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

on the implementation of macro-financial assistance to third countries in 2009

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1. INTRODUCTION

This report provides a general overview of EU macro-financial assistance (MFA) to third countries in 2009. It includes information on the most recent operations in the Western Balkans, the New Independent States and Mediterranean countries, together with tables providing statistics on the various MFA operations carried out since 2000.

Moreover, in response to the recommendation of the Court of Auditors in its special report of March 2002 on improvement of financial management in the beneficiary countries, the Commission has, since 2004, carried out several operational assessments of the financial circuits and procedures related to macro-financial assistance in each of the recipient countries. The conclusions drawn from these assessments, which were performed with the support of a professional audit firm, are being duly taken into account in the design of the policy conditions attached to the implementation of this assistance.

The results of the ex-post evaluations undertaken by the Commission in 2009 are also included in this report. The objective of these evaluations, which are required by the Financial Regulation, is to assess the impact of macro-financial assistance on economic stabilisation process and the structural reforms implemented in the recipient countries. Progress in this respect also reflects the degree to which the corresponding economic policy conditions attached to the EU macro-financial assistance have been met.

Finally, the report provides information concerning new MFA requests and possible Commission proposals together with an analysis of the changes that will be introduced in the management of further MFA operations after the adoption of the Lisbon Treaty.

This report is submitted in accordance with the Council decisions regarding Community macro-financial or exceptional financial assistance to third countries and follows on from the reports presented in previous years. A more detailed report (Commission Staff Working Document **SEC(2010) 1117**) providing economic and financial information regarding the beneficiary countries is being released in parallel, together with detailed statistical data on the various operations carried out since 1990.

2. BACKGROUND

2.1. The global financial crisis and its lasting effects

The global financial crisis, which emerged in 2007 and intensified dramatically during the second half of 2008 and the first half of 2009, triggered the most serious global recession since the Second World War. Although the initial effects of this crisis were mostly felt in the financial sector of advanced economies, emerging and developing economies were also seriously affected. The latter were affected by the collapse of world trade, falling remittances, heightened uncertainty and reversals in capital flows. As a result, the balance of payments and fiscal positions deteriorated in many emerging and developing countries. Risk premia and borrowing costs rose, while their exchange rates and foreign exchange reserve positions were generally subject to downward pressure. The crisis has therefore had a profound impact on those countries and policy makers are faced with significant challenges in order to ensure economic stability and continue to promote development.

At first, policy has tended to focus on stabilisation, the safeguarding of financial stability and fighting the impacts of the initial phase of the crisis. Nevertheless, important policy challenges lie ahead because the crisis is expected to have longer term implications by confronting these countries with a more constrained international environment, particular in terms of the demand, risk appetite and private capital flows from advanced economies. Moreover, the crisis has further underlined the need to implement structural reforms aimed at raising sustainable growth and safeguarding financial sector stability.

In this context, macro financial assistance, as a short-term crisis response instrument, is particularly appropriate in helping countries to deal with the serious balance of payments and budgetary deficits caused or exacerbated by the global crisis. Because of this, several countries faced with important challenges, not only in responding to the crisis but also in putting their economies back on a sustainable growth trajectory, have sought to benefit from EU MFA operations.

MFA operations take the form of medium/long term loans or grants (or an appropriate combination thereof). They are guided by the principles reaffirmed by the Council in its conclusions of 8 October 2002, which underline the exceptional nature of this assistance, its complementarity to the financing provided by the International Financial Institutions and its policy conditionality. MFA complement financing provided by the IMF and, generally, the World Bank for the funding of appropriate adjustment or reform programmes. Since 2000, MFA has been exclusively provided to the Western Balkans and the Eastern Neighbourhood Countries. The only exception was in 2007, when the Council adopted a Decision on an assistance programme in favour of Lebanon.

2.2. New legislative environment

On 1 December 2009, the Lisbon Treaty came into force, changing the legal basis for MFA. The Treaty contains in particular two articles relating to MFA:

Art. 212 states that each MFA operation shall be adopted in accordance with the ordinary legislative procedure (co-decision described in Art. 294) by the Parliament and the Council acting on a proposal from the Commission.

Art. 213 states that in case of urgent financial assistance, duly motivated by the economic or political situation of the beneficiary country, the Council shall adopt decision alone, using qualified majority voting, on a proposal from the Commission. This legal basis is to be used only in exceptional circumstances.

With a view to streamlining the decision-making process of the MFA instrument so as to make it more flexible and efficient and in order to better clarify the principles and criteria guiding this type of operations, the Commission is preparing a Framework Regulation in the context of the Lisbon Treaty. This should provide a more transparent legal basis to the instrument together with extended implementing powers to the Commission. This Regulation should increase the timeliness and, therefore, the effectiveness of the MFA instrument compared to the current procedures, which are based on the approval of legislative decisions on a case-by-case manner. The Commission intends to submit the proposal to the Parliament and the Council towards the end of 2010 or in early 2011.

3. OVERVIEW

3.1. Macro-Financial Assistance in 2009

Four new operations were committed in 2009. On 30 November, the Council decided to provide MFA to:

- Georgia (Council Decision 2009/889/EC) – up to EUR 46 million in grants
- Armenia (Council Decision 2009/890/ EC) – up to EUR 35 million in grants and EUR 65 million in loans
- Bosnia and Herzegovina (Council decision 2009/891/EC) – up to EUR 100 million in loans
- Serbia (Council Decision 2009/892/EC) – up to EUR 200 million in loans

Regarding the implementation of ongoing MFA operations, a second payment to Lebanon of EUR 25 million, in the form of a loan, was made in June 2009 as part of the MFA approved by the Council for this country in December 2007. For Georgia, part of the first tranche (amounting to EUR 23 million in the form of a grant) of the assistance approved by the Council in November 2009 was disbursed in December 2009 (EUR 15.3 million) and January 2010 (EUR 7.7 million).

3.2. Summary of the most recent operations in the beneficiary countries

3.2.1. Western Balkans

3.2.1.1. Bosnia and Herzegovina

On 30 November 2009, the Council of the European Union adopted a decision to make macro-financial assistance available to Bosnia and Herzegovina in the form of a loan facility of up to EUR 100 million (Decision 2009/891/EC). The objective of this assistance is to help the authorities to address residual external financing and budgetary needs that emerge as a consequence of the strong economic slowdown affecting the country. It is complementary to IMF and World Bank programmes. The disbursement is planned in two tranches, which are tentatively planned for the third and fourth quarter 2010, subject to satisfactory compliance with conditionality requirements.

3.2.1.2. Kosovo

The exceptional financial assistance for Kosovo approved by the Council in November 2006, in the form of EUR 50 million budget grants, was set to expire in December 2009. However, pursuant to a provision in Council Decision 2006/880/EC, the Commission has subsequently extended its period of availability by one additional year, until 11 December 2010. The conditions agreed in a Memorandum of Understanding signed with the authorities in December 2007 have not been yet fully met. In particular, one key requirement, namely the need to agree on an economic programme with the IMF, has so far not been fulfilled. As a result, it was, as in previous years, not possible to release the grant in 2009.

3.2.1.3. Montenegro

A separate loan agreement was signed with Montenegro in 2009 and entered into force on 4 February 2010. This implements Council Decision 2008/784/EC, under which part of the liabilities stemming from the long-term loans[1] granted by the EU to the State Union of Serbia and Montenegro – formerly the Federal Republic of Yugoslavia – were allocated to Montenegro. The same decision correspondingly reduced the liability of Serbia with regard to those loans from the EU[2]. This separation of EU claims on Montenegro from those on Serbia was the outcome of the independence of Montenegro in June 2006 and of an agreement reached between Serbia and Montenegro in July 2006 to allocate external liabilities among the two separate states. It did not create any new obligations for the EU and has no budgetary implications.

3.2.1.4. Serbia

On 30 November 2009, the Council of the European Union adopted a decision to make available to Serbia macro-financial assistance in the form of a loan facility of up to EUR 200 million (Decision 2009/892/EC). The objective of this assistance is to help the authorities to address residual external financing and budgetary needs that emerged in the context of the global crisis in the country. It is complementary to IMF and World Bank programmes. This assistance is expected to be released in 2010 subject to a satisfactory track record of conditionality requirements. The disbursement is planned in two tranches, which are tentatively foreseen for the third and fourth quarter 2010. In addition, and as noted above, Serbia's liabilities stemming from previous MFA to the former Federal Republic of Yugoslavia were reduced through the allocation of part of them to Montenegro pursuant to Council Decision 2008/784/EC.

3.2.2. Eastern Neighbourhood Countries

3.2.2.1. Armenia

The global economic downturn - and particularly the rapid deterioration of the Russian economy - had a strong impact on the Armenian economy, which contracted by 15% in 2009. In response, the Council Decision of 30 November 2009 provided macro-financial assistance consisting of a grant of EUR 35 million and a loan of EUR 65 million. The EU MFA will complement support from other donors and is intended to help cover Armenia's financing needs in 2010 - 2011. The conditions for the delivery of the MFA will complement the conditionality of the IMF programme and will include the satisfactory implementation of that programme, including reforms in the area of public finance management, debt management, procurement policy and custom policy.

3.2.2.2. Georgia

The Council Decision of 30 November 2009 foresaw a macro-financial assistance to Georgia in the amount of EUR 46 million in grants. This assistance was part of an international package amounting to 4.5 billion USD, to which the EU pledged up to EUR 500 million (including in the form of MFA) to support Georgia's economic recovery in the aftermath of the August 2008 armed conflict with Russia. This MFA complemented the Stand-By Arrangement agreed by the Georgian government with the IMF to help the country through the global crisis. The MFA contributed to the covering of Georgia's external financing needs in 2009-2010. The Commission made the first disbursement, amounting to EUR 23 million, in December 2009 and

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[1] These loans were approved by Council Decisions 2001/549/EC and 2002/882/EC.

[2] OJ L 269, 10.10.2008, p. 8.

January 2010. The MFA conditionality, which is consistent with the conditionality of the IMF programme, has two key components: the IMF's SBA programme must remain on-track and there must be satisfactory progress with reforms in the field of public finance management.

3.2.3. Mediterranean countries

3.2.3.1. Lebanon

In early June 2009, the Commission disbursed the first tranche of the 2007 macro-financial assistance programme - a loan of EUR 25 million. In December 2009, the Commission extended the availability period of the second tranche of the assistance programme, which will now expire on 21 December 2010. Disbursement of the second tranche is subject to the fulfilment of the conditionalities included on the Memorandum of Understanding agreed with national authorities.

Implementation of the reform agenda outlined in the Paris III programme stalled against the background of internal political divisions and the paralysis of legislative activity in the run-up to the June 2009 parliamentary elections and during the protracted subsequent negotiations on forming a new government. Hence, over the reporting period little progress was made concerning the fulfilment of the conditions for disbursement of the MFA.

4. EVALUATIONS

In line with the Financial Regulation, the Commission has implemented a series of evaluation programmes in order to assess the impact of MFA in each beneficiary country. The analyses are carried out by external consultants selected by an open call for tender, under the supervision of a Steering Committee made up of officials of different Commission's services such as DG AIDCO and DG RELEX. Since 2004, a total of 10 evaluations have been undertaken. The two last evaluations, respectively on Georgia and Moldova, were completed in 2009.

These evaluations use a methodology that describes the objectives the MFA tries to achieve, identifies its overall macroeconomic and structural effects, and compares the results with a counterfactual scenario that assumes the absence of the MFA in question. The evaluation then draws the main conclusions and recommendations. The evaluators base their work on a variety of methods, including document analysis, collection of relevant statistical data, interviews with key officials and macroeconomic analysis.

4.1.1.1. Georgia

The evaluation assessed the MFA of up to EUR 33.5 million in the form of grants provided by the European Commission to Georgia in 2006-2008. The objective of this assistance was "*to support economic reforms and help Georgia improve debt sustainability"*. The assistance was to be disbursed in three tranches, each being linked to conditions about PFM reforms. The first two tranches (of EUR 11 million each) were disbursed in August and December 2006. In parallel, Georgia reduced the amount of its outstanding debt to the Community by EUR 13 and EUR 15 million. The third tranche was not disbursed due to the non-fulfilment of the condition related to the law on the Chamber of Control.

The net impact of MFA on Georgia's debt stock, in percent of GDP, is assessed to have been small but positive. On the public finance management reform, the impact was seen as significant although less so than intended. Thus, the measures supported by the assistance contributed to the reinforcement of the internal audit and control functions and the adoption of the Chamber of Control Law even though changes in this area were slow. Also, the budget preparation process has been improved by the introduction of policy based budgeting. Efforts to improve budget execution are now focused on the introduction of international accounting standards. It is the opinion of the evaluators that without the MFA operation, these reforms would not have taken place or would probably have taken longer to materialise.

4.1.1.2. Moldova

The evaluation assessed the MFA granted by the EU to Moldova in the period September 2007 to December 2008. The assistance consisted of a grant of EUR 45 million that was disbursed in three tranches. The objective of this assistance was to support Moldova's balance of payments and encourage the implementation of its economic adjustment and reform programme. The first tranche, amounting to EUR 20 million, was disbursed in September 2007, the second tranche of EUR 10 million in August 2008 and the third and last tranche in December 2008.

The evaluation concluded that the MFA operation helped the country improve its economic situation and also to face the consequences of the drought that had affected Moldova's agriculture production (MFA is found to have boosted cumulative economic growth by around 0.6 percent) and contributed in part to solving its balance of payments difficulties. However, the macroeconomic and financial situation deteriorated subsequently reflecting the impact of the global crisis.

While the EU's MFA contributed to alleviation of the country's financial constraints and supported its adjustment efforts in the short term, its medium and long term impact was deemed to be more limited.

4.1.1.3. Meta evaluation

The Commission decided in 2008 to carry out a "meta evaluation" in order to assess the general impact of MFA operations in benefit countries. A consultant was selected specifically for this purpose. The study that was carried was essentially a synthesis of the methodology and outcomes of the seven ex-post MFA evaluations completed between 2004 and 2008.

The meta evaluation concluded that, in the short to medium term, MFA appears to have had a positive but non-uniform impact on the implementation of structural reforms in the recipient countries. MFA has contributed to the success of structural reforms by providing additional revenue to the governments. This contributed to save resources for social expenditure by decreasing the cost of the servicing of foreign debt. Nevertheless, structural reforms may take a considerable time to materialise and MFA, being a short-term and crisis instrument, can only make a significant contribution to the acceleration of the reform process in a shorter term horizon.

The impact of MFA on long term external sustainability of beneficiary countries was found to be positive, albeit small and indirect. Structural reforms initiated by MFA have globally contributed to improving their growth capacity.

The global financial crisis has highlighted the fact that there was a real need in recipient countries for a short-term crisis financial instrument, distinct from traditional longer term budgetary instruments provided by the IFIs. It is thus very plausible that in absence of the previous support provided by MFA, the impact of the current financial crisis might have been more severely felt by these countries.

According to the meta evaluation, the most important improvements that MFA has contributed to produce were reforms linked to public finance management.

A key conclusion of the study is also the desirability of a framework regulation for the MFA instrument in order to obtain a clear and stable legal basis while streamlining the decision process for increased efficiency.

5. IMPROVING FINANCIAL MANAGEMENT IN BENEFICIARY COUNTRIES: THE OPERATIONAL ASSESSMENTS

According to the Financial Regulation related to the EU budget, the Commission must perform inspections before disbursing funds to recipient countries. In order to complement fiduciary information that is often available in reports already issued by the IFIs, such as the Public Expenditure and Financial Accountability (PEFA) studies[3], the Reports on the Observance of Standards and Codes (ROSCs)[4] and the Country Financial Accountability Assessments (CFAAs)[5], the Commission carries out operational assessments.

The objective of operational assessments is to obtain reasonable assurances on the functioning of administrative procedures and financial circuits of the recipient countries before disbursing the EU funds. Consultants from international audit firms assist Commission officials in performing these assessments. Operational assessments can be considered as one of the Commission's audit systems and their main results are shared among Directorates General.

For each country, an operational assessment is carried out before the disbursement of the first tranche of a MFA. A work programme is drafted in close cooperation between the officials of the Commission and the consultants, taking into account the specificities of each country. During on-the-spot missions, investigations focus on the organisation of the central bank and more specifically on the management of accounts receiving EU funds. Also, the existing procedures of the ministries of finance are described and assessed in areas such as budget processes, the functioning of the treasury and accounting departments, internal audit, human resources and IT units. In each case, special attention is given to how external audit institutions work, their independence, their work programmes and the effectiveness of their controls. In the most recent operational assessments an analysis of existing procedures in the procurement agencies was also undertaken. The conclusions of the operational assessments are communicated to the national authorities, who have the opportunity to comment on the analysis and recommendations contained in the reports.

3 The PEFA diagnostic tool, developed by the World Bank in cooperation with the Commission and bilateral donors, is used to establish baselines for measuring whether countries are making progress in their public finance management system.

4 ROSCs summarize the extent to which countries observe certain internationally recognized standards and codes, such as auditing, anti-money laundering, banking supervision, fiscal transparency, insurance supervision, payments systems and securities regulation. They are used to help sharpen the institutions' policy discussions with national authorities and in private sector.

5 The objective of the CFAA is to evaluate a country's accounting and auditing framework from the point of view of its compatibility with international standards and the country's own needs. CFAA reports also formulate an action plan outlining the technical assistance and the sequencing of reforms needed to strengthen the existing legal, accounting and auditing framework.

Follow-up inspections are generally undertaken before the disbursement of the second or third tranches in order to assess the improvements implemented in national administrations following the first mission.

Between 2004 and the end of 2009, a total of nine operational assessments were completed in countries benefiting from macro-financial assistance and follow up missions have been undertaken in most of them. In each case the consultants' opinion was that "the framework for sound financial management was effective".

However, these assessments pointed out the need to implement improvements at various levels of national administrations:

The main weaknesses found in ministries of finance are usually in the capacities of internal audit departments, which must generally be strengthened by recruiting skilled auditors, and by having their independence formally recognised. In some cases, the current budget process must also be improved by implementing a real dialogue, including financial needs, with line ministries. In addition, departments in charge of macroeconomic forecasts are, in many cases, unable to properly fulfil their role.

External audit institutions must be guaranteed independence (both politically and financially) and their reports must be examined by national Parliaments before voting the yearly discharge.

The existing procurement procedures observed in countries benefiting of macro-financial assistance generally need to be enhanced in order to comply with the General Procurement Agreement defined by WTO.

In order to correct weaknesses in public finance management in the beneficiary countries, recommendations have been addressed to the national authorities. Some of the recommendations are considered as prior actions that have to be fulfilled before disbursement can be made. This has been the case for the strengthening of internal control departments within the ministries of finance.

These operational assessments have provided the opportunity to open a dialogue between the European Commission and the national authorities. Furthermore, they have allowed the Commission's staff to play a knowledgeable and supportive role in the area of public finance management, notably in the fields of public internal financial control and external audit. The recommendations and advice given by the representatives of the EU have helped national authorities and officials to implement much needed changes on the various levels of local administrations. Five years after the beginning of these operational assessments and despite some delays in the implementation of some of the requested modifications, the Commission has noticed real improvements in the public finance management of the beneficiary countries, at all levels. The implementation of the public finance management reforms recommended in the operational assessments has in some cases been supported by the EU through the provision of technical assistance financed by the Community cooperation instruments.

The main conclusions of the different OAs undertaken are reported in the Working Document published in parallel to this report.

6. REQUESTS FOR ASSISTANCE AND FUTURE COMMISSION PROPOSALS

In the wake of the financial crisis, several neighbourhood countries requested MFA support in order to alleviate pressure on foreign exchange reserves and to contribute to economic stability and reforms. In November 2009, the Council adopted MFA decisions for Armenia (EUR 100 million), Georgia (EUR 46 million), Serbia (EUR 200 million) and Bosnia and Herzegovina (EUR 100 million). In addition, the Commission adopted in October 2009 a proposal for a MFA in the amount of EUR 500 million for Ukraine (which is to be added to the EUR 110 million still available from the 2002 decision) and on 9 June 2010 a proposal for a MFA for Moldova in the amount of EUR 90 million. The proposal for Ukraine was adopted by the Council on 29 June 2010 and signed by the Parliament on 7 July 2010.

Other neighbouring countries (Georgia and Belarus), as well as other third countries, (Iceland, Kyrgyz Republic and Tajikistan), have also requested MFA from the EU. Georgia's request refers to the second part of the conditional pledge made by the EU at the international donors conference organised for this country in October 2008. The Commission is still examining these requests and may submit related proposals in 2010. In the face of this surge in MFA operations, the substantial cuts proposed by the Council in the course of the 2010 and 2011 Draft Budgets might well cause difficulties in the future implementation of the instrument.

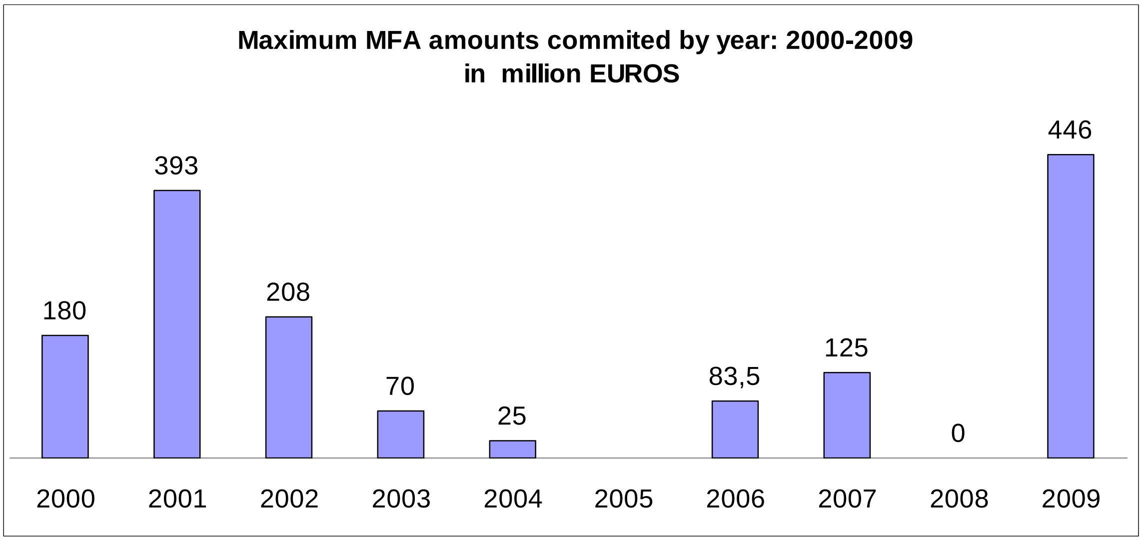
Macro-financial assistance 2000-2009
Maximum amounts authorised: million euro

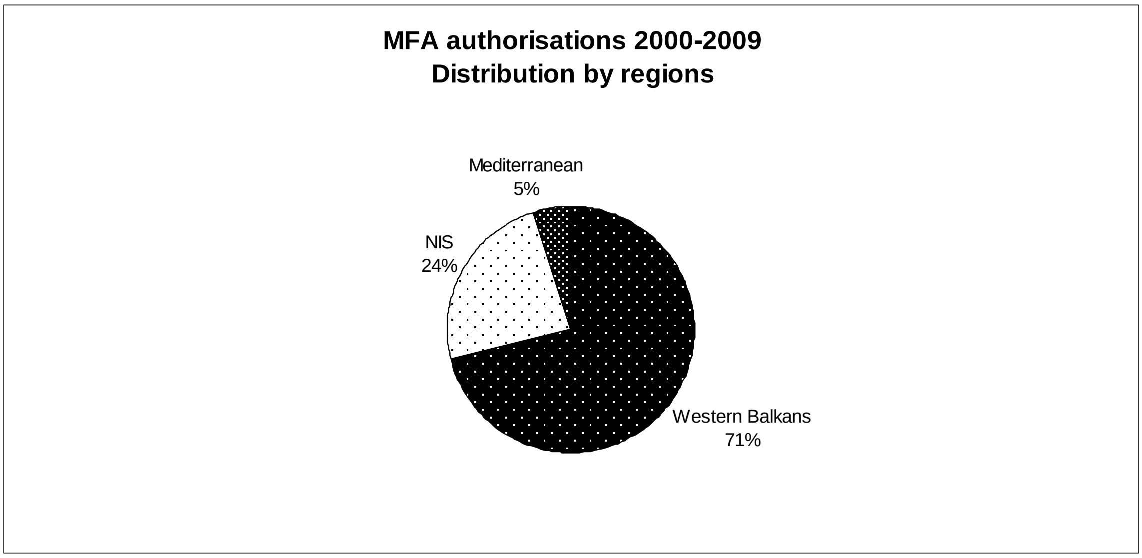
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
By region											
Western Balkans	55	393	190	70	25		50			300	1083
NIS	125		18 (a)				33,5	45		146	367,5
Mediterranean								80			80
Total amounts authorised[1]	**180**	**393**	**208**	**70**	**25**		**83,5**	**125**	**0**	**446**	**1530,5**
Loans	90	225	78	25	9		0	50	0	365	842
Grants	90	168	130 (b)	45	16		83,5	75	0	81	688,5

(a) Net amount for Ukraine taking into account new loan of EUR 110 million together with simultaneous cancellationof EUR 92 million out of the EUR 150 million decided in 1998

(b) Grant for Moldova of EUR 15 million and simultaneous cancellation of the EUR 15 million loan decided in 2000

[1] More detailed information is available in the statistical data of the working document





Macro-financial assistance, 2000-2009
Disbursements: million euro

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
By region											
Central Europe	160			50							210
Western Balkans		312	130	146	20	58	32				698
NIS		80	11	7	12	8,5	29	20	25	15,3	207,8
Mediterranean									15	25	40
Total amounts disbursed[1]	**160**	**392**	**141**	**203**	**32**	**66,5**	**61**	**20**	**40**	**40,3**	**1155,8**
Loans	75	287	0	118	10	15	19	0	9	25	549
Grants	85	105	141	85	22	51,5	42	20	40	15,3	606,8

[1] More detailed information is available in the statistical data of the working document