COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.7.1999
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Proposal for a

COUNCIL DECISION

providing further macro-financial assistance to Bulgaria

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

Since the introduction of a comprehensive reform programme in mid-1997, the macroeconomic situation in Bulgaria has improved substantially. This programme, supported by a stand-by arrangement with the IMF, included the introduction of a currency board arrangement, a tightening of fiscal policy and renewed efforts at structural reforms. The programme yielded impressive stabilisation results. Economic growth and real wages recovered from the depressed levels of early 1997, inflation rapidly declined as the exchange rate stabilised, and foreign exchange reserves substantially increased. On the structural front, major steps were taken to advance the process of transition to a market economy. In support of the government's programme, the resources provided by the IMF and the World Bank were complemented by a balance of payments loan of ECU 250 million from the Community and additional support from the Group of Twenty-Four industrialised countries. In view of Bulgaria's compliance with the conditions specified in the Memorandum of Understanding, the two tranches of the Community loan were fully disbursed in 1998.

Last fall, the Bulgarian government presented its request for further macro-financial assistance from the Community in support of the new economic programme of the authorities which is backed by a three-year arrangement with the IMF under the Extended Fund Facility approved in last September. On 21 April 1999, the European Commission and the World Bank organised jointly a high-level G-24/Consultative Group meeting to review progress made by Bulgaria on stabilisation and structural reform, and to mobilise complementary support from official creditors to help cover the country's external financing needs for 1999. In view of the favourable opinion of the Economic and Financial Committee, the Commission announced at the meeting its intention to propose Community macro-financial assistance of up to €100 million in favour of Bulgaria. Some bilateral donors also gave preliminary indications of financial support for Bulgaria's reform programme.

Bulgaria's relations with the European Union are governed by the Europe Agreement which entered into force on 1 February 1995. Bulgaria submitted on 14 December 1995 an application to become a member of the Union. In December 1997, on the basis of the Commission's opinions, the Luxembourg European Council decided to launch an accession process comprising Bulgaria as well as the other Central and East European applicant countries and Cyprus. The Council has so far approved three macro-financial loans in favour of Bulgaria in the context of successive IMF-supported programmes.

2. ECONOMIC SITUATION AND PROGRESS WITH STABILISATION AND STRUCTURAL REFORM

Two years after the deep financial crisis of early 1997, the economic situation in Bulgaria has improved substantially. Economic difficulties, which had been building up during 1996, culminated in February 1997 in the downfall of the socialist government and a bout of hyperinflation. The landslide victory of the United Democratic Front in the April 1997 elections created the momentum for a long-awaited reform of economic policy. The newly elected government opted for a stabilisation strategy centred on a currency board regime, which the IMF agreed to support by a stand-by arrangement. The boldness of the reform programme and the strong commitment of the government to its implementation attracted additional support from the World Bank, the EU and other official creditors.

Remarkable progress in macro-economic stabilisation was achieved in 1997. After a year and a half of recession, economic activity started to recover in the second half of 1997. The currency board mechanism led to a remonetisation of the economy, which contributed to a rapid decline in interest rates. Since December 1997, the basic interest rate has fluctuated between 5 and 6%, as against about 200% in early 1997. Inflation slowed down faster than anticipated. Fiscal performance was stronger than programmed. Sharply lower nominal interest rates and higher-than-expected revenues brought the general government deficit down to 2.6% of GDP, against a revised target of 4%. A large current account surplus associated with significant foreign direct investment inflows led to a substantial increase in the central bank's foreign reserves.

Despite the less favourable external environment, economic developments continued to be positive during 1998. Following a contraction by a cumulative 17% in 1996-1997, real GDP is estimated to have grown by 4% in 1998. Inflation continued to decelerate, partly reflecting the fall in international energy and commodity prices. The end-year inflation rate was 1%, far below the 16% forecast underlying the budget.

In 1998, as in 1997, the outturn on the budget was better than planned. As a result of unexpectedly high revenues and expenditure restraint, the consolidated budget recorded a surplus of 1% of GDP, against a projected deficit of 1.7%. One-off factors led to higher-than-expected receipts from the personal income tax and the corporate tax. VAT revenues were also positively affected by changes in tax legislation.

However, developments on the external accounts were less favourable in 1998 than in the previous year. After the large surpluses recorded in 1997, the trade and current account balances moved into deficit, partly reflecting the adverse impact of the Russian crisis on the Bulgarian economy.

The stabilisation results achieved in 1997 and their consolidation in 1998 owe much to the government's commitment to the currency board arrangement (CBA). Under the CBA, the objective of the Central Bank is to foster the stability of the currency. On 1 January 1999, the deutsche mark was replaced with the euro as peg currency.

1997 and 1998 witnessed a revitalisation of structural reforms. Measures were taken to liberalise the economy, including the removal of most price controls, the lifting of export bans on agricultural products and a reduction in the import surcharge. In addition, some 80% of agricultural land have been restituted. In the state-owned enterprises, privatisation was re-launched. However, after the spurt of progress made in mid-1997, the pace of privatisation slowed down in 1998. The authorities also achieved some progress in limiting the losses of state-owned enterprises and promoting their restructuring by isolating the major loss-makers from the banking system.

In the financial sector, major reforms of the banking sector were introduced to accompany the currency board arrangement and measures were taken to strengthen prudential regulations and introduce a limited deposit insurance system. Progress was made in strengthening banking supervision and the weakest banks were closed. As a result, the financial position of the banking sector has improved significantly. However, banks still need to strengthen their balance sheets and to reduce operating costs, and they remain weak in fulfilling their role of financial intermediaries. Bank privatisation is proceeding slowly. Two of the seven state banks were privatised in the last two years.

3. THE MEDIUM-TERM ECONOMIC PROGRAMME OF BULGARIA

Since the expiration of the stand-by arrangement in June 1998, the Bulgarian authorities have started to implement an ambitious medium-term economic programme. Building on the positive results achieved since mid-1997, and recognising that much remains to be done to transform Bulgaria into a competitive market economy, the government has reiterated its commitment to reform and agreed with the IMF on a comprehensive economic adjustment and reform programme for the period July 1998-June 2001.

The authorities' programme aims to achieve strong economic growth on a sustainable basis while substantially advancing the transformation of the Bulgarian economy into a competitive market economy. The main elements of the programme are the continuation of the currency board arrangement, underpinned by prudent fiscal policies and structural reforms. The authorities intend to maintain an underlying broadly balanced budget with allowance for an actual deficit of up to 2% to cover the transitional costs of structural reform and higher public investment in infrastructure. To increase medium-term fiscal sustainability, the programme includes measures to improve fiscal transparency, strengthen the efficiency and administration of the tax system and reform the major expenditure systems (social assistance, health care and pensions).

The medium-term programme focuses on privatisation as the most effective means of strengthening financial discipline in state-owned enterprises and banks. The government plans to complete the privatisation of all commercial enterprises, as well as a significant part of the utilities, by end-1999. Until privatisation takes place, financial discipline in state-owned enterprises will be strengthened through a better enforcement of incomes policy, the continuation of the isolation of loss-making companies from the banking system and increased application of bankruptcy legislation. In the financial sector, the authorities intend to privatise the remaining major state-owned banks. Bank privatisation together with the establishment of an appropriate legal and regulatory framework will help increase the level of financial intermediation, while a stronger banking supervision should contribute to further improving the financial position of the banking system. Other structural reform and liberalisation measures include reform of the energy sector, further liberalisation of the exchange and trade regimes, liberalisation of agricultural policies, and legal and judiciary reforms needed for a well-functioning market economy.

4. BALANCE OF PAYMENTS DEVELOPMENTS AND FINANCING NEEDS

Since the Debt and Debt-Service Reduction operation (DDSR) that Bulgaria concluded with its commercial creditors in July 1994, the country has serviced its external financial obligations regularly.

The unfavourable external environment created by the Asian and Russian crises has adversely affected balance of payments developments in 1998 and is expected to continue weakening Bulgaria's external position in 1999. The current account balance shifted from a large surplus in 1997 to a deficit estimated at 2¼ % of GDP in 1998, as imports were stimulated by the recovery of domestic demand and exports declined as a result of lower foreign demand and falling international prices for key exports. On the capital account, foreign investment inflows, which were substantial in 1997, tapered off significantly in 1998 reflecting the turmoil in the international financial markets and slow progress on privatisation. But the decline in private capital inflows was partially compensated by large disbursements from official creditors, which contributed to a further rise in the reserves of the central bank. They stood at €2.7 billion in end-1998, which is the equivalent of over 6 months of imports of goods and services.

In view of the weaker-than-expected external environment, the IMF revised the balance of payments projections for Bulgaria in late March. Excluding the effects of the Kosovo crisis, the current account deficit is now estimated to reach 4.5% of GDP in 1999, against an initial projection of a 3% deficit. Import volumes should grow moderately, while export volumes are likely to continue falling, due to low world market prices and ongoing enterprise restructuring. With regard to the Kosovo crisis, its impact on the Bulgarian economy will depend on the duration of the conflict. The main channels through which the conflict is likely to affect the Bulgarian economy are the substantial increase in transportation costs due to the closing of the border with Serbia, a loss of trade and tourism revenues, and increased uncertainty of the investment climate which will affect the confidence of foreign investors and make borrowing from international capital markets more costly.

In support of Bulgaria's reform programme, the IMF approved a three-year arrangement with Bulgaria under the Extended Fund Facility on 28 September 1998. The access to IMF financing under the arrangement is worth SDR 627.6 million (about US$ 860 million), with 12 purchases of SDR 52.3 million spread over the programme period. So far, performance under the programme has been good, making possible the release of the first three instalments of the arrangement.

Furthermore, the Word Bank envisages to support Bulgaria's reform effort by providing a total of US$365 million over 1999-2001. A Social Protection Adjustment Loan (SPAL) for a total of US$80 million was already approved in November 1998. In addition, the World Bank is prepared to provide two Financial and Enterprise Sector Adjustment Loans (FESAL) as well as adjustment loans to support reforms in the agricultural and environment sectors.

However, after taking into account the contributions from the IMF and the World Bank, the programme shows a substantial financing gap over the period 1999-2001. According to the revised projections presented by the IMF at the Joint G-24/Consultative Group meeting, excluding the impact of the Kosovo crisis, the residual financing gap for 1999 is estimated at US$500 million. In the case of a crisis quickly resolved, the conflict would entail an increase of the financing gap for 1999 by some US$100 million. Alternatively, assuming a prolonged crisis, the additional financing gap arising from the conflict could be in the range of US$300-400 million.

Unless the remaining gap can be closed, Bulgaria's ability to implement its adjustment and reform programme and to meet its external financial commitments would be put into question. The success of the Bulgarian government's programme depends in the first instance on its vigorous implementation by the national authorities. In this regard, in view of the continuing deterioration of the country's external environment, the Bulgarian authorities have committed themselves to redoubling efforts at structural reform and to tightening fiscal stance. But financial support is also required from the international community, and in particular the European Union, as Bulgaria is a candidate country whose progress towards accession depends greatly on the successful implementation of the programme.

5. PROPOSED FURTHER MACRO-FINANCIAL ASSISTANCE 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 €100 million with a maximum duration of ten years. The proposed duration of the loan is identical to that of the previous loan to Bulgaria and consistent with the medium and long-term balance of payments outlook for the country, which is expected to face substantial financing needs for the years to come.

The assistance would be granted in the context of the present extended arrangement and would complement resources made available by the International Financial Institutions and bilateral donors.

The assistance would be released in two tranches subject to a satisfactory track record of the country's economic programme agreed with the IMF and progress with respect to structural reforms (including observance of a number of performance criteria). The Economic and Financial Committee would be consulted prior to each disbursement.

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 €100 million to Bulgaria would imply a €14 million provisioning of the Fund.

Proposal for a

COUNCIL DECISION

providing further macro-financial assistance to Bulgaria

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 308 thereof,

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

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

(1) Whereas the Commission has consulted the Economic and Financial Committee before submitting its proposal;

(2) Whereas Bulgaria is undertaking fundamental economic reforms and is making substantial efforts to establish a well-functioning market economy;

(3) Whereas Bulgaria and the European Union have signed on a Europe Agreement establishing a relationship of association;

(4) Whereas the European Council at its meeting in Luxembourg in December 1997 decided to launch an accession process comprising Bulgaria along with the other Central and East European applicant countries and Cyprus;

(5) Whereas Bulgaria has reached an agreement with the International Monetary Fund (IMF) in September 1998 on an arrangement under the Extended Fund Facility (EFF) in support of the authorities' adjustment and reform programme;

(6) Whereas the World Bank has adopted a three-year Country Assistance Strategy for Bulgaria in April 1998, which envisages substantial adjustment and investment financing in support of Bulgaria's reform efforts in priority areas;

(7) Whereas the authorities of Bulgaria have requested financial assistance from the international financial institutions, the Community and other bilateral donors; whereas, over and above the estimated financing which could be provided by the IMF and the World Bank, an important residual financing gap remains to be covered during the programme period in order to strengthen the country's reserve position and support the policy objectives attached to the government's reform programme;

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[1] OJ C

[2] OJ C

(8) Whereas a Community long-term loan to Bulgaria is an appropriate measure to help ease the country' external financial constraints, supporting the balance of payments and strengthening the reserve position;

(9) Whereas the Community loan should be managed by the Commission;

(10) Whereas the Treaty does not provide, for the adoption of this Decision, powers other than those of Article 308,

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 100 million euro with a maximum maturity of ten years, with a view to ensuring a sustainable balance of payments situation and comforting the implementation of the necessary structural reforms.

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 Economic and Financial Committee and in a manner consistent with any agreement reached between the IMF and Bulgaria.

Article 2

1. The Commission is empowered to agree with the authorities of Bulgaria, after consultation with the Economic and Financial 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 Economic and Financial Committee and in co-ordination with the IMF, that the economic policy in Bulgaria 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 tranches. Subject to Article 2, the first tranche is to be released on the basis of a satisfactory track record of Bulgaria's macroeconomic programme in the context of the present EFF arrangement agreed with the IMF.

2. Subject to Article 2, the second tranche shall be released on the basis of a satisfactory continuation of Bulgaria's adjustment and reform programme 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 terms and 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 maturity of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the 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 Economic and Financial 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 of the implementation of this Decision.

Done at Brussels,

For the Council
The President

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1999 AND MARGIN UNDER THE RESERVE FOR LOANS AND LOAN GUARANTEES IN FAVOUR OF THIRD COUNTRIES

(EUR million)

Operations	Basis of the calculation[3]	Provisioning of the Fund[4]	Reserve Margin
			346.0 [5]
Operations decided			
EIB/New mandates[6]			
CEEC	872.9	122.2	223.8
ALA	218.1	30.5	193.3
South Africa	143.5	20.1	173.2
MED	351.4	49.2	124.0
FYROM	38.5	5.4	118.6
Bosnia	42.0	5.9	112.7
EIB/Old protocols[6]			
Syria	-30	-4.2	116.9
Macro-financial assistance			
Albania III	20	2.8	114.1
Bosnia I	20	2.8	111.3
Operations proposed			
EIB/Turkey[7]	105	14.7	96.6
EIB/Croatia [8]	35	4.9	91.7
Macro-financial assistance			
Bulgaria IV[9]	100	14.0	77.7
Romania IV[9]	200	28.0	49.7

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3 The provisioning basis is calculated by applying the relevant guarantee cover rate, namely 70% (EIB loans new mandates), 75% (EIB loans old protocols) or 100% (macro-financial assistance loan).

4 In accordance with the provisioning rules in Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994, the Fund having reached its target amount on 31 December 1997, the provisioning rate has been reduced to 14%.

5 Amount of the Reserve for loans and loan guarantees in favour of third countries for 1999 under the financial perspective.

6 Annual amounts of loans scheduled to be signed in 1999 and correction of amounts already provisioned in the Fund to take account of actual signings at the end of 1998: Transfer 5/99 to the Guarantee Fund.

7 Proposal for a Council Regulation on a special financial cooperation measure for Turkey (COM(95) 389/3).

8 EC/Croatia cooperation agreement (SEC(95) 180/final).

9 Commission proposal.

FINANCIAL STATEMENT

1. TITLE OF OPERATION

Further macro-financial assistance to Bulgaria.

2. BUDGET HEADING INVOLVED

Heading BO-211 reflecting the European Community guarantee for borrowing programmes contracted by the Community to provide financial assistance for non-member countries in Central and Eastern Europe.

3. LEGAL BASIS

Article 308 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 in the international capital markets), in the amount of up to 100 million euro with a view to supporting Bulgaria's reform efforts.

b) Justification for the action

The viability of Bulgaria's external position 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

The evaluation of the amount of the assistance deemed necessary is based on the present estimates of Bulgaria's residual external financing needs.

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 the budget guarantee will not be called.

b) Effect of the action on intervention credits

Activated only in the case of an effective call on the guarantee.

c) Financing of the 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 of the Economic and Financial Committee and in liaison with the IMF and World Bank Services, that the macro-economic policies implemented in these countries 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 Bulgaria's macroeconomic reform efforts and complementing financing by the International Community provided in the context of the IMF agreed programme, this assistance would ease the country's external financing constraints, would underpin its transition towards a market economy, and would improve its growth prospects.

b) Monitoring and evaluation

This assistance is of macro-economic nature and its monitoring and evaluation is undertaken in the framework of the IMF-supported adjustment and reform programme that Bulgaria is implementing.

The Commission services will monitor the action on the basis of a genuine system of macro-economic 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 Bulgaria's 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.