COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.05.1997
COM(97) 234 final

97/0143 (CNS)

Proposal for a

COUNCIL DECISION

providing macro-financial assistance

to Bulgaria

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

Following several preliminary contacts with the Commission, Bulgaria presented its request for macrofinancial assistance from the Community and the Group of Twenty-four industrial countries at a high level G-24/Consultative Group meeting which took place in Brussels on April 8 jointly organized by the World Bank and the European Commission. The request for assistance is in support of the government's economic programme which is the basis for a 14-month Stand-By Arrangement approved by the International Monetary Fund (IMF) board on April 11.

The purpose of the G-24/Consultative Group Meeting was to review Bulgaria's past and future stabilization and reform path and to secure the external funding needed to ensure that the government's programme was adequately financed. In the light of an agreement in principle from the Council, the Commission announced at the meeting its intention to propose Community macro-financial assistance of up to ECU 250 million in favour of Bulgaria. Other bilateral donors also gave indications of support.

Bulgaria's relations with the European Union are governed by the Association Agreement which entered into force on 1 February 1995. Bulgaria submitted on 14 December 1995 an application to become a member of the Union. This application is currently being considered by the Commission.

The Council has decided two previous macrofinancial loans in favour of Bulgaria, in each case in the context of IMF-supported economic adjustment programmes. A first loan of 290 MECU was decided in 1991 and disbursed in two instalments in 1991 and 1992. A second loan was decided in October 1992. However, because of repeated policy slippages, disbursement was much delayed. A first instalment was disbursed in 1994, while the final instalment was only disbursed in 1996.

2. ECONOMIC SITUATION AND PROGRESS WITH STABILIZATION AND REFORM

Bulgaria is beginning to emerge from its severe economic and social difficulties. Following a period of acute instability in 1996 when GDP fell by almost 10% and the first weeks of 1997, when the population suffered hyperinflation, considerable and rapid progress has been made in restoring a degree of both economic and political stability.

Bulgaria's transition to a market economy has been particularly difficult. Bulgaria started economic reform under exceptionally unfavourable conditions. The legacy of central planning included an excessively developed heavy industrial sector, based in part on artificially cheap energy and lax regulation of pollution, and systematic neglect of the traditionally competitive agricultural sector. From 1990, the country also suffered a number of serious external shocks:

- the collapse of trade with the CMEA, and in particular the USSR, on which Bulgaria was particularly dependent

- the need to import energy at world prices to replace cheap Soviet supplies

- the lack of access to commercial credit as a result of the unilateral moratorium on external debt declared in March 1990

- the effect of international embargoes on Iraq and Serbia.

In these difficult circumstances, Bulgaria made a late but bold start to economic reform. Prices of most goods were liberalized, subsidies were sharply reduced, a floating exchange rate was introduced, and the state monopoly on foreign trade was abolished. Good progress was made also in establishing the legislative basis for a market economy: by mid-1992 much of the legal framework was in place.

However, structural change was slow. Initial progress in restructuring state enterprises stalled as the political and social consensus surrounding reform began to break down. Nevertheless, agreement reached in 1994 between Bulgaria and its commercial bank creditors on a Debt and Debt Service Reduction (DDSR) operation appeared to have a healthy effect on confidence, and Bulgaria enjoyed two years of relatively good economic performance. Gross Domestic Product grew in real terms by 1.8% and 2.6% in 1994 and 1995 respectively. By early 1996 annual inflation had fallen to under 30%.

The macroeconomic recovery did not have a solid structural base, due to a lack of structural reform. From the second half of 1995, signs that the recovery was unsustainable began to appear. Industrial output slowed, the balance of payments weakened, and in early 1996 the national currency came under pressure on the foreign exchange market. Individuals lost confidence in the banking system, withdrew their savings and converted them into dollars. A steep depreciation of the leva got underway. This continued until February this year, by which time the leva had lost approximately 95% of its April 1996 value against foreign currencies.

Hyperinflation reduced the real value of wages and pensions to pitiful levels: in early 1997, the average monthly wage was less than US$15, while the average pension was worth no more than US$4. In response to this desperate situation, the European Union decided to allocate 20 MECU from the PHARE programme to a special programme in support of the social safety net.

3. THE MEDIUM-TERM ECONOMIC PROGRAMME OF BULGARIA

In the wake of the deep economic crisis of winter 1996/97, a new consensus behind market reforms has emerged. Exceptionally, the interim government formed pending parliamentary elections on April 19 was mandated to negotiate agreement with the International Financial Institutions and other lenders to obtain support for an economic reform programme.

The government's economic programme which formed the basis for the agreement with the IMF commits Bulgaria to the adoption of a currency board arrangement, probably in June of this year. The introduction of the currency board entails fixing the exchange rate and limiting the amount of domestic currency in circulation through a central bank guarantee to exchange domestic currency for foreign currency, at the fixed exchange rate. The success of this policy crucially depends on adherence by the government to a responsible fiscal policy. The programme also includes ambitious targets for the rapid privatization of the enterprise and banking system, price liberalization, and reform of the agriculture sector. This far-reaching package of structural reforms is expected to be supported by the World Bank through a Financial and Enterprise Sector Adjustment Loan. Additional World Bank lending will cover support to agricultural restructuring and for the improvement of the social safety net.

It is planned to complete the privatization of state enterprises and banks by the end of 1998. As confidence in the health of the banking sector is another key to successful operation of a currency board arrangement, capital adequacy requirements are to be gradually strengthened, so that all banks will have to meet the Basle requirements on capital adequacy by mid-1998. Foreign investment in the banking and enterprise sectors will also be encouraged.

Implementation of the programme has begun with liberalization of almost all prices, other than five basic foodstuffs, for which strict ceilings have been placed on budgetary subsidies. The authorities have implemented steep increases in fuel and utility prices, in order to stem losses of public enterprises in these sectors.

In the agriculture sector, land restitution will be accelerated. Combined with price liberalization and extensive privatization, this is expected to contribute to the development of a land market and a recovery in agricultural output. The land market will also be promoted through legislative reform which will facilitate leasing and mortgaging of farmland.

4. BALANCE OF PAYMENTS DEVELOPMENTS AND FINANCING NEEDS

Since the DDSR operation, Bulgaria has serviced its external obligations promptly.

In 1996, the current account of the balance of payments is provisionally estimated to have recorded a small surplus. This is expected to continue to be the case in 1997 and 1998. Bulgaria's balance of payments difficulties are concentrated in the capital account. In 1996, a large capital outflow was recorded linked to the loss of confidence in the banking system. While this should not recur, Bulgaria is faced with a net outflow of capital in the coming years due to foreign debt amortization, which is expected to be only partly offset by inflows of foreign direct investment. Bulgaria is at present unable to raise funds on the international capital markets. Combined with the need to rebuild the central bank's foreign reserves, this yields an external financing gap for 1997-98 of some US$1.9 billion.

In support of Bulgaria's reform programme the International Monetary Fund on April 11 granted Bulgaria a fourteen-month Stand-by Arrangement of SDR 372 million (US$510 million) and a proposed drawing of SDR 107 million (US$148 million) under the cereals component of the Compensatory and Contingency Financing Facility. In addition, the World Bank is expected to commit in excess of US$250 million in the form of two Financial and Enterprise Sector Adjustment Loans, an Agriculture Sector Adjustment Credit, and support for the reform of the social security system. An additional US$400 million is projected to be raised from privatization. Taking this and the contributions of the IMF and World Bank into account, the remaining residual financing gap is estimated at US$ 550 million for the programme period.

Unless this remaining gap can be closed, Bulgaria's ability to implement its structural adjustment programme and to meet its external financial commitments would be put under severe strain. Indeed, attempts to relaunch economic reform in Bulgaria could be derailed almost before they had begun. Pro-reform forces would have their position seriously undermined.

The success of the Bulgarian government's programme depends in the first instance on its vigorous implementation by the national authorities. But it also requires an appropriate response by the international community, and in particular from the Community. It is important for the Union's credibility that it provide adequate support to an Associated Country and potential future member of the Union.

5. PROPOSED FURTHER MACRO-FINANCIAL ASSISTANCE TO BULGARIA AND MAIN FEATURES OF THE LOAN

The Commission is proposing that the Community would make available to Bulgaria a balance of payments loan of up to ECU 250 million with a maximum duration of ten years. The proposed duration of the loan is consistent with the medium and long-term balance of payments outlook for Bulgaria, which is expected to face substantial financing needs for the years to come.

The assistance would be granted in the context of the present Stand-by Arrangement with the IMF and would complement resources made available by the International Financial Institutions and bilateral donors.

The assistance would be released in two instalments subject to a satisfactory track record of the country's economic programme agreed with the IMF and progress with respect to structural reforms. This will include observance of a number of performance criteria which would be agreed between the Bulgarian authorities and the Commission in consultation with the Monetary Committee. Its effective implementation would take place on the understanding that Bulgaria will continue to remain current with respect to all its external financial obligations.

As in the case of similar operations in favour of other partner countries, the Community would provide the funds through market borrowing with a guarantee by the general budget. Bulgaria would subsequently borrow from the Community. The borrowing and lending operations would be perfectly matched and without any commercial risk for the Community.

In accordance with the Guarantee Fund mechanism, the budgetary implications of a decision to make available assistance of up to ECU 250 million to Bulgaria would imply an ECU 37.5 million provisioning of the Fund.

Proposal for a

COUNCIL DECISION

providing macro-financial assistance

for Bulgaria

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal of the Commission[1],

Having regard to the opinion of the European Parliament[2],

Whereas the Commission has consulted the Monetary Committee before submitting its proposal;

Whereas Bulgaria is undertaking fundamental economic reforms and is making strenuous efforts to implement a market economy model;

Whereas Bulgaria and the European Union have concluded a Europe Agreement establishing a relationship of association;

Whereas, by Decision 91/311/EEC[3], the Council decided to grant Bulgaria medium-term financial assistance for an amount of ECU 290 million, to ensure a sustainable balance of payments by that country, and whereas, by Decision 92/511/EEC[4], the Council decided to grant Bulgaria further assistance for an amount of ECU 110 million;

Whereas however additional adjustment and reform measures are necessary in Bulgaria to strengthen the financial sector and to accelerate privatization;

Whereas Bulgaria has reached an agreement with the International Monetary Fund (IMF) in April 1997 on an economic programme which would be supported by a Stand-By Arrangement;

Whereas the authorities of Bulgaria have requested financial assistance from the international financial institutions, the Community and other bilateral donors, and whereas, over and above the estimated financing which could be provided from private sources and by the IMF and the World Bank, a residual financing gap of

---

1

2

3 OJ No L 174, 3. 7. 1991, p. 36

4 OJ No L 317, 31. 10. 1992, p. 94

some US$550 million remains to be covered during the programme period in order to strengthen Bulgaria's reserve position and support the policy objectives attached to the government's economic programme;

Whereas the provision by the Community of a new long-term loan to Bulgaria is an appropriate measure to support the balance of payments and to strengthen the country's reserve position;

Whereas the Community loan should be managed by the Commission;

Whereas, for the adoption of this Decision, the Treaty does not provide for powers to act other than those of Article 235,

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall make available to Bulgaria a long-term loan facility of a maximum principal amount of ECU 250 million, with a maximum maturity of ten years, with a view to ensuring a sustainable balance-of-payments situation and strengthening the country's reserve position.

2. To this end, the Commission is empowered to borrow, on behalf of the European Community, the necessary resources that will be placed at the disposal of Bulgaria in the form of a loan.

3. This loan will be managed by the Commission in close consultation with the Monetary Committee and in a manner consistent with any agreement reached between the International Monetary Fund and Bulgaria.

Article 2

1. The Commission is empowered to agree with the authorities of Bulgaria, after consultation with the Monetary Committee, the economic policy conditions attached to the loan. These conditions shall be consistent with the agreements referred to in Article 1(3).

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in co-ordination with the International Monetary Fund, that Bulgaria's economic policy is in accordance with the objectives of this loan and that its conditions are being fulfilled.

Article 3

1. The loan shall be made available to Bulgaria in two instalments. Subject to Article 2 the first instalment is to be released on the basis of the completion of the first review of the "stand-by arrangement" agreed with the International Monetary Fund.

2. Subject to Article 2 the second instalment shall be released on the basis of a satisfactory continuation of the "stand-by arrangement" and not before one quarter after the release of the first instalment.

3. The funds shall be paid to the Bulgarian National Bank.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest rate risk, or in any other commercial risk.

2. The Commission shall take the necessary steps, if Bulgaria so requests, to ensure that an early repayment clause is included in the loan conditions and that it may be exercised.

3. At the request of Bulgaria, and where circumstances permit an improvement in the interest rate on the loans, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average duration of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Bulgaria.

5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

At least once a year the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

Done at ....,

For the Council

The President

FINANCIAL RECORD

1. Title of operation

Macro-financial assistance to Bulgaria

2. Budget heading involved

Heading BO-2132 reflecting the budget guarantee for the Community loan facility to Bulgaria (to be created through an amending and/or a supplementary budget).

3. Legal basis

Article 235 of the Treaty

4. Description and Justification for the action

a) Description of the action

Provision of a Community loan (to be financed by Community borrowing on the international capital markets) in the amount of up to ECU 250 million with a view to supporting Bulgaria's adjustment and reform efforts.

b) Justification for the action

The viability of Bulgaria's external accounts heavily depends on external financial assistance from official sources.

5. Classification of the Expenditure

Obligatory

6. Nature of the expenditure

Potential activation of budget guarantee for the Community borrowing aimed to fund the loan to Bulgaria.

7. Financial Impact

a) Method of calculation

A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that this budget guarantee will not be called.

b) Effect of the action on intervention credits

Only in the case of an effective call on the guarantee.

c) Financing of intervention expenditure

In case of call on the budget guarantee:

- Recourse to the Guarantee Fund established by Council Regulation (EC, EURATOM) n° 2728 of 31 October 1994.
- In case the Guarantee Fund did not contain sufficient resources, additional payments would be called up from the budget by transfer:
  - of any margin remaining in the Reserve for guarantees;
  - of any late payments to the budget for which the budget guarantee has been activated (under article 27(3) of the Financial Regulation);
  - of any margin available under the ceiling of category 4 of the financial perspectives or redeployment therein.
- In order to fulfil its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 of the Council Regulation (EEC, Euratom) n° 1552/89 of 29.5.1989 will apply.

8. Fraud prevention measures

The funds will be paid directly to the Central Bank of the beneficiary country only after verification by the Commission Services, in consultation with the Monetary Committee and in liaison with the IMF and World Bank Services, that the macroeconomic policies implemented in this country are satisfactory and that the specific conditions attached to this assistance are fulfilled.

9. Elements of cost-effectiveness analysis

a) Grounds for the operation and specific objectives

By supporting the beneficiary country's macroeconomic reform efforts and complementing financing by the International Community provided to this country in the context of an IMF agreed programme, this assistance would underpin its transition towards a market economy, improve growth prospects and alleviate social unrest.

b) Monitoring and evaluation

This assistance is of a macroeconomic nature and its monitoring and evaluation is undertaken in the framework of the IMF-supported adjustment and reform programme that the beneficiary country is implementing.

The Commission services will monitor the action on the basis of a genuine system of macroeconomic and structural policy indicators to be agreed with the authorities of the beneficiary country. They will also remain in close contact with the IMF and World Bank services and will benefit from their assessment of the recipient country's stabilization and reform achievements.

An annual report to the European Parliament and to the Council is foreseen in the proposed Council decision, which will include an evaluation of the implementation of this operation.

10. Administrative expenditure

This action is exceptional in nature and will not involve an increase in the number of Commission staff.

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1997 AND MARGIN UNDER THE RESERVE FOR LOANS AND LOANS GUARANTEE IN FAVOUR OF THIRD COUNTRIES

(IN ECU MILLION)

Operations	Basis of the Calculation	Provisioning of the Fund [1]	Reserve Margin
			329.0 [2]
Decided operations [3]			
Project-related assistance			
EIB/MED	-14	-1.71	330.7
EIB/PVDALA	-38	-5.32	336.0
EIB/SOUTH AFR.	55	8.25	327.8
EIB/Renewal of mandates [4]	1536.5	230.48	97.3
Macro-financial assistance			
Slovakia (Cancellation)	-130	-18.20	115.5
Belarus (Suspension)	-25	-3.75	119.3
Proposed operations			
Project-related assistance			
EIB/Turkey [5]	105	15.75	103.5
EIB/FYROM [6]	35	5.25	98.3
EIB/ Croatia [7]	49	7.35	90.9
Macro-financial assistance			
Georgia, Armenia and, if appropriate, Tajikistan [8]	170	25.50	65.4
FYROM [9]	40	6.00	59.4
Bulgaria [9]	250	37.50	21.9

1 According to the provisioning rules provided in the Council regulation (EC, Euratom) n° 2728/94 of 31 October 1994. After a first drawing of the Guarantee Fund, and in compliance with Article 5 of the Regulation, the rate of provisioning for new operations has been increased from 14 % to 15% in 1995. New macro-financial assistance operations have been provisioned with a 15% rate.

2 Reserve amount in 1997 under the financial perspective.

3 Corrections of the amounts to be transfered to the Fund in compliance with annex to Council regulation n° 2728/94.

4 Council Decision of 14 April 1997.

5 Proposal for a Council regulation relative to a special action of financial cooperation in favour of Turkey (COM(95) 389 final).

6 Proposal for a Council decision concerning the conclusion of a cooperation agreement with FYROM (COM(96) 533 final) of 25 November 1996.

7 Cooperation agreement EC/Croatia (SEC(95) 180/final). Negotiations suspended since Summer 1995. It is therefore unlikely that this operation would be implemented in 1997.

8 Commission proposal for a Council decision (COM(97) 24 final) of 3 February 1997.

9 Commission proposal.

ISSN 0254-1475

COM(97) 234 final

DOCUMENTS

EN **01 11**

Catalogue number : CB-CO-97-225-EN-C

ISBN 92-78-19800-5

Office for Official Publications of the European Communities

L-2985 Luxembourg