EN

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 14.7.2008
COM(2008) 451 final

REPORT FROM THE COMMISSION

to the budgetary authority on guarantees covered by the general budget
Situation at 31 December 2007

{SEC(2008) 2249}

TABLE OF CONTENTS

1. INTRODUCTION AND TYPES OF COVERED OPERATIONS

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

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

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Following a second amendment of the Council Regulation which was adopted in 2004 by the Council, the Fund's coverage is withdrawn if third countries become Member States.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

2. NEW LEGAL BASES

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

---

1 COM(2008)2 and SEC(2008)18 make up the previous report on the guarantees covered by the Budget at 30 June 2007.

2 SEC(2008)[…].

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

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

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

6 Council Decision (EC) 2006/1016/EC of 19 December 2006, OJ L 414, 30.12.2006, p. 95.

7 C/2007/3592.

Regarding macro-financial assistance provided to third countries, a new Council Decision was adopted on 10 December 2007 providing macro-financial assistance to Lebanon[8].

3. EVENTS SINCE THE LAST REPORT AT 30 JUNE 2007

The Council Decision for an MFA loan to Lebanon was approved. There were no disbursements under MFA and Euratom loans during the second half of 2007.

As mentioned under Section 2 above, the new Guarantee Agreement with the EIB covers financing operations signed after 17 April 2007. As of 31 December 2007, a total amount of EUR 3 165 million worth of EIB financing operations had been signed by the EIB, of which EUR 1 267 million under the general mandate which expired on 31 July 2007[9] and EUR 1,898 million under the new general mandate

4. DATA ON RISKS COVERED BY THE BUDGET

4.1. Definition of risk

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

Defaulting operations will be covered by the Fund when they are linked to third countries (72% of the total outstanding amount guaranteed as of 31 December 2007) and directly by the Budget where Member States are involved (loans to or for the benefit of projects in Member States account for the remaining 28% of the total outstanding amount). The large proportion of guaranteed loans linked to Member States is the result of the recent enlargement rounds. According to Article 1, third paragraph of the Fund Regulation, once a country becomes a Member State, the risk on the loans is transferred from the Fund to the Budget.

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

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

– The budgetary approach defined as "the annual risk borne by the Budget" is based on the calculation of the maximum amount which the Community would have to pay out in a financial year assuming that all guaranteed loans are in default[10].

---

8 Council Decision (EC) 2007/860/EC of 10 December 2007, OJ L337, 21.12.2007, p.111.

9 The general Mandate was decided in the framework of the 2000-2006 Financial Perspective, see Council Decision 2000/24/EC of 22 December 1999, OJ L 9, 13.1.2000, p. 24, as amended (hereinafter "the previous general mandate")

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

Table 1: Total outstanding amounts covered as of 31 December 2007 in EUR million

	Outstanding Capital	Accrued Interest	Total	%
Member States*				
MFA	253	2	255	1%
Euratom	435	7	442	3%
EIB	4 060	38	4 098	24%
Sub-total Member States*	4 748	48	4 795	28%
Third Countries				
MFA	534	7	540	3%
Euratom	39	1	40	<1%
EIB	11 729	118	11 848	69%
Sub-total third countries	12 302	126	12 428	72%
Total	**17 050**	**173**	**17 223**	**100%**

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

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

4.2. Risk linked to Member States

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

In 2008, the Budget will bear a risk linked to Member States of EUR 769 million including Bulgaria and Romania as they have joined the Union on 1 January 2007. Table 2 shows that these two states are ranked first and second in terms of their outstanding amount.

Table 2: Ranking of the Member States according to the exposure with regard to the maximum risk borne by the budget in 2008 (EUR million)			
Ranking	**Country**	**2008**	**%**
1	Romania	257.5	33.5%
2	Bulgaria	158.1	20.6%
3	Poland	89.0	11.6%
4	Czech Republic	88.8	11.5%
5	Slovakia	71.7	9.3%
6	Hungary	38.2	5.0%
7	Slovenia	30.4	4.0%
8	Cyprus	15.3	2.0%
9	Latvia	8.0	1.0%
10	Lithuania	6.9	0.9%
11	Estonia	4.3	0.6%
12	Malta	0.8	0.1%
	Total	768.9	100.0%

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

4.3. Risk linked to third countries

In 2008, the Fund will bear a maximum risk related to third countries of EUR 1 322 million. The top ten countries according to their total outstanding are listed below. They account for 78% of the risk borne by the Fund in 2008. The economic situation of these countries is analyzed and commented in Section 7 below.

Table 3: Ranking of the 10 most important third countries according to the exposure with regard to the maximum risk borne by the Fund in 2008 (EUR million)			
Ranking	**Country**	**2008**	**% of the total maximum risk**
1	Turkey	255.6	19.3%
2	Egypt	199.3	15.1%
3	Morocco	127.1	9.6%
4	Tunisia	121.9	9.2%
5	Brazil	86.1	6.5%
6	South Africa	84.3	6.4%
7	Serbia and Montenegro[11]	55.0	4.2%
8	Croatia	38.5	2.9%
9	Bosnia and Herzigovina	30.0	2.3%
10	Syria	27.9	2.1%
Total of the 10		1 025.6	77.6%

The Fund covers the guaranteed loans of 54 countries with maturities ending 2037. Details by country are provided in Table A2 of the Annex.

4.4. Global risk covered by the Budget

In total, the Budget will cover in 2008 an amount of EUR 2 091 million representing the amounts due during this period, of which 37% are due by Member States (see Table A2 in the Annex).

4.5. Evolution of risk

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

[11] Now the Republic of Serbia and the Republic of Montenegro.

MFA loans to third countries are subject to individual decisions by the Council. The financial assistance granted under the Council Decision 2007/860/EC of 10 December 2007 providing macro-financial assistance to Lebanon consists of EUR 50 million in loans and up to EUR 30 million in grants. The intention is to disburse the loan part in two equal tranches starting in 2008.

The Euratom lending to Member States or in certain eligible non-member countries (Russian Federation, Armenia, Ukraine) has a ceiling of EUR 4 billion of which around 85% have already been used. The remaining margin is about EUR 600 million. Under the existing loan agreement of 2004 to K2R4 in Ukraine (EUR equivalent of USD 83 million Loan Facility Agreement), of which EUR 39 million have already been disbursed, further tranches may be disbursed in 2008.

The previous general mandate to the EIB expired on 31 July 2007. At this date, contracts corresponding to a total 98% of the overall ceiling under this mandate (EUR 20 060 million – see Table A5 of the Annex) had been signed. A total amount of EUR 7 663 million remains to be disbursed under previous EIB mandates, of which 93% relate to the previous general mandate[12] and should be disbursed within 10 years from the end of this mandate, as the guarantee of the Community lapses at the end of this period[13].

The most important item that will impact the risk for the Budget in future is the recent Community guarantee granted to the EIB under the new general mandate. The Community guarantee is restricted to 65% of the aggregate amount of credit disbursed and guarantees provided under EIB Financing Operations, less amounts reimbursed and plus all related sums, with a maximum ceiling of EUR 27 800 million[14]. An amount of EUR 1 898 million was signed during 2007 under this new mandate, of which EUR 1 820 million remain undisbursed at the end of 2007.

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

5. DEFAULTS, ACTIVATION OF BUDGET GUARANTEES AND ARREARS

5.1. Payments from cash resources

The Commission draws on its cash resources in order to avoid delays and resulting costs in servicing its borrowing operations when a debtor is late in paying the Commission[15].

---

12 See Section 1.3 of the Annex.

13 See Article 1.06 of the Restated and Amended Guarantee Agreement signed between the EC and the EIB on 30 August/2 September 2005.

14 Broken down into a basic ceiling of a fixed maximum amount of EUR 25 800 million and an optional mandate of EUR 2 000 million to be decided upon by the Council.

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

5.2. Payments from the Budget

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

5.3. Activation of the Guarantee Fund for external actions

In the event of late payment by the beneficiary of a loan (third countries) granted or guaranteed by the Community, the Fund is called on to cover the default within three months of the date on which payment is due.[16]

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

The total arrears at 31 December 2007, i.e. penalty interests with the Republic of Argentina, amount to USD 1 718 493.12; thereof USD 1 448 433.44 (EUR equivalent 983 923.27) are still to be recovered by the Fund. As the Fund was not called for the remaining difference, this amount is due to the EIB. The Commission and the EIB have on several occasions reminded the Argentinean authorities of the need to fully clear these arrears before the resumption of new EIB lending financing in the country.

6. GUARANTEE FUND FOR EXTERNAL ACTIONS

6.1. Recoveries

No recovery occurred in 2007.

6.2. Assets

At 31 December 2007, the net assets of the Fund amounted to EUR 1 026 515 043.63.

6.3. Target amount

The Fund has to reach an appropriate level (target amount) set at 9% of the total outstanding capital liabilities arising from each operation, plus accrued interest. The ratio between the Fund's resources (EUR 1 026 515 043.63) and outstanding capital liabilities[17] (EUR 12 427 584 330.13) within the meaning of the Fund Regulation was 8.26%.

At year-end 2007, the Fund resources were lower than the target amount. According to the new provisioning rules adopted by the Council on 30 January 2007[18], a provisioning of EUR 91.60 million was inserted in the Preliminary Draft Budget of 2009 together with an amount of EUR 500 000.00 for the external evaluation under the mid-term review of the EIB external mandate pursuant to Council Decision 2006/1016/EC of 19 December.2006[19].

---

16 For more details, see Section 1.4.3 of the Annex.

17 Including accrued interests.

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

19 OJ L 414, 30.12.2006, p.102.

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

7.1. Introduction

Previous sections of the report provide information on quantitative aspects of the risk borne by the Budget. However, the quality of the risks which depend on the type of operation and the standing of the borrowers (see Section 4.3 above) should also be assessed. Tables on the country risk evaluation are presented separately in the Commission Staff Working Paper. A summary of this analysis is provided below for the ten countries having the highest risk to the Budget in 2008 (see Section 4.3 above) and the countries having a direct exposure with the Community budget.

7.2. Candidate countries

In **Croatia,** real GDP (Gross Domestic Product) growth rose to 5.6% in 2007, up from 4.8% in 2006. Growth was mainly driven by an acceleration of private and public consumption growth, fuelled by strong, but decelerating credit growth, one-off payments to pensioners, and pre-election spending. The growth of investment slowed to 6.5%, from 10.9% in 2006, reflecting a gradual termination of large public investment projects in the transport network. At the same time, private investments became more dynamic, partially reflecting some improvements in the overall business environment. The current account deficit widened to 8.6% of GDP, compared to 7.9% a year before, mainly on account of a higher deficit in merchandise trade, resulting from strong imports and a decline in the growth of exports in the fourth quarter. Net inflows of FDI (Foreign Direct Investment) increased significantly and reached 9.1% of GDP, and thus more than off-set the current account deficit. Gross external debt continued to increase, driven by an acceleration of direct borrowing of the corporate sector while the general government as well as the banking sector reduced their outstanding foreign liabilities. The gross external debt ratio increased from 85.5% of GDP at end-2006 to 88.9% at end-2007.

In the **former Yugoslav Republic of Macedonia,** output growth accelerated markedly to about 5% (in real terms) in 2007, compared to 4% in 2006. Important sources for growth were exports of steel products and private consumption. The current account deteriorated during the last months of the year, reaching a deficit of nearly 3% of GDP end-2007. Gross FDI inflows came back to 4.8% of GDP end-2007, after a single privatisation project in the energy sector had raised FDI inflows to nearly 6% of GDP in 2006. Early debt repayments reduced the external debt of the country to some 50% of GDP.

In **Turkey,** annual GDP growth amounted to 4.5% in 2007, down from 6.9% in 2006. Higher inflation and a severe monetary policy tightening by the Central Bank in mid-2006 dampened domestic demand growth. The current account deficit remained constant at almost 6% of GDP. Gross FDI inflows reached 3% of GDP in 2007, and about two thirds targeted the financial sector. In the previous year, the external debt of the country fell by about 2 percentage points to 37% of GDP by end-2007. At the same time, public debt fell to 39% of GDP from 46% of GDP in 2006. Turkish banks frequently borrow internationally to finance lending domestically, so they are expected gradually to feel the effect of the global credit squeeze.

7.3. Potential candidate countries

In **Bosnia and Herzegovina** real GDP growth decelerated from 6.7% in 2006 to 6% in 2007. In 2007 the widening of the trade deficit contributed to an increase of the current account deficit from 8.4% of GDP in 2006 to 13.1% of GDP in 2007. The current account deficit was fully financed by net FDI as large privatisations in the Republika of Serbia together with a relatively better performance of greenfield investments led to a surge in FDI to 13.8% of GDP. External public debt declined to 18.5% of GDP at the end of 2007, while the total external debt is estimated below 50% of GDP.

In **Serbia** real GDP grew by 7.5% during 2007. The current account deficit widened to 16% of GDP, driven by a growing trade deficit and a decline in net current transfers. Net FDI inflow declined to 5.1% of GDP while foreign borrowing grew to 10.3% of GDP. As a result of the slowdown in capital inflows, foreign exchange accumulation of the National Bank of Serbia fell to 3% of GDP. Foreign exchange reserves of the National Bank of Serbia stood at 7.5 months worth of imports of goods and services at the end of the year. External debt remained at 62% of GDP while private and public sector external debt by the end of 2007 accounted for 41% and 21% of GDP, respectively.

In **Montenegro**, GDP estimates points to an expansion of the economy by 7% in 2007 supported by a record-high tourist season, and the rise in disposable income of households boosted by the rapid lending expansion. The current account deficit strongly deteriorated to 44.2% of GDP driven by the sizeable trade deficit and notably decreasing exports. Yet, FDI inflows surged by 56% over the year. However, concurrent huge outflows brought net FDI to 23% of GDP. The public debt increased to 32.4% of GDP due to the surge in domestic indebtedness. By contrast, the external public debt was down by 8.3% y-o-y to 20.3% of GDP, following several early repayments to multilateral creditors facilitated by the good fiscal outcome.

7.4. New Independent States

In ***Georgia,*** the current account further deteriorated in 2007 reaching a deficit of nearly 20% of GDP, with a trade deficit of about 26% of GDP. Export diversification is underway in the aftermath of Russia's trade embargo, but the overall growth in exports has not been large enough to countervail the surge in demand for imports in general and the impact of higher import price of natural gas. The current account deficit was however financed by foreign capital inflows, including foreign direct investment that surged to USD 1584 million in 2007 (USD 1076 million in 2006). Also, the banking sector has increased its borrowing in foreign capital markets. Economic growth was robust 12.4%, supported by strong credit growth, privatisation, foreign direct investment and structural reforms. Public spending (especially in the military) was increased in the course of 2007, and the fiscal deficit is estimated at 4.7% of GDP. As privatisation proceeds financed the deficit, public debt was stable in nominal terms, declining as a percentage of GDP to about 25% (external public debt about 17% of GDP). The main economic policy challenge has been to keep inflation in single digits. The 12-month inflation was 11% as of December 2007 and international commodity prices continue to put a pressure in consumer prices. Standard & Poor's maintained Georgia's sovereign credit rating at B+ with a positive outlook. Fitch assigned Georgia a sovereign credit rating BB- with a stable outlook in July 2007, reflecting notably the decline in the public debt burden.

In ***Ukraine***, real GDP growth was maintained at 7.3% in 2007, supported by a strong credit growth and increases in real incomes. The current account deteriorated somewhat, reaching a deficit of 4.2% of GDP. The trade deficit was 5.6% of GDP, driven by strong import demand

and higher energy import prices. Overall, the terms of trade remained however positive for Ukraine thanks to high steel prices in the world markets (Ukraine's main export sector accounting for 40% of total exports). Fiscal deficit was kept at 1.5% as robust economic growth supported the government's revenue collection. Ukraine's public external debt declined to about 10% of GDP, while the banking sector's borrowing in foreign capital markets drove the total external debt to about 60% of GDP. The 12-month inflation continued to accelerate in late 2007, reaching 16.6% in December 2007, driven by food prices that account for about 50% of the consumption basket of the index. The main risks still relate to the turbulent political situation, which culminated in the pre-term parliamentary elections of September 2007. The thin parliamentary majority of the government that came to power thereafter and the continuing political struggle between the key political actors are not conducive for the necessary structural reforms. Standard & Poor's confirmed, however, Ukraine's sovereign long-term credit rating at BB-, supported in particular by the low level of indebtedness of the public sector.

Tajikistan's economy has continued to grow strongly in 2007, recording a growth rate of 7.8% of GDP. Following a budget surplus of 1.7% in 2006 the government budget is expected to register a deficit in 2007 of 14.1% of GDP (IMF estimate). Thanks to the successful bilateral debt agreements with mainly Russia – Tajikistan's largest creditor – and debt relief from the IMF MDRI (Multilateral Debt Relief Initiative) initiative in 2006, external debt initially had fallen to 33.6% of GDP in 2006, however following the sharply increased budget deficit in 2007, increased again to around 41.9% of GDP in 2007. A deteriorating trade deficit is only partly offset by the rapid growth in foreign remittances. The current account deficit has increased sharply from 3.0% in 2006 to about 9.5% in 2007. Import coverage of gross official reserves remains relatively low, around two months of imports. The IMF PRGF (Poverty Reduction and Growth Facility) arrangement was successfully completed in 2006. The authorities have started the preparation of a successor arrangement, possibly under the PSI programme (IMF Policy Support Instrument).

7.5. Other non-member countries

7.5.1. Mediterranean countries

Morocco's economy was strongly affected by the droughts in 2007; the fall in agricultural output resulted in a decline of economic growth from 8% in 2006 to 2.2% in 2007. The steady growth of non-agricultural GDP (5.5% end-2007 up from 5.2% in 2006) and ongoing diversification are helping to increase the Moroccan economy's resilience to shocks. GDP growth is driven mainly by domestic demand: private consumption has been fuelled by urban wage growth, rapid credit expansion, the positive evolution of the labour market, and high level of remittances; public consumption has strongly accelerated following the 8% increase in recurrent expenditures. The external environment remains shaped by a substantial and widening trade deficit (21.0% of GDP in 2007). In 2007, for the first time, it was not fully compensated by tourism revenues and remittances, and Morocco's current account was in deficit. Rising GDP is expected to consolidate the steady fall in the external debt-to-GDP ratio to 22% of GDP at the end of 2007. The overall fiscal deficit is estimated to have significantly contracted in 2007 to 0.2% of GDP (excluding privatization receipts). Inflationary pressures were kept down, with average inflation of 2.0% end-2007. Moderate price increases also reflect the strength of the Moroccan currency (MAD). The current exchange rate regime which pegs the MAD to an euro-dominated basket of currencies has resulted in deteriorating terms of trade owing to the MAD appreciation in line with the EUR-USD exchange rate. The authorities have decided to gradually liberalise the external capital account, which would mean abandoning the current peg, moving towards a more flexible exchange rate regime and inflation targeting.

The economic growth of ***Tunisia*** accelerated from 5.5% in 2006 to 6.3% in 2007, originating from the non-textile manufacturing, the energy sector, the transportation and the telecommunication services. Despite stronger economic growth, unemployment remained high at around 14%. A significant part of the unemployed people has a university degree. The central public deficit, excluding privatisations, stabilized around 3%. The prudent fiscal policy along with a tightening of monetary policy has been beneficial for the Tunisian economy because inflation remained moderate in 2007, at 3.1%. Fiscal discipline along with two increases in domestic oil prices helped to alleviate the fiscal burden of the oil subsidies. Due to the higher economic growth and to the privatisation receipts mainly used for debt amortization the central government debt has regressed and is expected to continue this trend in the near future. Debt, for a major part foreign, is currently still above 50% of GDP;. However, Tunisia exhibits resilience in external shocks due to the long-term structure of the external debt. Public debt is expected to decline further due to the favourable short term economic outlook.

The economic growth of ***Egypt*** accelerated from 6.8% in fiscal year 2006 to a record 7.1% in fiscal year 2007. Growth is underpinned by investment, especially foreign direct investments, and private consumption (also via tourism). Inflation, reflecting both government spending and higher food import prices, surged again to double digits in fiscal year 2007. The high inflation seems now the main risk for macroeconomic stability. A positive sign was the slowdown of unemployment, but it remains relatively high at almost 10%. Despite the strong economic growth and the sale of (semi-)state owned enterprises, the general public deficit hardly narrowed (7.7% in fiscal year 2007 compared with 9.2% for fiscal year 2006). Consequently, the gross government debt remained high, at almost 90% of GDP. Reforms in the financial sector are progressing. Sound fiscal policy combined with price stability will have positive effects on job creation.

The economy of ***Lebanon*** is recovering from the 2006 conflict with Israel in a context of continuous political stalemate and recurrent outbreaks of violence. Real GDP growth in 2007 is estimated to 4%, a much better result than initially foreseen. Inflation has declined despite the depreciation of the US dollar, to which the Lebanese pound is pegged. Reflecting reconstruction needs, the current account deficit is estimated to have increased to 10.7% of GDP. However, it is largely financed by official inflows and foreign direct investment. The fiscal deficit was contained on the back of stronger than projected revenue collection. Public debt-to-GDP ratio decreased slightly (to 171% by the end of 2007), but remains very high. The government continues to strike a careful balance between reconstruction and social needs, and the challenges resulting from the large public debt overhang. Fiscal policy aims at containing the primary deficit while accommodating reconstruction and relief spending. Lebanon's financing arrangement with the IMF concluded in April 2007 under the Fund's Emergency Post-Conflict Assistance (EPCA) was successfully completed in early 2008.

The economic growth of ***Syria*** moderated to 3.9% in 2007 from 4.4% in 2006, largely because of falling oil output and adverse weather conditions which affected corps. These negative trends are expected to be offset in the future by persistent expansion in the services sector, boosted by solid growth in tourism and demand for goods and services, in part from the large Iraqi refugee population. The expected recovery in the agricultural sector will also underpin economic growth. Inflation rate rose on average by 5.5% in 2007 mainly due to the presence of the Iraqi refugees but also as a result of the tourism-related demand for food and the higher food and oil prices. The decline in oil output and the escalating cost of the subsidies bill resulted in a fiscal deficit of 5.0% of GDP in 2007. Despite the increased revenues from telecommunication sector and a slight improvement in tax revenues, the fiscal situation in 2008 is expected to deteriorate as the elimination of subsidies has not been decided and the implementation of VAT has been postponed for 2009. As a result, public debt increased to 37.8% of GDP in 2007 and is expected to reach 41% of GDP in 2008. Syria's poor payment record, budget deficits and falling oil output, as well as the slow pace of economic reforms and the risk of international sanctions, undermine the country's creditworthiness.

7.5.2. South American countries

Supported by rising commodity prices and a still very favourable global economic environment, **Brazil** posted a 5.4% GDP growth rate in 2007. Economic growth was primarily driven by domestic demand, with capital formation showing double-digit growth (+13.4%). Private consumption also performed strongly with a growth rate of 6.5%. With domestic demand very strong, the current account surplus declined from 1.3% of GDP in 2006 to 0.3% last year. Due to the high inflow of both direct and portfolio investment, the balance of payment posted a surplus of USD 87.5 billion. Having succeeded in paying back in 2006 all its outstanding debt of Brazil to the IMF and the Paris Club, Brazil's foreign debt ratios have declined significantly. Also, the country has accumulated foreign exchange reserves of USD 180 billion, or 14% of GDP. All this had made Brazil clearly less vulnerable to externally induced economic turmoil than in the past.

Led by strong domestic investment and consumption, the **Argentinean** economy continued to grow strongly in 2007, with GDP expanding by 8.7%. With final demand being strong, imports jumped by 19.5% on the year compared to a growth rate of 7.5% for exports. As net FDI inflows remained close to 2 ½% of GDP, Argentina's foreign exchange reserve rose to USD 46.9 billion (18.6% of GDP) and total external debt declined from 51.5% of GDP in 2006 to 45.2% of GDP last year. The situation of public finances, however, has deteriorated somewhat in 2007 as government consumption expanded at double-digit figures in the presidential election year. With government consumption likely to normalize again Argentinean growth is projected to decelerate to around 6% of GDP in the current year. These positive developments are overshadowed by the deterioration in the inflation outlook, which partly reflects the strength of domestic demand and a policy of maintaining a relatively undervalued peso. Argentina remains in arrears to the EIB, having failed to pay the penalty interest (US$1.7 million) steaming from previous arrears on a Regional Road Transportation project. Also, it has not normalised yet its relations with the Paris Club.

7.5.3. *South Africa*

In **South Africa** real GDP growth in 2007 reached 5.1% with strong contributions from construction and financial sectors. Export volumes rose strongly in the end of 2007, led by mining products where inventories were run down, while export prices where strong. Real imports remained high, while average import prices rose somewhat, reflecting e.g. the higher price of crude oil. For 2007 the current account deficit increased further to 7.3% of GDP. The net capital inflow was sufficient to further increase foreign exchange reserves relative to imports (13.5 weeks). The nominal effective exchange rate of the rand depreciated by 3.5% during 2007, but depreciated by 13.5% over the first two months in 2008 due to sentiments regarding the prospects of economic growth for export volumes arising from electricity shortages. Alongside rising international prices of energy and food, this continued to cloud inflation prospects with CPI accelerating to 9.4% p.a. in February 2008. Inflation is expected to reach its peak in the first half of 2008. The widening current account deficit and the reliance of portfolio inflows have raised the vulnerability to external shocks. However, the country's strong fundamentals should limit the adverse impact of these shocks on the economy. Internal pressures might arise from energy shortages, high unemployment, high inequality, high HIV/AIDS prevalence, and high crime rates.