Investment and Macroeconomic Climate in Bulgaria, Romania and Ukraine

Dr. Edilberto Segura

June 2005
Investment Climate
Real GDP Growth (%) in Ukraine compares favourably with other Transition Economies:
Despite positive inflow dynamics, cumulative FDI in Ukraine is still extremely low compared to other economies in the region.

Cumulative FDI per capita in 2004

- Czech Republic: $5,220
- Slovenia: $2,042
- Croatia: $2,201
- Poland: $1,367
- Bulgaria: $1,160
- Romania: $770
- Russia: $116
- Ukraine: $186
The Bleyzer Foundation Investment Drivers

1. Liberalization and Deregulation of Business Activities
2. Stable and Predictable Legal Environment (the Rule of Law)
3. Privatization, Public Administration reform and Corporate Governance
4. Removal of International Capital & Foreign Trade Restrictions
5. Facilitation of Business Financing by the Financial Sector
6. Reducing Corruption levels
7. Minimization of Political Risks
8. Improving Country Promotion and Image
9. Macroeconomic Performance
TBF Ratings

- The Macroeconomic indexes are derived from an evaluation of the following factors: (i) fiscal policies, including control of the fiscal deficit, tax burden, control of expenditures and adequacy of tax collections and administration; (ii) monetary policies, including control of inflation, and credit policies; (iii) government debt policies, including debt management, debt service capacity and size of debt over GDP; and (iv) likely sustainability of macroeconomic policies. The indexes are calculated by TBF and SigmaBleyzer staff on the basis of information from the IMF, The World Bank and EBRD.

- The indexes for Investment Drivers are obtained from a number of sources, including (i) The Heritage Foundation; (ii) Euromoney’s country risk ratings; (iii) IFC/The World Bank; (iv) EBRD; (v) Economic Intelligence unit; (vi) Freedom House; (vii) International Country Risk Guide; and (viii) Transparency International. They are adjusted and updated by TBF on the basis of interviews with officials of international organizations familiar with the business environment in these countries.
Driver 2: Business Liberalization and Deregulation
Driver 3: Stability and Predictability of Legal Environment

The chart compares the stability and predictability of legal environments across various countries. The y-axis represents the score ranging from 0 to 80, and the x-axis lists the countries: Albania, Serbia, Bosnia, Moldova, Macedonia, Ukraine, Romania, Bulgaria, Croatia, Poland, Czech Rep, Estonia, Slovenia, and Chile. The chart shows a range of scores indicating varying degrees of stability and predictability.
Driver 4: Corporate and Public Governance
Driver 5: Liberalization of Foreign Trade and Capital Movements

- Bosnia
- Macedonia
- Serbia
- Albania
- Moldova
- Ukraine
- Romania
- Bulgaria
- Slovenia
- Croatia
- Poland
- Chile
- Czech Rep
- Estonia
Driver 6: Financial Sector Development

- Bosnia
- Macedonia
- Serbia
- Moldova
- Albania
- Ukraine
- Romania
- Croatia
- Bulgaria
- Slovenia
- Poland
- Chile
- Czech Rep
- Estonia
Driver 7: Non-Corruption Level

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<td>Chile</td>
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Driver 8: Political risks

- Serbia
- Macedonia
- Bosnia
- Moldova
- Ukraine
- Albania
- Romania
- Croatia
- Bulgaria
- Poland
- Estonia
- Czech Rep
- Chile
- Slovenia
Driver 9: Country Promotion and Image
Aggregate Investment Attractiveness Index

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<td>Chile</td>
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Ukraine Overview
UKRAINE -- Economic Highlights

- Few countries can show the following combination of economic achievements over the last three years:
  - High average rate of economic growth at about 9% pa
  - Low average annual inflation rate of less than 7% pa
  - Low average fiscal deficit of about 1% of GDP
  - High current account surplus of more that 8% of GDP
  - Fairly stable foreign exchange rate
  - High international reserves (currently $13 billion) in excess of three months of imports
  - Very low ratio of external debt to GDP of 20%
## Economic Performance

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<th>2005</th>
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<tr>
<td>Real GDP Growth</td>
<td>6.0%</td>
<td>9.2%</td>
<td>4.8%</td>
<td>9.4%</td>
<td>12.1%</td>
<td>5.0%</td>
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<td>Fiscal Balance (% GDP)</td>
<td>0.6%</td>
<td>-0.3%</td>
<td>0.7%</td>
<td>-0.5%</td>
<td>-3.3%</td>
<td>3.8%</td>
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<td>Consumer Inflation</td>
<td>25.8%</td>
<td>6.1%</td>
<td>-0.6%</td>
<td>8.2%</td>
<td>12.3%</td>
<td>14.7%</td>
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<td>Exchange Rate (Hr/$)</td>
<td>5.4</td>
<td>5.4</td>
<td>5.3</td>
<td>5.3</td>
<td>5.3</td>
<td>5.05</td>
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<tr>
<td>Current Account ($bn)</td>
<td>1.2</td>
<td>1.4</td>
<td>3.2</td>
<td>2.9</td>
<td>7.0</td>
<td>1.7</td>
</tr>
<tr>
<td>(as % of GDP)</td>
<td>3.7%</td>
<td>3.7%</td>
<td>7.7%</td>
<td>6.3%</td>
<td>11.0%</td>
<td>10.6%</td>
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<tr>
<td>International Reserves($bn)</td>
<td>1.6</td>
<td>1.7</td>
<td>4.4</td>
<td>6.9</td>
<td>9.5</td>
<td>13.0</td>
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<tr>
<td>Foreign Debt/GDP</td>
<td>32%</td>
<td>27%</td>
<td>24%</td>
<td>22%</td>
<td>23%</td>
<td>18%</td>
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1/ Data for January-April 2005

2/ Preliminary numbers for January-March 2005
Recent Economic Developments

- In January-April, real GDP grew by 5.0% yoy supported by 7.1% and 6.8% expansion in industry and transport, respectively.
- Inflationary pressures have continued; the consumer price index increased 14.7% yoy in April (compared to 14.7% in March yoy).
- The stock of public debt declined 2% since the beginning of 2005 to $15.6 billion as the redemption volume exceeded the amount of new borrowings. The currency structure of public debt has changed - hryvnia denominated share of debt increased.
- In the first quarter of 2005, the Ministry of Finance successfully placed UAH 2.2 billion worth of T-bills, the cost of new borrowing fell almost twice since the beginning of the year to an average of 5% per annum.
- Extremely high demand for T-bills issued by the government in 2005 and their low yields indicate that the lion’s share of them might have been purchased by non-residents provoking large inflow of foreign exchange over the short period of time (end of April 2005).
Recent Economic Developments

- In April, hryvnia appreciated 4.4% against the dollar. Thus, the official hryvnia rate went down from 5.299 UAH/USD to 5.05 UAH/USD.
- Robust inflow of foreign exchange associated with successful export performance and inward foreign capital flows were at the root of hryvnia appreciation.
- The banking system fully recovered from the liquidity crisis that occurred at the end of 2004. Commercial banks managed to restore their deposit base as deposits growth sped up to 42% yoy in April.
- The NBU managed to replenish its gross international reserves to $13.0 billion by the end of April.
- The surplus in the Goods Trade Balance reached $860 million in January-March, equivalent to 5.5% of period GDP (10.6% surplus is estimated for the current account balance).
Ukraine- Net FDI inflows, $ million, are increasing...
Possible Risks to Economic Growth

- Possible high fiscal deficit in 2005 – The amended budget for 2005 envisages high social expenditures approved by the previous government in late 2004; the government target budget deficit of 1.6% of GDP may be hard to achieve.
- But so far, the fiscal budget shows surpluses.
- Nevertheless, inflationary pressures could continue.
- Rapid credit expansion and low quality of credit portfolio make banks vulnerable to external crises.
- Risk of external shocks -- Ukrainian growth, to a great extent led by exports, has benefited from high metal prices as metal products represent about 40% of exports
- Implementation of structural economic reforms may be handicapped by Parliamentary elections in 2006.
Mr. Yushchenko's Presidency: First Steps

- Yushchenko’s track record both as Chairman of the National Bank and Prime Minister set the basis for Ukraine’s recent impressive economic performance, and bode well for Ukraine’s future.

- The following reforms and changes have been taken by the new government since the beginning of 2005:

1. On March 25, 2005, an amended Fiscal Budget for 2005 was approved by Rada, eliminating most tax privileges and exemptions, and reducing privileges of free economic zones. The amended Budget envisages a 1.6% of GDP deficit. This deficit was calculated based on the following macroeconomic assumptions:
   - Real GDP growth 8.2% yoy in 2005
   - Consumer inflation 9.8% eop
   - Producer inflation 17.5% eop
   - Significant increases in tax revenues as % of GDP
2. Steps were taken to reduce the size of the shadow economy (extensive anti-smuggling campaign -- Smuggling-STOP -- performed by customs authorities). The campaign has yielded its first results. In March, the State Customs Committee collected 42% more customs duties than was targeted for the period, while import volumes did not increase significantly.

3. On the path to foreign currency market liberalization, the NBU abandoned its regulation requiring the mandatory sale of 50% of exports proceeds starting April 1, 2005.

4. On April 29, 2005, the NBU cancelled its regulation #482 that required multiple conversion of currencies for non-residents investing into Ukrainian enterprises.

5. The country has developed stronger working relationship with the West.

6. Increased interest and support from international institutions (WB, IMF and EBRD).
7. The Privatization strategy is currently under revision. Disputed privatizations will be limited in number (the declared list contains 29 enterprises). The Kryvorizhstal deal will be resolved soon (court proceedings are under way). Other disputed privatizations will be settled in the courts too.

8. The new government proposed a number of reductions in import duties and changes to be introduced in customs procedures to streamline customs clearance of goods coming into Ukraine. These initiatives have yet to be approved by Parliament.
Future Reform Agenda

SigmaBleyzer/The Bleyzer Foundation developed a set of policy recommendations for the government:

- **Short Term Reforms:**
  - Perform quick deregulation and liberalization of business activities by implementing a “regulatory guillotine”
  - Eliminate other excessive administrative interventions in businesses (price controls)
  - Enact key pending legislation (e.g., the Joint Stock Companies law)
  - Improve image through more frequent communication and better transparency.
  - Clarify the government’s policy on Privatization
  - Create an Investment Promotion Agency
  - Implement specific promotional activities for large investors: Identify major projects, carry out targeted promotional campaigns, identify niches/sectors.
  - Implement specific promotional activities for small/medium firms: access to bank credit, better information on laws, and the business environment
….. Future Reform Agenda

- **Long Term Reforms**
  - Ensure “sustainable” fiscal deficits and low inflation (the 2005 deficit can be financed and capital expenditures curtailed; thereafter, the budget must be sustainable)
  - Implement a fundamental public administration reform by undertaking a comprehensive “audit” of government activities (this will help to improve administrative efficiency, deal with corruption and also bring equilibrium to the fiscal budget)
  - Strengthen monetary and foreign exchange rate activities (to abandon the exchange rate anchor, techniques for inflation targeting must be developed – open market operations, forecasting models)
  - Liberalize trade and sign free trade agreements with the CIS, EU, US, and other countries
  - Improve the legal environment (particularly by ensuring the independence of the Judiciary)
Bulgaria Overview
Political Trends

- **Bulgaria became a member of NATO in March 2004**
  - Resulted from the stabilizing role of the country in Southeast Europe and its successful reform programs

- **Membership in EU**
  - Bulgaria completed the EU accession negotiations in June 2004
  - European Parliament approved the admission of Bulgaria to the EU in April 2005
  - Bulgaria will likely join the EU in 2007
  - In its annual report the EU criticizes the justice system reform and the effectiveness of measures against corruption in Bulgaria
  - The government partially fulfilled its election mandate and improved the country’s image through its success in achieving EU and NATO membership
Political Trends

- **Elections:**
  - Next parliamentary elections are scheduled for June 25, 2005
  - While the parties on the left of the political spectrum have consolidated their position in anticipation of the upcoming elections, the parties of the center right are still attempting to align interests
  - It is unlikely that any single party will win a majority. Hence, the government will most likely be a coalition
  - There is no likelihood that any future government of the right or the left would reverse the country’s strategic course towards the EU or the major economic policies that have been successful
Economic Trends

- Bulgarian economy has been growing steadily since 1998:
  - Real GDP growth exceeded 4% each year after 2000
  - In 2004 GDP growth was 5.6%, and is expected to be 5-6% in 2005
  - GDP per capita in 2004 was about $3,300
  - Inflation is steadily decreasing and in 2005 it is expected to be 3.6%
  - Recent country rating upgrades: S&P: BBB- with a positive outlook (investment grade); Fitch: BBB- with a stable outlook (investment grade); Moody’s: Ba1 with a positive outlook (just below investment grade)
  - Considerable progress in structural reforms
Economic Trends

- Significant expansion of the country's industrial (23.2% yoy), agricultural (8.3%) and service (15.0%) sectors supported the strong economic growth in 2004
- Prudent fiscal policy, directed at improvement of tax collection and optimization of expenditures, resulted in a budget surplus for 2004, which is expected to continue in 2005
- Effective control of inflation, evidenced by decreasing consumer and producer price indices
- Slight improvement of current account deficit in 2004 to 7.5% of GDP, up from 11% the previous year
- Strong foreign direct investment inflow of over EUR 2 billion in 2004, which represents about 30% of FDI inflow to South Eastern Europe
Economic Risks

- Rapid credit expansion might increase the risk to the economy and the financial sector. The strong capitalization of the banks and the recent actions of the Central Bank to contain credit growth limit the threat of a future financial crisis.
- Surge in bank credit, as well as the strong FDI inflows, have been factors in the sharp weakening of the trade balance. While this deficit has been mostly financed by FDI inflows, its sustainability may be difficult once privatization inflows dry up.
Romania Overview
Political outlook

Romania

**Domestic**
- President: Mr. Traian Basescu, ex-mayor of Bucharest - Democratic Party (PD)
- Prime Minister: Mr. Calin Popescu-Tariceanu of National Liberal Party (PNL)
- Government center-right coalition formed by PNL, PD, Hungarian Democratic Union of Romania (UDMR), and Humanist Party (PUR)
  - Controls 51% of the Senate and 45% of the Lower House of Parliament
- The PNL-PD-UDMR-PUR coalition was formed following 2004 elections in which the center-left Social Democratic Party (PSD) lost power

**International**
- EU Accession Treaty signed on April 25, 2005, with accession planned for 2007
- Accession Treaty has a safeguard clause which could delay accession by one year, should Romania not implement EU entry commitments
  - Main challenges are fighting corruption and justice reform
- NATO member since 2004
Economic Outlook

- GDP rose 8.3% in 2004
  - Expect 5.5% growth in 2005
  - Since 2001, average growth rate of 6.0%
- Per capita GDP in 2004 reached EUR 2,715
- Main drivers of the GDP growth in 2004 were household consumption and fixed capital formation, up 10.8% yoy and 10.1% yoy respectively
- The new government changed the Fiscal Code introducing a 16% flat tax for both corporate profit and individual incomes
  - Previous corporate profit tax was 25%
  - Individual income tax had been 18%-40%
- Inflation, one of the chronic problems of the economy declined in 2004 to single-digits: 9.3% end-year
  - Inflation target for 2005 is 7.0% year-end
- Central Bank switched monetary policy to inflation targeting in 2005
The trade deficit worsened in 2004 due to increases in consumption and investments

- Caused the Current Account (CA) deficit to reach EUR 4.4 billion or 7.5% of GDP
- Curbing the CA deficit increases - one of the main challenges for 2005

Large Foreign Direct Investments (FDI) of EUR 4.0 billion financed most of the CA deficit in 2004.

- IN 2005, FDI is expected to remain high, due to privatizations, and help finance the CA deficit again

Rated investment grade by Fitch (BBB-), while Moody’s and S&P rating are one notch below investment grade, with a positive outlook.

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<th>Local Currency</th>
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### Economic Outlook: Romania

#### PRODUCTION

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<td>1,167,243</td>
<td>1,512,257</td>
<td>1,890,778</td>
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<td>GDP US$bn</td>
<td>35.6</td>
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<td>40.3</td>
<td>44.8</td>
<td>48.4</td>
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<td>GDP Real Growth Rate (%)</td>
<td>-1.2</td>
<td>2.1</td>
<td>5.7</td>
<td>5.0</td>
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<td>Industrial Production Growth (%)</td>
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#### TRADE

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<tr>
<td>Exports (fob)</td>
<td>8,387</td>
<td>11,269</td>
<td>12,738</td>
<td>14,675</td>
<td>15,614</td>
<td>18,935</td>
<td>22,334</td>
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<td>Imports (cif)</td>
<td>10,273</td>
<td>14,191</td>
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<td>18,881</td>
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<td>Current Account Balance</td>
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<td>Capital and Financial Account Balance</td>
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<td>1,568</td>
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<td>Foreign Direct Investment</td>
<td>1,013</td>
<td>1,169</td>
<td>1,311</td>
<td>1,194</td>
<td>1,910</td>
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<td>Current Account Balance/GDP</td>
<td>-4.2</td>
<td>-3.7</td>
<td>-5.8</td>
<td>-3.5</td>
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#### BUDGET

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<td>Consolidated Budget Balance/GDP</td>
<td>-1.9</td>
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<td>-3.2</td>
<td>-2.5</td>
<td>-2.0</td>
<td>-1.2</td>
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#### INFLATION

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<tr>
<td>CPI (year-end)</td>
<td>54.8</td>
<td>40.7</td>
<td>30.3</td>
<td>17.8</td>
<td>14.1</td>
<td>9.3</td>
<td>8.0</td>
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<tr>
<td>CPI (avg)</td>
<td>45.8</td>
<td>45.7</td>
<td>34.5</td>
<td>22.5</td>
<td>15.3</td>
<td>11.9</td>
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#### EXCHANGE RATE

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<tr>
<td>ROL/US$ (year-end)</td>
<td>18,255</td>
<td>25,926</td>
<td>31,597</td>
<td>33,500</td>
<td>32,595</td>
<td>29,067</td>
<td>27,764</td>
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<tr>
<td>ROL/US$ (average)</td>
<td>15,333</td>
<td>21,670</td>
<td>29,061</td>
<td>33,052</td>
<td>33,200</td>
<td>32,637</td>
<td>28,416</td>
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<tr>
<td>Devaluation ROL against US$ %</td>
<td>66.7</td>
<td>42.0</td>
<td>21.9</td>
<td>6.0</td>
<td>(2.7)</td>
<td>(10.8)</td>
<td>(4.5)</td>
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<tr>
<td>ROL/EUR (year-end)</td>
<td>18,331</td>
<td>24,118</td>
<td>27,881</td>
<td>34,919</td>
<td>41,117</td>
<td>39,663</td>
<td>36,093</td>
</tr>
<tr>
<td>ROL/EUR (average)</td>
<td>16,296</td>
<td>19,956</td>
<td>26,027</td>
<td>31,255</td>
<td>37,556</td>
<td>40,532</td>
<td>37,878</td>
</tr>
<tr>
<td>Devaluation ROL against EUR %</td>
<td>43.3</td>
<td>31.6</td>
<td>15.6</td>
<td>25.2</td>
<td>17.7</td>
<td>(3.5)</td>
<td>(9.0)</td>
</tr>
</tbody>
</table>

#### DEBT STOCK

<table>
<thead>
<tr>
<th></th>
<th>EURmn</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Debt Stock</td>
<td>8,757</td>
<td>11,113</td>
<td>13,507</td>
<td>14,648</td>
<td>15,681</td>
<td>17,885</td>
<td>20,457</td>
</tr>
<tr>
<td>Public and public guaranteed foreign debt</td>
<td>6,158</td>
<td>7,474</td>
<td>8,770</td>
<td>9,183</td>
<td>9,674</td>
<td>10,304</td>
<td>10,700</td>
</tr>
<tr>
<td>Central Bank's FX Reserves</td>
<td>1,520</td>
<td>2,655</td>
<td>4,445</td>
<td>5,877</td>
<td>6,374</td>
<td>10,839</td>
<td>15,000</td>
</tr>
</tbody>
</table>