COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of Bulgaria, 2008-2011

EXPLANATORY MEMORANDUM

1. General background

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. Background for the assessment of the updated programme

The Commission has examined the most recent update of the convergence programme of Bulgaria, submitted on 1 December 2008, and has adopted a recommendation for a Council opinion on it.

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”);

(2) the most recent assessment of the country’s position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme).

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance

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1 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2 Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability or convergence programmes.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2010, as follows. “The overall conclusion is that the programme aims at maintaining a sound budgetary position throughout the period, planning the continuation of high general government surpluses. The budgetary targets seem plausible. The programme proposes a significant upward revision of the MTO from a balanced structural position to a surplus of 1½% of GDP, which will be comfortably met throughout the programme period. Safeguarding macroeconomic stability and sustaining catching-up in a context of rising external imbalances and high inflation requires the continuation of tight fiscal policies, further improvements in the quality of public spending, including in healthcare, and fiscal institutions and a public sector wage policy that contributes to overall wage moderation in line with productivity gains”. In view of this assessment, the Council invited Bulgaria to “(i) continue avoiding a pro-cyclical fiscal stance with a view to help contain existing external imbalances, notably by saving any budgetary over-performance and continuing expenditure growth; (ii) strengthen policies to contain inflationary pressures, including through prudent public sector wage policy contributing to wage moderation; and (iii) further strengthen the efficiency of public spending in particular through full implementation of programme budgeting, reinforced administrative capacity and reform in the areas of labour market, education and healthcare”.

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On the updated convergence programme of Bulgaria, 2008-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[3], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [10 March 2009] the Council examined the updated convergence programme of Bulgaria, which covers the period 2008 to 2011[4].

(2) Bulgaria has experienced strong economic growth at over 6% on average over the past several years, accompanied by mounting macroeconomic imbalances, such as a widening external deficit and high inflation. In the context of the currency board framework, monetary and credit conditions tightened in 2008 amid higher country risk perceptions and a continued appreciation of the real effective exchange rate. As the adverse impact of the global economic slowdown and the financial crisis unfolds, GDP growth is set to decelerate sharply and remain well below potential in 2009-2010, putting pressure on tax revenues. Thus Bulgaria faces the challenge of sustaining growth in a severe and protracted global economic downturn, while addressing the existing macroeconomic imbalances through maintaining tight fiscal and incomes policies. Against this background, the policy response in the programme envisages measures aiming at strengthening the economy's resilience. Despite the starting position of low public debt-to-GDP ratio and large fiscal surpluses, the high inflation and large current account deficit have prevented the government from adopting a fiscal stimulus package for boosting domestic demand. In the long term, the country is confronted with the need to improve the quality of public finances while facing fast ageing population and worsening demographics.

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3 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

4 On 23 December 2008 the Bulgarian authorities submitted an addendum to the programme detailing the measures adopted in response to the economic downturn. The addendum did not present any significant changes in the fiscal and structural policies compared to those in the convergence programme and the budgetary projections remained unchanged.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will fall from 6.5% in 2008 to 4.7% in 2009 before recovering to an average rate of 5.5% over the rest of the programme period. Assessed against currently available information[5], this scenario appears to be based on markedly favourable growth assumptions for 2009 and thereafter. This reflects high domestic demand, in particular investment growth, and acceleration in real exports throughout the programme period, which are inconsistent with the slowdown in both foreign direct investment inflows and world trade. However, due to a much higher import growth assumed in the programme, in line with domestic demand, the external deficit would narrow only gradually in 2009-2011. Based on the assumption of a milder slowdown, the programme projects inflation in 2009 to be on the high side, implying limited progress towards nominal convergence. The inflation outlook for 2010-2011 appears realistic.

(4) For 2008, the general government surplus is estimated at 3% of GDP in the most recent update of the programme, which is in line with the original target. The budgetary outcome reflects a better starting position (after correcting for an unanticipated one-off debt cancellation measure in 2007, amounting to 3½% of GDP). Despite the significant import growth and high inflation in 2008, revenue collected from indirect taxes was 1½% of GDP lower than initially projected. Following the introduction of a 10% flat personal income tax rate, direct tax revenues collection was ½% of GDP less than anticipated in the December 2007 update. On the expenditure side, discipline has not been fully maintained, as additional social and infrastructure spending of around 1¾% of GDP was adopted. Nevertheless, thanks to higher-than-expected nominal GDP growth, the expenditure-to-GDP ratio was lower than envisaged in the previous programme.

(5) The 2009 budget law targets a general government surplus of 3% of GDP. The law includes some discretionary measures, which would have an overall neutral budgetary impact. On the revenue side, the impact of the reduction of the contribution rate to the public pension fund by 4% would be offset by the increase in the healthcare contribution rate by 2% and in the average mandatory minimum insured income thresholds by 26½% in nominal terms. On the expenditure side, primary expenditure is set to grow, mainly due to higher social payments and compensation of employees. Pensions will be increased by almost 20% in two steps from 1 April and 1 July. The wage bill in the general government sector is envisaged to grow by 10%. To ensure meeting the budgetary targets, the rule limiting the disbursement of non-interest expenditure (excluding social security transfers) to 90% of budgeted allocations in case of a worse-than-budgeted revenue outcome has been re-introduced. The 2009 budget law provides for even lower disbursements if the underperformance in the consolidated general government revenues falls to a level that would result in a negative budget balance.

(6) The budgetary strategy outlined in the program projects the medium-term objective (MTO) of a 1½% of GDP surplus to be respected throughout the programme period. The current update envisages the general government balance to remain in surplus of 3% of GDP and the primary balance to stay unchanged at a surplus of almost 4% of GDP until 2011. In structural terms (i.e. cyclically-adjusted net of one-off and other

[5] The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

temporary measures), the budgetary balance is projected to remain in surplus of around 3½% of GDP over the programme period. While the negative output gap is projected to widen, the underlying fiscal policy stance appears to be broadly neutral in the medium term.

(7) The programme budgetary outcomes are subject to significant downside risks. The main risk stems from the underlying macroeconomic scenario, which is based on markedly favourable growth assumptions for 2009 and 2010. On the revenue side, risks for public finances in 2009-2010 are higher than in previous years and are associated with a sharper contraction and rebalancing of economic growth towards less revenue rich growth composition. In view of the expected economic slowdown and pressures to increase demand-enhancing expenditure, controlling expenditure growth through the 90% budget execution rule might prove to be difficult in 2009.

(8) In the absence of the long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Bulgaria on a comparable and robust basis as it is currently done for the previously acceded 25 Member States. The budgetary position in 2008, with a large structural surplus, contributes significantly to debt reduction before considering the long-term budgetary impact of ageing. Maintaining high primary surpluses over the medium-term would contribute to limiting the risks to the sustainability of public finances, which are currently at a low level.

(9) Bulgaria's budgetary framework has so far demonstrated a very good track record by meeting the budgetary targets, although in a context of buoyant economic growth. In the recent past, it has been improved by streamlining the budgetary procedure, enhancing reporting requirements, and including a more comprehensive macro-economic analysis and assessment of the fiscal risks in the budgetary documents. However, the framework is binding only in the first year of the three-year budgetary planning horizon and allows for certain discretionary spending powers of the government which undermines the fiscal transparency and accountability. Despite these weaknesses, the programme does not envisage any substantial changes to the budgetary framework apart from further progress with the implementation of performance-based budgeting. The re-introduction of the 90% budget execution rule into the 2009 budget law aims at ensuring the budgetary target through limiting the general government expenditure growth. However, the implementation of the rule is not clearly defined in the law, which might leave some room for discretionary execution.

(10) The Bulgarian government has not adopted any specific package to stabilize the financial sector. However, in order to enhance the confidence in the banking system the deposit guarantee level was raised to BGN 100,000 and the government increased the capital of the state-owned Bulgarian Development Bank to boost interbank lending and facilitate financing to SMEs.

(11) In view of the economic imbalances, fiscal policy is geared towards maintaining investor confidence and preserving the macro-economic stability. The Bulgarian government has therefore not adopted a short-term stimulus package in response to the economic slowdown, which is in line with the EERP agreed in December by the European Council. Related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs, the programme foresees structural measures

which aim at strengthening the economy's resilience, such as those aimed at sustaining employment, enhancing business capacity to adapt to the crisis environment, improving market functioning, providing, if needed, capital support to commercial banks, boosting lending to SMEs, promoting export performance, and improving EU funds absorption. These measures represent a timely and adequate response to the main policy objectives in terms of the short-term outlook. The update also includes a series of other structural reform measures, which are part of the longer-term strategy for improving the quality and sustainability of public finances, such as the reform in the pension system, the implementation of next steps under the education reform strategy, including through further optimization of the school network and strengthening the schools delegated budget system, and the implementation of the recently adopted healthcare strategy.

(12) The consolidation programme of the Bulgarian government would help contain the economy's high external and internal imbalances. More specifically, the programme envisages a structural consolidation of 1% of GDP over the period 2008-2011. The overall fiscal stance, as measured by the change in the structural balance, is restrictive in 2009 and remains broadly neutral in 2010-2011. The programme's objective of maintaining a cyclically adjusted surplus of 1½ of GDP would be achieved throughout the programme period.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the optional data[6].

The overall conclusion is that the programme aims at maintaining a sound budgetary position throughout the period, reflected in the planned high general government surpluses. The measures foreseen in response to the economic slowdown aim at strengthening the economy's resilience and are in line with the EERP. Subject to the significant downside risks attached to the budgetary outcomes, as well as those stemming from the uncertainty to the current economic juncture and its impact on revenues, the budgetary stance would imply that the objective of 1½% of GDP surplus in structural terms would be achieved throughout the programme period. Bulgaria faces the challenge of sustaining growth in a severe and protracted global economic downturn. Moreover the country should urgently implement policies to correct the large external deficit, including through maintaining a tight fiscal policy and bringing wage developments in line with productivity gains. In addition, the country is confronted with the need to improve the quality of public expenditure by improving administrative capacity and stepping up structural reforms.

In view of the above assessment and also given the need to ensure sustainable convergence, Bulgaria is invited to:

(i) continue maintaining a sound fiscal position by restraining expenditure growth, with a view to help contain existing external imbalances and counteract possible revenue shortfalls;

(ii) contain public sector wage growth in order to contribute to overall wage moderation and improve competitiveness;

(iii) further strengthen the efficiency of public spending, in particular through full implementation of programme budgeting, reinforced administrative capacity and

[6] In particular, some long-term sustainability data are not provided.

reforming the areas of labour and product markets, education and healthcare, in order to increase productivity and reduce the external deficit.

		2007	2008	2009	2010	2011
Real GDP (% change)	**CP Dec 2008**	**6.2**	**6.5**	**4.7**	**5.2**	**5.8**
	COM Jan 2009	6.2	6.4	1.8	2.5	n.a.
	CP Dec 2007	*6.4*	*6.4*	*6.8*	*6.9*	*n.a.*
HICP inflation (%)	**CP Dec 2008**	**7.6**	**12.4**	**6.7**	**4.7**	**4.0**
	COM Jan 2009	7.6	12.0	5.4	4.8	n.a.
	CP Dec 2007	*7.2*	*6.9*	*4.4*	*3.7*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Dec 2008**	**1.5**	**1.1**	**-0.7**	**-1.8**	**-1.4**
	COM Jan 2009[2]	2.7	3.0	-0.3	-2.3	n.a.
	CP Dec 2007	*0.7*	*-0.1*	*-0.6*	*n.a.*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Dec 2008**[3]	**-20.6**	**-22.9**	**-20.7**	**-18.4**	**-16.6**
	COM Jan 2009	-21.3	-23.3	-19.1	-17.6	n.a.
	CP Dec 2007	*-19.9*	*-20.7*	*-19.5*	*-18.6*	*n.a.*
General government revenue (% of GDP)	**CP Dec 2008**	**41.6**	**41.3**	**43.4**	**43.4**	**43.7**
	COM Jan 2009	41.6	41.4	40.8	40.9	n.a.
	CP Dec 2007	*42.2*	*43.7*	*43.9*	*43.9*	*n.a.*
General government expenditure (% of GDP)	**CP Dec 2008**	**41.5**	**38.3**	**40.4**	**40.4**	**40.7**
	COM Jan 2009	41.5	38.2	38.8	38.9	n.a.
	CP Dec 2007	*39.1*	*40.7*	*40.9*	*41.0*	*n.a.*
General government balance (% of GDP)	**CP Dec 2008**	**0.1**	**3.0**	**3.0**	**3.0**	**3.0**
	COM Jan 2009	0.1	3.2	2.0	2.0	n.a.
	CP Dec 2007	*3.1*	*3.0*	*3.0*	*3.0*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2008**	**1.1**	**3.9**	**3.9**	**3.9**	**3.9**
	COM Jan 2009	1.1	4.1	2.8	2.7	n.a.
	CP Dec 2007	*4.3*	*4.0*	*4.0*	*4.0*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Dec 2008**	**-0.4**	**2.6**	**3.2**	**3.6**	**3.5**
	COM Jan 2009	-0.8	2.2	2.1	2.8	n.a.
	CP Dec 2007	*2.8*	*3.1*	*3.3*	*n.a.*	*n.a.*
Structural balance[4] (% of GDP)	**CP Dec 2008**	**2.9**	**2.6**	**3.2**	**3.6**	**3.5**
	COM Jan 2009	2.5	2.2	2.1	2.8	n.a.
	CP Dec 2007	*2.9*	*3.1*	*3.3*	*n.a.*	*n.a.*
Government gross debt (% of GDP)[5]	**CP Dec 2008**	**18.2**	**15.4**	**15.4**	**15.3**	**15.2**
	COM Jan 2009	18.2	13.8	12.2	10.7	n.a.
	CP Dec 2007	*19.8*	*18.3*	*17.4*	*16.9*	*n.a.*

Notes:
[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.
[2] Based on estimated potential growth of 5.0%, 6.3%, 6.0% and 6.0% respectively in the period 2007-2010.
[3] The different net borrowing position in 2007 in the current update of the programme and the Commission services' January 2009 interim forecast reflects a discrepancy in the balance on goods and services component.
[4] Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. The most recent programme provides no information on one-off and other temporary measures; according to the Commission services' January 2009 interim forecast, they are 3.3% of GDP(expenditure side) in 2007.
[5] The differing projections about the debt-to-GDP ratio in the programme compared to the Commission services' January 2009 interim forecast are due almost entirely to the higher projected accumulation of financial assets, which is not considered by the Commission services under a no-policy-change scenario.

Source:

Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.