This concerns measures aimed at improving budget formulation and execution, cash management and implementation of a Single Treasury Account. The 2010 budget approved in April 2010 includes some provisions on fiscal accountability, but this does not imply a multi-annual fiscal framework.

In summer 2010, the Commission undertook, with the help of a team of consultants, an assessment of the PFM systems in Lebanon according to the methodology developed in the context of the Public Expenditure and Financial Accountability (PEFA) partnership. The PEFA assessment is still being discussed with the authorities and has not been finalised yet.

It should be noted that several of the above reforms, namely the introduction of a Single Treasury Account, the reform of electricity tariffs and the privatisation of mobile phone networks were among the key policy conditions of the MFA operation decided in 2007.

In view of the large weight of the financial sector in the Lebanese economy, actions to improve prudential oversight and regulations are a key component of the structural reform agenda. Against this background, the Banque du Liban and IMF agreed to have an updated examination under the Financial Stability Assessment Programme in 2010. This would be valuable to identify vulnerabilities in the Lebanese financial system and to benchmark against new standards of oversight that are being implemented internationally. The high interest rate spreads charged by commercial banks on domestic loans discourage both lending (notably to small and medium-term enterprises) and the growth of local currency deposits in a highly dollarized economy.

More generally, many impediments to a conducive business climate remain unresolved. Hence, the ranking of Lebanon according to several business climate measures remained poor in comparison with regional peers, many of which made progress in recent years. It is crucial that the authorities proceed with reviving the stalled reform agenda to make growth in the country less dependant on a few industries only, such as finance, and to develop growth potential in other sectors. Despite relatively favourable macroeconomic developments in the last year, the fiscal deficit and public debt remain high and progress with fiscal consolidation to reduce the hefty burden of public debt service remains a key priority to ensure sustainability.



#### **8.4. Implementation of macro-financial assistance**

In 2008, the Commission started the implementation of the Council Decision 2007/860/EC providing macro-financial assistance of EUR 80 million in the form of a combination of a medium-term loan and grant of EUR 50 and 30 million respectively. The assistance complemented support from the Bretton Woods institutions, bilateral donors (including EU Member States and Arab countries), and other EU assistance provided under the ENPI and in the form of EIB loans.

The EU MFA aimed primarily at supporting the authorities' effort of fiscal consolidation, strengthening public finance management and encouraging privatisation efforts. Thus, the specific reform measures targeted by the programme focused on public finance management and on two specific sector policies of particular importance for fiscal adjustment and debt reduction, namely the power sector and the social sector. Agreement on the conditions to be attached to the disbursement of the assistance was reached in the course of 2008. Subsequently, the EUR 15 million first tranche of the grant was disbursed end-December 2008. The first tranche of a 5-year loan of EUR 25 million was disbursed on 4 June 2009.

The disbursement of the second tranche was subject to the fulfilment of the agreed policy conditionality. One important element of conditionality is the existence of an ongoing IMF programme. On 9 April 2007 the IMF Board had approved an Emergency Post-Conflict Arrangement (EPCA I) of SDR 50.75 million based on the five-year reform program presented by the Lebanese authorities at the Paris III conference in January 2007. In November 2008, the IMF Board approved a second EPCA package of SDR 25.375 million. The EPCA II programme expired at the end of June 2009, with the quantitative targets (focusing on an increase in foreign currency reserves and on targeting a reduction in the primary fiscal balance) comfortably met. However, key non-quantitative targets were not met, notably the introduction of a single Treasury account; the reform of electricity tariffs; and the privatisation of mobile phone networks. No further IMF programmes have been launched.

Following the expiration of the IMF arrangement, progress with fulfilling the conditions was very limited in 2009 due to the difficult political situation in the run-up to elections. Against this background, in December 2009, the Commission proposed to extend the availability period of the second tranche of the assistance programme by one year (from 21 December 2009 to 21 December 2010) through an addendum to the MoU. This addendum was, however, never signed by the Lebanese authorities.

On 13 December 2010 the Lebanese Minister of Finance requested an extension on the disbursement period of the second tranche by the Commission and a review of the conditionality attached to the MFA program. The request was rejected by the Commission on the grounds of poor implementation by the national authorities of the key structural reform conditions during the period of validity of the MFA operation, the lack of a successor IMF financial arrangement, the failure of the authorities to accept the proposed extension of the period of validity of the MoU and the improvement of Lebanon's balance of payments position. Hence, this MFA expired without the disbursement of the second tranche.

<b>LEBANON - SUMMARY STATUS OF ECONOMIC REFORM</b>
<p><b>1. Price liberalisation</b></p> <p>Most prices are free, but the government subsidises the price of wheat.</p>
<p><b>2. Trade liberalisation</b></p> <p>Liberal international trade policy, but protectionist measures are occasionally introduced. Lebanon is a founding member of GATT but it withdrew in 1949. It is now negotiating the accession to WTO.</p>
<p><b>3. Exchange regime</b></p> <p>Fixed exchange rate (peg to the USD). No restrictions on current international transactions in conformity with Article VIII of the IMF's Articles of Agreement. Lebanon has also achieved substantial capital account convertibility.</p>
<p><b>4. Foreign direct investment</b></p> <p>Unlimited repatriation of capital and profits and no limitations on holding foreign currency bank accounts. Legislation is overall adequate and an investment development authority exists but enforcement of contracts is sometimes problematic in the absence of commercial courts and independent judiciary.</p>
<p><b>5. Monetary policy</b></p> <p>The Banque du Liban uses a wide range of monetary policy instruments to maintain financial stability and provide liquidity to the banking sector. It also occasionally provides financing to the government (on a temporary basis). The exchange rate peg is regarded as a key factor in maintaining monetary stability</p>
<p><b>6. Public finance</b></p> <p>The high public debt ratio and high interest rates at which the government is borrowing remain issues of concern. The tax base remains shallow and skewed towards indirect taxes. Significant tax exemptions are granted to the banking sector, notably as regards the taxing foreign deposits. Public finance management reform focuses on budget formulation and execution and medium-term planning. There has been little progress on this front in recent years. Key issues, such as the Treasury Single Account law, are still pending before Parliament.</p>
<p><b>7. Privatisation and enterprise restructuring</b></p> <p>The structural reform programme focuses on privatisation, improvement of business climate, privatisations, and opening of markets, but progress has been stalled due to the political situation. Important privatisations, for instance of mobile telephony licenses and the electricity company, have been postponed.</p>
<p><b>8. Financial sector reform</b></p> <p>Lebanon has a sophisticated and developed financial sector, based on domestic private banks, which proved resilient to shocks despite vulnerabilities. However, it exhibits a high degree of dollarization, with 79.6% of loans and 62.9% of deposits as of March 2010 being denominated in foreign currency.</p>

## Annex 1A - COMMUNITY MACRO-FINANCIAL AND EXCEPTIONAL FINANCIAL ASSISTANCE TO THIRD COUNTRIES BY DATES OF COUNCIL DECISIONS

**Status of effective disbursements as of end-December 2010 (in millions of €)**

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals disbursed</u>	<u>Undisbursed</u>
<b>Hungary I</b> (Loan)	22.02.90	90/83/EC	<b>870</b>	Apr. 1990 Feb. 1991	350 260	<b>610</b>	<b>260</b> (Suspended)
<b>Czech and Slovak Federal Republic</b>	25.02.91	91/106/EC	<b>375</b>	Mar. 1991 Mar. 1992	185 190	<b>375</b>	
<b>Hungary II</b> (Loan)	24.06.91	91/310/EC	<b>180</b>	Aug. 1991 Jan. 1993	100 80	<b>180</b>	
<b>Bulgaria I</b> (Loan)	24.06.91	91/311/EC	<b>290</b>	Aug. 1991 Mar. 1992	150 140	<b>290</b>	
<b>Romania I</b> (Loan)	22.07.91	91/384/EC	<b>375</b>	Jan. 1992 Apr. 1992	190 185	<b>375</b>	
<b>Israel<sup>1</sup></b> (Loan)	22.07.91	91/408/EC	<b>187,5</b>	Mar. 1992	187,5	<b>187,5</b>	
<b>Algeria I</b> (Loan)	23.09.91	91/510/EC	<b>400</b>	Jan. 1992 Aug. 1994	250 150	<b>400</b>	
<b>Albania I</b> (Grant)	28.09.92	92/482/EC	<b>70</b>	Dec. 1992 Aug. 1993	35 35	<b>70</b>	
<b>Bulgaria II</b> (Loan)	19.10.92	92/511/EC	<b>110</b>	Dec. 1994 Aug. 1996	70 40	<b>110</b>	
<b>Baltics</b> (Loans); of which:	23.11.92	92/542/EC	<b>220</b>			<b>135</b>	<b>85</b> (Suspended)
<b>Estonia</b>			<b>(40)</b>	March 1993	20	<b>(20)</b>	<b>(20)</b>
<b>Latvia</b>			<b>(80)</b>	March 1993	40	<b>(40)</b>	<b>(40)</b>
<b>Lithuania</b>			<b>(100)</b>	July 1993 Aug. 1995	50 25	<b>(75)</b>	<b>(25)</b>
<b>Romania II</b> (Loan)	27.11.92	92/551/EC	<b>80</b>	Feb. 1993	80	<b>80</b>	
<b>Moldova I</b> (Loan)	13.06.94	94/346/EC	<b>45</b>	Dec. 1994 Aug. 1995	25 20	<b>45</b>	
<b>Romania III</b> (Loan)	20.06.94	94/369/EC	<b>125</b>	Nov. 1995 Sep. 1997 Dec. 1997	55 40 30	<b>125</b>	

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals disbursed</u>	<u>Undisbursed</u>
<b>Albania II</b> (Grant)	28.11.94	94/773/EC	<b>35</b>	June 1995 Oct. 1996	15 20	<b>35</b>	
<b>Algeria II</b> (Loan)	22.12.94	94/938/EC	<b>200</b>	Nov. 1995	100	<b>100</b>	<b>100</b> (Suspended)
<b>Slovakia</b> (Loan)	22.12.94	94/939/EC	<b>130</b>	July 1996			<b>130</b> (Cancelled)
<b>Ukraine I</b> (Loan)	22.12.94	94/940/EC	<b>85</b>	Dec. 1995	85	<b>85</b>	
<b>Belarus</b> (Loan)	10.04.95	95/132/EC	<b>55</b>	Dec. 1995	30	<b>30</b>	<b>25</b> (Suspended)
<b>Ukraine II</b> (Loan)	23.10.95	95/442/EC	<b>200</b>	Aug. 1996 Oct. 1996 Sep. 1997	50 50 100	<b>200</b>	
<b>Moldova II</b> (Loan)	25.03.96	96/242/EC	<b>15</b>	Dec. 1996	15	<b>15</b>	
<b>Former Yugoslav Republic of Macedonia I</b> (Loan)	22.07.97	97/471/EC	<b>40</b>	Sep. 1997 Feb. 1998	25 15	<b>40</b>	
<b>Bulgaria III</b> ( Loan)	22.07.97	97/472/EC	<b>250</b>	Feb. 1998 Dec. 1998	125 125	<b>250</b>	
<b>Armenia, Georgia and Tajikistan<sup>2</sup></b> (Loans and grants) Agreed amounts with the recipient countries:	17.11.97 modified by 28.3.00	97/787/EC 00/244/EC	<b>375</b>  <b>(328)</b>			<b>294,5</b>	<b>80,5</b>
<b>Armenia</b> (Loan and grant)			<b>(58)</b>	Dec. 1998 (loan) Dec. 1998 (grant) Dec. 1999 (grant) Feb. 2002 (grant) Dec. 2002 (grant) June 2004 (grant) Dec. 2005 (grant)	28 8 4 5,5 5,5 5,5 1,5	<b>(58)</b>	
<b>Georgia</b> (Loan and grant)			<b>(175)</b>	Jul. 1998 (loan) Aug. 1998 (grant) Sep. 1999 (grant) Dec. 2001 (grant) Dec. 2004 (grant)	110 10 9 6 6,5	<b>(141,5)</b>	<b>(33,5)</b>
<b>Tajikistan</b> (Loan and grant)			<b>(95)</b>	Mar. 2001 (loan) Mar. 2001 (grant) Dec. 2001 (grant) Feb. 2003 (grant) May. 2005 (grant) Oct. 2007 (grant)	60 7 7 7 7 7	<b>(95)</b>	

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals disbursed</u>	<u>Undisbursed</u>
<b>Ukraine III</b> (Loan)	15.10.98 12.07.02	98/592/EC 02/639/EC	<b>150</b>	July 1999	58	<b>58</b>	<b>92</b> (Cancelled)
<b>Albania III</b> (Loan)	22.04.99	99/282/EC	<b>20</b>				<b>20</b>
<b>Bosnia I<sup>3</sup></b> (Loan and grant)	10.05.99 modified by 10.12.01	99/325/EC 01/899/EC	<b>60</b>	Dec. 1999 (grant) Dec. 1999 (loan) Dec. 2000 (grant) Dec. 2000 (loan) Dec. 2001 (grant)	15 10 10 10 15	<b>60</b>	
<b>Bulgaria IV</b> (Loan)	08.11.99	99/731/EC	<b>100</b>	Dec. 1999 Sep. 2000	40 60	<b>100</b>	
<b>Former Yugoslav Republic of Macedonia II<sup>4</sup></b> (Loan and grant)	08.11.99 modified by 10.12.01	99/733/EC 01/900/EC	<b>80</b> <b>18</b>	Dec. 2000 (grant) Dec. 2000 (loan) Dec. 2001 (loan) Dec. 2001 (grant) May 2003 (grant) June 2003 (loan) Dec. 2003 (loan) Dec. 2003 (grant)	20 10 12 10 10 10 18 8	<b>98</b>	
<b>Romania IV</b> (Loan)	08.11.99	99/732/EC	<b>200</b>	June 2000 July 2003	100 50	<b>150</b>	<b>50</b>
<b>Kosovo I<sup>5</sup></b> (Grant)	19.02.00	00/140/EC	<b>35</b>	Mar. 2000 Aug. 2000	20 15	<b>35</b>	
<b>Montenegro<sup>5</sup></b> (Grant)	22.05.00	00/355/EC	<b>20</b>	Aug. 2000 Dec. 2000	7 13	<b>20</b>	
<b>Moldova III</b> (Loan)	10.07.00 19.12.02	00/452/EC 02/1006/EC	<b>15</b>				<b>15</b> (Cancelled)
<b>Kosovo II<sup>3</sup></b> (Grant)	27.06.01	01/511/EC	<b>30</b>	Sep. 2001 Dec. 2002	15 15	<b>30</b>	
<b>Serbia and Montenegro I<sup>6</sup></b> (ex FRY) (Loan and grant)	16.07.01 modified by 10.12.01	01/549/EC 01/901/EC	<b>345</b>	Oct. 2001 (loan) Oct. 2001 (grant) Jan. 2002 (grant) Aug. 2002 (grant)	225 35 40 45	<b>345</b>	
<b>Ukraine IV</b> (Loan) Modification of Decision 98/592/EC	12.07.02	02/639/EC	<b>110</b>				<b>110</b>
<b>Serbia and Montenegro II<sup>7</sup></b> (ex FRY) (Loan and grant)	05.11.02	02/882/EC	<b>130</b>	Dec. 2002 (grant) Feb. 2003 (loan) Aug. 2003 (grant) Aug. 2003 (loan)	30 10 35 30	<b>105</b>	<b>25</b>

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals disbursed</u>	<u>Undisbursed</u>
<b>Bosnia II<sup>8</sup></b> (Loan and grant)	05.11.02	02/883/EC	<b>60</b>	Feb. 2003 (grant) Dec. 2003 (grant)	15 10	<b>25</b>	the rest was paid under 04/861/EC
<b>Moldova IV</b> (Grant)	19.12.02	02/1006/EC	<b>15</b>				<b>15</b>
<b>Serbia and Montenegro II<sup>7</sup></b> (ex FRY) Modification Decision 02/882/EC (grant)	25.11.03	03/825/EC	<b>70</b>	Dec. 2004 (grant)	10	<b>10</b>	<b>20</b> the rest was paid under 04/862/EC
<b>Albania IV<sup>9</sup></b> (Loan and grant)	29.04.04	04/580/EC	<b>25</b>	Nov. 2005 (grant) March 2006 (loan) July 2006 (grant)	3 9 13	<b>25</b>	
<b>Bosnia II<sup>8</sup></b> Modification Decision 02/883/EC (grant and loan)	7/12/2004	04/861/EC	the balance of 02/883/EC	Dec. 2004 (loan) June 2005 (grant) Feb. 2006 (loan)	10 15 10	<b>35</b>	
<b>Serbia and Montenegro II<sup>7</sup></b> (ex FRY) Modification Decision 02/882/EC (Grant and loan)	07.12.2004	04/862/EC	the balance of 03/825/EC	April 2005 (loan) Dec. 2005 (grant)	15 25	<b>40</b>	
<b>Georgia II</b> (Grant)	24.01.06	06/41/EC	<b>33,5</b>	August 2006 (grant) Dec. 2006 (grant)	11 11	<b>22</b>	<b>11,5</b>
<b>Kosovo</b> (Grant)	30.11.06	06/880/EC	<b>50</b>	Sept. 2010 (grant)	30	<b>30</b>	<b>20</b> (expired)
<b>Moldova</b> (Grant)	16.04.07	07/259/EC	<b>45</b>	Oct. 2007 (grant) June 2008 (grant) Dec. 2008 (grant)	20 10 15	<b>45</b>	
<b>Lebanon<sup>10</sup></b> (Loan and grant)	10.12.07	07/860/EC	<b>80</b>	Dec. 2008 (grant) June 2009 (loan)	15 25	<b>40</b>	<b>40</b>
<b>Georgia</b> (Grant)	30.11.09	09/889/EC	<b>46</b>	Dec. 2009 (grant) Jan. 2010 (grant) August 2010 (grant)	15,3 7,7 23	<b>46</b>	
<b>Armenia<sup>11</sup></b> (Loan and grant)	30.11.09	09/890/EC	<b>100</b>				<b>100</b>
<b>Bosnia and Herzegovina</b> (Loan)	30.11.09	09/891/EC	<b>100</b>				<b>100</b>

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals disbursed</u>	<u>Undisbursed</u>
Serbia (Loan)	30.11.09	09/892/EC	200				200
Ukraine (Loan)	29.06.10	338/2010/EU	500				500
Moldova (Grant)	20.10.10	938/2010/EU	90	Dec. 2010 (grant)	40	40	50
<b>TOTAL</b>			<b>7440</b>			<b>5391</b>	<b>2049</b>

- <sup>1</sup> Assistance to Israel includes a loan principal amount of €160 million and grants of €27.5 million in the form of interest subsidies
- <sup>2</sup> Exceptional financial assistance, which includes a ceiling of €245 million for the loans and a ceiling of €130 million for the grants  
Out of the global amount of €375 million, maximum amounts of €58 million, €175 million and €95 million were actually agreed with the beneficiary countries
- <sup>3</sup> Includes a loan principal amount of up to €20 million and grants of up to €40 million
- <sup>4</sup> Includes a loan principal amount of up to €50 million and grants of up to €48 million
- <sup>5</sup> Exceptional financial assistance
- <sup>6</sup> Includes a loan principal amount of €225 million and grants of €120 million
- <sup>7</sup> Includes a loan principal amount of €55 million and grants of €75 million
- <sup>8</sup> Includes a loan principal amount of €20 million and grants of €40 million
- <sup>9</sup> Includes a loan principal amount of €9 million and grants of €16 million
- <sup>10</sup> Includes a loan principal amount of €50 million and grants of €30 million
- <sup>11</sup> Includes a loan principal amount of €65 million and grants of €35 million

## Annex 1B - COMMUNITY MACRO-FINANCIAL AND EXCEPTIONAL FINANCIAL ASSISTANCE TO THIRD COUNTRIES BY REGION

### Status of effective disbursements as of end-December 2010 (in millions of €)

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals</u>	<u>Undisbursed</u>
<b>A. EU Accession countries</b>							
<b>Baltics</b> (Loans) of which :	23.11.92	92/542/EC	<b>220</b>			<b>135</b>	<b>85</b> (Suspended)
<b>Estonia</b>			<b>(40)</b>	March 1993	20	<b>(20)</b>	<b>(20)</b>
<b>Latvia</b>			<b>(80)</b>	March 1993	40	<b>(40)</b>	<b>(40)</b>
<b>Lithuania</b>			<b>(100)</b>	July 1993 Aug. 1995	50 25	<b>(75)</b>	<b>(25)</b>
<b>Bulgaria I</b> (Loan)	24.06.91	91/311/EC	<b>290</b>	Aug. 1991 March 1992	150 140	<b>290</b>	
<b>Bulgaria II</b> (Loan)	19.10.92	92/511/EC	<b>110</b>	Dec. 1994 Aug. 1996	70 40	<b>110</b>	
<b>Bulgaria III</b> (Loan)	22.07.97	97/472/EC	<b>250</b>	Feb. 1998 Dec. 1998	125 125	<b>250</b>	
<b>Bulgaria IV</b> (Loan)	08.11.99	99/731/EC	<b>100</b>	Dec. 1999 Sep. 2000	40 60	<b>100</b>	
<b>Czech and Slovak Federal Republic</b> (Loan)	25.02.91	91/106/EC	<b>375</b>	March 1991 March 1992	185 190	<b>375</b>	
<b>Hungary I</b> (Structural adjustment loan)	22.02.90	90/83/EC	<b>870</b>	Apr. 1990 Feb. 1991	350 260	<b>610</b>	<b>260</b> (Suspended)
<b>Hungary II</b> (loan)	24.06.91	91/310/EC	<b>180</b>	Aug. 1991 Jan. 1993	100 80	<b>180</b>	
<b>Romania I</b> (Loan)	22.07.91	91/384/EC	<b>375</b>	Jan. 1992 Apr. 1992	190 185	<b>375</b>	
<b>Romania II</b> (Loan)	27.11.92	92/551/EC	<b>80</b>	Feb. 1993	80	<b>80</b>	
<b>Romania III</b> (Loan)	20.06.94	94/369/EC	<b>125</b>	Nov. 1995 Sep. 1997 Dec. 1997	55 40 30	<b>125</b>	
<b>Romania IV</b> (Loan)	08.11.99	99/732/EC	<b>200</b>	June 2000 July 2003	100 50	<b>150</b>	<b>50</b>



<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals</u>	<u>Undisbursed</u>
<b>Slovakia</b> (Loan)	22.12.94	94/939/EC	<b>130</b>	July 1996			<b>130</b> Cancelled
<b>TOTAL A</b>			<b>3305</b>			<b>2780</b>	<b>525</b>

#### B. Western Balkans

<b>Albania I</b> (Grant)	28.09.92	92/482/EC	<b>70</b>	Dec. 1992 Aug. 1993	35 35	<b>70</b>	
<b>Albania II</b> (Grant)	28.11.94	94/773/EC	<b>35</b>	June 1995 Oct. 1996	15 20	<b>35</b>	
<b>Albania III</b> (Loan)	22.04.99	99/282/EC	<b>20</b>				<b>20</b> (Cancelled)
<b>Bosnia I<sup>1</sup></b> (Loan and grant)	10.05.99 10.12.01	99/325/EC modified by 01/899/EC	<b>60</b>	Dec. 1999 (grant) Dec. 1999 (loan) Dec. 2000 (grant) Dec. 2000 (loan) Dec. 2001 (grant)	15 10 10 10 15	<b>60</b>	
<b>Former Yugoslav Republic of Macedonia I</b> (Loan)	22.07.97	97/471/EC	<b>40</b>	Sep. 1997 Feb. 1998	25 15	<b>40</b>	
<b>Former Yugoslav Republic of Macedonia II<sup>2</sup></b> (Loan and grant)	08.11.99 10.12.2001	99/733/EC modified by 01/900/EC	<b>80</b> <b>18</b>	Dec. 2000 (grant) Dec. 2000 (loan) Dec. 2001 (loan) Dec. 2001 (grant) May 2003 (grant) June 2003 (loan) Dec. 2003 (loan) Dec. 2003 (grant)	20 10 12 10 10 10 18 8	<b>98</b>	
<b>Kosovo I<sup>3</sup></b> (Grant)	19.02.00	00/140/EC	<b>35</b>	March 2000 Aug. 2000	20 15	<b>35</b>	
<b>Kosovo II<sup>3</sup></b> (Grant)	27.06.01	01/511/EC	<b>30</b>	Sep. 2001 Dec. 2002	15 15	<b>30</b>	
<b>Montenegro<sup>3</sup></b> (Grant budgetary support)	22.05.00	00/355/EC	<b>20</b>	Aug. 2000 Dec. 2000	7 13	<b>20</b>	
<b>Serbia and Montenegro I<sup>4</sup></b> (ex FRY)	16.07.01 10.12.2001	01/549/EC modified by 01/901/EC	<b>345</b>	Oct. 2001 (grant) Oct. 2001 (loan) Jan. 2002 (grant) Aug. 2002 (grant)	35 225 40 45	<b>345</b>	

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals</u>	<u>Undisbursed</u>
<b>Serbia and Montenegro II<sup>5</sup></b> (ex FRY) (Loan and grant)	05.11.02	02/882/EC	<b>130</b>	Dec. 2002 (grant) Feb. 2003 (loan) Aug. 2003 (grant) Aug. 2003 (loan)	30 10 35 30	<b>105</b>	<b>25</b>
	modified by 25.11.03 07.12.04	03/825/EC (7) 04/862/EC	<b>70</b>	Dec. 2004 (grant) April 2005 (loan) Dec. 2005 (grant)	10 15 25	<b>50</b>	<b>20</b>
<b>Bosnia II<sup>6</sup></b> (Loan and grant)	05.11.02	02/883/EC	<b>60</b>	Feb. 2003 (grant) Dec. 2003 (grant) Dec 2004 (loan)	15 10 10	<b>60</b>	
	modified by 07.12.04	04/861/EC		June 2005 (grant) Feb. 2006 (loan)	15 10		
<b>Albania IV<sup>8</sup></b> (Loan and grant)	29.04.04	04/580/EC	<b>25</b>	Nov 2005 (grant) Mar 2006 (loan) Jul 2006 (grant)	3 9 13	<b>25</b>	
<b>Kosovo (Grant)</b>	30.11.06	06/880/EC	<b>50</b>	Sept. 2010	30	<b>30</b>	<b>20</b> (expired)
<b>Bosnia-Herzegoviona (Loan)</b>	30.11.09	09/891/EC	<b>100</b>				<b>100</b>
<b>Serbia (Loan)</b>	30.11.09	09/892/EC	<b>200</b>				<b>200</b>
<b>TOTAL B</b>			<b>1388</b>			<b>1003</b>	<b>385</b>

### C. New Independent States (NIS)

<b>Armenia, Georgia and Tajikistan<sup>9</sup></b> (Loans and grants) Agreed amounts with the recipient countries:	17.11.97 modified by 28.3.00	97/787/EC 00/244/EC	<b>375</b> downsized to <b>(328)</b>			<b>294,5</b>	<b>80,5</b>
<b>Armenia</b>			<b>(58)</b>	Dec. 1998 (loan) Dec. 1998 (grant) Dec. 1999 (grant) Feb. 2002 (grant) Dec. 2002 (grant) June 2004( grant) Dec. 2005(grant)	28 8 4 5,5 5,5 5,5 1,5	<b>(58)</b>	
<b>Georgia</b>			<b>(175)</b>	July 1998 (loan) Aug. 1998 (grant) Sep. 1999 (grant) Dec. 2001 (grant) Dec. 2004 (grant)	110 10 9 6 6,5	<b>(141,5)</b>	<b>(33,5)</b>
<b>Tajikistan</b>			<b>(95)</b>	March 2001 (loan) March 2001 (grant) Dec. 2001 (grant) Feb. 2003 (grant) May 2005 (grant) Oct 2006 (grant)	60 7 7 7 7 7	<b>(95)</b>	

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>			
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals</u>	<u>Undisbursed</u>
<b>Belarus</b> (Loan)	10.04.95	95/132/EC	<b>55</b>	Dec. 1995	30	<b>30</b>	<b>25</b> (Suspended)
<b>Moldova I</b> (Loan)	13.06.94	94/346/EC	<b>45</b>	Dec. 1994 Aug. 1995	25 20	<b>45</b>	
<b>Moldova II</b> (Loan)	25.03.96	96/242/EC	<b>15</b>	Dec. 1996	15	<b>15</b>	
<b>Moldova III</b> (Loan)	10.07.00 19.12.02	00/452/EC 02/1006 EC	<b>15</b>				<b>15</b> (cancelled)
<b>Moldova IV</b> (Grant)	19.12.02	02/1006/EC	<b>15</b>				<b>15</b>
<b>Ukraine I</b> (Loan)	22.12.94	94/940/EC	<b>85</b>	Dec. 1995	85	<b>85</b>	
<b>Ukraine II</b> (Loan)	23.10.95	95/442/EC	<b>200</b>	Aug. 1996 Oct. 1996 Sep. 1997	50 50 100	<b>200</b>	
<b>Ukraine III</b> (Loan)	15.10.98	98/592/EC	<b>150</b>	July 1999	58	<b>58</b>	<b>92</b> (cancelled)
<b>Ukraine IV</b> (Loan) Modification of decision 98/592/EC	12.07.02	02/639/EC	<b>110</b>				<b>110</b>
<b>Georgia II</b>	21.01.06	06/41/EC	<b>33,5</b>	Aug. 2006 Dec 2006	11 11	<b>22</b>	<b>11,5</b>
<b>Moldova</b>	16.04.07	07/259/EC	<b>45</b>	Oct. 2007 June 2008 Dec. 2008	20 10 15	<b>45</b>	
<b>Georgia</b>	30.11.09	09/889/EC	<b>46</b>	Dec. 2009 (grant) Jan. 2009 (grant) Aug. 2010 (grant)	15,3 7,7 23	<b>46</b>	
<b>Armenia<sup>10</sup></b> (Loan and grant)	30.11.09	09/890/EC	<b>100</b>				<b>100</b>
<b>Ukraine</b> (Loan)	29.06.10	388/10/EU	<b>500</b>				<b>500</b>
<b>Moldova</b> (Grant)	20.10.10	938/2010/EU	<b>90</b>	Dec. 2010 (grant)	40	<b>40</b>	<b>50</b>
<b>TOTAL C</b>			<b>1879,5</b>			<b>880,5</b>	<b>999,0</b>

<u>Country</u>	<u>Authorisations</u>			<u>Disbursements</u>		
	<u>Date of Decision</u>	<u>Reference of Decision</u>	<u>Maximum amount</u>	<u>Dates of disbursements</u>	<u>Amounts of disbursements</u>	<u>Totals</u>

**D. Mediterranean countries**

<b>Israel<sup>11</sup></b> (Structural adjustment soft loan)	22.07.91	91/408/EC	<b>187,5</b>	March 1992	187,5	<b>187,5</b>	
<b>Algeria I</b> (Loan)	23.09.91	91/510/EC	<b>400</b>	Jan. 1992 Aug. 1994	250 150	<b>400</b>	
<b>Algeria II</b> (Loan)	22.12.94	94/938/EC	<b>200</b>	Nov. 1995	100	<b>100</b>	<b>100</b> (Suspended)
<b>Lebanon<sup>12</sup></b>	10.12.07	07/860/EC	<b>80</b>	Dec. 2008 June 2009	15 25	<b>40</b>	<b>40</b>
<b>TOTAL D</b>			<b>867,5</b>			<b>727,5</b>	<b>140</b>
<b>TOTAL A+B+C+D</b>			<b>7440</b>			<b>5391</b>	<b>2049</b>

<sup>1</sup> Includes a loan principal amount of €20 million and grants of €40 million.

<sup>2</sup> Includes a loan principal amount of up to €50 million and grants of up to €48 million.

<sup>3</sup> Exceptional financial assistance.

<sup>4</sup> Includes a loan principal amount of €225 million and grants of €120 million.

<sup>5</sup> Includes a loan principal amount of €55 million and grants of €75 million

<sup>5</sup> Includes a loan principal amount of €20 million and grants of €40 million

<sup>6</sup> Includes a loan principal amount of €25 million and grants of €45 million

<sup>8</sup> Includes a loan principal amount of €9 million and grants of €16 million

<sup>9</sup> Exceptional financial assistance, which includes a ceiling of €245 million for the loans and a ceiling of €130 million for the grants  
Out of the global amount of €375 million, maximum amounts of €58 million, €175 million and €95 million were actually agreed with the beneficiary countries

<sup>10</sup> Includes a loan principal amount of €65 million and grants of €35 million

<sup>11</sup> Assistance to Israel includes a loan principal amount of ECU 160 million and grants of ECU 27,5 million in the form of interest subsidies.

<sup>12</sup> Includes a loan principal amount of €50 million and grants of €30 million