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Focus Notes: Bulgaria

Poor fiscal performance compels the government to revise 2010 target

The budget executions in Q1 2010 showed that the 0.7%-of-GDP deficit target stipulated in the initial budget, approved in last December, was unrealistic. The cash-based budget deficit increased to BGN 1.67 bn in Q1 or 2.5% of the projected full-year GDP compared to a surplus of 0.8% of GDP in Q1 2009. Preliminary official estimates indicated a budget surplus of BGN 0.3bn in April. The recession had a widespread negative effect on overall, revenues, which declined by 19.2% yoy. VAT receipts lagged behind in Q1, fulfilling only 14.6% of the 2010 full-year target. On the other hand, increased spending on pensions and unemployment benefits weighted negatively on expenditures, which rose by 16.2% yoy. On the positive side, around one third of the budget deficit is attributed to the poor absorption of EU funds; it is anticipated that EU funds will cover this specific part of shortfall in the following months.

In view of the deteriorated fiscal situation, the government decided to amend the 2010 budget law. The new budget provides for a rise in the target of the cash-based budget deficit to 4.8% of GDP from 0.7% of GDP planned initially. It also forecasts that total revenues will be lower by BGN 2 bn or 2.9% of GDP. At the same time, the new budget institutionalized a 20%yoy cut in expenditures, which was a part of the 60 anti-crisis measures announced in late March. The government has decided to finance the resulting budget deficit through the use of the fiscal reserve instead of resorting to the bond markets or IMF funding. The government assessed that the cost of a Eurobond issue would be too high given prevailing current market conditions. Moreover, it repeatedly turned down the option of an IMF loan on the basis that such an arrangement would weigh negatively on the prospective application for ERM II entry, sending the wrong signal to the markets.

The amendments provide for a reduction of the fiscal reserve threshold to BGN 4.5 bn, compared to BGN 6.3 bn or 9.5% of projected GDP in February. The revised budget has just been approved by the tripartite council, comprised by trade unions, employers and the government. Yet, it has not yet being approved by the parliament.

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In our previous issue of New Europe, we have highlighted the need of a harder effort on behalf of the government in order to contain the budget deficit below 3% of GDP and thus avoid the activation of the excessive deficit procedure. Hence, the revision of the law came as no surprise; it does a reality check to the budget execution and brings the fiscal target to a more realistic and attainable level.

Nevertheless, the fiscal situation in Bulgaria is much healthier than in other EU member states even after this revision. The revised draft of the budget foresees that the 2010 fiscal deficit in ESA 95 terms (EU methodology which calculates the deficit on an accrual basis) would reach 3.9% of GDP. Minister of Finance Simeon Djankov has vowed to maintain it below 3%. Even if this is not fully achieved, the fiscal performance would favorably compare to that of the rest of EU members. According to the latest EU forecasts, the EU-27 fiscal deficit will reach 7.2% of GDP in 2010. Furthermore, Bulgaria's public debt ratio stood at 14.8% of GDP which is the third lowest in the EU in 2009.

The EU commission launched earlier in May, as it was anticipated, an excessive deficit procedure against Bulgaria. For the time being, the activation of EU´s disciplinary mechanism does not pose a serious threat to the Bulgarian economy. The excessive deficit was qualified as exceptional, as it resulted from the severe economic downturn. The 2009 fiscal deficit in cyclically adjusted terms was 2.8% of GDP, below the Treaty's 3% threshold and, more importantly, it was seen as temporary. At this point, the EU Commission expects that the 2010 deficit will decline to 2.8% of GDP, though recognized that there are certain risks to that outcome. Yet, a lot will depend on the execution of the 2010 budget.

However, the revision in a broad sense represents a significant fiscal relaxation relative to the initial budget targets. Although there is no imminent risk of breaking the currency board arrangement, that relaxation is certainly not good news for the medium-term stability of it. Maintaining a sound fiscal position is a necessary, albeit not sufficient, condition to maintain public confidence on the present currency regime. The IMF has estimated the level of budget deficit that poses no risk to the macroeconomic stability at 1.8% of GDP. Moreover, IMF advised Bulgaria's government to consider all available options before tapping into the fiscal reserve to fill in the budget gap. For that reason, markets are now expected to monitor more closely the developments on the fiscal front. An illustration of this is that the 5Y-CDS spreads have jumped 57 basis points to 250 basis points since the end of March.

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