



**COUNCIL OF  
THE EUROPEAN UNION**

**Brussels, 19 April 2010**

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**NOTE**

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From: General Secretariat of the Council  
To: COREPER/COUNCIL

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Subject: Draft Council Opinion on the updated Convergence Programme of Bulgaria,  
2009-2012

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Delegations will find attached the draft Council Opinion on the updated Convergence Programme of Bulgaria, 2009-2012, on the basis of the Commission Recommendation, as prepared by the Economic and Financial Committee and politically endorsed by the Ministers of Economic and Financial Affairs at their informal meeting on 16 April 2010.

Encl.:

**Draft COUNCIL OPINION**

**on the updated convergence programme of Bulgaria, 2009-2012**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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<sup>1</sup>, 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 [22 April 2010] the Council examined the updated convergence programme of Bulgaria, which covers the period 2009 to 2012.
- (2) Before the onset of the global economic and financial downturn Bulgaria had witnessed strong real GDP growth underpinned by fast credit expansion and large foreign investment inflows. The robust economic activity, however, was accompanied by increasing macroeconomic imbalances such as the build-up of a very large external deficit and private debt as well as substantial inflationary pressures. The FDI-led investment boom and high wage increases, far exceeding productivity gains, aggravated these imbalances. As the global economic crisis unfolded, economic activity was hit hard, resulting in a contraction of real GDP by 5% in 2009.

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<sup>1</sup> 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/sgp/index\\_en.htm](http://ec.europa.eu/economy_finance/sgp/index_en.htm).

At the same time the downturn brought about a welcome correction in the imbalances whereby average inflation decelerated to 2.5% in 2009 and the current account deficit declined rapidly to 9.4% of GDP. Although the current account deficit was fully financed with FDI, the country's gross external debt at around 110% of GDP remains relatively high. Bulgaria has not adopted a short-term fiscal stimulus package in response to the economic slowdown. Taking into account the wide macroeconomic imbalances prior to the downturn, in line with the European Economic Recovery Plan (EERP), the emphasis of policy efforts was geared toward fiscal consolidation measures, notably by restricting expenditures and improving tax compliance. As a consequence, the Bulgarian convergence programme estimated a general government deficit at below 3% of GDP in 2009<sup>2</sup>. Going forward, the main short- to medium-term challenge for the economy is to secure a sustained catching-up process without compromising fiscal and macroeconomic stability.

- (3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will continue at a lower pace. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis compounds the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Bulgaria it is important to undertake reforms in the areas of healthcare, pensions, education, public administration, and business environment.

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<sup>2</sup> However, on 9 April the Bulgarian authorities announced that the general government deficit could have reached 3.7% of GDP in 2009.

- (4) The baseline macroeconomic scenario which the programme considers the reference scenario for assessing the budgetary projections envisages that real GDP growth will improve from -5% in 2009 to 0.3% in 2010 before recovering to an average rate of 4¼% over the rest of the programme period. Assessed against currently available information<sup>3</sup>, it appears to be based on slightly favourable growth assumptions as both projected growth in 2010 and its evolution in the medium term appear to be on the high side of the current forecasting range. The unwinding of the imbalances that started in 2009 is projected to continue over the programme period. Inflation is expected to remain subdued in 2010-2012, and its projections appear realistic and broadly in line with the Commission services' autumn 2009 forecast. The external accounts are also expected to continue to improve. While in 2009 these dynamics were driven by imports declining faster than exports, in the medium-term the correction would be a result of exports picking up faster and earlier than imports. Although the baseline scenario appears to be only slightly favourable compared with the Commission services' autumn forecast and taking into account the most recently available information, its plausibility critically depends on the assumed rebalancing of growth towards a more sustainable pattern, with exports as a main driver. The programme also presents a “pessimistic” and an “optimistic” alternative scenarios. They differ from the baseline scenario mainly with respect to the assumptions about the timing of the economic recovery and the dynamics of exports. The pessimistic scenario presents a continued contraction of real GDP by 2% in 2010 on the back of further decline of exports, assuming that the recovery would take place only in 2011. According to the optimistic scenario, a faster global recovery would raise GDP growth by ¾ of a percentage point over the entire programme period.

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<sup>3</sup> The assessment notably takes into account the Commission services' autumn 2009 forecast, but also other information that has become available since then.

- (5) The significant deterioration of the general government balance in 2009 reflects to a large extent the impact of the crisis on government finances. Given the need to maintain macroeconomic stability under the currency board arrangement, in line with the EERP the government did not adopt stimulus measures. The deterioration was therefore mainly driven by a shortfall of revenue as a result of the unexpectedly sharp downturn and a change in GDP composition. Revenue losses were however partly compensated by spending cuts. To stabilize the fiscal position, in the second half of the year the authorities implemented a fiscal consolidation package amounting to 2.3% of GDP. The package consisted of measures to further decrease primary expenditure (beyond the 90% limit implied by the existing budgetary execution rule) as well as measures to improve tax compliance. Despite several downward revisions of the budgetary target, the significant additional retrenchment notwithstanding, in the course of the year, the fiscal consolidation policy effort permitted Bulgaria to achieve a relatively low general government deficit in 2009.
- (6) For 2010, the convergence programme aims to achieve a balanced budget. The revenue-to-GDP ratio is expected to increase to almost 39¼% of GDP (from 37½% of GDP in the previous year), supported by higher indirect taxes and other revenue. In spite of moving to a less tax-favourable GDP composition, the strong pick-up in indirect tax revenue is explained by an expected significant improvement in tax compliance and an increase in excise tax rates for cigarettes and electricity for industrial production. However, the programme does not give any details on the expected increase in other revenues by 1% of GDP. By contrast social contributions are projected to decline by ¼ of a percentage point of GDP due to a lowering of contribution rates by 2 percentage points. The expenditure-to-GDP ratio is expected to decline slightly by approximately ¼ of a percentage point of GDP in 2010, mostly as a result of streamlining public administration. Nominal public sector wages and intermediate consumption are set to remain unchanged at the 2008 level, reducing their share as a percentage of GDP in 2010.

These expenditure-reducing measures more than compensate the increase by 0.2% of GDP in pensions for widowers and the elderly in 2010. Gross fixed capital formation is planned to remain constant as a percentage of GDP in 2009-2011. As a result, the structural balance (recalculated by the Commission services on the basis of the information in the programme according to the commonly agreed methodology) is projected to increase as a share of GDP by 2¾ percentage points compared to 2009, implying a planned restrictive fiscal policy stance in 2010. The bottom-up estimate of the fiscal stance in 2010 accounts for about a half of the envisaged structural adjustment, based on the measures that are outlined in the programme. The improvement of the structural balance in the programme is significantly above the projections of the Commission services' autumn forecast.

- (7) The main goal of the medium-term budgetary strategy is to maintain a balanced general government budget throughout the programme period. This is achieved by keeping the revenue and expenditure-to-GDP ratios roughly unchanged at 39¼% on average in the outer years. The medium-term budgetary objective (MTO), defined in structural terms (i.e. cyclically-adjusted net of one-off and other temporary measures), is a surplus of ½% of GDP, which the programme aims to achieve from 2010 onwards. Given the most recent projections and the debt level, the MTO more than adequately reflects the objectives of the Pact.
- (8) The budgetary outcomes could turn out worse than projected. The main risk stems from the underlying macroeconomic scenario, which is based on slightly favourable growth assumptions for the programme period. In particular, revenue could be lower than projected in 2010-2012 as a result of a slower and less pronounced economic recovery. Moreover, the projected rebalancing of growth towards less tax rich components also poses a significant downside risk to government revenue, while the full effect of the measures to improve tax compliance and budgetary discipline still remains to be seen. On the expenditure side, considerable savings in the other expenditure category remain unspecified.

Furthermore, the scope for additional expenditure cuts to compensate for revenue may turn out to be limited following the significant frontloading of fiscal consolidation efforts in 2009. Finally, the downward revision of the 2009 general government balance announced after the submission of the programme poses additional risks to the budgetary outcome in 2010.

- (9) The government gross debt ratio is well below the Treaty reference value throughout the programme period. It is estimated at close to 15% of GDP in 2009, slightly up from the year before. The main contributors to the small rise in the debt ratio were the deterioration of the budgetary balance and the decline in GDP growth which to a certain extent were offset by debt-reducing stock-flow adjustment. The debt ratio is projected to stabilize broadly at the 2009 level over the programme period, mainly due to projected balanced government budgets. The risks to the expected evolution of the debt ratio, other than those also related to the deficit, appear to be broadly balanced.
- (10) The government gross debt is at a low level and the medium-term debt projections until 2020 that assume GDP growth rates will only gradually recover to the values projected before the crisis, tax ratios will return to pre-crisis levels and that include the projected increase in age-related expenditures show that the budgetary strategy envisaged in the programme, taken at face value and with no further policy change, would be enough to decrease the debt-to-GDP ratio and to allow to reach a net asset position by 2020.

- (11) The long-term budgetary impact of ageing is slightly lower than the EU average. The budgetary position in 2009, as estimated in the programme, compounds the budgetary impact of population ageing on the sustainability gap. Achieving higher primary surpluses over the medium term, as already foreseen in the programme, would contribute to reducing further the risks to the sustainability of public finances which were assessed in the Commission 2009 sustainability report<sup>4</sup> as low.
- (12) The domestic budgetary framework appears relatively strong as evidenced by the good track record of meeting the budgetary targets, although in an environment of benign macro-economic conditions. In 2009, Bulgaria mitigated the negative budgetary impact of the crisis by implementing sizeable consolidation measures. The shortcomings of the present fiscal framework are related to the existence of certain discretionary powers of the central government. In addition, the framework does not incorporate any multi-annual rules and the expenditure ceilings set in the course of the medium-term fiscal planning are binding only in the short-term. The programme does not envisage any substantial changes to the budgetary framework except for increasing the time horizon of the medium-term fiscal framework from three to four years to coincide with the government mandate and thus making the medium-term policy more predictable. The 90% budget execution rule is replaced by a provision that allows the government to offset a likely budget revenue shortfall by cutting primary expenditures below the annual appropriations. The new rule provides greater flexibility and space for discretionary consolidation policy by the government in time of a crisis. However, the lack of clearer design and definition on the implementation of the rule induces certain non-transparency in the budgetary framework.

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<sup>4</sup> In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.



- (13) The programme recognises the existing weakness in the quality of public finances. It acknowledges the need to take urgent policy action to counteract the unfavourable consequences of population aging and worsening demographic trends on the long-term sustainability of government finances. Ambitious structural reform measures are presented in the area of healthcare, education, pension system, and public and revenue administration with a view to enhancing the efficiency and effectiveness of public revenue and expenditure and increasing the growth potential of the economy to ensure sustainable convergence within the European Union. The reforms envisage optimisation of existing structures, streamlining of public employment, changing the costing and funding mechanism for health services, implementing reform measures under the newly adopted pension reform strategy, measures to reform tertiary education and R&D, and changing the model of managing public state assets.
- (14) Taking into account the risks to the fiscal targets mentioned above, the programme's budgetary strategy can be regarded as broadly in line with the requirements of the Pact and conducive to preserving macroeconomic stability and investor confidence in the Bulgarian economy. It envisages quite an ambitious structural consolidation by  $-2\frac{3}{4}$  % of GDP in 2010, with no further improvements in the following years. The planned consolidation in 2010 is not fully underpinned by measures outlined in the programme. In addition, its full achievement depends on an optimistic macroeconomic scenario with further risks coming from the upward revision of the 2009 deficit. For 2011 on, the lack of specification of measures in the programme could further undermine the envisaged adjustment path. The MTO is expected to be reached and exceeded by quite a large margin already in 2010 making the pace of structural consolidation quite ambitious in view of the economic bad times that the economy is undergoing and the risks to the budgetary strategy outlined above. The overall fiscal stance, as measured by the change in the structural balance, is restrictive in 2010, broadly neutral in 2011, and provides for fiscal relaxation in 2012. The programme's medium-term objective of maintaining cyclically adjusted surplus of  $\frac{1}{2}$ % of GDP would be achieved starting in 2010.

- (15) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data<sup>5</sup>.

The overall conclusion is that the programme's aim to maintain a sound budgetary position, reflected in planned general government balanced budgets, is considered adequate at the current economic juncture and in view of the need to contain the economy's external imbalances. The undertaken consolidation measures and the strong political commitment to fiscal discipline are expected to partially compensate the risks stemming from the slightly favourable assumptions on growth and revenue collection. In the short- to medium-term the programme foresees ambitious structural reforms that aim to strengthen the sustainability of public finances and at the same time to underpin the economic recovery. Subject to the downside risks from the still high uncertainty in the external environment, the budgetary stance would imply that the medium term objective of ½% of GDP, although more than adequately reflecting the objectives of the Pact, would be achieved throughout most of the programme period. Bulgaria faces the challenge of sustaining its catching-up process in a less benign global economic environment. At the same time keeping tight fiscal policy and restricting wage development in line with productivity growth is warranted from the need to enhance competitiveness and correct the external imbalances. In the long-run, improving the quality and sustainability of public finances requires vigorous implementation of the planned and long-delayed structural reforms and strengthening the administrative capacity.

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<sup>5</sup> In particular, data on one-off and other temporary measures, intermediate consumption, interest expenditure and some long-term sustainability data are not provided.

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

- (i) continue implementing strict fiscal policies and adopt further consolidation measures to achieve the programme target for 2010 with a view to sustaining the on-going adjustment in the external imbalances and safeguarding investor confidence in the economy; in particular, contain public sector wage growth in order to contribute to overall wage moderation and improve competitiveness;
- (ii) strengthen the efficiency of public spending by vigorously implementing the planned structural reforms in the area of public administration, healthcare, education, and pensions in order to boost productivity and ensure sustainable convergence within the European Union.

## Comparison of key macro economic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	<b>CP Jan 2010</b>	<b>6.0</b>	<b>-4.9</b>	<b>0.3</b>	<b>3.8</b>	<b>4.8</b>
	COM Nov 2009	6.0	-5.9	-1.1	3.1	n.a.
	CP Dec 2008	6.5	4.7	5.2	5.8	n.a.
HICP inflation (%)	<b>CP Jan 2010</b>	<b>12.0</b>	<b>2.5</b>	<b>2.4</b>	<b>2.8</b>	<b>2.8</b>
	COM Nov 2009	12.0	2.4	2.3	2.9	n.a.
	CP Dec 2008	12.4	6.7	4.7	4.0	n.a.
Output gap <sup>1</sup> (% of potential GDP)	<b>CP Jan 2010</b>	<b>4.8</b>	<b>-3.5</b>	<b>-5.7</b>	<b>-4.7</b>	<b>-2.5</b>
	COM Nov 2009 <sup>2</sup>	6.0	-3.1	-6.0	-5.1	n.a.
	CP Dec 2008	1.1	-0.7	-1.8	-1.4	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	<b>CP Jan 2010</b>	<b>-24.6</b>	<b>-8.2</b>	<b>-4.1</b>	<b>-1.2</b>	<b>-0.5</b>
	COM Nov 2009	-22.1	-12.8	-8.7	-6.7	n.a.
	CP Dec 2008	-22.9	-20.7	-18.4	-16.6	n.a.
General government revenue (% of GDP)	<b>CP Jan 2010</b>	<b>39.1</b>	<b>37.5</b>	<b>39.2</b>	<b>39.6</b>	<b>39.1</b>
	COM Nov 2009	39.1	38.7	38.4	38.4	n.a.
	CP Dec 2008	41.3	43.4	43.4	43.7	n.a.
General government expenditure (% of GDP)	<b>CP Jan 2010</b>	<b>37.3</b>	<b>39.4</b>	<b>39.2</b>	<b>39.5</b>	<b>39.0</b>
	COM Nov 2009	37.3	39.5	39.5	38.7	n.a.
	CP Dec 2008	38.3	40.4	40.4	40.7	n.a.
General government balance (% of GDP)	<b>CP Jan 2010</b>	<b>1.8</b>	<b>-1.9<sup>3</sup></b>	<b>0.0</b>	<b>0.1</b>	<b>0.1</b>
	COM Nov 2009	1.8	-0.8	-1.2	-0.4	n.a.
	CP Dec 2008	3.0	3.0	3.0	3.0	n.a.
Primary balance (% of GDP)	<b>CP Jan 2010</b>	<b>2.7</b>	<b>-1.3</b>	<b>0.9</b>	<b>1.0</b>	<b>1.1</b>
	COM Nov 2009	2.7	0.0	-0.3	0.5	n.a.
	CP Dec 2008	3.9	3.9	3.9	3.9	n.a.
Cyclically-adjusted balance <sup>1</sup> (% of GDP)	<b>CP Jan 2010</b>	<b>0.2</b>	<b>-0.7</b>	<b>1.9</b>	<b>1.7</b>	<b>1.0</b>
	COM Nov 2009	-0.3	0.3	1.0	1.5	n.a.
	CP Dec 2008	2.6	3.2	3.6	3.5	n.a.
Structural balance <sup>4</sup> (% of GDP)	<b>CP Jan 2010</b>	<b>0.2</b>	<b>-0.7</b>	<b>1.9</b>	<b>1.7</b>	<b>1.0</b>
	COM Nov 2009	-0.3	0.3	1.0	1.5	n.a.
	CP Dec 2008	2.6	3.2	3.6	3.5	n.a.
Government gross debt (% of GDP)	<b>CP Jan 2010</b>	<b>14.1</b>	<b>14.7</b>	<b>14.6</b>	<b>14.5</b>	<b>14.4</b>
	COM Nov 2009	14.1	15.1	16.2	15.7	n.a.
	CP Dec 2008	15.4	15.4	15.3	15.2	n.a.
<p><u>Notes:</u></p> <p><sup>1</sup> Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.</p> <p><sup>2</sup> Based on estimated potential growth of 3.4%, 3.1%, 2.9% and 3.0% respectively in the period 2009-2012.</p> <p><sup>3</sup> Eurostat is currently discussing with the Bulgarian statistical authorities the recording in national accounts of capital injections into Bulgarian energy companies, which could increase the government deficit in 2009 by 0.6% of GDP.</p> <p><sup>4</sup> Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures in the most recent programme and Commission services' autumn forecast.</p> <p><u>Source:</u> Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations</p>						