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Bulgaria: 2010 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Bulgaria

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on March 1, 2010, with the officials of Bulgaria on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 12, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of April 28, 2010.

- A Public Information Notice (PIN).

- A statement by the Executive Director for Bulgaria

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BULGARIA

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representative for the 2010 Consultation with Bulgaria

Approved by Anne-Marie Gulde and Aasim Hussain

April 12, 2010

Consultation discussions were held in Sofia, February 18–March 1, 2010. The staff team met with Minister of Finance S. Djankov, Central Bank Governor I. Iskrov, other senior officials, financial and business sector representatives, unions, representatives from international financial institutions, the diplomatic community, and the media. The mission team included Mr. B. B. Bakker (head), Ms. P. Mitra and Ms. J. Zhou (all EUR), Ms. A. Schaechter (FAD), Mr. J. Vandenbussche (MCM), and Mr. E. Vesperoni (SPR). Mr. T. Lybek (Regional Resident Representative) and Ms. I. Paliova (Resident Representative Office) assisted the mission. Ms. A. M. Gulde (EUR) joined the discussions on February 24–26. Mr. V. Yotzov (OED) attended most of the meetings. Teams from the EC, ECB, and the World Bank were also present.

Political Background: Following elections in July 2009, the center-right Citizens for European Development of Bulgaria (GERB), led by Mr. B. Borisov, the former Mayor of Sofia, formed a new minority government, with 116 out of 240 seats in the National Assembly. It has promised to crack down on organized crime and corruption and to reduce the role of the government. The largest opposition parties include the Bulgarian Socialist Party, the National Movement for Stability and Progress (the former King Simeon Saxe-Coburg's party), and the Movement for Rights and Freedom. The next parliamentary elections will take place in July 2013, while the presidential election is scheduled for October 2011.

Fund Relations and Exchange Rate Regime: The previous Article IV consultation was concluded by the Executive Board on March 4, 2009. Since July 1, 1997, the Bulgarian National Bank has operated a currency board arrangement, pegged to the euro at the rate of lev 1.95583 per €1. Bulgaria has accepted the obligations of Article VIII, Sections 2–4, and maintains an exchange system free of restriction on the making of payments and transfers for current international transfers.

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I. STAFF APPRAISAL AND EXECUTIVE SUMMARY

1. **In the years that preceded the global economic and financial crisis, large capital inflows into Bulgaria generated a domestic demand boom.** This brought strong GDP and employment growth, but also widened the current account deficit to very high levels, and led to an overheating of the economy, with high wage growth and double-digit inflation.

2. **The boom came to an end in the fourth quarter of 2008, amid the global crisis that followed the default of Lehman Brothers.** A sharp adjustment in capital inflows led to a contraction of domestic demand, while the recession in Bulgaria's trading partners caused a drop in exports. As a result, GDP contracted by 5.0 percent in 2009.

3. **With capital inflows unlikely to re-reach pre-crisis levels both the private sector and public sector will need to adjust.** The private sector will need to shift resources from the non-tradable to the tradable sector. For the shift to the tradable sector to be successful, wage growth will need to slow considerably in 2010 and remain moderate over the medium term. Public policies will also need to attune to the end of the domestic demand-driven revenue boom and adjust spending growth to the new environment. Sustaining the built-up public buffers is important because private sector vulnerabilities remain considerable. Private sector external debt is 106 percent of GDP, while foreign currency debt of the non-financial private sector amounts to 80 percent of GDP.

4. **Adjusting public policies would also help prepare the country for eventual euro area membership.** The currency board has been a pillar of stability and eventual euro adoption continues to be the only viable exit strategy. Maintaining fiscal discipline and deepening structural policies will strengthen economic fundamentals and the viability of the Bulgarian economy. It will also help make a compelling case that Bulgaria can rapidly adjust its economy within the confines of the currency board, meet all the Maastricht criteria, and prevent the re-emergence of external and internal imbalances.

5. **Fiscal policy in 2010 will be challenging—notably meeting the government's cash deficit target of 0.7 percent of GDP.** On the revenue side, projections seem optimistic, in particular given the shortfalls in the second half of 2009. Recent increases in excise duties and a number of reforms to improve tax compliance are important contributions in preventing a further erosion of tax revenues. However, in the short term they may not be sufficient to offset the deterioration in receipts resulting from the macroeconomic situation and the cut in the social security contribution rate by 2 percentage points. On the expenditure side, the budget foresees a tight envelope, including a welcome freezing in public wages and general pensions, streamlining of the public administration, and stricter controlling of health care spending. The repayment of arrears built up in 2009 will further add to pressures on the cash deficit but should be swiftly pursued to prevent cascading of arrears in the private sector. Staff currently projects a cash deficit of 1.8 percent of GDP for 2010. Given the large

uncertainties on the revenue side, it will be key that the budgeted spending limits are closely adhered to avoid risking an even larger deficit.

6. **For 2011 and beyond, giving fiscal policy a larger role in stabilizing the economy can best be achieved by focusing, within a medium-term budgetary framework, on the overall spending envelope rather than on headline balances.** Targeting real spending growth in line with cautious estimates of potential GDP growth would make public spending more predictable, help prioritize spending and contain the large intra-year adjustments that have characterized the past few years. Revenue windfalls should be used to build up fiscal buffers that can be used in times when revenues fall short, while tax rate reductions would need to be compensated by further expenditure reductions.

7. **As the Bulgarian economy emerges from the crisis and shifts toward more export-led growth, fiscal policies can lend support to the adjustment also by creating room for growth-enhancing expenditure shifts.** By rationalizing the public administration and making it more efficient and effective, including in absorbing EU funds, fiscal space for expenditure in other areas could be created, including accommodating needs for higher infrastructure outlays. Containing public wage growth, through the announced public wage freeze in 2010 and increases in line with productivity over the medium term would not only serve the budget constraint but also help limit economy-wide wage growth and help competitiveness.

8. **Ensuring the sustainability of the social pension systems requires urgent reforms.** The combination of large pension increases and reductions in social security contribution rates in the past has widened the gap between pension contributions and pension expenditures, and the increases in minimum insurable incomes were insufficient to make up for the revenue losses. At the same time, in the health care system distorted incentives have led to a proliferation of hospitals, mispricing, and rising financing pressures, while satisfaction with the quality of health services remains low.

9. **Continued stability of the financial system is key to safeguarding the economic recovery.** The main challenge for the banking system will be to absorb the increase in non-performing loans that Bulgaria, like other countries, is currently experiencing. Thanks to prudent regulation, the banking system has built up substantial buffers during the boom years. Nevertheless, supervisors' enforcement of a cautious dividend policy continues to be appropriate. Contingency planning remains of the essence in Bulgaria as elsewhere, and in that respect the recent creation of a financial stability unit at the BNB is welcome.

10. **It is proposed that the next Article IV consultation be held on the standard 12-month cycle.**

II. Introduction

11. **This year's Article IV Consultation focused on how Bulgaria can adjust to the end of the capital-inflows boom.** Previous concerns that the global crisis might trigger a balance of payments or banking crisis have not materialized, and the downturn has led to a correction of previously built-up flow imbalances, although stock imbalances and vulnerabilities remain high. However, while capital inflows will, over time, recover somewhat from the low levels during the crisis, they will mostly likely remain well below the unsustainable levels experienced before 2009, and both the private sector and public sector will need to adjust to lower capital inflows.[1]

Box 1. Bulgaria's Reactions to Past IMF Advice

Bulgaria and the IMF have maintained excellent relations, as reflected in the successful completion of a series of Stand-By Arrangements. In recent years, the government has maintained, in line with IMF advice, a prudent fiscal policy and built up large fiscal reserves, thus providing strong support to the currency board.

Last year's staff report noted that with the end of the domestic demand and fiscal revenue boom, expenditure growth would need to slow substantially. The new government that came into office in mid-2009 heeded this advice, and reversed much of the large spending increases that had occurred in the first half of the year. Many of the key recommendations of the 2008 FSAP update mission and the FAD TA missions on tax administrations are being implemented.

III. The Global Crisis and the End of the Capital-Inflows Driven Boom

A. The Boom of 2003–08

12. **Between 2004, when agreement was reached on EU accession, and 2008, Bulgaria experienced a surge in capital inflows and a credit boom.** Inflows were driven by expectations of rapid convergence with the EU, and were further boosted by the confidence-enhancing effect of the currency board and strong fiscal policy. By 2008, net inflows had increased to about 34 percent of GDP—one of the highest among emerging market economies. Boosted by capital inflows, credit to the private sector rose rapidly, and the credit-to-GDP ratio climbed from 35 percent in 2004 to 73 percent in 2008.

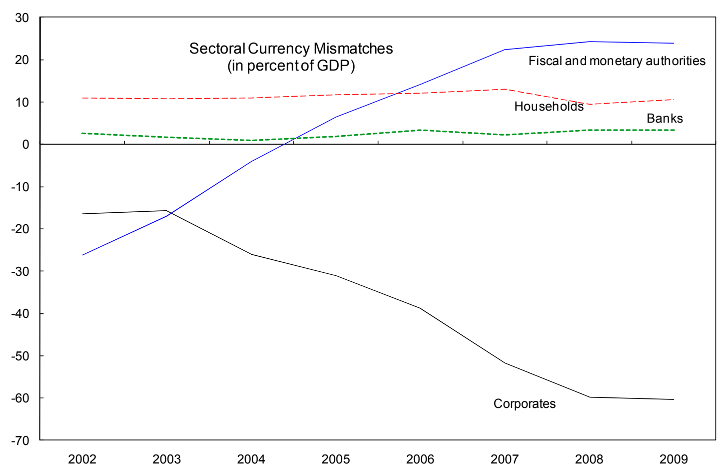
13. **The surge in inflows generated strong GDP growth, but also a sharp widening of external and internal imbalances.**

[1] Experience in previous EMC-crises suggests that after capital inflows-driven booms have ended, capital inflows tend to remain depressed for a considerable time.

- Real GDP grew by more than 6 percent annually, leading to a significant narrowing of the income gap with Western Europe.
- As the increase in domestic demand outpaced GDP growth, the current account deficit widened from 5.5 percent of GDP in 2003 to 24 percent of GDP in 2008.
- With unemployment dropping and the labor market tightening, wage growth accelerated to a peak of 25 percent in June 2008. The overheating of the economy, together with rising food and oil prices, resulted in a surge of inflation, which peaked at 14.7 percent in June 2008.
- The overheating of the labor market resulted in a real exchange rate appreciation. Between the third quarter of 2006 and the third quarter of 2008, the unit labor cost (ULC)-based real effective exchange rate (REER) appreciated by 26 percent, while the CPI-based REER appreciated by about 16 percent.
- GDP growth was to a large extent been driven by activities in the non-tradable sectors—in particular financial services, real estate and construction.[2]

14. **As a result of the capital inflows boom, private sector balance sheet vulnerabilities became large.**

- Foreign currency mismatches—largely in euros—have become substantial. Foreign currency debt of the non-financial corporate sector stands at 80 percent of GDP; of households 10 percent of GDP.
- External debt, which is mostly owed by the private sector, increased to 111 percent of GDP by end-2009. Sixty percent of external debt is intercompany debt and debt owed by banks –which is largely debt owed by subsidiaries to their parent



Sources: BNB; Fund staff estimates.

[2] Construction and real estate business contributed more than half of gross valued added (GVA) growth between 2004 and 2008H1, raising its share in GVA from 20.7 percent to 24.5 percent. During the same period, average housing prices increased by more than 150 percent, with prices in Sofia and resort areas rising even faster.

banks, which reduces concerns about debt sustainability. Public sector debt, on the other hand, declined rapidly to only 16 percent of GDP (Table 1).

- The net international investment position deteriorated to minus 112 percent of GDP as of end-September 2009 (Table 2).

15. **With private sector vulnerabilities increasing, the public sector built up significant buffers.** Between 2004 and 2008, Bulgaria's fiscal surplus averaged 2.8 percent of GDP (the highest among EU new member states), which led to a sharp decline in the public debt-to-GDP ratio (from 48 percent at end-2003 to 16 percent by end-2009), and significant reserves in the fiscal reserve account (12 percent of GDP at end-2009).

Table 1. Bulgaria: Gross External Debt, 2002–09
(Percent of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009 Q3
General Government	44.9	37.4	30.1	20.4	14.7	10.7	7.6	8.2
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	44.9	37.4	30.1	20.4	14.7	10.7	7.6	8.2
Bonds and Notes	28.3	22.2	16.6	9.9	8.2	5.9	5.1	4.7
Bonds and Notes held by residents	-1.9	-2.0	-1.5	-2.0	-1.8	-1.6	-2.1	-1.7
Loans	18.6	17.2	15.0	12.5	8.3	6.4	4.6	5.2
Monetary Authorities	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks	2.5	4.5	8.2	12.2	14.1	20.0	26.6	24.0
Short-term	1.9	3.4	5.7	8.8	10.4	15.0	20.1	19.1
Loans	0.1	0.1	0.4	1.9	2.4	1.0	2.3	2.4
Currency and deposits	1.8	2.8	5.0	6.4	7.5	13.6	17.5	16.5
Other debt liabilities	0.0	0.5	0.3	0.5	0.5	0.4	0.3	0.2
Long-term	0.6	1.1	2.4	3.5	3.7	5.0	6.5	4.9
Bonds and Notes	0.0	0.0	0.0	0.5	0.6	0.5	0.1	0.1
Loans	0.6	1.1	2.4	3.0	3.1	4.5	6.4	4.8
Other Sectors	13.3	10.6	15.2	19.4	28.4	32.4	35.1	35.3
Short-term	7.3	5.2	6.6	9.2	14.0	17.4	18.3	18.4
Loans	0.9	1.5	2.5	4.3	7.6	11.9	13.3	13.8
Trade credits	6.4	3.7	4.0	4.9	5.7	5.5	5.0	4.6
Long-term	6.1	5.4	8.6	10.2	14.4	15.0	16.8	16.9
Bonds and Notes	0.0	0.0	0.0	0.2	1.2	1.1	0.8	0.6
Loans	5.8	5.3	8.6	10.0	13.2	13.9	15.9	16.3
Direct investment: Intercompany Lending	4.1	7.6	10.3	18.9	24.8	37.2	39.1	41.4
Total	65.0	60.1	63.8	70.9	82.0	100.3	108.4	108.9
Memorandum items:								
Long-term external debt	55.9	51.5	51.5	52.9	57.6	67.9	69.9	71.4
Short-term external debt	9.1	8.6	12.3	18.0	24.4	32.4	38.4	37.5
Public and publicly guaranteed external debt	48.1	39.8	33.2	23.8	18.0	14.2	11.6	12.2
Private non-guaranteed external debt	17.0	20.3	30.6	47.1	64.0	86.2	96.7	96.7

Source: BNB.

Table 2 . Bulgaria: International Investment Position, 2004–09
(Percent of GDP)

	2004	2005	2006	2007	2008	2009 Q3
International Investment Position, net	-27.6	-46.9	-60.8	-90.0	-106.1	-112.2
Assets	61.2	60.7	69.3	68.6	61.4	61.3
Direct investment abroad	-0.7	0.5	1.4	1.9	3.0	3.3
Equity capital and reinvested earning	0.3	0.5	1.1	1.6	2.9	3.1
Other capital	-1.0	0.0	0.2	0.3	0.1	0.1
Portfolio investment	3.3	3.1	3.8	3.6	3.2	3.6
Equity securities	0.1	0.1	0.5	1.0	0.4	0.5
Debt securities	3.3	3.0	3.3	2.7	2.8	3.1
Bonds and notes	2.6	2.3	2.9	2.5	2.4	2.6
Money-market instruments	0.7	0.7	0.4	0.2	0.4	0.4
Financial derivatives	0.4	0.1	0.8	0.4	0.3	0.1
Other investment	23.6	23.3	28.0	21.4	17.7	17.8
Trade credits	1.7	2.0	2.2	2.2	2.3	2.4
Loans	0.5	0.7	1.2	1.6	2.0	2.0
Monetary authorities	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0
Banks	0.4	0.6	0.5	0.8	0.9	0.9
Other sectors	0.1	0.2	0.6	0.8	1.1	1.1
Currency and deposits	10.2	11.8	18.0	15.4	12.2	12.4
Other assets	11.2	8.8	6.6	2.2	1.2	1.0
Monetary authorities	0.1	0.1	0.0	0.0	0.0	0.0
General government	11.0	8.5	6.5	1.8	0.8	0.7
Banks	0.1	0.2	0.1	0.4	0.4	0.3
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	34.5	33.7	35.4	41.3	37.3	36.6
Liabilities	88.8	107.5	130.1	158.5	167.5	173.5
Direct investment in Bulgaria	37.4	53.7	70.6	92.9	96.5	104.3
Equity capital and reinvested earning	29.3	36.2	47.1	57.9	60.0	66.0
Other capital	8.1	17.5	23.5	35.0	36.6	38.4
Portfolio investment	12.2	10.3	10.9	8.2	5.5	5.3
Equity securities	1.1	1.7	2.0	2.4	1.5	1.5
Debt securities	11.2	8.5	8.9	5.8	4.0	3.8
Bonds and notes	11.2	8.5	8.2	5.8	4.0	3.8
Money-market instruments	0.0	0.0	0.7	0.0	0.0	0.0
Financial derivatives	0.8	0.1	0.3	0.1	0.2	0.2
Other investment	38.4	43.4	48.3	57.3	65.3	63.7
Trade credits	4.0	4.9	5.7	5.5	5.0	4.6
Loans	29.0	31.7	34.6	37.8	42.5	42.4
Monetary authorities	4.4	2.6	1.0	0.0	0.0	0.0
General government	10.6	9.9	7.3	6.4	4.6	5.2
Banks	2.9	4.9	5.5	5.5	8.7	7.2
Other sectors	11.1	14.3	20.8	25.9	29.3	30.0
Currency and deposits	5.0	6.4	7.5	13.6	17.5	16.5
Other liabilities	0.3	0.5	0.5	0.4	0.3	0.2
Monetary authorities	0.0	0.0	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.0	0.0	0.0	0.0
Banks	0.3	0.5	0.5	0.4	0.3	0.2
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0

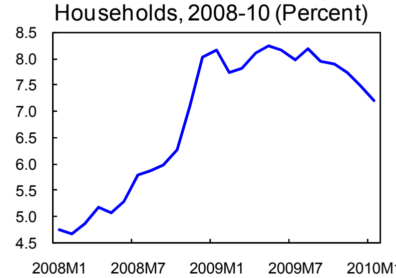
Source: Bulgarian National Bank.

B. The Global Crisis of 2008–09

16. **In the fall of 2008, the boom came to an end.** In the global crisis that followed the default of Lehman Brothers, the Bulgarian economy was hit by two shocks: capital inflows declined sharply, which reduced domestic demand, while exports were hit by the recession in Bulgaria's trading partners (Figure 1). The impact of the shocks was fully felt in 2009, when GDP declined by 5 percent—the first decline since the crisis of 1996/97:

- Many advanced countries' banks, which were confronted with liquidity and capital shortages, saw themselves forced to stop new lending or even deleverage. In a change of strategy, they advised their subsidiaries that credit growth would henceforth need to be financed from local deposits rather than from parent funding. In addition, the market for syndicated loans froze. As a result, flows to banks declined from +10 percent of GDP in 2008 to -2½ percent in 2009. The decline in foreign funding resulted in strong competition for deposits and rising interest rates, while credit growth came to near-standstill (Figure 1A).

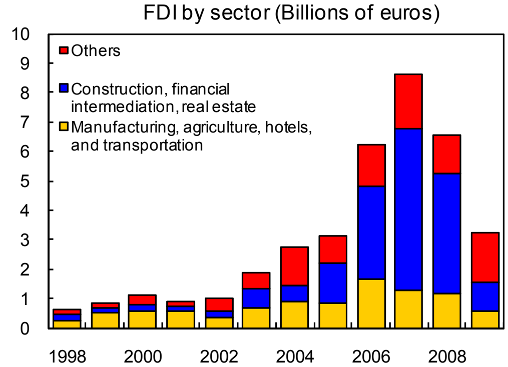
Interest Rate on New Time Deposits of Households, 2008-10 (Percent)



Source: Bulgariam National Bank.

- FDI and other capital inflows declined as well, although not as sharply. FDI decreased from 18¼ percent of GDP in 2008 to 9¾ percent in 2009 with the sharpest drop in the real estate sector, falling by 75 percent in 2009. Overall, capital inflows declined from 34.2 percent of GDP in 2008 to 7.8 percent in 2009.

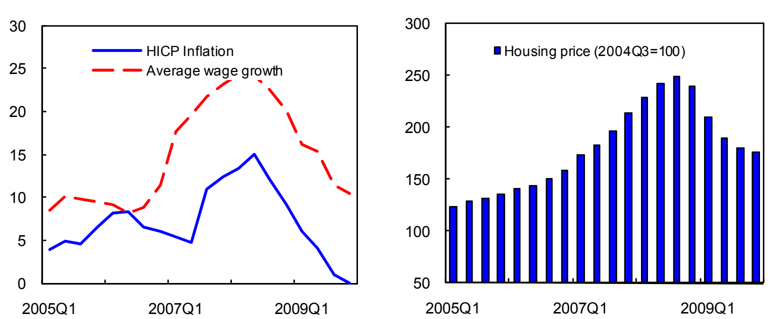
FDI by sector (Billions of euros)



Source: NSI.

- The reduction in capital inflows and the associated end of the credit boom led to a sharp drop in domestic demand and asset prices (Figure 2). Domestic demand contracted by 15 percent in 2009, as

Bulgaria: Inflation, Wages, and Housing Prices



Source: BNB and IMF Staff calculations.

investment plunged by 28.5 percent), and credit stagnated. Housing prices slumped by 29 percent from their peak in Q3 2008, and the stock market corrected sharply.[3]

- At the same time, exports were hit by the recession in Bulgaria's trading partners. Exports declined strongly in the fourth quarter of 2008 and the first quarter of 2009, and stabilized thereafter. For the year as a whole, they declined by 22½ percent (10 percent in volumes).

17. **The downturn led to a correction of previously built-up private sector flow imbalances** (Figure 3). The current account deficit narrowed from 24 percent in 2008 to an estimated 9½ percent of GDP in 2009, and inflation dropped to 1 percent—from 15 percent in mid-2008. Nevertheless, stock imbalances remain high (Figure 4).

18. **The decline in domestic demand led to a drop in fiscal revenues, but strong corrective action in the second half of the year ensured that this did not result in a large fiscal deficit** (Figure 5).

- **In the first half of the year, in the run-up to the elections, expenditure continued to increase rapidly** (growing by 24.5 percent y/y in the first seven months) even though revenue dropped by 11 percent. Most of the expenditure surge came from pension increases (by 17 percent) and higher capital spending (66 percent increase in the first seven month of 2009 y/y). Revenue shortfalls were exacerbated by a reduction in social security contribution rates by 2.4 percentage points.

- **Decisive correction was taken in the second half of the year.** The new government that took office in July 2009 implemented sharp across-the-board spending cuts, in particular for maintenance and capital spending. At the same time, most end-year and other bonus payments in the public sector were scrapped, allowing to contain overall cash spending growth in 2009 to less than 1 percent. Overall, the government managed to contain the cash deficit to 0.8 percent of GDP. However, the cash deficit was artificially lowered by the build-up of arrears, largely to the construction sector, and the accrual based deficit widened to around 1.9 percent (in ESA-95 terms).

19. **The banking system remained stable (Figure 6).** The end-2009 aggregate Capital Adequacy Ratio (CAR) was 17 percent—well above the BNB regulatory minimum of 12 percent and the EU minimum of 8 percent—and the Tier I ratio increased to 14 as a result of conversion of Tier II capital. Asset quality has deteriorated since the third quarter of 2008 but banks have been able to generate enough profits to cover the associated impairment costs, and the coverage ratio of non-performing loans (NPLs) by provisions of 80 percent is

[3] As of March 15, 2010, the blue chip SOFIX index is still some 78 percent below its peak reached in Q3 2007.

comfortable. Contrary to fears expressed by some international market participants 18 months ago, foreign parent banks have broadly maintained their level of funding of their local subsidiaries and the BNB is unlikely to ask for commitment letters from parents of systemic banks as it did last year.

20. **Nevertheless, aggregate financial soundness indicators mask substantial heterogeneity across institutions.** A few banks have a CAR just above 13 percent; several domestic banks maintained positive profitability but provisioned less than their peers; and most banks have limited the increase in NPLs by renegotiating with borrowers facing difficulties. Banks that were the most expansionary just before the peak of economic activity face more significant challenges.

C. Outlook for 2010 and Risks

21. **The authorities agreed that an increase in exports will lead to a recovery this year, in line with other countries in the region.** Staff projects that real GDP will increase by 0.2 percent. However, domestic demand is expected to decline further, even though financial markets have stabilized (Figure 7). On the back of an unwinding investment boom, tightened credit, and weak economic activity, investment will likely drop further. At the same time, private consumption is forecast to suffer from the decline in employment. As a result, the current account deficit will continue to narrow, from 9½ percent in 2009 to 6¼ percent of GDP in 2010. Inflation is projected to remain moderate, at about 2.2 percent, almost half of which is the effect of higher excise duties; and unemployment is expected to increase from an estimated 7.8 percent in 2009 to 9.2 percent in 2010.

Real GDP Growth
(Percent)

	2008	2009	2010	2011-15
Poland	5.0	1.7	2.2	3.8
Czech Republic	2.5	-4.3	1.7	3.3
Romania	7.1	-7.0	1.3	5.0
Bulgaria	**6.0**	**-5.0**	**0.2**	**4.0**
Hungary	0.6	-6.3	-0.2	3.6
Estonia	-3.6	-14.1	-0.4	3.2
Lithuania	2.8	-15.0	-1.5	3.6
Latvia	-4.6	-18.0	-4.0	3.7

Sources: IMF WEO database.

22. **Risks to the outlook are significant.** On the upside, a stronger-than-expected global recovery could boost Bulgarian exports and growth. On the downside, the main risk is a reversal of parent funding to their Bulgarian subsidiaries (Section IV). This risk could be exacerbated by renewed turmoil in global financial markets and concerns about sovereign debt sustainability of euro area countries.

Current Account Balance
(Percent of GDP)

	2007	2008	2009	2010
Romania	-13.5	-12.4	-4.5	-5.8
Bulgaria	**-26.8**	**-24.0**	**-9.4**	**-6.2**
Slovak Republic	-5.3	-6.5	-3.0	-3.3
Poland	-4.8	-5.1	-1.6	-2.4
Czech Republic	-3.1	-3.1	-2.1	-1.7
Hungary	-6.8	-7.2	0.4	-0.4
Lithuania	-14.6	-11.9	3.2	2.5
Estonia	-17.8	-9.4	4.8	4.5
Latvia	-22.3	-13.0	9.0	8.4

Sources: IMF WEO database.

IV. POLICY CHALLENGES

The currency board remains the appropriate exchange rate regime for Bulgaria, and euro area membership is the only viable exit strategy (section A). Maintaining the fixed exchange rate regime, however, puts restrictions on policies. Growth will need to shift towards the tradable sector (section B); fiscal policy will need to address the challenges arising from the end of the revenue boom and heightened financing pressures in the social security system (section C); while financial sector stability needs to be maintained (section D).

A. ERM-II Membership and Euro Adoption

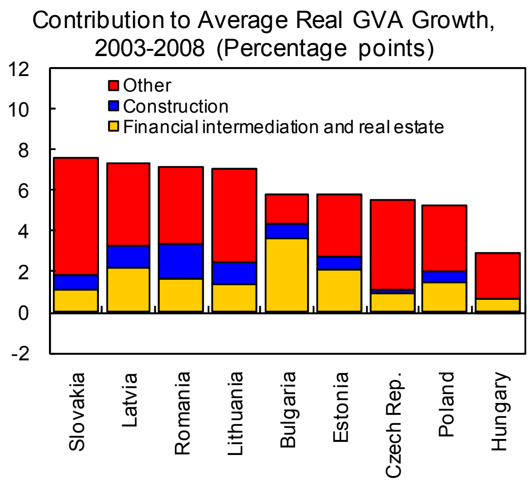
23. **The authorities and the mission agreed that the currency board remains the appropriate exchange rate regime for Bulgaria and euro area membership is the authorities' declared policy goal.** The currency board has contributed to macro-economic stability, not only by providing a nominal anchor, but also by disciplining fiscal policy. To protect the currency board, Bulgaria has run large fiscal surpluses during the boom years, built up significant foreign exchange reserves (Box 2), and these buffers served the country well when the global crisis hit—avoiding the financing difficulties that have affected other countries in the region.

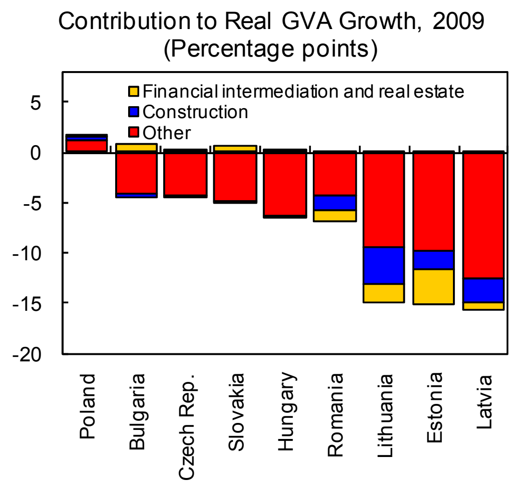
24. **The government aims to apply for ERM-II membership in the spring.** It would proceed with this after its Convergence Report has been assessed by the European Commission. The authorities felt they had strong arguments to be admitted, as they were one of the few countries in the European Union that met the fiscal Maastricht criteria, the other one being Estonia.

25. **Staff argued that the best way for Bulgaria to boost its ERM-II membership prospect would be to maintain fiscal discipline and deepen structural reforms.** This would not only strengthen economic fundamentals and the viability of the Bulgarian economy; but also help make a compelling case that Bulgaria can rapidly adjust its economy within the confines of the currency board, meet all the Maastricht criteria, and prevent the re-emergence of external and internal imbalances.

B. Shifting Growth Toward the Tradable Sector

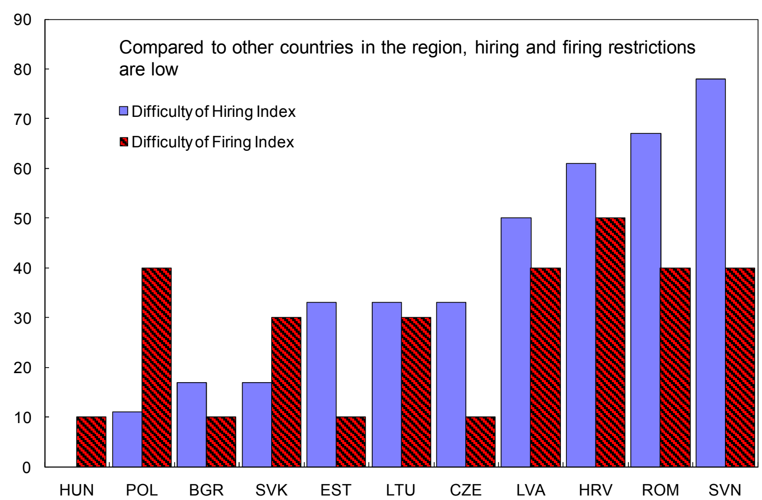
26. **With the end of the domestic demand boom, growth will need to shift from domestic demand to exports.** During the boom years, growth in Bulgaria was to a large extent driven by capital-inflows that fuelled domestic demand (Figure 8), and GDP growth was concentrated in the non-tradable sector.





Source: Haver.

27. **To facilitate the shift, wage growth, which had accelerated to over 20 percent annually during the boom years, will need to be moderate.** Average wage growth of the employed under labor contract increased from 6 percent in 2004, to 22.7 percent in 2008, resulting in a sharp appreciation of the ULC-based REER (37 percent since 2006).[4] Wage growth slowed in 2009, but, according to official statistics, in 2009Q4 was still 10½ percent y/y.



Source: Eurostat

28. **The authorities were confident that this will would happen, arguing that the labor market was flexible. Hiring and firing restrictions are low—also comp**ared to other countries in the region. Average statistics had overstated actual wage growth, as they did not include the sharp reductions in under the table payments. Another composition effect which boosted official wage growth, the authorities pointed out, was that employment had declined most strongly among the lowest paid. Overall, the authorities stressed that labor markets and private sector wages had already started to adjust; the freeze in public sector would also help contain private sector wage growth.

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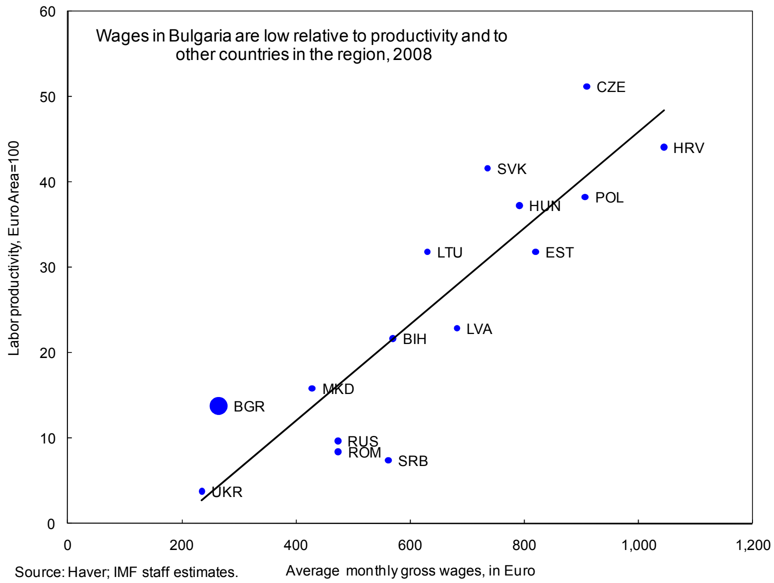
[4] The CPI-based REER has appreciated by 20 percent.



Source: Haver; IMF staff estimates.

Hourly Labor Costs, 2008
(Euros)

Bulgaria	2.42
Latvia	5.71
Lithuania	5.86
Slovakia	7.17
Estonia	7.61
Hungary	7.61
Poland	7.89
Czech Republic	9.04
Slovenia	13.98
Spain	18.10
United Kingdom	23.84
Germany	28.20
Belgium	32.45
Denmark	34.82
Switzerland	35.42

Source: Eurostat

29. **Staff and the authorities agreed that while the real exchange rate had appreciated sharply in recent years, it was not obvious that the real exchange rate level had become a problem (Box 3).** Seen over a longer time period, Bulgaria's real exchange rate appreciation has been smaller than that of most other new member states of the EU (Figure 9). Also, its market share has continued to increase, while wages remain the lowest in the EU. This judgment was further corroborated by interactions of the mission with the private sector, which did not consider the level of wages or the real exchange rate as an issue.

30. **A sustainable longer-term adjustment of the economy would be further helped by a number of supportive structural reforms (Box 4).** The business climate can be strengthened by further cutting red tape and reducing the regulatory costs for doing business, which are still considered burdensome and costly by the private sector, and by decisively tackling the high share of the informal economy and corruption. As the health of the corporate sector has deteriorated during the downturn, it is important to have strong legal and institutional frameworks in place that support corporate workouts, restructuring and bankruptcy procedures. Staff welcomed the authorities' plan to assess the effectiveness of the corporate insolvency framework and to amend it with a view to making it more supportive of fast resolutions and of trust between creditor and debtor.

C. Fiscal Policy

31. **The 2010 budget sets out a cash deficit of 0.7 percent of GDP, to be achieved through a combination of revenue and expenditure measures**.

- On the revenue side, the government has taken several measures. To increase tax compliance, the government has restructured the National Revenue and Customs Agencies, and intensified inspections to tackle particularly contraband activities. It projects that these measures will yield about 0.6 percent of GDP in increased revenue. It has also raised excises on cigarettes and electricity, and taxes on gambling and real estate (with an estimated yield of ½ percent of GDP). These revenue gains, however, will in part be offset by the reduction in social security contributions rate by 2 percentage points.[5]

- On the expenditure side, cuts are planned in a number of areas. Wages and general pensions in 2010 will be frozen and no end-year bonuses paid. The number of civil servants will be reduced by 3 percent (with greater cuts at the ministries of about 15 percent) and the originally planned increase of pensions to widowers and those over 75 years old was delayed from January 1 to July 1, 2010 (a saving of 0.2 percent of GDP). Capital spending and subsidies are budgeted to rise; but the increase is contingent on the expected higher absorption of EU funds and could be halted if absorption falls short of targets.

Bulgaria: General Government Operations, 2007–10
(In percent of GDP unless indicated otherwise)

	2007	2008	2009	2010 (Proj.)	
			(Prel.)	Budget 1/	IMF Proj.
Revenue	40.7	39.5	36.3	37.7	37.1
Expenditure	37.2	36.5	37.1	38.4	38.8
Fiscal balance	3.5	3.0	-0.8	-0.7	-1.8
Revenue growth (Percent change)	20.0	14.7	-8.7	6.5	3.5
Expenditure growth (Percent change)	20.7	15.9	0.9	6.1	6.1
Average HIPC inflation (Percent change)	7.6	12.0	2.5		2.2
Public debt 1/	19.8	16.1	16.1	16.2	16.2
Structural balance (adjusted for absorption gaps) 2/	0.5	-0.1	0.1	1.0	-0.1
Structural fiscal balance (not adjusted)	2.5	1.6	0.5	1.1	0.0
Output gap 3/	2.4	3.4	-3.3	-4.5	-4.5
Nominal GDP (millions of leva)	56,520	66,728	66,256	68,061	67,210

Sources: Ministry of Finance; and Fund staff estimates and projections.
1/ Public sector debt (includes guaranteed debt).
2/ Actual fiscal balance adjusted for the automatic effects of internal imbalance (output gap) and external imbalance (absorption gap) on fiscal position. Structural balance (adjusted) = Fiscal balance - 0.4 * output gap - 0.1 * absorption gap (see Country Staff Report 07/390, Chapter III).
3/ Percentage deviation of actual from potential GDP.

32. **Staff argued that meeting the government's cash deficit would be challenging, and projected a cash deficit of 1.8 percent of GDP**. While increases in excise duties and reforms to improve tax compliance were important contributions in preventing a further erosion of tax revenues, in the short term they may not be sufficient to offset the deterioration in receipts resulting from the macroeconomic situation and the cut in the social

[5] To partly compensate for this reduction, the minimum insurance income for self-employed and farmers was raised with a view to tackling the problem of underreporting the insurance base.

security contribution rate. Moreover, the projected yields from improved tax compliance seemed optimistic, in particular given the shortfalls at end-2009 that highlighted the difficulties to achieve measurable impacts from better tax compliance in difficult economic times. On the spending side the repayment of arrears built up in 2009 would further add to pressures on the cash deficit, but should be swiftly pursued to prevent cascading of arrears in the private sector. Also, the projected savings on health care and social spending were uncertain as they depend on the implementation of reforms. Given the large uncertainties on the revenue side, it would be key that the budgeted spending limits are closely adhered to avoid risking an even larger deficit.

33. **The authorities acknowledged the risks, but noted that they were committed to not letting the deficit exceed 2 percent of GDP.** Containing the fiscal deficit with a view to supporting the currency board arrangement and preparing the way for ERM-II and euro area membership remained the authorities' overarching objective and they stood ready to take additional measures on both the expenditure and revenue side.

34. **The mission argued it would be important to shift from ad hoc fiscal measures to a medium-term strategy of fiscal policy from 2011 and beyond.** Giving fiscal policy a larger role in stabilizing the economy can be achieved by focusing, within a medium-term budgetary framework, on the overall spending envelope rather than on headline balances. Zooming in on headline balances in the past had given fiscal policy a pro-cyclical character. Targeting real spending growth in line with cautious estimates of potential GDP growth would make public spending more predictable, help prioritize spending and avoid across-the-board-cuts, and contain the large intra-year adjustments that have characterized the past few years. Revenue windfalls should be used to build up fiscal buffers that can be drawn down in times when revenues fall short. The authorities agreed with the desirability of a greater medium-term orientation, particularly in the light of lower revenues.

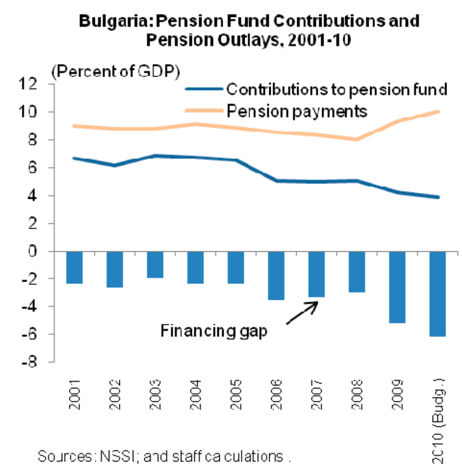
35. **Within such a medium-term framework any tax rate reductions would need to be compensated by further expenditure cuts.** The authorities are well aware that lowering the social security contributions rates further, an announced element of the government's fiscal strategy to reduce the cost of labor and support competitiveness, would widen the financing gap of the social security system and require larger government transfers. This would put at risk the government's medium-term balanced budget targets and the sustainability, in particular of the pension system. Staff also advised against a cut of VAT rates as the budget relied heavily on this source of income[6] and with the end of the demand boom shortfalls are expected to be significant for years to come. The authorities agreed that

[6] At 55 percent of total revenue, Bulgaria has the highest share of indirect taxes in the EU.

there might not be space for further tax rate reductions, and noted that they would only cut tax rates further, if there was fiscal space.

36. **Staff argued that as the Bulgarian economy shifts toward more export-led growth, fiscal policies can lend support to the adjustment process needs in a number of ways.** This includes not only containing the overall spending envelope, but also creating room for growth-enhancing expenditure shifts, including accommodating needs for higher infrastructure outlays. Priority should be given to the following areas (see also Box 4):

- Ensuring the sustainability of the social pension systems requires urgent reforms. The combination of large pension increases and reductions in social security contribution rates in the past has widened the gap between pension contributions and pension expenditures, and the increases in minimum insurable incomes were insufficient to make up for the revenue losses. While government transfers averaged about 3 percent of GDP until 2008, they have surged to 5.2 percent in 2009, and are expected to rise further to 6.2 percent in 2010, as a result of the carry-over of the sharp pension increase in 2009. This gap can be reduced by a combination of the envisaged slowing of pension increases over the next years, after the freeze in 2010, an adjustment of the pension system parameters—including an increase in the retirement age or the minimum years of contribution—addressing the underreporting of insurable income, as well as a revision of those parameters that have created inefficiencies in the system, including weaknesses in management of disability pensions.



- At the same time, distortions in the health care system need to be addressed. Due to mispricing and other distorted incentives in particular hospitals have proliferated in recent years (122 new hospitals had been created since 2004; about a 40 percent increase) and created financing pressures for the public health insurance fund. A comprehensive health care reform, with a view to improve the efficiency and quality of the health care system is needed.[7] The government's on-going reform efforts aim at

[7] Bulgaria has one of the highest numbers of hospitals and an above average number of hospital beds per capita in the EU as well as longer hospital stays, lower bed occupancy rates, and an above average share of non-wage spending.

mitigating the weaknesses in the health care system, including by rationalizing the in-patient care. Swift completion of a broad-based health care reform will be crucial.

- By rationalizing the public administration and making it more efficient and effective, including in by raising the poor absorption of EU funds, fiscal space for expenditure in other areas could be created. This is particularly needed to complete the delayed agenda for upgrading Bulgaria's public infrastructure and avoid it becoming a bottleneck to economic growth as well as through other productivity-raising measures, including in education and training.

- Containing public wage growth, through the announced public wage freeze in 2010 and increases in line with productivity over the medium term would not only serve the budget constraint but also help limit economy-wide wage growth and help competitiveness.

- A renewed push for privatization would not only enlarge the role of the private sector, but also yield resources that could be used to replenish the fiscal reserve account.

37. **The authorities broadly agreed on these issues, including the need for fiscal structural reforms.** They noted that health care reforms were already underway with the goal of raising the system's efficiency while improving quality of care. Eligibility criteria to obtain funds from National Health Insurance Fund had been tightened and would soon result in the closure of many hospitals. Moreover, the authorities are in the process of developing quality standards, conducting a cost analysis, and review the pricing policies of medication. On pension reforms, the authorities noted that an advisory council of experts had been set up to develop reform proposals. Improving the absorption of EU funds is a priority of the government as reflected in the recent nomination of a Deputy Prime Minister in charge of this issue.

D. Financial Sector Stability

38. **The mission and the BNB agreed that existing capital buffers, together with further countercyclical macro-prudential measures should allow the banking system to absorb the increase in NPLs and associated provisions.** Both the BNB and the mission expect a further increase of the NPL ratio from 6½ percent at end-2009 to 10–10½ percent in 2010 under the baseline scenario.[8] Even if banking sector earnings could come under

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[8] The mission's and BNB's methodology were very similar: the mission used an estimated relationship between the NPL ratio and the output gap, while the BNB's methodology related the NPL ratio to the cumulative GDP loss relative to the pre-crisis GDP growth trend.

greater pressure this year as a result of greater loss recognition and lower collateral values, capital buffers are large. These buffers were further boosted by the BNB's decision in March 2010 to align its risk-weights to less conservative EU standards. This decision, which is a further step in the BNB's countercyclical regulatory policy, added about 1 percentage point to the aggregate CAR. In addition, the BNB has asked banks to fully retain 2009 earnings and has decided to allow the inclusion of previous year's audited earnings in the calculation of own funds prior to a decision taken at the shareholders' meeting.

39. **Another source of risk is a reversal of parent funding to their Bulgarian subsidiaries.** With many subsidiaries operating with a loan-to-deposit ratio well above 100, the banking system crucially depends on parent funding for the extension of credit. Although all foreign-owned institutions appear adequately capitalized and sufficiently liquid at the current juncture, persistent financial tensions in a parent bank's country of origin (which could result from market concerns about sovereign debt sustainability) could spill over to Bulgaria. The authorities emphasized that the BNB had appropriate tools in place for liquidity monitoring and regular exchanges of information with parent bank supervisors. Furthermore, the level of minimum reserve requirements as well as the requirement of a 15 percent coverage ratio of deposits from credit institutions, households and retail customers by liquid assets have created buffers against liquidity risk.

Bulgaria: Banking Sector

(as of end-Q4 2009)

Bank Name	Nationality of Controlling Shareholder	Total Assets (in billion leva)	Asset Market Share (in percent)	Loan-to-Deposit Ratio 4/ (in percent)
Largest banks				
Unicredit	Italy/Austria	11.5	16.3	147
DSK 1/	Hungary	8.7	12.3	126
United Bulgarian Bank 2/	Greece	8.2	11.5	156
Raiffeisen	Austria	6.6	9.4	124
Eurobank	Greece	6.0	8.5	112
First Investment Bank	Bulgaria	4.1	5.8	97
Piraeus	Greece	3.6	5.1	261
Other Greek banks				
Alpha 3/	Greece	2.2	3.2	235
Emporiki	Greece	0.5	0.7	319
Total banking system		70.9		133

Sources: BNB; and IMF staff calculations.

1/ Controlling shareholder is OTP.

2/ Controlling shareholder is National Bank of Greece.

3/ Branch (not subsidiary).

4/ Excludes deposits of financial corporations.

40. **The financial stability framework has recently been enhanced with the creation of a Financial Stability Unit at the BNB.** The mission welcomed the establishment of this new unit, which reports directly to the Governor. It will produce an annual financial stability report and will serve as the BNB's secretariat in the context of the Domestic Standing Group for Financial Stability. Other expected enhancements to the framework include the increase of the deposit insurance coverage from EUR 50,000 to EUR 100,000 by end-2010 and the inclusion of so-called preferential deposits in the set of insured deposits during 2011, in line with a new EU directive in the making.[9]

41. **The frameworks for emergency liquidity assistance and bank resolution have remained unchanged since the conclusion of the last Article IV consultation.** According to the BNB Law and BNB's Ordinance No. 6, the BNB may extend loans in the event of a liquidity risk affecting the stability of the banking system only to solvent banks experiencing acute need of liquidity that cannot be provided from other sources. Such loans may not exceed the limit fixed by the currency board arrangement. In case of need, the law would also permit the use of part of the fiscal reserve account (3.9 bn euros at end-February 2010) by the government. Following an FSAP Update recommendation, the BNB and the BDIF are currently analyzing the modalities of the introduction of purchase and assumption transactions in the bank resolution framework.

42. **The BNB believes it continues to be appropriate to give the same prudential treatment to exposure denominated in euros and in leva.** Forthcoming discussions at the EU level will soon address the question of how EU level prudential regulation could help reduce banks' indirect currency risk in countries with high foreign currency denomination of loans. The BNB explained that the Bulgarian real estate market was completely euroized and that, as a consequence, the collateral value of most euro-denominated loans was also denominated in euros, even if the borrowers' income was denominated in domestic currency.

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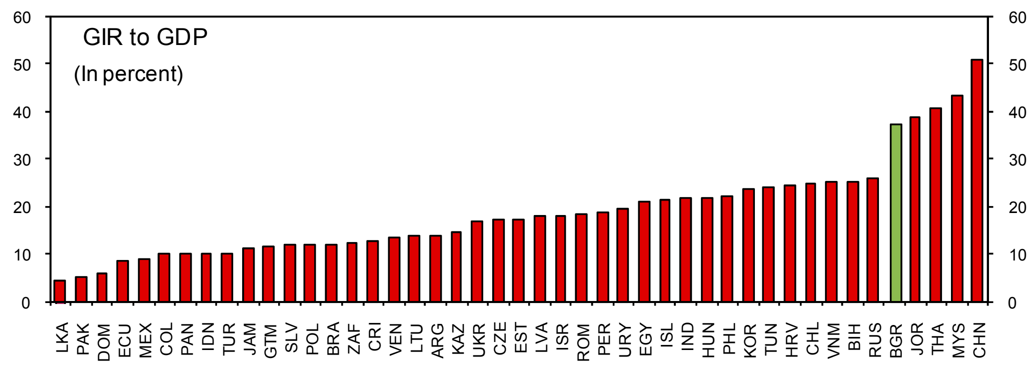
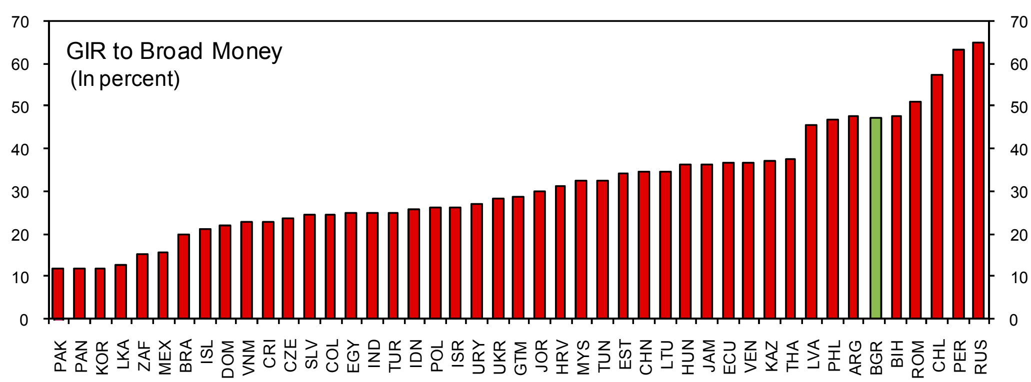
[9] As of end-March 2010, before the increase in coverage, the resources of the deposit insurance fund covered 2.6 percent of insurable deposits.

Box 2. Reserve Coverage

Reserve coverage remains relatively comfortable under the staff's baseline scenario. At end 2009, official reserves (which were equal to 36 percent of GDP) covered 182 percent of base money. Bulgaria's currency board was designed in a way that foreign currency reserves equal much more than 100 percent of the monetary base, as they also cover the government's deposit with the central bank and the deposit of the central bank's Banking Department (the latter being set aside as a safeguard against systematic liquidity problems). As a result, reserve coverage of broad money (49½ percent) is well above the median of 34 percent for emerging economies and 32 percent among emerging markets pegged regimes. Reserve coverage of short-term debt on a residual maturity basis is 75 percent. Large part of short-term debt is from Bulgarian subsidiaries to their parent banks, which reduces the roll-over risk.

Bulgaria: Reserve Coverage in International Perspective, 2008



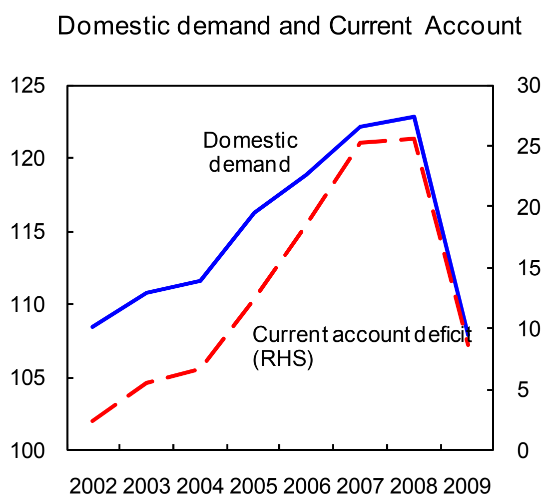


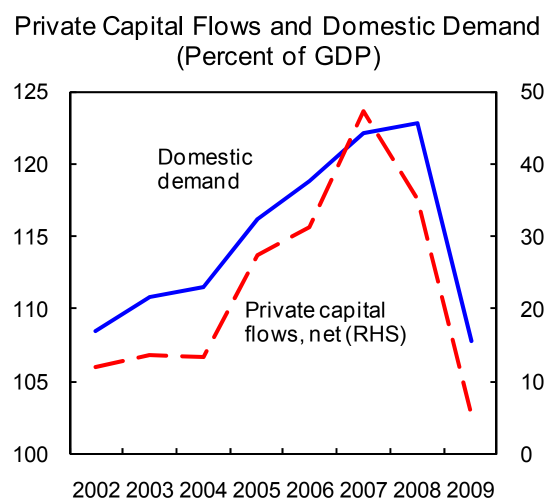
Sources: Haver Analytics; World Economic Outlook; and IMF staff estimates.

Box 3. Bulgaria: Competitiveness

As a result of the sharp reduction in the current account deficit, CGER estimates of possible overvaluation are well below last year's estimates. According to the macro balance approach, which compares the underlying current account deficit with the current account "norm"[10] the real exchange rate is now undervalued by 6.5 percent (compared to an overvaluation of 7.4 percent in last year's report). The external sustainability approach—which assesses the REER change needed to stabilize the international asset position at the current level—suggests that the REER is undervalued by 4 percent—compared to an estimate of an overvaluation of 16.1 percent last year. Even with a far more ambitious target (stabilizing the international investment position (IIP) at 60 percent of GDP), the overvaluation would be only 5.6 percent.

However, CGER-type methods, which link the current account balance to the real exchange rate level, may be less appropriate for Bulgaria, given that the large swings in the current account deficit have primarily been the result of the swings in capital inflows and domestic demand, rather than changes in the REER. The current account deficit increased between 2004 and 2007, as capital inflows generated a domestic demand boom, and came down in 2009, when capital inflows declined. Indeed, while the current account deficit came down in 2009, the CPI-based REER has continued to appreciate in 2009, rising by 2.2 percent between 2008Q4 and 2009Q4.





Source: WEO.

Other indicators of competitiveness do not suggest that the real exchange rate is overvalued. Seen over a longer time period, Bulgaria's real exchange rate appreciation has been smaller than that of most other new member states of the EU (Figure 8). Also, its market share has continued to increase, averaging that of other EU transition economies, while wages remain the lowest in the EU.

[10] See Rahman, Jesmin, "Current Account Developments in New Member States of the European Union: Equilibrium, Excess and EU-phoria" IMF Working Paper 08/92, 2008

Box 4. Structural Reforms and Convergence of the Bulgarian Economy[11]

Structural reforms can help accelerate the convergence of Bulgaria's income levels with those in Western Europe. In addition to the need for pension and health care reforms, discussed in the main text, the following reforms are most essential:

- **Public administration reform.** This reform is central to achieving higher levels of efficiency and effectiveness of public spending, improving administrative capacity to use EU funds, and further improvements in revenue collection. Optimization of administrative structures includes reorganization of units, including closing down of unnecessary or duplicated units and restructuring of staff. In addition, development of e-government may enhance transparency, improve timely delivery of services, and minimize conditions for corruption.

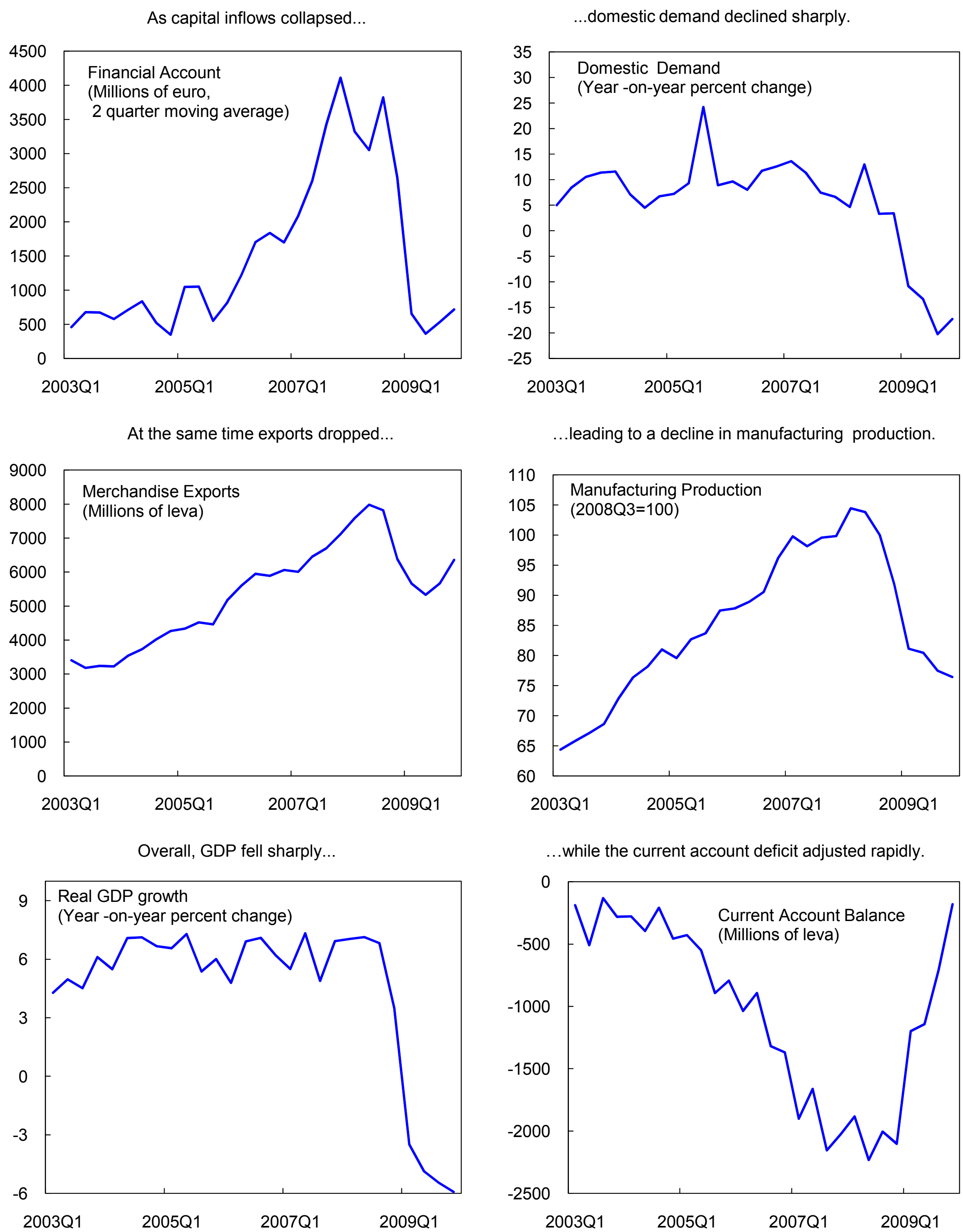
- **Education reforms:** Building on past achievement, education reforms can now focus on enhancing the quality of student learning. Specifically reforms aim at improving quality of education, promoting life-long learning, and providing equal access to education.

- **Business environment reform.** Reducing the administrative burden on businesses and enhancing entry/exit of firms is key to improving competitiveness and productivity, and to developing a knowledge-based economy. The government aims at reducing the administrative burden for businesses by 20 percent by 2012. While important improvements in business environment have been undertaken, including reduction of the start-up capital for firms, further reforms are needed to modernize the insolvency framework, extend the regulatory reform to the municipal level, streamline the construction permits regime, contract enforcement, and reduce costs of trading across borders.

Structural reforms in other areas—including energy and agriculture would also be helpful. Public investment has a critical role in addressing infrastructure and environmental challenges in the medium term. The government expects to make better use of EU funds to finance public investments. Strengthening administrative capacity to absorb EU funds including at the municipal level together with public-private partnerships can be main instruments for regional development, rural development, and environmental protection.

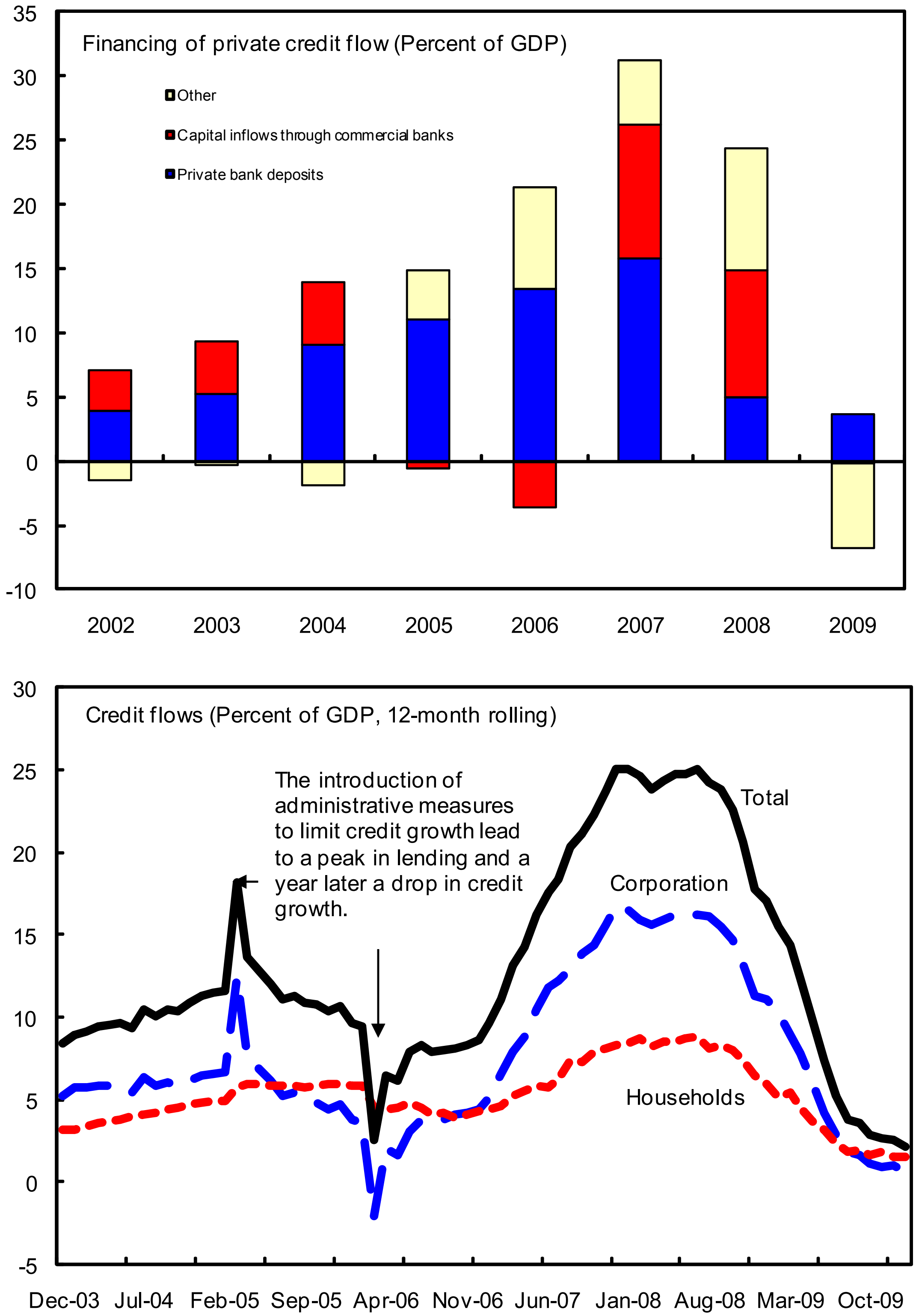
[11] Prepared by World Bank staff.

Figure 1. Bulgaria: External Shocks and Recession, 2003–09



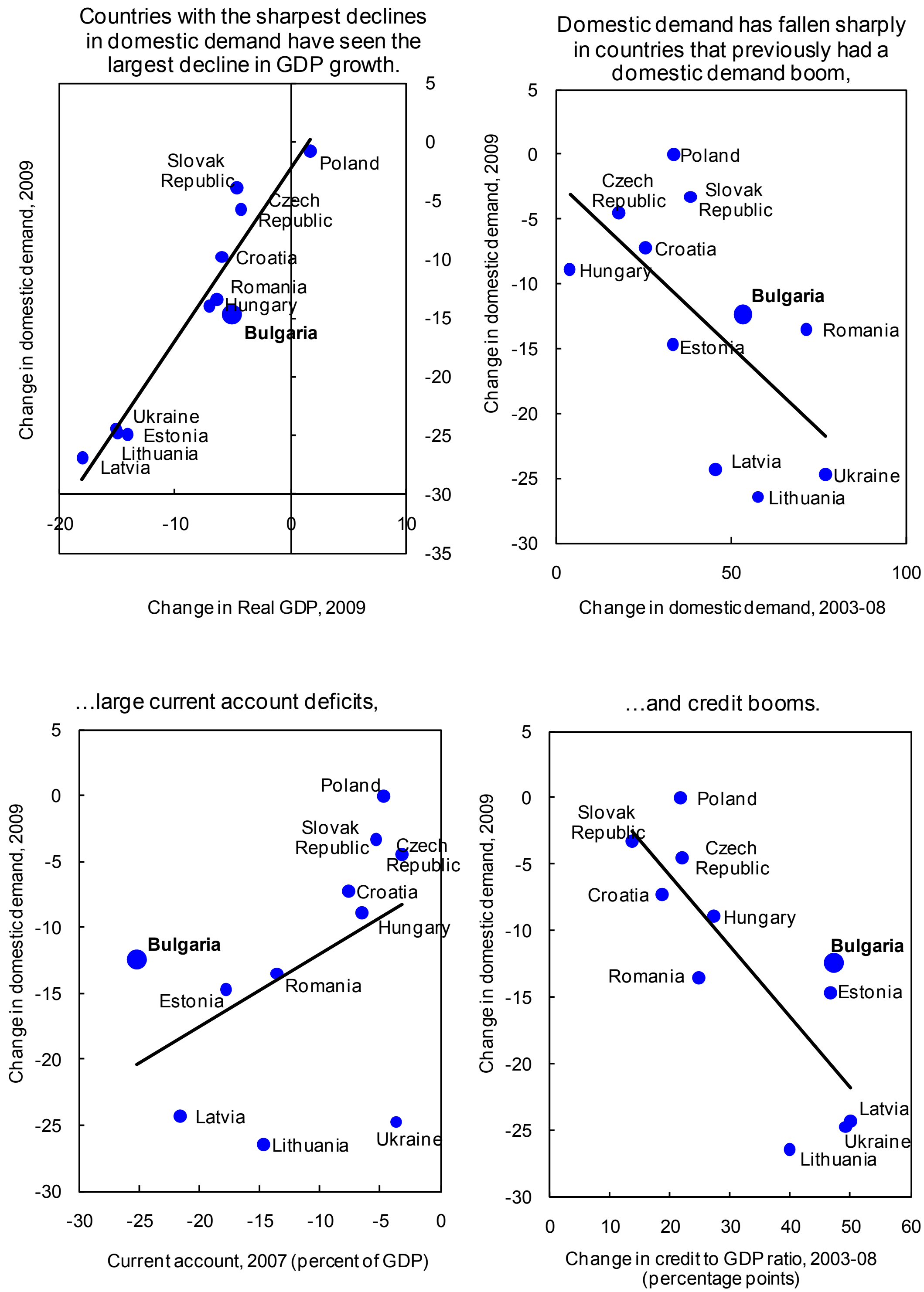
Source: Haver; IMF staff estimates.

Figure 2. Bulgaria: Capital Inflows and Credit Boom



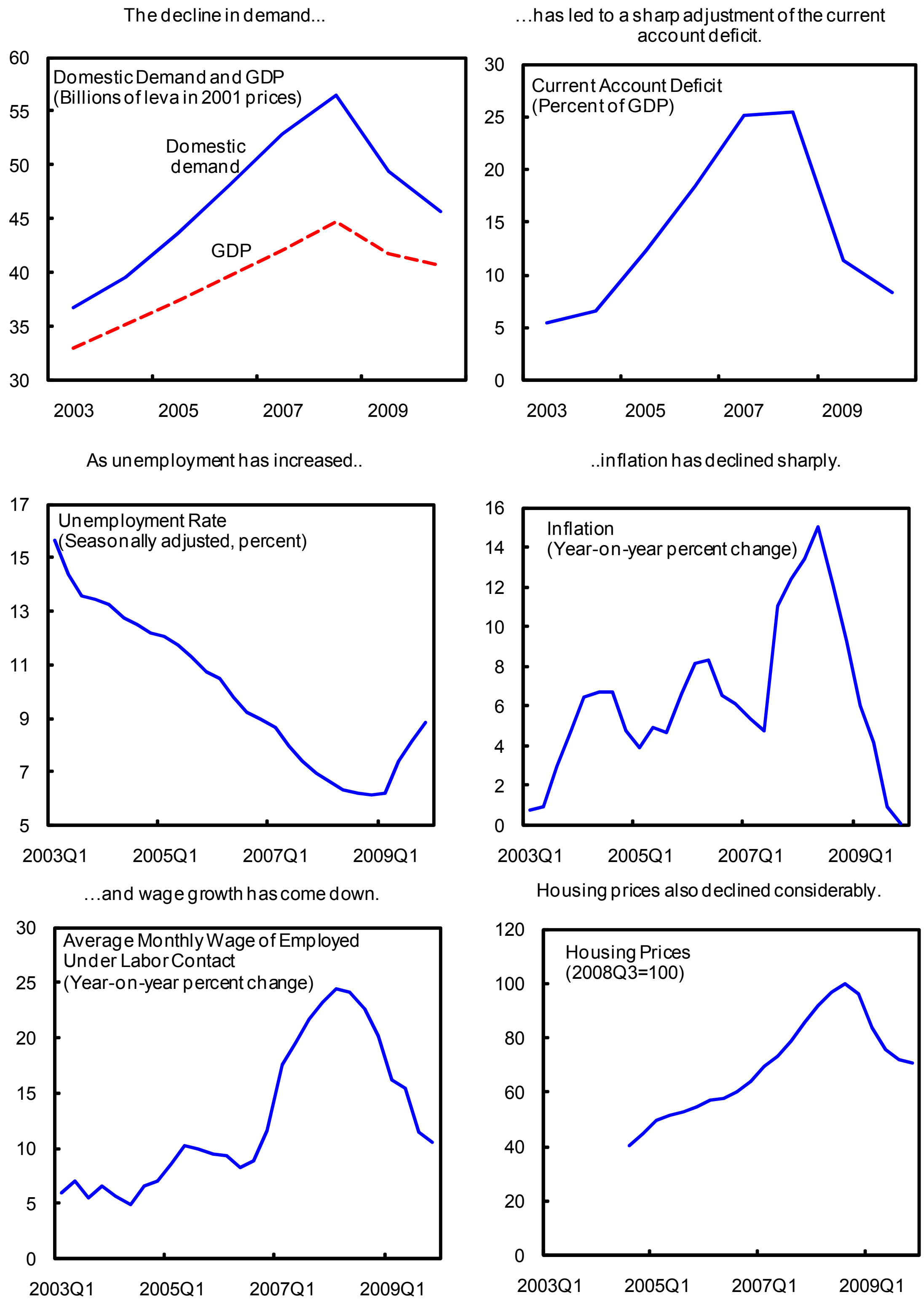
Source: Bulgarian National Bank and Haver.

Figure 3. Bulgaria: Factors Behind the Domestic Demand Bust
(Percent, unless otherwise indicated)



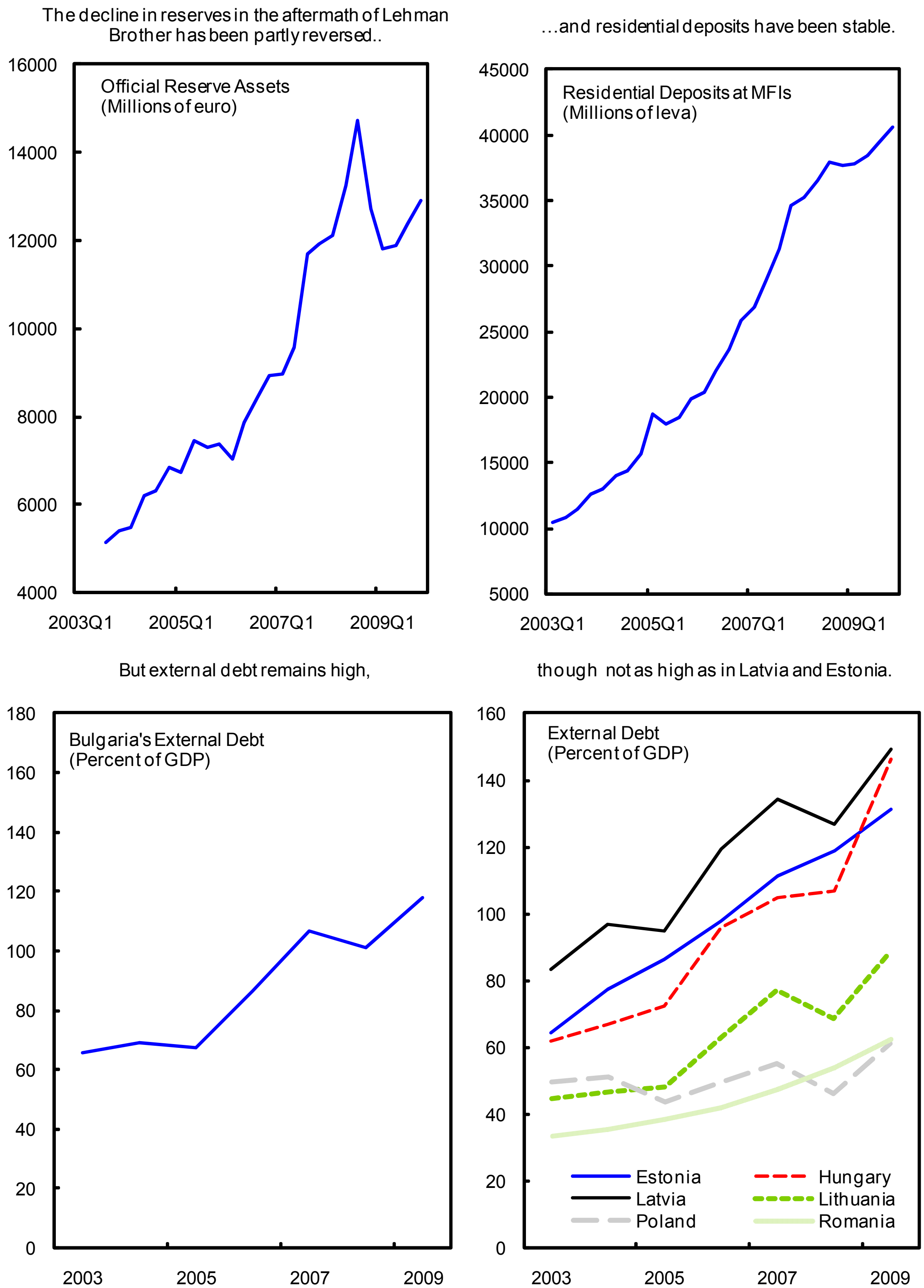
Source: World Economic Outlook; International Financial Statistics.

Figure 4. Bulgaria: Adjustment of Imbalances



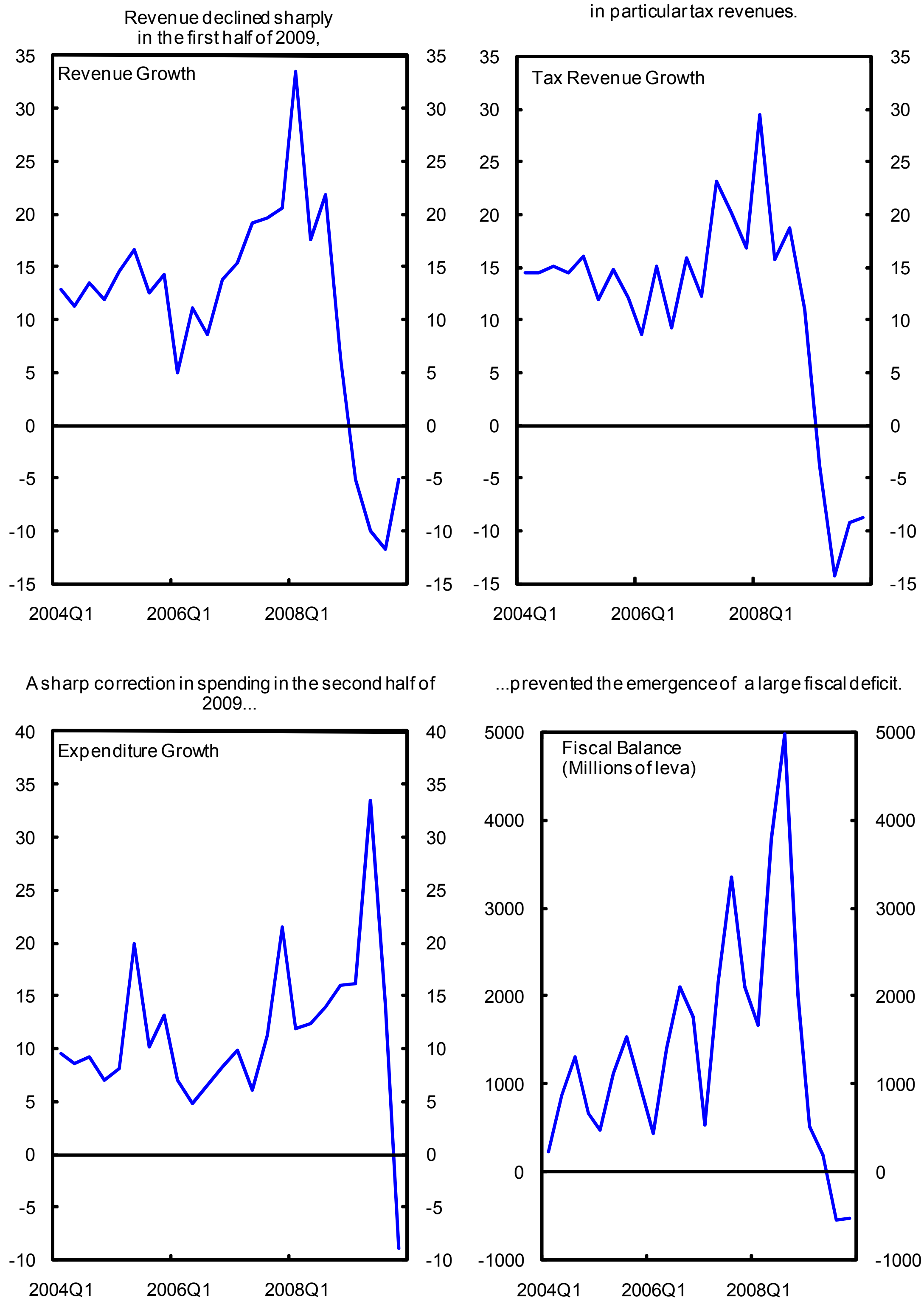
Source: Haver; World Economic Oultook.

Figure 5. Bulgaria: Stabilization, but High Vulnerabilities



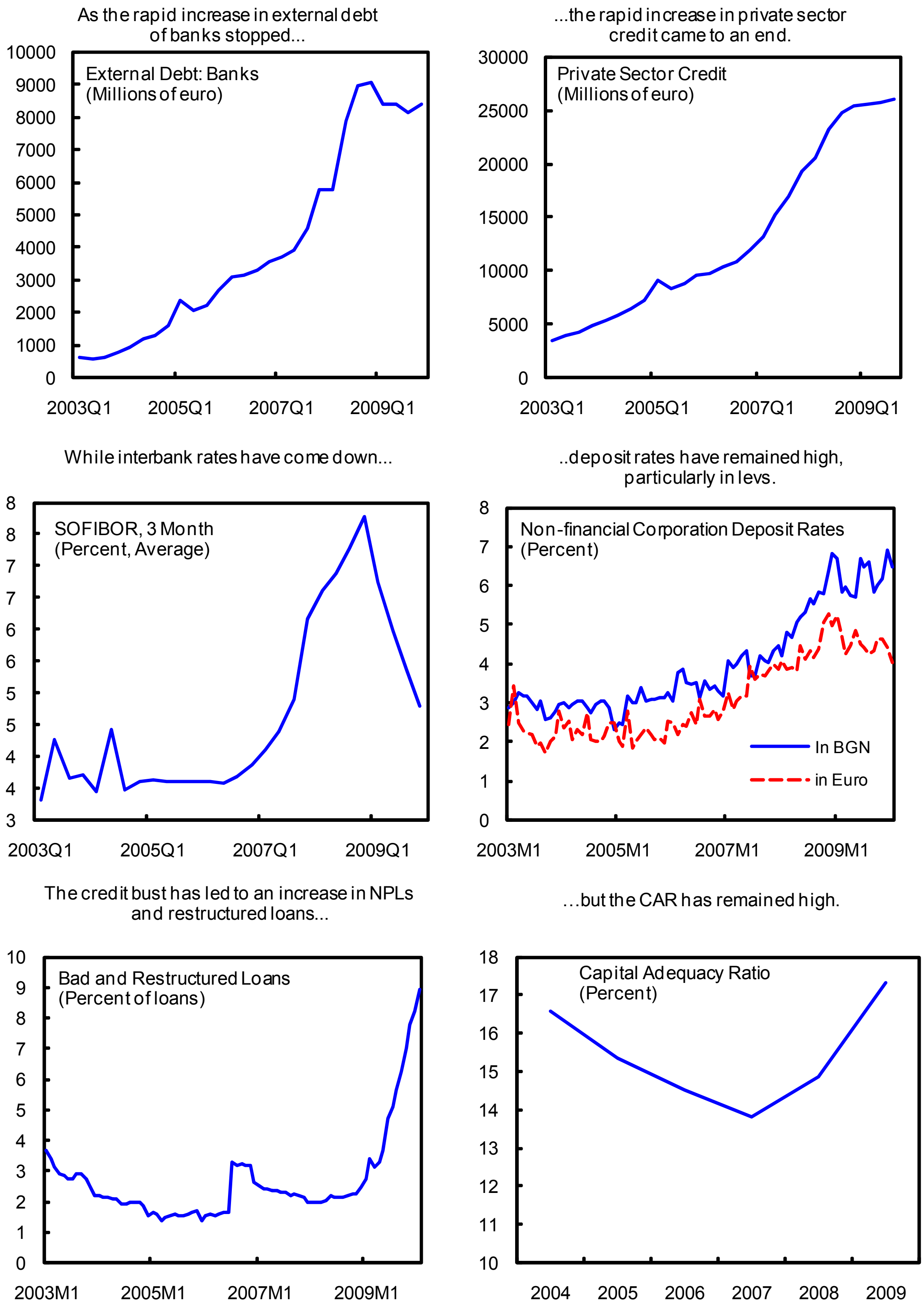
Source: World Economic Outlook; Haver.

Figure 6. Bulgaria: Fiscal Policy
(Year-on-year percent change, unless otherwise indicated)



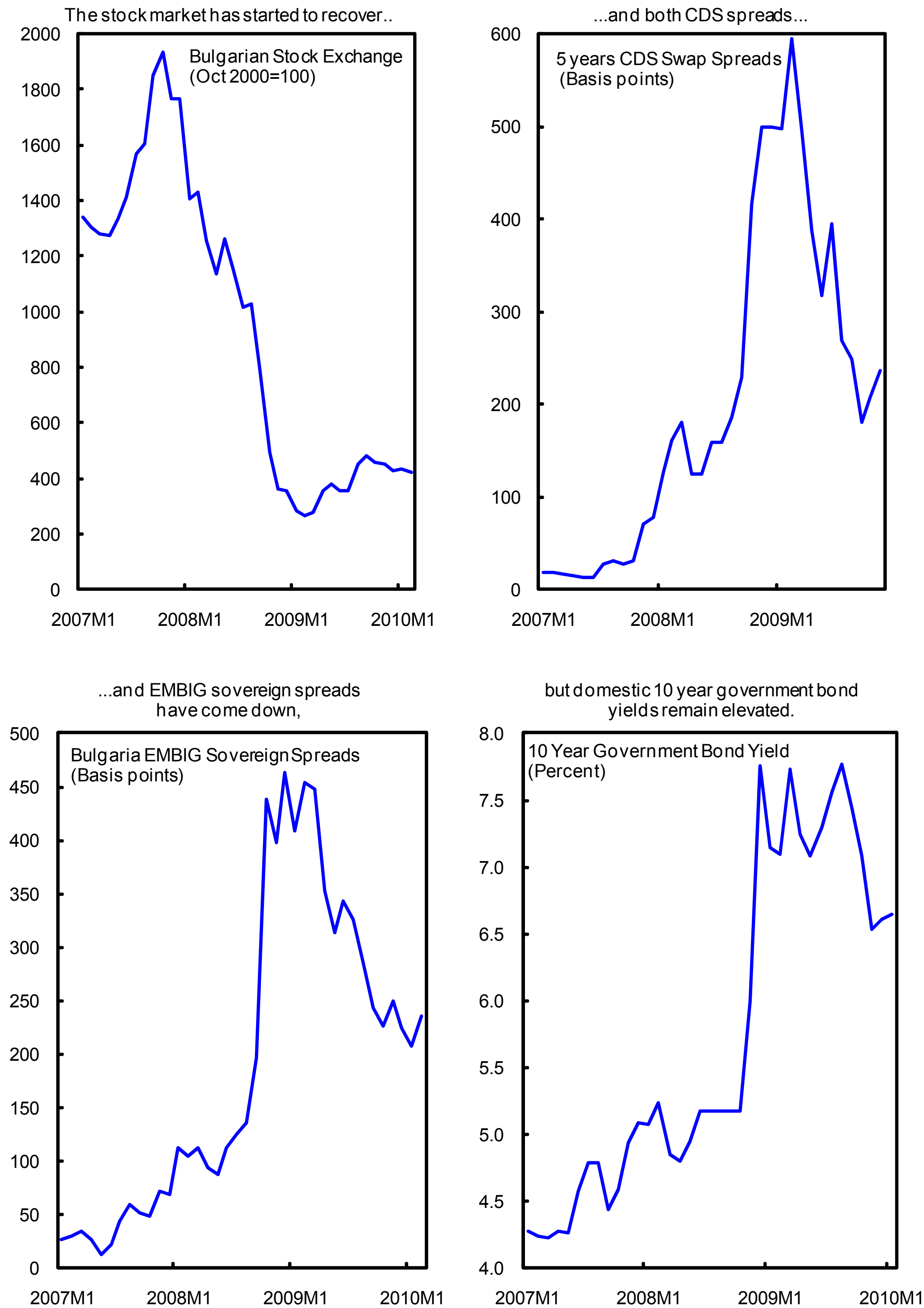
Source: Haver.

Figure 7. Bulgaria: Financial Sector



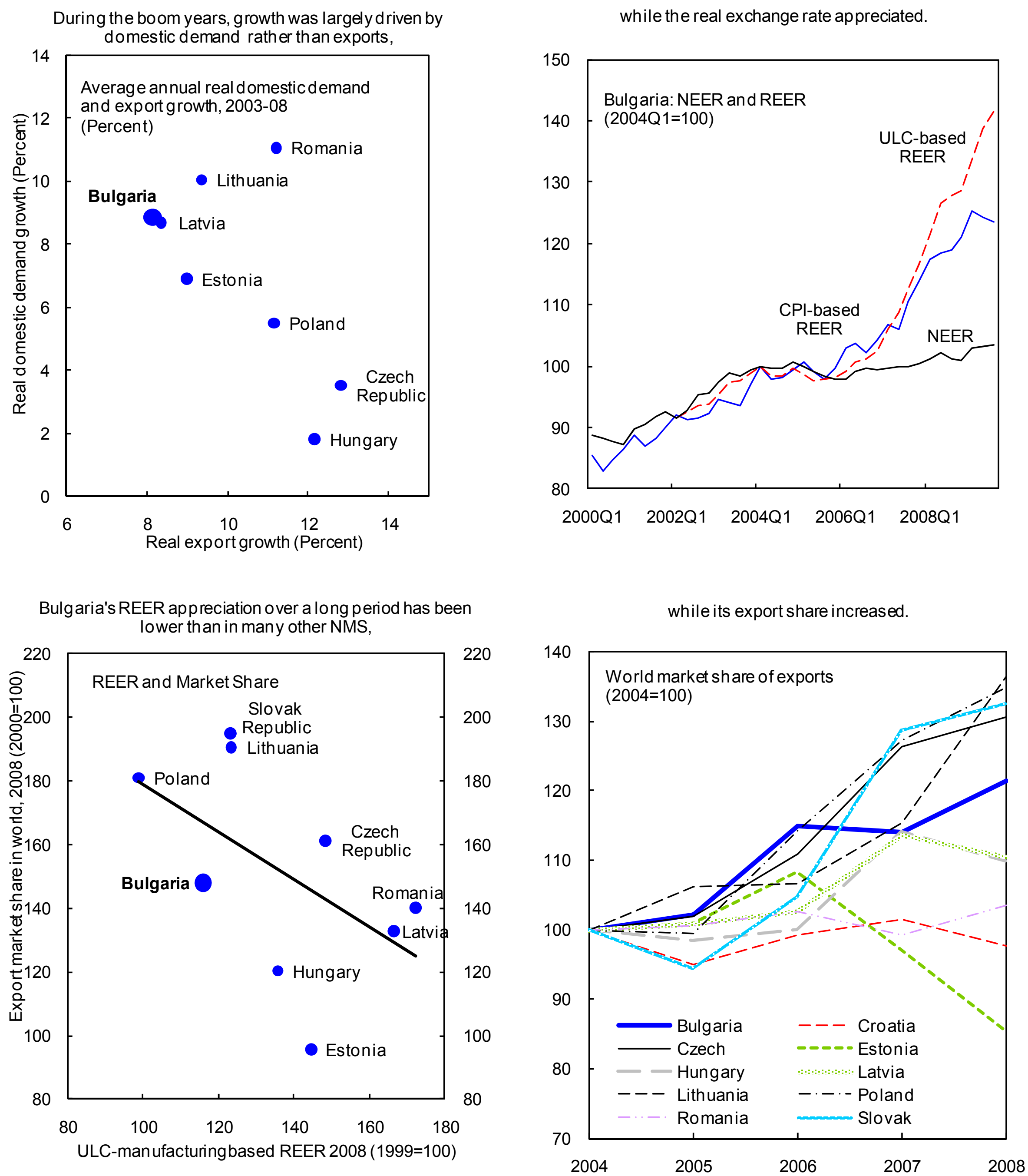
Source: National Authorities; Haver, IMF staff estimates.

Figure 8. Bulgaria: Financial Markets



Source: Bloomberg; Haver.

Figure 9. Bulgaria: Competitiveness



Source: World Economic Outlook; International Financial Statistics; Haver; Bulgarian National Bank.

Table 3. Bulgaria: Selected Economic and Social Indicators, 2005–11

	2005	2006	2007	2008	2009 Est.	2010 Proj.	2011 Proj.
Output, prices, and labor market			(Annual percentage change)				
Real GDP	6.2	6.3	6.2	6.0	-5.0	0.2	2.0
Real domestic demand	10.4	10.7	9.5	6.9	-15.0	-2.4	1.3
Consumer price index (HICP, average)	6.0	7.4	7.6	12.0	2.5	2.2	2.9
Consumer price index (HICP, end of period)	7.4	6.1	11.6	7.2	1.6	2.7	3.0
Employment	1.9	4.3	3.5	2.8	-4.0	-2.2	0.0
Unemployment rate 1/	10.1	9.0	6.9	5.7	7.8	9.2	8.5
Nominal wages	9.5	9.5	20.6	22.7	12.4	2.2	4.0
Public sector wages	11.3	8.9	17.4	25.4	11.0	0.0	2.0
Private sector wages	10.4	10.9	23.3	22.3	13.0	3.0	5.0
General government finances			(In percent of GDP)				
Revenue	39.8	38.8	40.7	39.5	36.3	37.1	36.9
Expenditure	37.4	35.3	37.2	36.5	37.1	38.8	38.4
Fiscal balance	2.4	3.5	3.5	3.0	-0.8	-1.8	-1.5
Privatization proceeds	3.4	1.5	1.0	0.8	0.1	0.3	0.0
External financing	-5.6	-1.9	-0.6	-1.0	0.9	1.0	0.5
Domestic financing	-0.2	-3.1	-3.9	-2.8	-0.2	0.5	1.0
Gross public debt	31.3	24.6	19.8	16.1	16.0	16.2	16.4
Financial net worth	6.0	9.9	10.2	11.5	10.8	8.9	7.1
Money and credit			(Annual percentage change)				
Broad money (M3)	23.9	26.9	31.2	8.8	4.3	0.3	4.8
Domestic credit	32.4	24.6	62.5	31.6	3.8	1.6	6.1
Interest rates			(In percent)				
Euro, 6-month LIBOR	2.2	3.1	4.3	4.6	1.2	1.0	1.8
Interbank rate, 3-month SOFIBOR	3.6	3.7	4.9	7.1	6.4	…	…
Lending rate	8.7	8.9	10.0	10.5	5.7	…	…
Real lending rate (HICP adjusted)	2.5	1.4	2.3	-1.3	3.1	…	…
Balance of payments			(In percent of GDP)				
Current account balance	-12.4	-18.4	-26.8	-24.0	-9.4	-6.3	-5.8
Merchandise trade balance	-20.2	-22.0	-25.1	-25.2	-12.1	-9.9	-9.8
Capital and financial account balance	19.8	28.8	45.3	34.2	7.8	6.7	8.6
Foreign direct investment balance	14.7	24.1	30.6	18.2	9.8	8.1	7.8
International investment position	-46.9	-60.8	-90.0	-106.1	-120.2	-123.8	-123.8
Gross official reserves	33.7	35.4	41.3	37.3	35.6	35.6	37.2
Gross external debt	70.9	82.0	100.3	108.4	111.0	109.2	106.3
Exchange rates							
Leva per euro			Currency board peg to euro at lev 1.956 per euro				
Leva per U.S. dollar (end of period)	1.65	1.48	1.34	1.44	1.34	…	…
Real effective exchange rate							
CPI based (percentage change)	0.9	4.3	5.6	8.5	2.1	1.4	2.0
GDP deflator based (percentage change)	1.7	6.4	5.6	9.0	3.8	0.6	0.6

Social Indicators (reference year in parentheses)

Per capita GNI (Atlas method, 2008): US $5490; Poverty rate (2001): 12.8 percent;

Life expectancy at birth (2007): 72.7 years; Mortality under 5 (per 1,000) (2007): 11.80; Fertility rate per woman (2007): 1.42

Income distribution (Gini index, 2003): 29.2; Primary education completion rate (2007): 98.2

Sources: Bulgarian authorities; IMF staff estimates and projections; and World Development Indicators database.

1/ As percent of labor force.

Table 4: Bulgaria: Macroeconomic Framework, 2007–15

	2007	2008	2009 Est.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
GDP and prices (annual percent change)									
Real GDP	6.2	6.0	-5.0	0.2	2.0	4.0	4.0	5.0	5.0
Real domestic demand	9.5	6.9	-15.0	-2.4	1.3	3.5	3.5	4.4	4.1
GDP deflator	7.9	11.4	4.6	1.2	1.5	3.1	3.9	3.8	3.8
Domestic demand deflator	7.5	11.1	2.5	1.8	1.7	3.9	4.7	4.7	4.8
Consumer price index (HICP, average)	7.6	12.0	2.5	2.2	2.9	3.0	3.0	3.0	3.0
Consumer price index (HICP, end of period)	11.6	7.2	1.6	2.7	3.0	3.0	3.0	3.0	3.0
Nominal wages	20.6	22.7	12.4	2.2	4.0	4.2	4.4	4.5	4.5
Public sector wages	17.4	25.4	11.0	0.0	2.0	2.5	3.0	3.5	3.5
Private sector wages	23.3	22.3	13.0	3.0	5.0	5.0	5.0	5.0	5.0
Real effective exchange rate, CPI based	5.6	8.5	2.1	1.4	2.0	1.8	1.6	1.6	1.6
Real effective exchange rate, GDP deflator based	5.6	9.0	3.8	0.6	0.6	2.0	2.6	2.3	..
Monetary aggregates (e.o.p. percent change)									
Broad money	31.2	8.8	4.3	0.3	4.8	6.7	7.7	8.3	8.5
Domestic credit	62.5	31.6	3.8	1.6	6.1	7.4	8.2	8.6	9.4
Saving and investment (in percent of GDP)									
Foreign saving	26.8	24.0	9.4	6.3	5.8	5.9	6.1	6.2	6.3
Gross national saving	10.0	14.3	16.7	17.9	18.3	19.9	21.7	23.8	25.6
Government	9.7	9.3	4.3	4.3	4.6	5.0	5.4	6.0	6.4
Private	0.2	5.0	12.5	13.6	13.8	14.9	16.3	17.8	19.2
Gross domestic investment	36.8	38.3	26.2	24.1	24.1	25.8	27.8	30.0	31.8
Government	6.3	6.3	5.1	6.0	6.0	5.9	5.9	5.9	5.9
Private	30.5	32.1	21.1	18.1	18.1	19.9	21.9	24.1	25.9
General government (in percent of GDP)									
Revenue	40.7	39.5	36.3	37.1	36.9	36.5	36.1	35.8	35.5
Tax revenue	32.6	31.8	29.0	29.0	29.3	29.0	28.7	28.3	28.1
Non-Tax revenue	5.9	6.0	5.3	5.0	5.0	4.9	4.9	4.9	4.9
Grants	2.1	1.7	2.0	3.1	2.7	2.6	2.6	2.6	2.6
Expenditure	37.2	36.5	37.1	38.8	38.4	37.4	36.7	35.7	35.0
Fiscal balance	3.5	3.0	-0.8	-1.8	-1.5	-0.9	-0.5	0.1	0.5
Gross public debt	19.8	16.1	16.0	16.2	16.4	16.1	14.3	12.3	9.0
Net financial worth	10.2	11.5	10.8	8.9	7.1	5.7	4.8	4.4	4.6
Balance of payments (in percent of GDP)									
Current account	-26.8	-24.0	-9.4	-6.3	-5.8	-5.9	-6.1	-6.2	-6.3
Trade balance	-25.1	-25.2	-12.1	-9.9	-9.8	-10.1	-10.2	-10.4	-10.8
Services balance	4.1	3.9	4.6	4.5	4.9	4.9	4.7	4.7	5.0
Income balance	-8.2	-5.2	-4.7	-3.6	-3.9	-3.6	-3.3	-3.1	-3.1
Transfers balance	2.4	2.4	2.7	2.8	3.0	2.9	2.7	2.7	2.7
Capital and financial account	45.3	34.2	7.8	6.7	8.6	8.3	8.4	8.5	7.8
Foreign direct investment	30.6	18.2	9.8	8.1	7.8	7.6	7.7	7.8	8.0
Memorandum items:									
Gross international reserves (in millions of euros)	11,937	12,713	12,063	12,221	13,223	14,128	15,084	16,116	16,866
Gross international reserves (in percent of short term debt) 1/	91.7	72.6	75.4	78.4	83.1	86.1	89.7	87.6	90.3
International investment position (in percent of GDP)	-90.0	-106.1	-120.2	-123.8	-123.8	-120.4	-116.8	-112.7	-109.0
External debt (in percent of GDP)	100.3	108.4	111.0	109.2	106.3	100.4	94.3	88.2	82.0
Short-term external debt (in percent of GDP) 2/	32.4	38.4	38.4	36.3	35.7	33.9	31.9	29.8	27.8
Export volume (percent change)	9.9	11.6	-7.5	4.5	5.4	5.8	5.9	6.0	6.0
Import volume (percent change)	14.5	12.2	-21.7	-0.6	4.3	5.0	4.9	5.4	5.9
Terms of trade (percent change)	-0.8	-1.3	-1.7	2.0	0.5	-1.6	-1.6	-1.7	-1.8
Nominal GDP (in millions of leva)	56,520	66,728	66,256	67,210	69,598	74,603	80,601	87,868	95,782
Nominal GDP (in millions of euros)	28,898	34,118	33,876	34,364	35,585	38,144	41,211	44,926	48,973

Sources: Bulgarian authorities; and IMF staff estimates and projections.

1/ Including deposits of banks.
2/ At original maturity.

Table 5. Bulgaria: Real GDP Components and Implicit Deflators, 2007–15

	2007	2008	2009 Est.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
	(Real growth rate by expenditure category, in percent)								
Real GDP	6.2	6.0	-5.0	0.2	2.0	4.0	4.0	5.0	5.0
Domestic demand	9.5	6.9	-15.0	-2.4	1.3	3.5	3.5	4.4	4.1
Private demand	8.9	7.8	-15.9	-4.1	2.0	4.0	3.7	4.7	4.3
Public demand	12.4	2.4	-10.3	5.7	-1.6	0.9	2.4	3.0	3.6
Final consumption	4.9	4.0	-6.2	-0.6	0.5	2.8	3.1	3.8	4.0
Private consumption	5.3	4.8	-6.3	-0.8	1.3	3.5	3.6	4.4	4.4
Public consumption	3.1	0.1	-5.5	0.3	-3.5	-0.8	0.3	0.4	1.2
Gross fixed investment	21.7	20.4	-26.9	-2.1	2.4	5.5	6.7	7.7	7.7
Private investment	17.3	23.8	-28.5	-7.6	2.4	5.9	6.7	7.7	7.7
Public investment	41.4	7.7	-20.4	19.2	2.4	4.2	6.4	7.7	7.7
Inventories 1/	1.2	-1.1	-3.5	-1.2	0.6	0.2	-0.3	0.1	-0.2
Net exports 1/	-4.9	-2.3	12.6	2.4	0.6	0.4	0.3	0.3	0.5
Exports of goods and services	5.2	2.9	-9.8	6.2	4.4	6.2	6.1	6.7	7.5
Imports of goods and services	9.9	4.9	-22.3	1.2	3.1	5.1	5.1	5.6	6.0
	(Contribution to real GDP growth, in percentage point)								
Domestic demand	11.1	8.4	-17.7	-2.2	1.4	3.6	3.7	4.7	4.5
Private demand	8.6	7.9	-15.5	-3.2	1.9	3.5	3.2	4.2	3.9
Public demand	2.5	0.5	-2.2	1.0	-0.4	0.1	0.4	0.5	0.6
Final consumption	4.2	3.3	-5.2	-0.5	0.3	2.2	2.3	2.8	2.9
Private consumption	3.7	3.3	-4.3	-0.6	0.8	2.3	2.3	2.7	2.7
Public consumption	0.5	0.0	-0.9	0.1	-0.6	-0.1	0.1	0.1	0.2
Gross fixed investment	5.6	6.1	-9.0	-0.5	0.6	1.3	1.6	1.9	1.8
Private investment	3.7	5.6	-7.7	-1.5	0.4	1.1	1.2	1.4	1.4
Public investment	1.9	0.5	-1.3	1.0	0.1	0.3	0.4	0.5	0.5
Inventories	1.2	-1.1	-3.5	-1.2	0.6	0.2	-0.3	0.1	-0.2
Net exports	-4.9	-2.3	12.6	2.4	0.6	0.4	0.3	0.3	0.5
Exports of goods and services	3.3	1.8	-5.9	3.1	2.4	3.6	3.5	3.7	4.1
Imports of goods and services	8.2	4.2	-18.5	0.7	1.9	3.3	3.2	3.5	3.7
	(Percentage change in implicit deflators)								
GDP deflator	7.9	11.4	4.6	1.2	1.5	3.1	3.9	3.8	3.8
Domestic demand	7.5	11.1	2.5	1.8	1.7	3.9	4.7	4.7	4.8
Final consumption	7.0	12.4	2.2	1.5	2.0	2.1	2.1	2.1	2.1
Private consumption	6.8	11.0	1.7	1.5	2.0	2.1	2.1	2.1	2.1
Public consumption	8.0	18.9	4.3	3.8	4.9	5.2	5.2	5.2	5.2
Gross fixed investment	8.0	9.8	1.0	0.9	1.2	1.2	1.2	1.2	1.2
Exports of goods and services	6.9	9.4	-9.0	5.4	4.7	-0.1	-0.7	-0.6	-0.9
Imports of goods and services	6.9	9.6	-11.4	5.5	4.7	1.5	0.9	1.1	1.0

Sources: Bulgaria National Statistical Institute (NSI); IMF staff estimates and projections.

1/ Contributions to GDP growth.

Table 6. Bulgaria: Balance of Payments, 2007–15
(In millions of euros, unless otherwise indicated)

	2007	2008	2009 Est.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
Current account balance	-7,755	-8,203	-3,196	-2,152	-2,057	-2,260	-2,511	-2,774	-3,061
Merchandise trade balance	-7,245	-8,602	-4,103	-3,416	-3,503	-3,870	-4,204	-4,671	-5,305
Exports (f.o.b.)	13,512	15,199	11,787	13,252	14,691	15,522	16,330	17,214	18,094
Imports (f.o.b.)	-20,757	-23,801	-15,889	-16,668	-18,195	-19,392	-20,534	-21,885	-23,399
Services balance	1,174	1,329	1,553	1,551	1,758	1,871	1,947	2,093	2,429
Exports of non-factor services	4,760	5,375	4,879	5,406	5,704	6,117	6,487	6,985	7,701
Imports of non-factor services	-3,586	-4,046	-3,326	-3,856	-3,946	-4,246	-4,540	-4,892	-5,272
Income balance	-2,364	-1,762	-1,578	-1,244	-1,380	-1,372	-1,374	-1,412	-1,512
Receipts	828	989	805	1,103	1,230	1,361	1,488	1,630	1,868
Payments	-3,192	-2,751	-2,383	-2,347	-2,610	-2,733	-2,863	-3,042	-3,380
Current transfer balance	681	831	931	958	1,068	1,110	1,122	1,215	1,327
Capital and financial account balance	13,089	11,673	2,650	2,310	3,059	3,165	3,467	3,806	3,811
Capital transfer balance	-587	277	479	317	527	402	323	272	255
Foreign direct investment balance	8,838	6,214	3,310	2,775	2,791	2,888	3,189	3,487	3,927
Portfolio investment balance	-580	-791	-612	-454	-453	-457	-535	-588	-521
Other investment balance	5,418	5,973	-527	-329	194	332	490	635	150
General government and monetary authorities	77	-308	278	-87	18	160	300	388	-242
Domestic banks	2,164	3,549	-852	-384	55	68	92	104	173
Other private sector	3,177	2,732	47	142	121	104	98	143	219
Errors and omissions	-2,170	-2,795	-104	0	0	0	0	0	0
Overall balance	3,164	674	-650	158	1,002	905	956	1,032	750
Financing	-3,164	-674	650	-158	-1,002	-905	-956	-1,032	-750
Gross international reserves (increase: -)	-2,908	-674	650	-158	-1,002	-905	-956	-1,032	-750
Use of Fund credit, net	-255	0	0	0	0	0	0	0	0
Purchases	0	0	0	0	0	0	0	0	0
Repurchases	0	0	0	0	0	0	0	0	0
Memorandum items:									
			(in percent of GDP, unless otherwise indicated)						
Current account balance	-26.8	-24.0	-9.4	-6.3	-5.8	-5.9	-6.1	-6.2	-6.3
Foreign direct investment balance	30.6	18.2	9.8	8.1	7.8	7.6	7.7	7.8	8.0
Merchandise trade balance	-25.1	-25.2	-12.1	-9.9	-9.8	-10.1	-10.2	-10.4	-10.8
Exports	46.8	44.6	34.8	38.6	41.3	40.7	39.6	38.3	36.9
Imports	71.8	69.8	46.9	48.5	51.1	50.8	49.8	48.7	47.8
Gross external financing requirement	60.3	62.2	61.1	52.8	49.6	47.6	45.9	43.6	43.8
Gross BNB reserves (in millions of EURO)	11,937	12,713	12,063	12,221	13,223	14,128	15,084	16,116	16,866
S.t. debt at originating maturity, in percent of reser	78	103	108	102	96	92	87	83	81
S.t. debt at remaining maturity, in percent of reserv	109	138	133	128	120	116	112	114	111
Terms of trade (merchandise)	-0.8	-1.3	-1.7	2.0	0.5	-1.6	-1.6	-1.7	-1.8
Merchandise export volume	9.9	11.6	-7.5	4.5	5.4	5.8	5.9	6.0	6.0
Merchandise import volume	14.5	12.2	-21.7	-0.6	4.3	5.0	4.9	5.4	5.9
Merchandise export prices	2.3	0.8	-16.2	7.6	5.2	-0.1	-0.7	-0.6	-0.9
Merchandise import prices	3.1	2.2	-14.7	5.5	4.7	1.5	0.9	1.1	1.0
GDP	28,898	34,118	33,876	34,364	35,585	38,144	41,211	44,926	48,973

Sources: Bulgarian authorities; and Fund staff estimates and projections.

Table 7. Bulgaria: External Financial Assets and Liabilities, 2008–15

(In millions of euro, unless otherwise indicated)

	2008 Prel.	2009 Prel.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
International investment position	-36,194	-40,705	-42,540	-44,069	-45,927	-48,114	-50,616	-53,416
Financial assets	20,951	20,483	20,559	22,313	23,964	25,762	27,726	29,379
Foreign direct investment	1,027	919	819	997	1,188	1,394	1,619	1,863
Portfolio investment	1,173	1,254	1,666	2,164	2,653	3,192	3,785	4,321
Other investments	6,037	6,248	5,852	5,929	5,995	6,091	6,205	6,329
Gross international reserves 1/	12,713	12,063	12,221	13,223	14,128	15,084	16,116	16,866
Financial liabilities	57,145	61,189	63,099	66,382	69,890	73,876	78,342	82,795
Foreign direct investment	32,937	37,336	40,012	42,980	46,059	49,454	53,166	57,338
Equity	20,454	23,000	25,675	28,644	31,697	35,092	38,804	42,738
Intercompany debt	12,483	14,336	14,336	14,336	14,363	14,363	14,363	14,600
Portfolio investment	1,928	1,872	1,830	1,876	1,907	1,911	1,916	1,927
Loans	14,503	15,034	14,521	14,574	14,831	15,265	15,886	16,056
BNB 1/	0	0	0	0	0	0	0	0
General government	1,558	1,783	1,697	1,715	1,875	2,175	2,562	2,318
Banks	2,952	2,951	2,779	2,875	2,927	2,991	3,103	3,340
Other sectors	9,993	10,299	10,045	9,985	10,030	10,098	10,221	10,397
Other liabilities	7,776	6,948	6,735	6,952	7,093	7,246	7,373	7,474
Memorandum items:								
GIR (in percent of GDP)	37.3	35.6	35.6	37.2	37.0	36.6	35.9	34.4
GIR (in percent of short-term debt, at remaining maturity)	72.6	75.4	78.4	83.1	86.1	89.7	87.6	90.3
GIR (in percent of short-term debt and FX deposits of banks)	36.0	…	…	…	…	…	…	…
GIR (in months of next year's imports)	7.9	7.1	6.6	6.7	6.8	6.8	6.7	7.1
NIR (in percent of GDP)	37.3	35.6	35.6	37.2	37.0	36.6	35.9	34.4
Gross external debt (in percent of GDP)	108.4	111.0	109.2	106.3	100.4	94.3	88.2	82.0
Public 2/	7.6	8.3	9.8	9.6	9.5	9.5	9.6	8.3
Private	100.8	102.7	99.4	96.7	90.9	84.9	78.7	73.7
Short-term	38.4	38.4	36.3	35.7	33.9	31.9	29.8	27.8
Long-term	62.3	64.3	63.1	61.0	57.0	53.0	48.9	45.9
Gross external debt (in percent of exports of GNFS)	179.7	225.6	201.1	185.5	176.9	170.4	163.8	155.7
Net international investment position (in percent of GDP)	-106.1	-120.2	-123.8	-123.8	-120.4	-116.8	-112.7	-109.1
GDP	34,118	33,876	34,364	35,585	38,144	41,211	44,926	48,973

Notes:

1/ It includes SDR allocation.

2/ General government. It does not include private sector publicly-guaranteed debt.

Sources: BNB; NSI; and Fund staff estimates and projections.

Table 8. Bulgaria: General Government Operations, 2007–15

(In millions of leva)

	2007	2008	2009 (Prel.)	2010 (Proj.) Budget 1/	2010 (Proj.) IMF Proj.	2011 (Proj.)	2012 (Proj.)	2013 (Proj.)	2014 (Proj.)	2015 (Proj.)
Revenue	22,985	26,358	24,068	25,637	24,913	25,678	27,261	29,130	31,447	34,033
Taxes	18,445	21,211	19,218	20,190	19,515	20,367	21,662	23,099	24,875	26,869
Taxes on profits	1,833	2,228	1,762	1,734	1,729	1,760	1,852	1,980	2,133	2,318
Taxes on income	1,809	1,971	2,051	1,987	1,987	2,068	2,162	2,261	2,368	2,482
Social security contributior	4,011	4,438	4,320	4,230	4,230	4,400	4,601	4,811	5,041	5,282
Value-added taxes	6,599	7,485	6,433	6,800	6,481	6,828	7,286	7,779	8,412	9,145
Excises	3,315	4,052	3,844	4,580	4,230	4,414	4,802	5,234	5,797	6,422
Customs duties	193	221	122	138	138	151	161	170	181	194
Other taxes	685	815	686	721	721	746	800	864	942	1,027
Nontax revenues	3,337	4,005	3,524	3,394	3,344	3,452	3,679	3,972	4,327	4,717
Grants	1,204	1,142	1,326	2,053	2,053	1,858	1,919	2,059	2,245	2,447
Expenditure	21,026	24,369	24,598	26,102	26,102	26,711	27,937	29,555	31,402	33,562
Current expenditure	17,177	19,854	20,940	21,689	21,814	22,090	23,056	24,329	25,687	27,332
Compensation of employee	3,204	3,836	4,115	3,980	3,980	3,903	3,881	4,006	4,151	4,301
Maintenance and operatior	4,436	4,913	4,306	4,243	4,243	4,463	4,761	5,144	5,608	6,113
Interest	631	585	518	547	547	601	687	799	663	663
Subsidies	781	1,114	1,201	1,660	1,660	1,510	1,544	1,588	1,696	1,849
Contribution to EU budget	595	720	746	780	780	818	912	982	1,057	1,139
Social benefits	7,450	8,594	9,954	10,422	10,547	10,737	11,209	11,743	12,439	13,188
Pensions	4,622	5,546	6,439	7,102	7,102	7,322	7,623	7,950	8,304	8,681
Social assistance	1,192	1,536	1,855	1,808	1,808	1,739	1,790	1,853	2,020	2,202
Health care	1,343	1,512	1,661	1,512	1,637	1,675	1,796	1,940	2,115	2,305
Other	294	0	0	0	0	0	0	0	0	0
Other spending	80	93	100	58	58	58	62	67	73	80
Capital expenditure	3,551	4,198	3,374	4,059	4,059	4,203	4,433	4,775	5,206	5,675
Contingency	298	317	283	354	229	418	448	451	510	556
Fiscal balance	1,960	1,989	-531	-465	-1,189	-1,033	-676	-425	45	471
Primary balance	2,590	2,574	-13	82	-642	-432	11	374	707	1,134
Financing	-1,960	-1,989	531	465	1,189	1,033	676	425	-45	-471
Privatization proceeds	574	544	60	202	202	0	0	0	0	0
External	-318	-694	627	680	680	346	536	-1,207	-78	-2,006
Domestic	-2,216	-1,840	-156	-416	308	687	140	1,632	34	1,535

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ After the adoption of the budget, a change in the expenditure composition was made with interest spending lowered by BGN 33 million, maintenance lowered by BGN 166 million, and capital spending raised by BGN 199 million. The overall spending envelope remained unchanged.

Table 8. Bulgaria: General Government Operations, 2007–15 (concluded)

(In percent of GDP)

	2007	2008	2009 (Prel.)	2010 (Proj.) Budget 1/	2010 (Proj.) IMF Proj.	2011 (Proj.)	2012 (Proj.)	2013 (Proj.)	2014 (Proj.)	2015 (Proj.)
Revenue	40.7	39.5	36.3	37.7	37.1	36.9	36.5	36.1	35.8	35.5
Taxes	32.6	31.8	29.0	29.7	29.0	29.3	29.0	28.7	28.3	28.1
Taxes on profits	3.2	3.3	2.7	2.5	2.6	2.5	2.5	2.5	2.4	2.4
Taxes on income	3.2	3.0	3.1	2.9	3.0	3.0	2.9	2.8	2.7	2.6
Social security contributions	7.1	6.7	6.5	6.2	6.3	6.3	6.2	6.0	5.7	5.5
Value-added taxes	11.7	11.2	9.7	10.0	9.6	9.8	9.8	9.7	9.6	9.5
Excises	5.9	6.1	5.8	6.7	6.3	6.3	6.4	6.5	6.6	6.7
Customs duties	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other taxes	1.2	1.2	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Nontax revenues	5.9	6.0	5.3	5.0	5.0	5.0	4.9	4.9	4.9	4.9
Grants	2.1	1.7	2.0	3.0	3.1	2.7	2.6	2.6	2.6	2.6
Expenditure	37.2	36.5	37.1	38.4	38.8	38.4	37.4	36.7	35.7	35.0
Current expenditure	30.4	29.8	31.6	31.9	32.5	31.7	30.9	30.2	29.2	28.5
Compensation of employees	5.7	5.7	6.2	5.8	5.9	5.6	5.2	5.0	4.7	4.5
Maintenance and operations	7.8	7.4	6.5	6.2	6.3	6.4	6.4	6.4	6.4	6.4
Interest	1.1	0.9	0.8	0.8	0.8	0.9	0.9	1.0	0.8	0.7
Subsidies	1.4	1.7	1.8	2.4	2.5	2.2	2.1	2.0	1.9	1.9
Contribution to EU budget	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2	1.2	1.2
Social benefits	13.2	12.9	15.0	15.3	15.7	15.4	15.0	14.6	14.2	13.8
Pension	8.2	8.3	9.7	10.4	10.6	10.5	10.2	9.9	9.5	9.1
Social assistance	2.1	2.3	2.8	2.7	2.7	2.5	2.4	2.3	2.3	2.3
Health care	2.4	2.3	2.5	2.2	2.4	2.4	2.4	2.4	2.4	2.4
Other	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other spending	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure	6.3	6.3	5.1	6.0	6.0	6.0	5.9	5.9	5.9	5.9
Contingency	0.5	0.5	0.4	0.5	0.3	0.6	0.6	0.6	0.6	0.6
Fiscal balance	3.5	3.0	-0.8	-0.7	-1.8	-1.5	-0.9	-0.5	0.1	0.5
Primary balance	4.6	3.9	0.0	0.1	-1.0	-0.6	0.0	0.5	0.8	1.2
Financing	-3.5	-3.0	0.8	0.7	1.8	1.5	0.9	0.5	-0.1	-0.5
Privatization proceeds	1.0	0.8	0.1	0.3	0.3	0.0	0.0	0.0	0.0	0.0
External	-0.6	-1.0	0.9	1.0	1.0	0.5	0.7	-1.5	-0.1	-2.1
Domestic	-3.9	-2.8	-0.2	-0.6	0.5	1.0	0.2	2.0	0.0	1.6
Memorandum items:										
Public debt (percent of GDP) 2/	19.8	16.1	16.1	16.2	16.2	16.5	16.2	14.3	12.3	9.0
Structural balance (adjusted for absorption gaps) 3/	0.5	-0.1	0.1	1.0	-0.1	0.2	0.4	0.4	0.4	0.3
Structural fiscal balance (not adjusted)	2.5	1.6	0.5	1.1	0.0	0.3	0.5	0.5	0.5	0.4
Output gap 4/	2.4	3.4	-3.3	-4.5	-4.5	-4.5	-3.6	-2.7	-1.2	0.2
Absorption gap 5/	19.9	17.5	4.5	1.3	1.3	0.8	1.0	1.2	1.2	1.3
Nominal GDP (millions of leva)	56,520	66,728	66,256	68,061	67,210	69,598	74,603	80,601	87,868	95,782

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ After the adoption of the budget, a change in the expenditure composition was made with interest spending lowered by BGN 33 million, maintenance lowered by BGN 166 million, and capital spending raised by BGN 199 million. The overall spending envelope remained unchanged.

2/ Public sector debt (includes guaranteed debt).

3/ Actual fiscal balance adjusted for the automatic effects of internal imbalance (output gap) and external imbalance (absorption gap) on fiscal position.
Structural balance (adjusted) = Fiscal balance - 0.4 * output gap - 0.1 absorption gap (see Country Staff Report 07/390, Chapter III).

4/ Percentage deviation of actual from potential GDP.

5/ Percentage deviation between actual absorption and the level consistent with external balance.

Table 9. Bulgaria: Financial Soundness Indicators, 2004–09
(In percent)

	2004	2005	2006	2007	2008 March	2008 June	2008 Sept.	2008 Dec	2009 Mar	2009 Jun	2009 Sep
Core indicators											
Capital adequacy											
Capital to risk-weighted assets	16.6	15.3	14.5	13.9	14.5	14.6	14.4	14.9	16.5	17.6	17.3
Tier 1 capital to risk-weighted assets	14.4	12.5	11.8	10.8	10.9	11.1	11.0	11.2	12.7	13.9	14.2
Asset quality											
Nonperforming loans to total gross loans	2.0	2.2	2.2	2.1	2.0	1.9	2.1	2.5	3.4	4.5	6.0
Nonperforming loans net of provisions to capital	1.8	2.9	2.5	2.4	2.4	2.5	2.9	4.3	7.4	10.1	14.4
Large exposures to capital	129.8	90.8	87.3	88.9	71.7	70.1	73.3	70.3	65.3	64.5	55.1
Earnings and profitability											
Return on assets	2.1	2.0	2.2	2.4	2.5	2.4	2.3	2.1	1.6	1.4	1.2
Return on equity 1/	19.6	21.4	25.0	24.8	28.6	25.9	24.5	23.1	1.6	13.4	10.8
Net interest income to gross income	68.1	68.5	69.4	70.3	76.1	75.4	75.4	75.1	74.7	75.2	75.5
Noninterest expense to gross income	58.3	55.3	56.0	47.8	47.6	48.1	48.3	49.9	49.4	49.5	49.4
Personnel expense to total income	21.4	19.5	18.8	17.5	18.6	18.6	18.6	19.0	18.7	18.8	18.6
Trading and fee income to total income	30.1	29.8	27.3	24.5	20.5	22.1	24.6	23.9	23.9	22.9	23.1
Liquidity											
Liquid assets to total assets	30.1	28.7	31.0	24.7	21.1	21.3	19.7	19.1	18.0	18.4	18.0
Liquid assets to short-term liabilities	34.7	33.1	35.7	28.9	24.8	24.8	23.1	22.6	20.5	21.1	21.6
Liquid assets to total liabilities					28.8	28.8	27.1	26.6	25.8	26.0	25.2
Encouraged indicators											
Deposit-taking institutions											
Capital to assets 2/	10.2	7.4	7.3	7.7	8.2	8.3	8.4	8.5	10.0	10.8	11.0
Trading income to total income	8.4	8.0	2.7	2.7	-0.3	0.9	3.3	2.8	4.8	3.8	3.7
Personnel expenses to noninterest expenses	36.7	35.3	33.7	36.6	39.1	38.7	38.5	38.2	37.9	38.1	37.6
Customer deposits to total (non-interbank) loans	121.2	111.3	121.1	104.2	96.7	90.7	87.4	84.8	82.6	83.0	84.1
Foreign currency denominated loans to total loans	48.2	47.8	45.6	50.4	51.6	54.0	55.5	56.9	57.7	57.8	58.4
Foreign currency denominated liabilities to total liabilities	56.0	55.0	54.5	58.6	59.2	62.3	60.9	60.0	60.1	61.3	61.9
Net open foreign-exchange position	-5.9	-5.6	…	…	…	…	…	…	…	…	…

Source: Bulgarian National Bank.

1/ Return on equity is calculated with **Tier I** as denominator.

2/ Capital to assets is based on Tier I capital.

Table 10. Bulgaria: External Debt Sustainability Framework, 2005–15

(In percent of GDP, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010 Proj	2011 Proj	2012 Proj	2013 Proj	2014 Proj	2015 Proj	Debt-stabilizing non-interest current account 6/
Baseline: External debt	70.9	82.0	100.3	108.4	111.0	109.2	106.3	100.4	94.3	88.2	82.0	-4.1
Change in external debt	7.1	11.1	18.3	8.1	2.6	-1.8	-2.9	-5.9	-6.0	-6.1	-6.2	
Identified external debt-creating flows (4+8+9)	-5.7	-8.0	-10.9	9.4	7.5	-2.1	-4.2	-5.6	-5.4	-6.0	-5.4	
Current account deficit, excluding interest payments	10.5	16.5	24.5	21.5	6.9	3.2	2.9	3.5	3.7	3.9	4.1	
Deficit in balance of goods and services	16.4	18.4	21.0	21.3	7.5	5.4	4.9	5.2	5.5	5.7	5.8	
Exports	59.5	64.2	63.2	60.3	49.2	54.3	57.3	56.7	55.4	53.9	52.7	
Imports	76.0	82.6	84.2	81.6	56.7	59.7	62.2	62.0	60.8	59.5	58.5	
Net non-debt creating capital inflows (negative)	-12.0	-16.5	-21.4	-9.9	-7.7	-8.0	-7.8	-7.5	-7.7	-7.8	-7.5	
Automatic debt dynamics 1/	-4.2	-8.0	-14.0	-2.2	8.4	2.8	0.8	-1.6	-1.4	-2.2	-2.0	
Contribution from nominal interest rate	1.8	1.9	2.4	2.6	2.6	3.0	2.9	2.4	2.3	2.2	2.1	
Contribution from real GDP growth	-3.6	-3.9	-4.0	-4.8	5.8	-0.2	-2.1	-4.0	-3.7	-4.4	-4.1	
Contribution from price and exchange rate changes 2/	-2.4	-6.1	-12.3	-16.4	1.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	12.8	19.1	29.3	-1.3	-4.9	0.2	1.3	-0.3	-0.6	-0.1	-0.8	
External debt-to-exports ratio (in percent)	119.0	127.7	158.7	179.7	225.6	201.1	185.5	176.9	170.4	163.8	155.7	
Gross external financing need (in billions of US dollars) 4/	13.3	17.2	29.0	38.3	40.7	37.2	36.7	37.5	38.6	39.4	42.0	
in percent of GDP	48.7	54.3	73.2	76.3	86.0	73.5	70.3	67.6	64.8	61.2	65.2	
Scenario with key variables at their historical averages 5/						107.3	99.0	91.3	84.5	78.5	72.2	-17.7
												For debt
Key Macroeconomic Assumptions Underlying Baseline												stabilization
Real GDP growth (in percent)	6.2	6.3	6.2	6.0	-5.0	0.2	2.0	4.0	4.0	5.0	5.0	
GDP deflator in US dollars (change in percent)	4.0	9.3	17.7	19.6	-0.9	6.9	1.0	2.4	3.2	2.9	2.9	
Nominal external interest rate (in percent)	3.2	3.1	3.6	3.3	2.2	2.9	2.7	2.4	2.5	2.5	2.6	
Growth of exports (US dollar terms, in percent)	16.1	25.3	23.1	20.9	-23.2	18.2	8.7	5.5	4.7	5.1	5.6	
Growth of imports (US dollar terms, in percent)	23.0	26.4	27.5	22.8	-34.6	12.7	7.4	6.1	5.4	5.7	6.1	
Current account balance, excluding interest payments	-10.5	-16.5	-24.5	-21.5	-6.9	-3.2	-2.9	-3.5	-3.7	-3.9	-4.1	
Net non-debt creating capital inflows	12.0	16.5	21.4	9.9	7.7	8.0	7.8	7.5	7.7	7.8	7.5	

Source: Bulgarian National Bank; and IMF staff estimates and projections.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

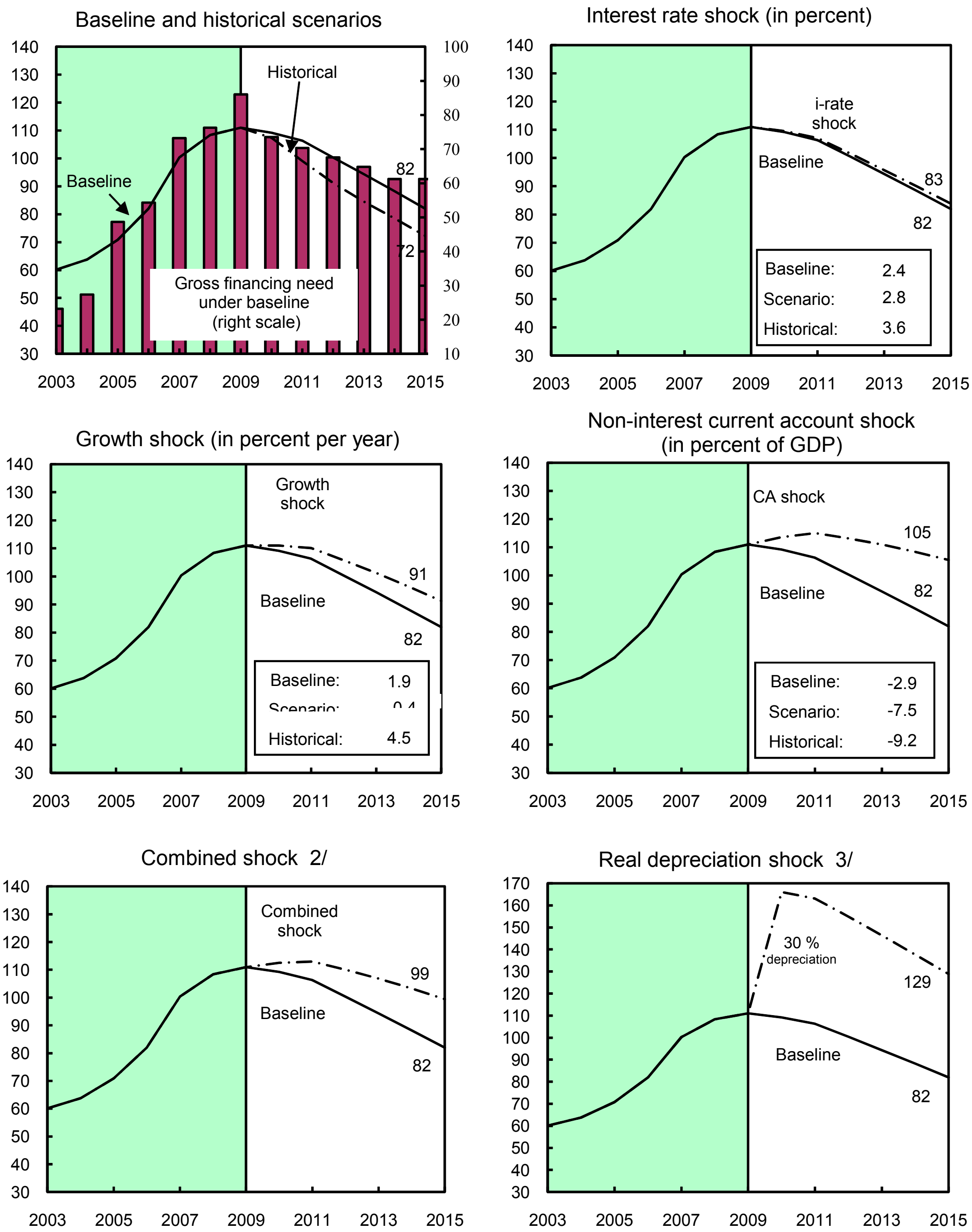
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 10. Bulgaria: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2009.

INTERNATIONAL MONETARY FUND

BULGARIA

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the European Department

April 16, 2010

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I. BULGARIA—FINANCIAL POSITION IN THE FUND

(AS OF MARCH 31, 2010)

I. Membership Status: Joined September 25, 1990

II. General Resources Account:

	SDR Million	%Quota
Quota	640.20	100.00
Fund holdings of currency	606.48	94.73
Reserve Position	33.74	5.24
Holdings Exchange Rate		

III. SDR Department:

	SDR Million	% Allocation
Net cumulative allocation	610.88	100.00
Holdings	610.88	100.00

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Aug. 6, 2004	Mar. 31, 2007	100.00	0.00
Stand-By	Feb. 27, 2002	Mar. 15, 2004	240.00	240.00
EFF	Sep. 25, 1998	Sep. 24, 2001	627.62	627.62

VI. Projected Payments to Fund: [1/]

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal					
Charges/Interest	0.05	0.05	0.05	0.05	0.05
Total	0.05	0.05	0.05	0.05	0.05

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not applicable

IX. Resident Representative

Mr. Lybek is the Regional Resident Representative, based in Bucharest. He took up the position on March 31, 2009.

II. Bulgaria: IMF-World Bank Relations

A. Partnership in Bulgaria's Development Strategy

1. The World Bank has been leading the policy dialogue in structural and institutional reforms aimed at Bulgaria's successful EU integration and convergence. On June 13, 2006 the Board of Directors discussed the Country Partnership Strategy (CPS) of the Bank which outlined the roadmap for the Bank's country support for the period FY07-09. The strategic priorities of the last CPS focused on: (i) productivity and employment; (ii) fiscal sustainability and absorption of EU funds; and (iii) social inclusion. In addition to the Bank's ongoing lending operations in areas such as revenue administration, social investment and employment promotion, district heating, and environment, the CPS included a three-year program of three development policy loans (DPLs), totaling US$500 million equivalent, that supported institutional reforms in the social sectors. In addition, the CPS program included investment lending in road, trade and transport facilitation for South East Europe, social inclusion, and municipal infrastructure. The Bank continues to undertake diagnostics, providing a solid base for policy dialogue and design and implementation of its lending operations in Bulgaria. The Bank is currently discussing with the Government the CPS for the period FY10-13.

B. IMF-World Bank Collaboration in Specific Areas

2. The Bank has the lead on the dialogue on the core structural aspects of the reforms, while the Fund has the lead on the dialogue on the macroeconomic, in particular fiscal and financial sector, aspects of the reforms. The IMF leads in the areas of macroeconomic stability, fiscal, income, external sector policies, and its analyses serve as inputs into World Bank policy formulation and advice. The Bank and the Fund share responsibility in the financial sector, public expenditure management and budgeting, and tax administration.

B.1. Areas of shared responsibility

3. **Financial Sector.** In late 2001, staff of the two institutions carried out a joint IMF-World Bank *Financial Sector Assessment Program* (FSAP) for Bulgaria, providing a shared perspective on the development agenda of the country and on the prioritization and sequencing of reforms in the financial sector. Key findings of the FSAP have been used as conditionalities on financial sector policies under both the SBA and the PAL program. A follow-up to the FSAP was undertaken by Fund staff in the context of the 2004 Article IV Consultation mission in March–April 2004, with the most recent update completed in June 2008.

4. **Revenue Administration.** Joint World Bank-IMF efforts led to the Revenue Administration Reform Project (€31.9 million), approved by the Bank's Board in 2003, under which the new National Revenue Agency became operational on January 1, 2006, integrating collection of tax and social security revenues and establishing an economically

efficient public revenue collection system that facilitates private sector development and complies with EU requirements.

5. **Public Expenditure Management.** The Bank has taken the lead in the dialogue on the efficiency and effectiveness of public expenditures and has outlined policy directions in the context of the Public Expenditure and Institutional Review[1] of 2002, the Public Finance Policy Review[2] of 2006, and the Judicial Public Expenditure Review of 2008[3]. In FY08-09, the Bank provided technical assistance to the Ministry of Finance in strengthening performance based budgeting and public investment budgeting and management. A public expenditure review of the agriculture sector is currently being finalized.

B.2. Areas where the World Bank leads and its analyses serve as inputs into the IMF policy formulation and advice.

6. **Education.** The Bank has supported the government program in education. The three DPLs, which were approved by the Bank's Board in March 2007, November 2008, and May 2009, supported the deepening of education reforms, in particular strengthening of the institutional capacity of the Ministry of Education and Science to assess the quality of education, and improve school governance and financing system. In addition, a second Public Finance Policy Review[4], finalized in 2007, outlined options for reforms aimed at improving quality of education at all levels with special focus on vocational education and training as well as the quality of and access to tertiary education.

7. **Health.** The Bank supported the government program in health through two investment operations and the DPL program. The DPL program focused on strengthening the financial sustainability of the national health insurance system and enhancing the efficiency of public spending on hospitals and pharmaceuticals.

8. **Social protection programs.** Social protection programs—pensions, labor market programs, social assistance, and short-term and family benefits—have a wide coverage among the population. The Bank's DPL program supported an employment promotion program, which includes interventions to alter incentives both on the labor supply and the labor demand sides. To create additional incentives for job searching and lower reliance of able-bodied individuals on social welfare programs, the government has changed eligibility criteria of some social assistance programs. In November 2008 the Bank completed a policy

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[1] *Bulgaria: Public Expenditure Issues and Directions for Reform*, August 2002, The World Bank (Report No. 23979-BUL).

[2] *Bulgaria: Public Finance Policy Review – Leveraging EU Funds for Productivity and Growth*, February 2006, The World Bank (Report No. 33992-BG).

[3] *Bulgaria: Resourcing the Judiciary for Performance and Accountability, A Judicial Public Expenditure and Institutional Review*, July 2008, The World Bank (Report No. 42159-BG).

[4] *Bulgaria: Accelerating Bulgaria's Convergence: The Challenge of Raising Productivity*, July 2007, The World Bank (Report No. 38570).

note focusing on policies to raise employment and address shortages of labor and skills mismatches.

9. The Bank has embarked on a multi-year poverty monitoring program aimed at assessing the impact of government policies and economic growth on the poor. The first poverty monitoring report[5] provides a feedback loop so that policy adjustments can be made as appropriate to take account of findings. In addition, in November 2008 the Bank's Board approved a Social Inclusion Loan aimed at addressing longer term constraints to social inclusion, and facilitating the government's absorption of grants from the European Social Fund.

C. The World Bank Group Strategy and Lending Operations

10. **The Country Partnership Strategy (CPS) for Bulgaria[6],** discussed by the Bank's Board on June 13, 2006, focused on three main themes: (i) productivity and employment, (ii) fiscal sustainability and absorption of EU funds, and (iii) social inclusion. A CPS covering the period FY10-13 will be presented to the Board in the latter half of FY10.

11. **The current active Bank portfolio in Bulgaria consists of 7 operations at the total amount of US$ 369.6 equivalent.** The World Bank's assistance program in Bulgaria to date comprises 46 IBRD operations with a total original commitment of US$3,003 million equivalent, consisting of 15 adjustment loans (US$1,725.8 million), 24 investment projects (US$1123 million), one debt reduction loan (US$125 million), four Bank-managed Global Environmental Fund (GEF) grants, and two Bank-managed Prototype Carbon Fund (PCF) operations. Of these 46 operations, 39 have been completed, of which 13 have been fully or partially cancelled during implementation, and 7 operations are currently under implementation (Table 1).

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[5] *Bulgaria: Living Conditions before and after EU Accession,* September 2009, The World Bank (Report No. 44289-BG).

[6] Memorandum of the President of the International Bank for Reconstruction and Development and the International Finance Corporation to the Executive Directors on a Country Assistance Strategy of the World Bank Group for Bulgaria, May 31, 2006.

Table 1. Bulgaria–Active World Bank Operations (Net of Cancellations)

	Operation	US$ million	Board Date
1.	District Heating Project (PCF)	5.0	2003
2.	Wood Residue to Energy (PCF)	1.6	2003
3.	Energy Efficiency (GEF Grant)	10.0	2005
4.	Second Trade and Transport Facilitation in Southeast Europe (TTFSE 2)	52.8	2007
5.	Road Infrastructure Rehabilitation Project	122.5	2007
6.	Social Inclusion Project	59.0	2008
7.	Municipal Infrastructure Development Project[7]	118.7	2009

12. **Economic and Sector Work.** The country diagnostic work recently completed by the Bank focuses on improving the transparency and accountability of public spending in the judiciary, on strengthening institutions and governance in the forestry sector, and on policies to increase skills and productivity of the labor force. A public expenditure review of the agriculture sector is currently being finalized. Various pieces of country diagnostic work also focused on private sector development issues and improvements in the regulatory environment for doing business. These include an Investment Climate Assessment, a review of the regimes of state fees, and a Review of Consumer Protection and Financial Capability. In addition, the Bank updated the assessment of Bulgaria's corporate governance and auditing and accounting standards in the context of the Report on the Observance of Standards and Codes program.

13. **As of March 1, 2010, IFC has 30 projects (completed and ongoing) in Bulgaria with total commitments of over US$ 660 million.** The single biggest investment of IFC in the country is in the field of renewable energy in the form of a loan for the construction of the largest wind park in Bulgaria. IFC is also involved in the development of the *Galata* gas field near the Black sea cost. In line with IFC's strategic goals for Bulgaria, IFC has supported a company investing in agricultural land and promoting land consolidation. In the financial sector, IFC is supporting two specialized SME banks; it established Bulgaria's first micro-lending bank and has invested in a venture fund, which is also targeting the SME sector. In other industries, IFC had contributed to key manufacturing projects in the country–it has supported the modernization and expansion of an electronics producer, a large steel mill, and two glass processing plants. Some IFC projects entail an important environmental component. One of the manufacturing plants, for example, is purchasing equipment which would reduce its GHG emissions and the electronics producing company is making sensors for cars that monitor the emission of polluting gases and improve fuel efficiency.

Questions may be referred to Ms. Stella Ilieva (3592-9697-251) and Ms. Sylvia Stoynova (3592-9697-220).

[7] The Municipal Infrastructure Development Project was approved by the Board on November 24, 2009 and is pending effectiveness.

III. BULGARIA: STATISTICAL ISSUES

Data provision is generally adequate for surveillance purposes. Bulgaria participates in the SDDS since 2003.

Real sector

1. The National Statistical Institute (NSI) is responsible for compiling national accounts, based on a system consistent with the *System of National Accounts 1993* (*SNA 1993*) and the *European System of Accounts 1995*. GDP data by activity and expenditure categories are compiled and reconciled within an annual supply and use framework. However, government output and final consumption are estimated on a cash basis. In addition, published national accounts include current and capital accounts for the five main domestic sectors (general government and its sub-sectors, financial corporations, nonfinancial corporations, nonprofit institutions serving households, and households). Financial accounts and balance sheets by institutional sectors and sub-sectors are compiled on annual basis since 2006. Quarterly financial accounts and balance sheets are prepared by Bulgarian National Bank.

2. The NSI has compiled estimates of quarterly GDP by the production and expenditure approaches in current and constant prices since 1994. The preliminary flash estimates of GDP and its components by production and expenditure side are produced and disseminated 45 days after the reference period. The quarterly updates are disseminated 70 days after the end of the reference quarter with final figures disseminated after approximately 5 quarters. The annual data are disseminated about 5 quarters after the end of the reference year. The estimates at constant prices, which follow international standards, use chain-linked indices. Problems remain in the coverage of private sector activities as well as regarding constant price estimates of capital formation and external trade, although progress has been made in the development of export and import deflators.

3. On price data, the NSI produces a domestic consumer price index (CPI), a harmonized consumer price index (HICP) according to Eurostat methods, and a producer price index (PPI). All are updated monthly. The CPI series begins in 1995, the PPI in 2000 and the HCPI in 2005 (for earlier years it is set equal to the CPI). The coverage of the CPIs was extended, although they still exclude some important sectors, mainly owner-occupied housing and health and life insurance. Since 2004, financial services are included. Currently, work has started on inclusion of owner-occupied housing in CPI within a Eurostat project. The geographical coverage of the index is restricted to 27 urban areas that account for an estimated 65 percent of sales.

4. The flow of customs data has improved significantly in recent years and a new system for processing customs records is near completion. The development of export and import unit value indices is progressing smoothly and additional support is expected from Eurostat in this area. The current indices are used as deflators for the import and export components of the national accounts. The Import and Export Division of the NSI meets monthly with the BNB to review data issues and ensure consistency between the NSI export and import data and the balance of payments data.

5. The national account data on employment and hours worked are compiled by the NSI based on Labor Force Survey and adjusted according to the ESA'95 methodology. The NSI also obtains current monthly estimates from a quarterly survey of establishments using all public enterprises and a sample of private employers that excludes establishments with less than five employees. The sample included 14,500 private employers out of approximately 142,000 qualifying private enterprises. The NSI household labor force survey is an alternative source of data, but improvements are needed to make it more consistent with the establishment survey, especially regarding agricultural employment. The survey is conducted four times a year.

6. The NSI also compiles and publishes wage data for various economic sectors. The main shortcomings include: (i) under-reporting of private sector wages; and (ii) reporting of average gross earnings only, not wages for time worked and wages by occupation. Since 2002, every four years a survey on earnings is conducted which provides information about average monthly and hourly earnings by economic activity, by occupation, by gender and by education. The National Social Security Institute (NSSI) administrative data are currently used to estimate wages by occupation and age (as well as the number of self-employed and employment in small firms). The household budget survey could provide an alternative source of data for private sector wages.

7. A Population Census was conducted in early 2001 and is a source for redesigning the household surveys conducted by the NSI, particularly the household budget survey and the labor force survey.

Government finance

8. In recent years, following the recommendations of a combined STA/FAD mission and within the framework of fiscal reporting requirements for EU accession, the authorities have made significant progress on implementing accrual accounting for government, budgetary and statistical systems. Consolidated data on a cash basis, covering general and central government operations, are routinely reported for publication in the *GFS Yearbook/Annual CD-ROM* and in *IFS.* In addition, quarterly accrual GFS data are reported on a quarterly basis for publication in *IFS*, through Eurostat. Since September 2008, the Ministry of Finance (MOF) prepares and submits the SDDS indicators for the central government finances in the IMF's GFSM 2001 format. The same indicators are published on the MOF's website on a monthly and quarterly basis.

9. The Ministry of Finance prepares data on the execution of the consolidated government budget on a monthly basis, following the national presentation. These data are not according to *GFS* standards. Aggregate data on revenue, expenditure, balance of the general government and composition of the financing (in national formats) are published in the monthly bulletin and posted on the MOF's website, in addition to the GFSM 2001 data. The authorities have made progress in presenting data on a disaggregated basis, including expenditure by functional classification. In addition, a full economic classification of expenditure is now available, and the authorities have provided such data on an annual basis back to 1998.

Money and banking statistics

10. BNB reports monetary data for publication in *IFS* based on the ECB framework for the collection and compilation of monetary data.

Balance of payments

11. Bulgaria provides quarterly balance of payments (BOP) statistics for dissemination in the IFS on a timely basis. Yearly BOP data are disseminated in the Balance of Payments Statistics Yearbook up to 2008. The BNB derives other sectors investment income data on reinvested earnings, (debit) from the annual direct investment surveys of the NSI, as well as through surveys of the largest foreign-owned enterprises, used for preliminary estimates. Starting from 2002, data series on freight were revised according to a new methodology introduced jointly by the BNB and the NSI. Since joining the EU in January 2007, the trade data with EU countries are being collected following the INTRASTAT system. Data collection for imports and exports with non-EU member states and the movement of goods within the EU are still recorded through customs declaration.

Table 1. Bulgaria: Common Indicators Required for Surveillance

As of March 8, 2010

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	Feb 2010	03/04/2010	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jan 2010	03/03/2010	M	M	M		
Reserve/Base Money	Jan 2010	03/03/2009	M	M	M	O, O, LO, LO	O, O, O, O, O
Broad Money	Jan 2010	03/03/2009	M	M	M		
Central Bank Balance Sheet	Jan 2010	03/03/2009	M	M	M		
Consolidated Balance Sheet of the Banking System	Jan 2010	03/03/2009	M	M	M		
Interest Rates[2]	Jan 2010	03/04/2010	M	M	M		
Consumer Price Index	Jan 2010	02/17/2010	M	M	M	O, LO, O, O	LO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec 2009	03/08/2010	A	A	A	O, LO, O, LO	LO, O, O, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec 2009	03/08/2010	M	M	M		
Stocks of General Government and General Government-Guaranteed Debt[5]	Dec 2009	03/08/2010	M	M	M		
External Current Account Balance	2009 Q3	12/23/2009	Q	Q	Q	LNO, LO, O, LO	LNO, LNO, LNO, LO, LO
Exports and Imports of Goods and Services	2009 Q3	12/23/2009	Q	Q	Q		
GDP	2009 Q3	12/23/2009	Q	Q	Q	O, LO, O, LO	O, O, O, O, O
Gross External Debt	2009 Q3	12/23/2009	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions. [2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds. [3] Foreign, domestic bank, and domestic nonbank financing. [4] On a gross cash basis. The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and local governments. [5] Including currency and maturity composition. [6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA). [7] Reflects the assessment provided in the data ROSC published in December 2003, which is based on the findings of the mission that took place during January 15-30, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO). [8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

BULGARIA

Staff Report for the Article IV Consultation—Supplementary Information

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Anne-Marie Gulde-Wolf and Aasim Husain

April 27, 2010

1. **New information has become available since the Staff Report was issued**. The information does not change the thrust of the staff report, but further adds to staff's concerns in para 5 of the staff report that fiscal policy in 2010 will be challenging, and raises the likely fiscal cash deficit for 2010.

Fiscal policy

2. **The 2009 fiscal deficit on an accrual basis (the concept used by the European Union) was revised from 1.9 to 3.9 percent of GDP.** The upward revision largely reflected previously unidentified payment commitments for capital, maintenance and hospital spending (1.3 percent of GDP) and exclusion of revenue of some cash dividends that were received in 2009.[1] The deficit on a cash basis has changed only marginally, from 0.8 to 0.9 percent of GDP.

3. **According to preliminary data, the cash deficit in the first three months of the year amounted to 2.4 percent of GDP.** The deficit in part reflects temporary factors. Expenditures were affected by the partial settlement of arrears and payment commitment built up in 2009. VAT receipts were affected by the temporary closure of the refinery in February, which led to a reduction in oil imports, and by the repayment of VAT refunds that had accumulated in the last quarter of 2009. Nevertheless, while detailed data are available only until February, underlying revenues seems to have been weaker than expected as well, highlighting the concerns in the staff report that revenue might fall short. The deficit has been largely financed by a draw-down of fiscal reserves.

4. **To contain the full-year deficit, the government has adopted a package of new fiscal measures, which it estimates will yield about 2.4 percent of GDP.** On the revenue

[1] The government had received in 2009 dividend payments from state-owned enterprises that exceeded the profits of the companies in 2009. To the extent that they exceeded the 2009 profits, the dividends were already included in revenues from previous years, which reduced revenues for 2009.

side, measures include the sales of emissions under the Kyoto protocol (0.7 percent of GDP), the introduction/ increase in lottery, gambling, and luxury taxes, as well as the rent and sale of state-owned land. On the expenditure side, the biggest savings are to come from across-the-board cuts in current spending (0.7 percent of GDP), a postponement in increases of special pensions, and a reduction in social spending, while subsidies to the poor will be raised somewhat.[2]

5. **With revenue shortfalls and higher payment obligations partly offset by new measures, the government now expects to contain the cash deficit to 2½ percent of GDP—compared with an original target of 0.7 percent of GDP, and a staff projection of 1.8 percent of GDP in the staff report.** The deficit on an accrual basis would be slightly lower (2.0 percent of GDP). The government plans to finance part of the higher deficit through additional privatization proceeds (0.4 percent of GDP) and by issuing euro-denominated securities on the domestic market.

6. **In staff's view, reaching the new deficit target with current measures alone may be challenging and more will likely be needed.** The estimated overall impact of measures both on the revenue and the expenditure side appears optimistic, in particular given the risk of implementation delays. To contain the cash deficit to below 3 percent of GDP, an increase in the VAT rate may be needed (raising the VAT by 2 percentage points on July 1—an option that is currently under consideration—could yield about 0.7 percent of GDP in 2010). Other possible measures are an increase in social security contribution rates, as well as additional expenditure restraint (in particular, maintenance and subsidies). The significant and unexpectedly high amount of payment commitments and arrears that was built up in 2009 also highlights the importance of timely and adequate fiscal reporting on an accrual basis.

Economic Outlook

7. **Staff's macro-economic projections remain broadly unchanged.** The recovery in exports is continuing (in the first two months of 2010, exports were 10 percent higher than a year earlier), while domestic demand and capital inflows remain weak. Based on the strong export performance, the government is considering raising its GDP growth projections for 2010 to 1.0 percent, but staff's projections remain unchanged at 0.2 percent.

[2] The expenditure cuts are to be implemented by the Ministry of Finance allocating only 90 percent of budgeted resources to line ministries for current non-interest expenditure until late in the year, when a revised budget is to be adopted depending on budgetary developments. This procedure was adopted after a Constitutional Court ruling rejected an article in the 2010 budget law which allows the government to revise the level of revenues and expenditure without parliamentary approval in case of worse-than-expected economic performance. The government has de facto resorted back to the "90-percent rule" used in previous years.

ERM-II membership

8. **Following the revision of the 2009 deficit, the government has put its ERM—II application on hold.** Whether it will pursue the application this year, will depend on whether the EU commission will start an excessive deficit procedure for the 2009 deficit. The European Commission has launched a procedure under which it will produce a report identifying whether an excessive deficit exists, which is tentatively scheduled for mid-May.

9. **Market reaction to the postponement has been muted.** CDS spreads changed little after the announcement, remaining in the 200 basis points range reached in the weeks prior to the announcement– well below the highs of over 650 basis points from a year ago. Similarly, the stock market has shown little reaction, with prices remaining stable. Ratings agencies have not changed their outlook on Bulgaria. Moody's even announced that a ratings upgrade for Bulgaria is still possible in the next 12-18 months despite the sharp revisions to the fiscal deficit and its subsequent implications. In the last week, CDS spreads have increased by 30 basis points, to 236, as contagion from Greece led to an increase in CDS spreads for most countries in Emerging Europe.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/69
FOR IMMEDIATE RELEASE
June 2, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with Bulgaria

On May 3, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bulgaria.[1]

Background

In the years that preceded the global economic and financial crisis, large capital inflows into Bulgaria generated a domestic demand boom. This brought strong GDP and employment growth, but also widened the current account deficit to very high levels, and led to an overheating of the economy, with high wage growth and double-digit inflation.

The boom came to an end in the fourth quarter of 2008, amid the global crisis that followed the default of Lehman Brothers. A sharp reduction in capital inflows led to a contraction of domestic demand, while the recession in Bulgaria's trading partners caused a drop in exports. As a result, GDP contracted by 5.0 percent in 2009.

An increase in exports will lead to a recovery this year, and real GDP is projected to increase by 0.2 percent in 2010. Investment will likely drop further, on the back of an unwinding investment boom, tightened credit, and weak economic activity, while private consumption is forecast to suffer from the decline in employment. Inflation is projected to remain moderate at

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

2.2 percent, while the current account deficit is expected to drop from 9½ percent in 2009 to 6¼ percent of GDP in 2010.

The downturn has led to a correction of previously built-up flow imbalances, although stock imbalances and vulnerabilities remain high. However, while capital inflows will, over time, recover somewhat from the low levels during the crisis, they will mostly likely remain well below the unsustainable levels experienced before 2009, and both the private sector and public sector will need to adjust to lower capital inflows. The private sector will need to shift resources from the non-tradable to the tradable sector. Public policies will also need to attune to the end of the domestic demand-driven revenue boom and adjust spending growth to the new environment. Sustaining the built-up public buffers is important because private sector vulnerabilities remain considerable. Private sector external debt stood at 102.7 percent of GDP at end-2009, while gross foreign currency debt of the non-financial private sector amounts to 80 percent of GDP.

Executive Board Assessment

Executive Directors commended the Bulgarian authorities for maintaining prudent macroeconomic policies, which had helped steer the economy through the global financial crisis. Directors noted that while the economy is poised to recover this year after a sharp contraction, large private external debt and the potential spillover from regional uncertainties pose considerable downside risks. Capital inflows are likely to remain low and domestic demand is expected to decline further, requiring substantial adjustments by both the private and public sectors. Wage moderation, alongside structural reforms to increase productivity, will help facilitate a reorientation of the economy toward the tradable sector, while containing the growth of public spending is a necessary response to the end of the revenue boom.

Directors underscored the importance of adjusting public policies to help prepare the country for eventual euro area membership. The currency board arrangement has been a pillar of stability, and euro adoption continues to be the most viable exit strategy. Maintaining fiscal discipline and deepening structural policies will not only strengthen economic fundamentals but also demonstrate that Bulgaria can rapidly adjust its economy within the confines of the currency board arrangement.

Directors recognized the challenges facing fiscal policy in 2010, arising from revenue shortfalls and a higher-than-expected stock of payables and arrears. They endorsed the government's plan to implement a package of measures in order to achieve the revised cash deficit target, notably further cuts in current spending. Directors welcomed the authorities' readiness to take further steps to preserve fiscal sustainability, including tax measures. The higher-than-expected build-up of arrears in 2009 also highlights the need for timely and adequate fiscal reporting, including on an accrual basis.

For 2011 and beyond, Directors saw a larger role for fiscal policy in stabilizing the economy by focusing, within a medium-term budgetary framework, on the overall spending envelope rather than on headline balances. This would help make public spending more predictable and limit the large intra-year adjustments. They encouraged the authorities to save revenue windfalls, and to compensate any tax rate reductions by further expenditure cuts. On the fiscal reform agenda, high priorities are closing the gap between pension contributions and pension expenditures, and improving the efficiency and quality of the health care system.

Directors welcomed the continued stability of Bulgaria's financial system, underpinned by prudent regulation and adequate capital buffers. Nevertheless, in light of the rising non-performing loans and the risk of a reversal of parent funding to subsidiaries in Bulgaria, it will be important that the authorities remain vigilant, monitor liquidity closely, and continue close cooperation with parent bank supervisors. Enforcement of a cautious dividend policy and contingency planning are also priorities. Directors welcomed the recent creation of a financial stability unit at the central bank, and looked forward to further improvements to the bank resolution framework.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the **2010** Article IV Consultation with **Bulgaria** is also available.

Bulgaria: Selected Economic Indicators

	2005	2006	2007	2008	2009 1/	2010 2/
Output, prices, and labor market	(Annual percentage change)					
Real GDP	6.2	6.3	6.2	6.0	-5.0	0.2
Consumer price index (average)	6.0	7.4	7.6	12.0	2.5	2.2
Consumer price index (end of period)	7.4	6.1	11.6	7.2	1.6	2.7
Employment	1.9	4.3	3.5	2.8	-4.0	-2.2
Public Finance	(In percent of GDP)					
General government overall balance	2.4	3.5	3.5	3.0	-0.9	-2.5
Gross public debt	31.3	24.6	19.8	16.1	16.1	16.2
Financial net worth	6.0	9.9	10.2	11.5	10.8	8.9
Money and credit	(Annual percentage change)					
Broad money (M3)	23.9	26.9	31.2	8.8	4.3	0.3
Credit claims on non-government sector	32.4	24.6	62.5	31.6	3.8	1.6
Balance of payments	(In percent of GDP)					
Merchandise trade balance	-20.2	-22.0	-25.1	-25.2	-12.1	-9.9
Current account balance	-12.4	-18.4	-26.8	-24.0	-9.4	-6.2
Gross international reserves	33.7	35.4	41.3	37.3	37.8	37.8
Exchange rates						
Exchange rate regime	Currency board arrangement					
Leva per euro	Lev 1.95583 per Euro					

Sources: Bulgarian authorities; and IMF staff estimates.
1/ Preliminary.
2/ Projections.

Statement by Age Bakker, Executive Director for Bulgaria
and Victor Yotzov, Advisor to Executive Director
May 3, 2010

The Bulgarian authorities appreciate the continued constructive dialogue with the Fund. They broadly share the staff analysis and policy advice as presented in the Article IV report.

The end of the capital-inflows driven domestic demand boom

Until late 2008, Bulgaria experienced high growth rates and a rapid catch-up with the EU countries. The confidence inspired by a good economic performance and, more recently, by the accession to the EU has continued to attract substantial amounts of private capital inflows, mostly in the form of FDI. While the surge in inflows did generate strong GDP growth (above 6 percent on average for the last four years), it also caused a sharp widening of the external current account deficit as the increase in domestic demand outpaced GDP growth.

As a consequence of the global financial crisis that followed the default of Lehman Brothers, the investment-driven boom came to an end. Capital inflows, that were fueling growth for years, dried up which led to a significant contraction of domestic demand. On top of that, the recession that hit Bulgaria's main trading partners, mostly EU countries, caused a substantial drop in exports. The impact of these two shocks was fully felt in the second half of 2009 when it became obvious that the economy will record the first contraction in more than a decade. The decline in domestic demand and the reduction of imports, in turn, led to a swift correction of previously built-up internal and external imbalances as evidenced by the sharp decline of inflation and current account deficit. At the same time, the decline in domestic demand, consumption in particular, along with shrinking imports, caused a considerable drop in fiscal revenues which eventually resulted in an overall budget deficit – the first one since 2002. The level of public debt, however, remained low (about 16 percent of GDP) and is not projected to rise.

The financial system, dominated by the banking sector, remained stable. Following the global financial turmoil that started in 2007 and intensified after September 2008, foreign funding declined, resulting in strong competition for deposits and a sharp reduction in credit growth. The interbank market was affected as well but calmed down after some targeted steps taken by the central bank it. Subsequently, volumes have resumed and interest rates have moderated.

The policy response

The effects of the global financial crisis were exacerbated, to some extent, by the political cycle and the large spending increases in the run up to the July 2009 parliamentary elections. However, the new government that took office after the elections promptly reversed the trend by implementing across-the-board spending cuts, in particular for maintenance and capital spending. Thus, the government managed to contain the cash deficit to just 0.9 percent of GDP. On accrual basis, however, the deficit is higher, currently estimated at about 3.9 percent of GDP. This rather big upward revision reflects accumulation of arrears due to some previously unidentified payment commitments for capital, maintenance and healthcare spending as well as exclusion of revenue of some cash dividends that were received in 2009. It should be clarified, though, that a large part of the accumulated arrears is due to ongoing revisions of the annexes to the contracts that various ministries had signed before the elections. The government is well aware that repayment of the arrears should be swiftly pursued to prevent cascading of arrears in the private sector. It has already started to repay to those firms where the revisions have been finalized.

With regard to the 2010 budget, the authorities are trying to preserve fiscal sustainability in the context of possible further slumps in revenue. In this regard, the National Revenue and Customs Agencies have been restructured to allow for more and better coordinated inspections so as to improve tax compliance. The excises on cigarettes, as well as taxes on real estate were raised. On the expenditure side, cuts are planned in a number of areas. Wages and general pensions in 2010 will be frozen and no end-year bonuses will be paid. The number of civil servants will be reduced by 3 percent and the originally planned increase of pensions to widowers and those over 75 years old was delayed. Moreover, while capital spending and subsidies are budgeted to rise, the increase is contingent on the expected higher absorption of EU funds and could be halted if absorption falls short of targets.

The authorities realize that fiscal policy will be challenging in the near future. As the crisis deepened, the overall fiscal deficit of 0.7 percent of GDP budgeted for 2010 is hardly achievable. Accordingly, the government is working on a new budgetary framework and a new set of measures. On the revenue side, measures include the sales of emissions under the Kyoto protocol, introduction/increase in lottery, gambling, and luxury taxes, as well as the rent and sale of state-owned land. All this is estimated to yield about 2.4 percent of GDP which, along with additional across-the-board cuts in current spending, will help offset revenue shortfalls (mostly VAT) and higher payment obligations. These measures notwithstanding, the overall fiscal deficit for 2010 (on cash basis) is now estimated to reach about 2.5 percent of GDP and about 2 percent on accrual basis. This said, the authorities stand ready to take further measures (including by raising the VAT rate) to preserve fiscal sustainability. By applying such an approach the authorities reaffirm their strong commitment to sound macroeconomic policies, acknowledging the paramount importance of a prudent fiscal stance.

With regard to the financial sector, thanks to the prudent regulation in the years before the crisis, the banking system has built up substantial buffers. The existing capital buffers, in particular, together with further countercyclical macro-prudential measures should allow the banking system to absorb the increase in NPLs and associated provisions. The BNB has asked banks, as it did in the previous year, to fully retain earnings which will add to capital buffers. Furthermore, the BNB recently implemented additional countercyclical measures such as the alignment of its risk-weights on the EU standards, which are less conservative, and inclusion of current and previous year earnings in the calculation of own funds. In addition, and in relation to recent economic developments in some neighboring countries, the central bank has intensified the liquidity monitoring and initiated regular exchanges of information with parent bank supervisors.

The challenges ahead

The authorities are fully cognizant that the end of the capital-inflow driven boom creates significant policy challenges. Recent economic developments in Bulgaria, as well as in the region as a whole, suggest the need of a swift change in policy priorities. Until just a short time ago, these were speeding up convergence and raising living standards, whereas now the priority is focused primarily on preserving macroeconomic stability. In this regard, the most important challenge is ensuring that the drop in capital inflows does not result in a confidence crisis. Accordingly, the authorities attach great value to maintaining confidence in the currency board arrangement and the financial system. Keeping public finances in check is regarded as the key instrument.

Given the paramount importance of fiscal policy in the context of the currency board arrangement, the authorities agreed with staff that an important policy challenge will be to shift from ad hoc fiscal measures to a medium-term strategy of fiscal policy from 2011 and beyond. More specifically, it was agreed that giving fiscal policy a larger role in stabilizing the economy can be achieved by focusing, within a medium-term budgetary framework, on the overall spending envelope rather than on headline balances. Under such a framework, targeting real spending growth in line with cautious estimates of potential GDP growth would make public spending more predictable, and help prioritize spending while avoiding across-the-board-cuts. In addition, any revenue windfalls could be used to build up fiscal buffers that can be drawn down in times when revenues fall short.

As the crisis escalated last year, there were some concerns that it might trigger a balance of payments or banking crisis which would have forced the country to seek financial assistance. Those concerns did not materialize. What happened was that the downturn led to a correction of previously built-up flow imbalances. While capital inflows will, over time, recover from the low levels during the crisis, an important policy challenge for the economy is to provide a business-friendly environment.

Finally, with regard to the ERM II, the authorities maintain their long-stated position that they will seek joining at the earliest possible date. The ongoing global financial crisis may delay somewhat the process but has not changed the authorities' determination. On the contrary, they have started talks with their European partners and are ready to provide them with firm and detailed policy commitments. The authorities' plan is to uphold the currency board arrangement at the existing exchange rate until Bulgaria joins the euro area. The Bulgarian government and the central bank have committed to unilaterally maintaining a zero deviation of the exchange rate after Bulgaria joins the ERM II.