December 2007
IMF Country Report No. 07/389

Bulgaria: 2007 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Bulgaria

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Bulgaria, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 16, 2007, 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 November 29, 2007. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its December 17, 2007 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Bulgaria.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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BULGARIA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Bulgaria

Approved by Juha Kähkönen and Matthew Fisher

November 29, 2007

Executive Summary

Background: Driven by massive capital inflows, the current-account deficit could reach a record level of 20 percent of GDP in 2007. The external imbalance finances an investment boom; private consumption, reflecting restrained fiscal and incomes policies, has remained contained. Credit growth is also strong, but the largely foreign-owned banking system seems well positioned to absorb adverse shocks. Headline inflation has picked up sharply, mainly reflecting non-core inflation shocks, but wage growth is also accelerating, owing to a tightening labor market. Pressures for large public-sector wage hikes threaten to add to labor cost and inflation pressures.

Staff views: The main challenge is to maintain prudent fiscal and incomes policies to avoid procyclical demand impulses. A stronger push on long-delayed structural reforms, particularly reforms raising public sector efficiency, is also needed. Credit portfolios should be monitored carefully, as present boom conditions may mask underlying credit quality weaknesses. These policies should provide a solid basis for sustaining the currency-board arrangement and achieving Bulgaria's medium-term ambition of accelerated real convergence and deeper EU integration, including through euro adoption. At the same time, failure to keep fiscal and incomes policies in line with the stringent requirements of the currency board could eventually result in a misaligned real exchange rate, likely entailing an abrupt external adjustment or a prolonged period of slow growth.

The authorities' views: The authorities broadly agreed with the staff's diagnosis and policy proposals. They noted that they see no viable alternative to the currency board arrangement. Policies would therefore have to remain consistent with sustaining external competitiveness while increasing buffers against adverse shocks.

Contents Page

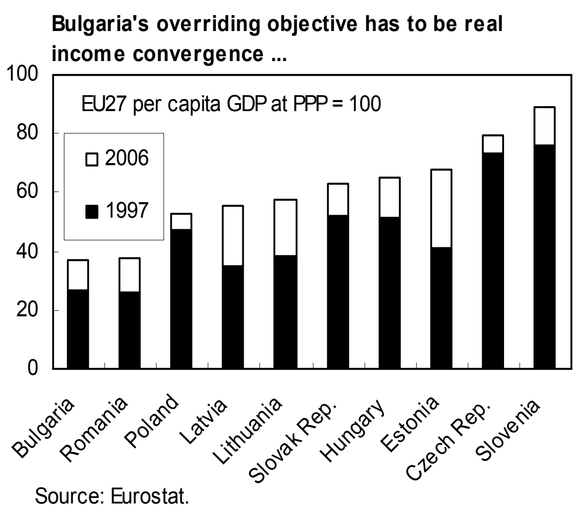
Appendices

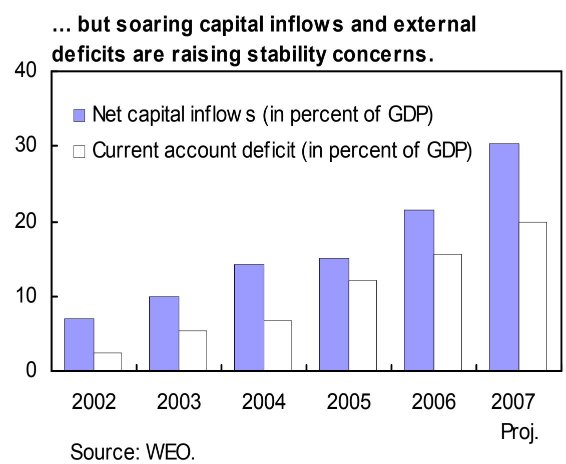
GLOSSARY

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BNB	Bulgarian National Bank
CDS	Credit Default Swaps
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EIU	Economist Intelligence Unit
EMBI	Emerging Market Bond Index
EUR	IMF European Department
FAD	IMF Fiscal Department
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GFS	Government Finance Statistics
GIR	Gross International Reserves
GNFS	Goods and Non-factor Services
GNI	Gross National Income
HICP	Harmonized Index of Consumer Prices
HIPC	Heavily-Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFS	International Financial Statistics
IIP	International Investment Position
ILO	International Labor Organization
LIBOR	London Interbank Offered Rate
MCM	IMF Monetary and Capital Markets Department
MDRI	Multilateral Debt Relief Initiative
MONEYVAL	Committee of Experts on the Evaluation of AML/CFT Measures
NMS	New Member States
NSI	National Statistical Institute
NSSI	National Social Security Institute
OED	Office of Executive Director
PB	Primary Balance
PDR	IMF Policy Development and Review Department
PPI	Producer Price Index
PPP	Purchasing Power Parity
REER	Real Effective Exchange Rate
ROSC	Report on the Observance of Standards and Codes
SDDS	Special Data Dissemination Standard
SME	Small and Medium Enterprises
STA	IMF Statistics Department

I. Overview

1. **The first Article IV Consultation following EU accession took place amid growing concerns about Bulgaria's external vulnerabilities.** Bulgaria has achieved much since the 1996–97 financial collapse: a currency board linked to the euro has anchored stability-oriented fiscal and incomes policies; a largely foreign-owned modern banking sector has developed from scratch; and EU accession has triggered a sweeping upgrade of Bulgaria as an investment location. With Bulgaria's economic policies broadly in line with Fund advice (Box 1), the reward has been robust, albeit not spectacular, catch-up growth. Accelerating sustainable real income convergence has to remain Bulgaria's overriding longer-term policy priority. However, massive and unexpectedly protracted capital inflows have resulted in a soaring current-account deficit, raising more immediate concerns about internal and external stability prospects, concerns accentuated by a recent raft of reports and speeches belaboring the external vulnerabilities of high current-account deficit countries in emerging Europe in general and Bulgaria in particular.





Box 1. Bulgaria's Reactions to IMF Advice

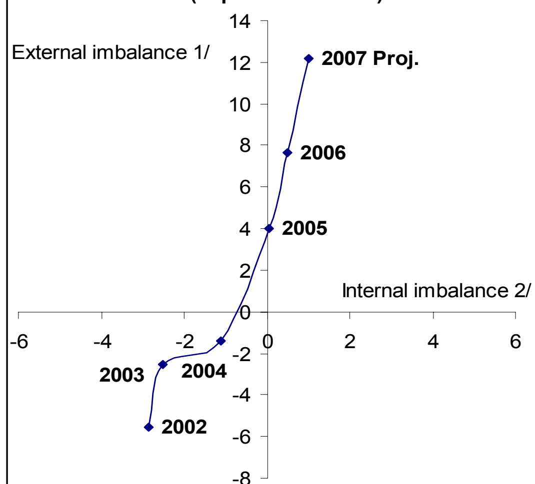
Since the establishment of the currency board in 1997, Bulgaria has had an excellent working relationship with the IMF. Policies have generally been consistent with IMF recommendations, as reflected in the successful completion of a series of Stand-By Arrangements. In particular, fiscal and incomes policies in recent years have responded prudently to the widening external deficit. However, structural reforms that require strong domestic consensus have tended to linger on the political backburner.

2. **The Article IV discussions focused on key policy requirements to contain and manage Bulgaria's external vulnerabilities and achieve deeper integration with the EU.** Notwithstanding Bulgaria's often fractious and volatile politics, all main political forces strongly and unequivocally support maintaining the currency board in the transition to euro adoption, and policy requirements were discussed with this perspective in mind.

II. Background

3. **Bulgaria's already large external imbalance has continued to widen, and underlying price pressures have picked up, although the economy's internal imbalance remains contained.** Massive capital inflows, particularly foreign direct investment (FDI) flows, are at the root of an unexpectedly persistent absorption (domestic demand) boom. The widening gap between the economy's absorption and GDP is reflected in a ballooning current-account deficit, projected to reach about 20 percent of GDP in 2007 (Figure 1, Tables 1-3).[1] Net capital inflows in 2007 could top 30 percent of GDP, far in excess of what is needed to finance the external deficit. In fact, about one third of net capital inflows during 2004–07 added to international reserves (Table 4). Turning to the economy's internal balance, real GDP growth has remained steady at just over 6 percent, reflected in a still moderate output gap estimate. But with labor market conditions tightening, underlying wage and price pressures have gradually picked up. In recent months, headline inflation, as measured by the Harmonized Index of Consumer Prices (HICP), surged into double digits, mainly owing to food- and energy-price shocks.

Bulgaria:
Internal and External Balance, 2002-07
(In percent of GDP)



Source: Fund staff estimates.
1/ Actual current-account deficit minus estimated equilibrium current-account deficit (see Box 2).
2/ Percent deviation of actual from potential GDP (output gap).

4. **Bulgaria's absorption boom reflects largely a private investment boom.** The changes in savings-investment balances during 2004–06 indicate that the foreign-savings influx has financed a boom in private investment. The private investment-GDP ratio surged well above its historical average, while the private consumption-GDP ratio remained close to average (Figure 1). Thus, private consumption has not been a driver of Bulgaria's

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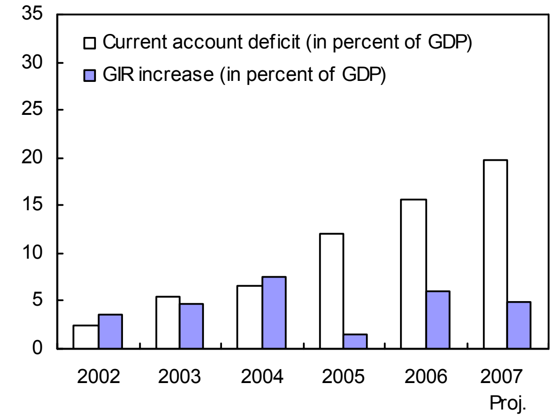
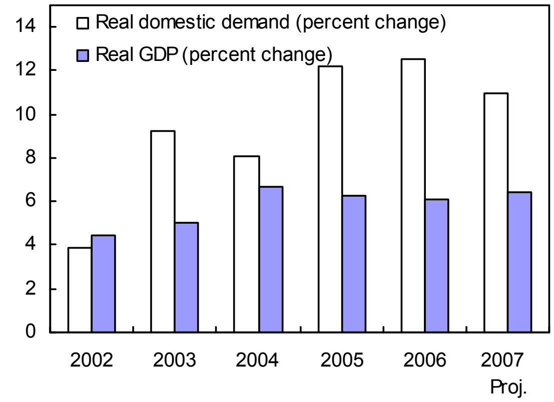
[1] With EU accession, collection of data on trade with EU countries shifted to the *Intrastat System*, a regime change that could have resulted in moderate downward bias in preliminary 2007 export data (Appendix IV).

Figure 1. Bulgaria: Key Macroeconomic Forces at Work, 2002–07

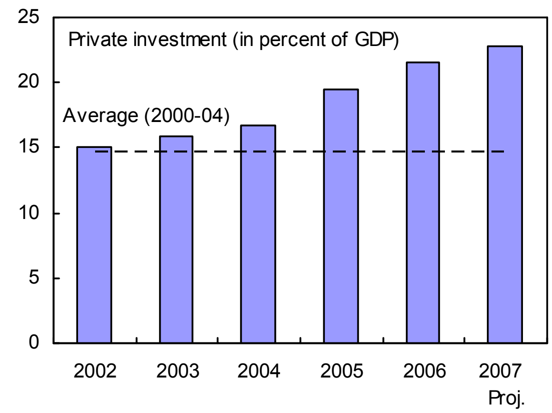
Capital inflows are financing a surge in the external deficit, but also a large build-up in international reserves.



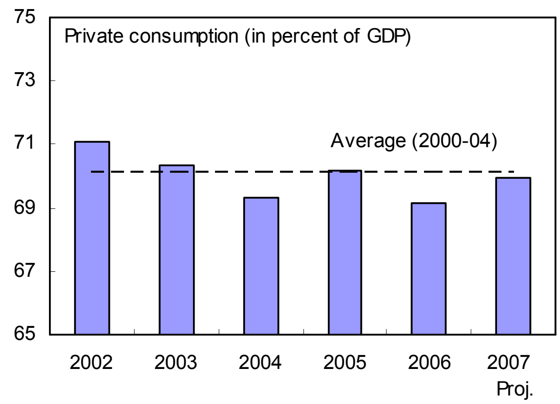
While real GDP growth has been steady, domestic demand is booming ...



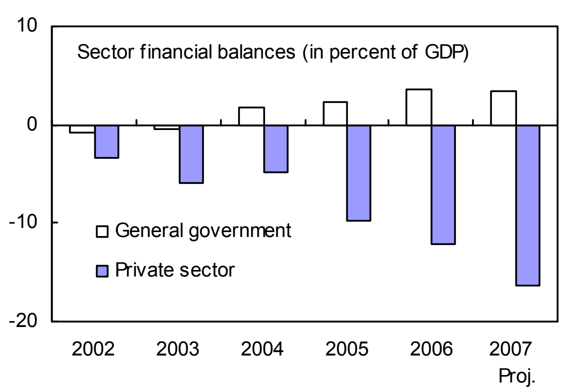
... largely reflecting a private investment boom ...



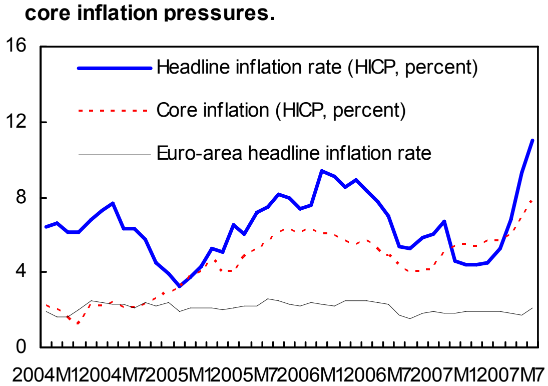
... while private consumption has remained subdued.



Financial balances in the private and government sectors have diverged.



Inflation, while volatile, increasesingly reflects core inflation pressures.



Sources: WEO; Eurostat; and Fund staff estimates and projections.

absorption boom, a conclusion also consistent with an only moderate pickup in imported consumer goods. Moreover, growing fiscal surpluses have accompanied the private sector's widening financial deficits, indicating that fiscal policy was also not an absorption-boom driver (Table 5). While Bulgaria's absorption boom shares similarities with recent trends in the Baltic countries and Romania, Bulgaria's relatively favorable combination of large FDI inflows, low exposures of banks to mortgages, and prudent fiscal and incomes policies stands out (Figure 2).

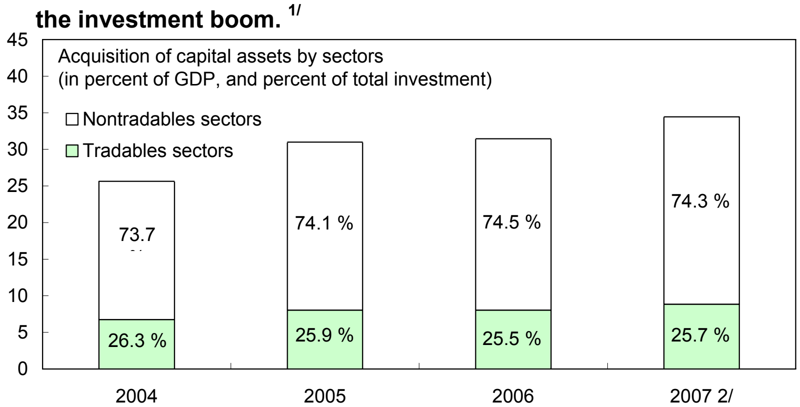
Bulgaria: Savings-Investment Balances, 2004–06
In percent of GDP

	Gross national saving	+	Foreign saving	=	Gross private investment	+	Gross public investment
2004	16.5		6.6		19.3		3.8
2006	16.2		15.7		27.2		4.7
Change 2004-06	-0.3		9.1		7.9		0.9

Sources: Bulgarian authorities; and staff estimates.

5. **Bulgaria's private investment boom likely reflects a one-off re-assessment of the country as an investment location.**[2] The currency board has locked in relatively low risk-free real interest rates, but these low rates can not fully explain the observed investment boom. Prices of financial and real assets—including sovereign bonds, equity, real estate—have skyrocketed only in recent years, roughly in tandem with a sharp drop in Bulgaria's country-risk scores (Figure 3). With an open capital account and international capital in search of yield as backdrops, risk premia on Bulgarian investment projects seem to have declined mainly for two reasons: (i) investors' previous concerns about elevated macroeconomic risks were largely addressed by the sustained and successful operation of the currency board; and (ii), investors' earlier concerns about microeconomic

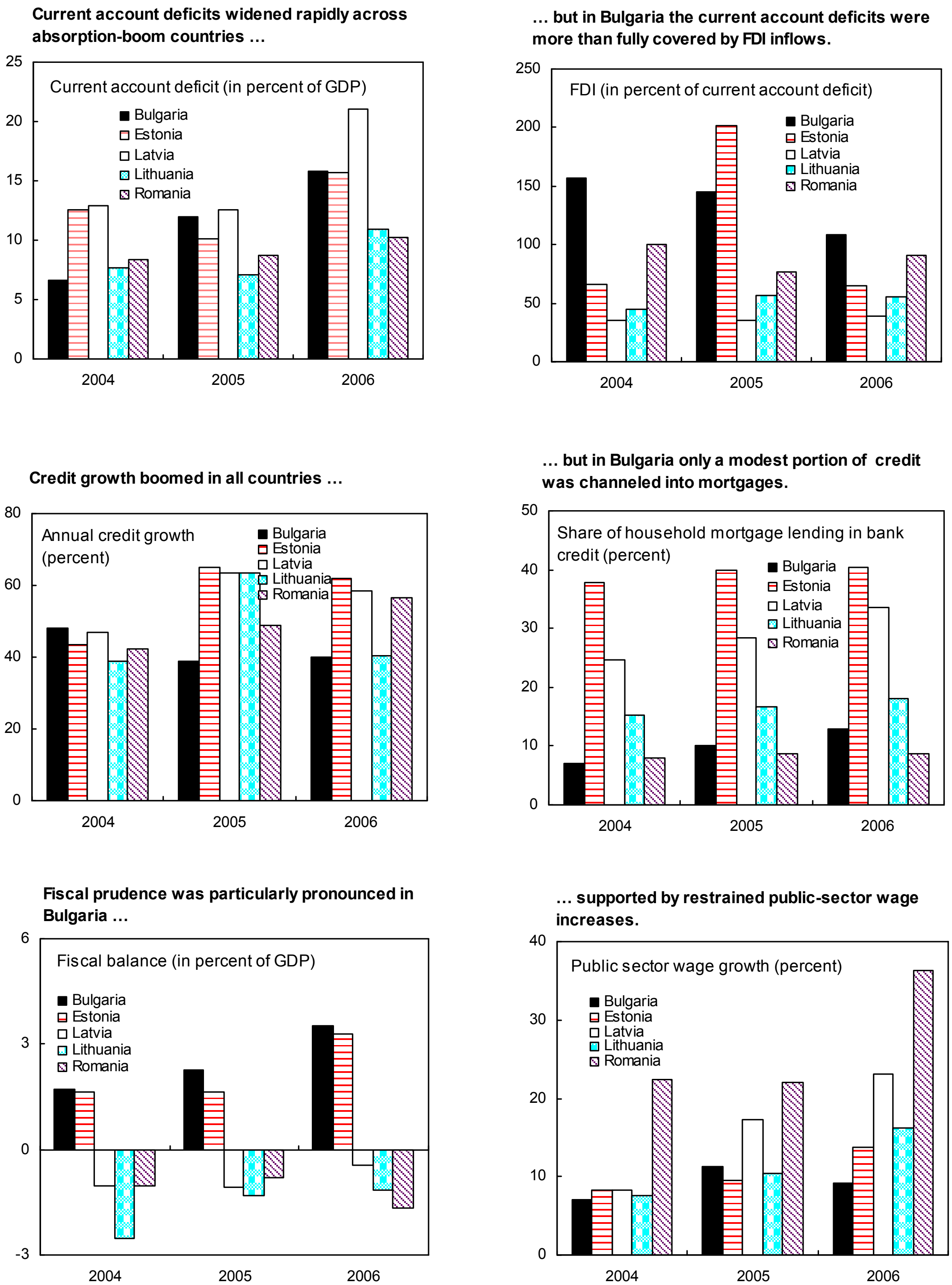
The tradables sectors' investment share has held up well during the investment boom. [1/]



Sources: NSI, and Fund staff calculations.
1/ Tradables sectors include agriculture, fishing, mining, and manufacturing.
2/ July 2006-June 2007.

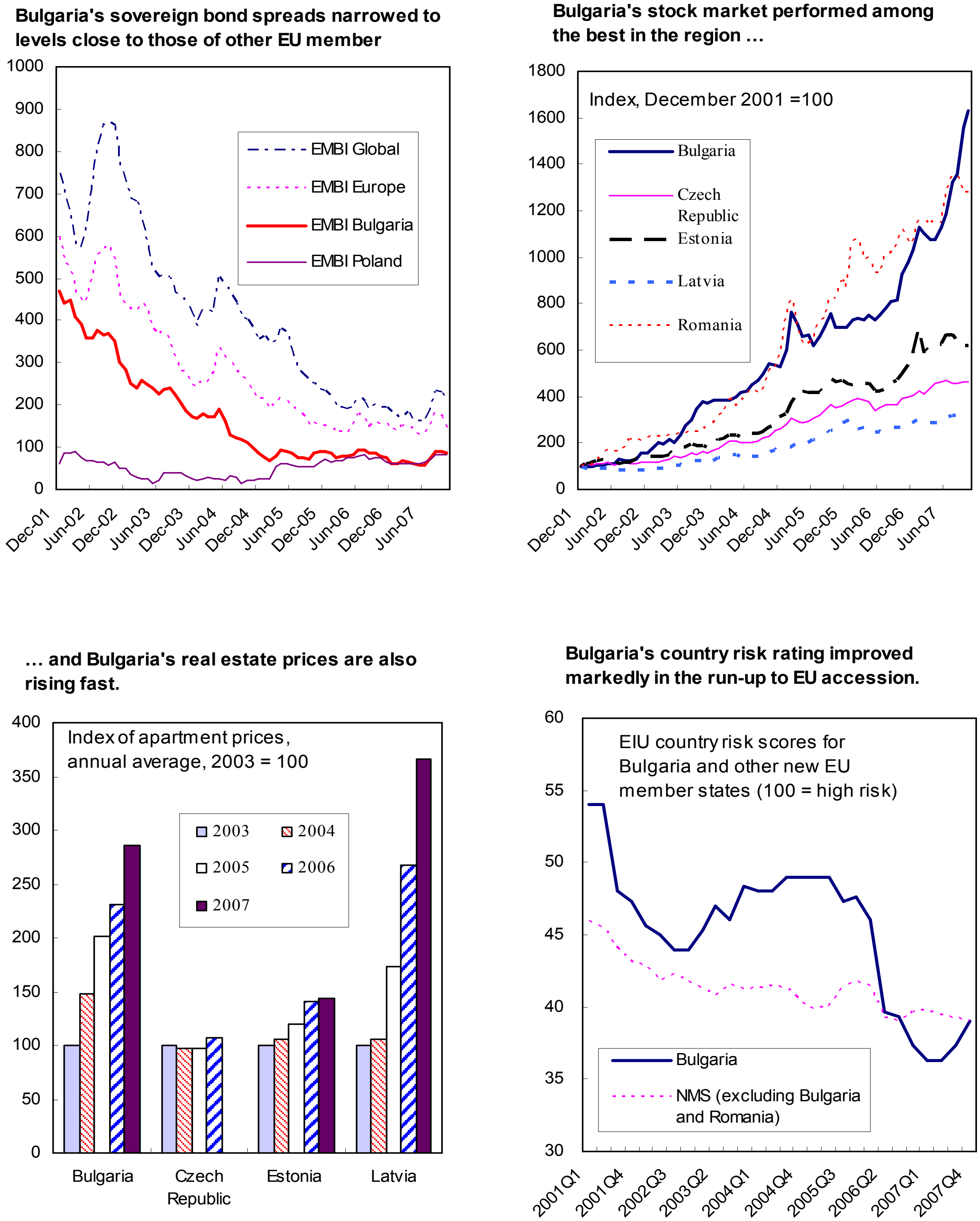
[2] See *Selected Issues* Chapter I "Bulgaria's Investment Boom: Drivers and Payoffs."

Figure 2. Bulgaria and Selected New Member States:
Similarities and Differences in their Absorption Booms, 2004–06



Sources: National authorities; IFS; EMED; Haver; and Fund staff estimates.

Figure 3. Bulgaria: Asset Price and Country Risk Developments, 2001–07

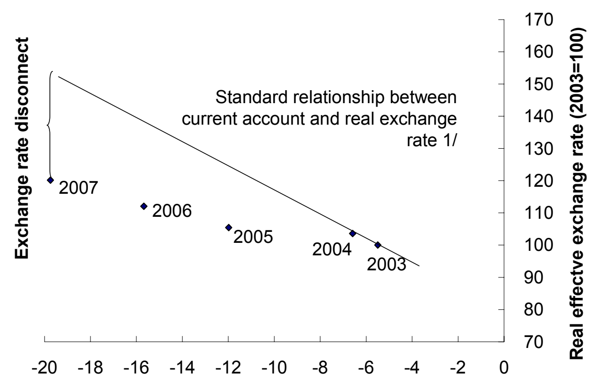


Sources: Bloomberg; Bulgarian authorities; Economist Intelligence Unit; Czech National Bank; Moody's; Statistics Estonia; and Latvia Real Estate Broker.

risks, particularly the security of property rights in the nontradables sectors, largely faded once EU accession was secured. In fact, recent FDI has been mainly absorbed by the nontradables sectors, raising concerns about Bulgaria's export prospects. However, globalization has rendered the conventional distinction between tradables and nontradables sectors increasingly blurry. Moreover, the share of real investment—as opposed to FDI—in Bulgaria's tradables sectors has remained broadly unchanged.

6. **The widening current-account deficit has not been accompanied by a significant loss of external competitiveness.** The present external deficit clearly exceeds sustainable levels: staff estimates of Bulgaria's equilibrium current-account deficit are centered around 8 percent of GDP, subject, however, to considerable margins of uncertainty (Box 2). At the same time, real effective exchange appreciation over recent years has been moderate when benchmarked against conventional relationships between the exchange rate and the current account. Purchasing-power-parity and dollar-wage comparisons across countries, as well as recent trends in export market shares, also suggest that Bulgaria's prices and costs remain broadly competitive. Finally, regression-based estimates of the real equilibrium exchange rate also do not indicate signs of substantial overvaluation (Box 2).

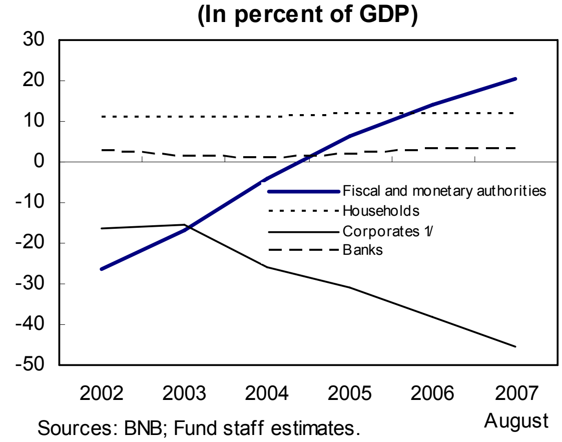
Bulgaria's ballooning current-account deficit has been accompanied by limited real appreciation.



Source: Fund staff estimates.
1/ Based on standard elasticities for exports (-0.71) and imports (0.92) with respect to real exchange rate changes.

7. **But Bulgaria's net IIP is deteriorating fast.** External financial liabilities have continued their steep upward climb in 2007, and the net IIP could deteriorate to about 65 percent of GDP (Table 4). However, external liabilities represent mostly FDI and long-term debt, with short-term debt more than fully covered by international reserves. Nevertheless, the widening currency mismatch position of nonfinancial corporates (excluding intercompany loans) is a concern, as it reflects rapidly growing and at least partly unhedged corporate borrowing abroad.

Bulgaria: Sectoral Currency Mismatches
(In percent of GDP)



Sources: BNB; Fund staff estimates.
1/ Excluding intercompany loans.

Box 2. Bulgaria: Inputs for External Stability Risk Assessment 1/

Staff estimates of the equilibrium current-account deficit center around 8 percent of GDP:

- The macroeconomic balance approach, based on panel data for 38 industrial and transition countries for 1992–2006, suggests that Bulgaria's current-account deficit norm is somewhat above 5 percent of GDP. However, this estimate is backward-looking and might underestimate the sustainable current-account deficit in a setting of globalized financial markets and EU convergence.

- External sustainability considerations based on stabilizing the net international investment position (IIP) at a medium-term level of about 80 percent of GDP, but ignoring EU capital grants, point to a sustainable current-account deficit of about 8 percent of GDP.

- Bulgaria is likely to receive EU capital grants amounting to about 2 percent of GDP, and the sustainable current-account deficit could be correspondingly higher as these grants will not add to Bulgaria's external liabilities.

Notwithstanding the presently large current-account deficit relative to equilibrium, the real effective exchange rate appears fairly valued (Box Figure):

- Different measures of Bulgaria's real effective exchange rate have all appreciated over recent years, but the pace of appreciation has been in line with experiences in other transition economies.

- Purchasing-power-parity and dollar wage-cost comparisons in industry across countries also yield no strong evidence of overvaluation.

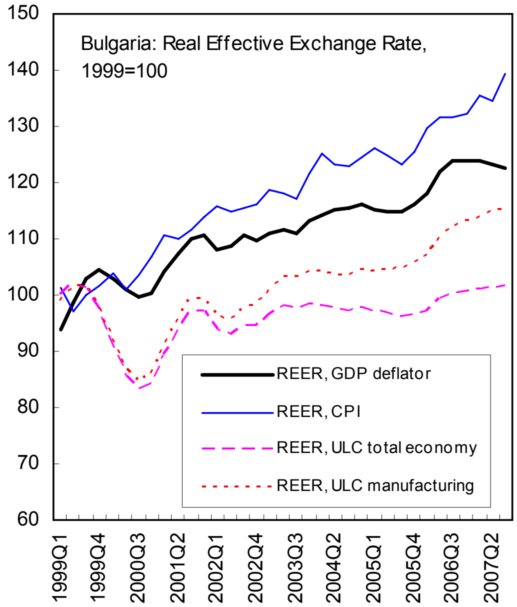
- Estimates of the real equilibrium exchange rate (CPI based) as a function of relative productivity and the net foreign asset position during 1996–2006 indicate that the actual real exchange rate has appreciated largely in line with the estimated equilibrium real exchange rate.

- Recent export volume growth (11 percent during 2004-06) remained solid, and export market shares have increased in all major export destinations. However, a constant market share analysis at SITC 1-digit product level indicates some erosion of competitiveness relative to other low- and middle-income countries during 2004–05, albeit coming on the back of large gains during 2001–03.

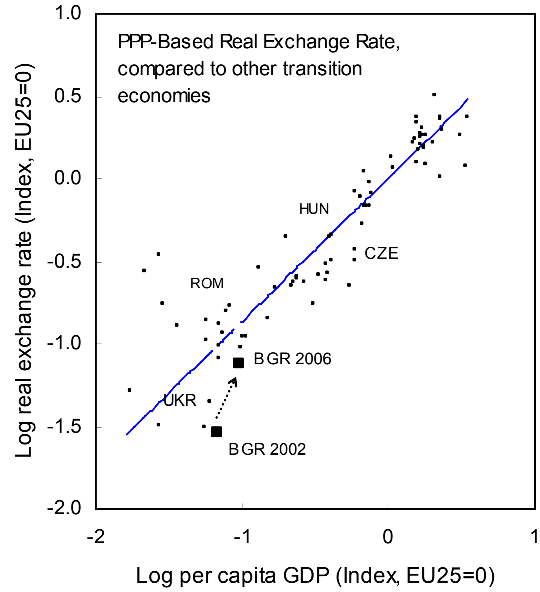
1/ See *Selected Issues* Chapter II "An Assessment of Bulgaria's External Stability Risks."

Box 2 Figure. Bulgaria: Real Exchange Rate Developments

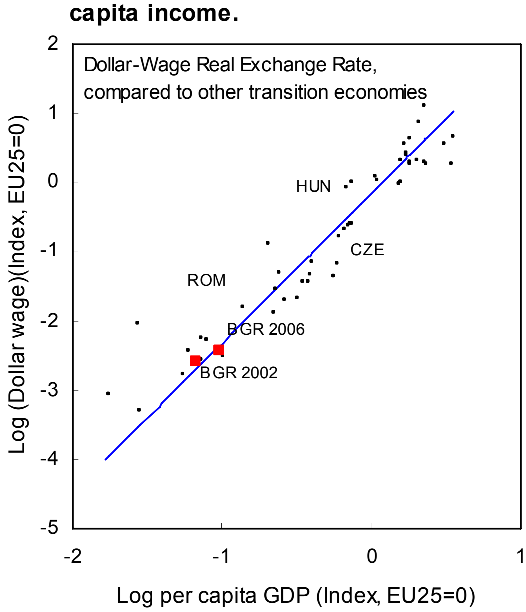
Although real exchange rate measures have generally appreciated ...



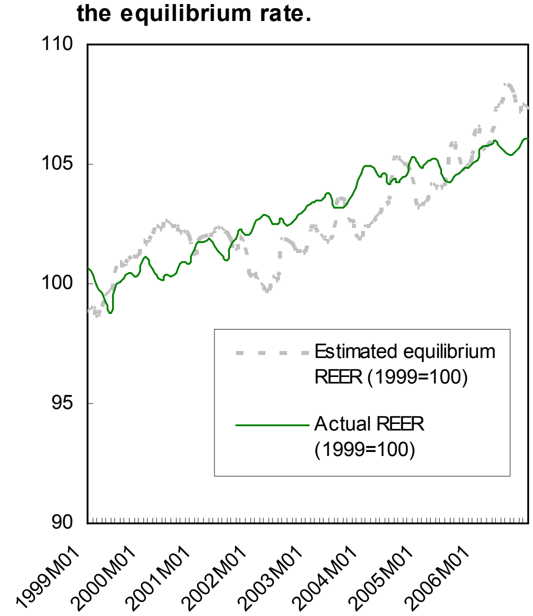
... estimates based on purchasing power parity do not indicate overvaluation ...



... and Bulgaria's dollar-wage cost indicator is broadly in line with its per capita income.



Appreciation in the real exchange rate seems to largely reflect movements in the equilibrium rate.



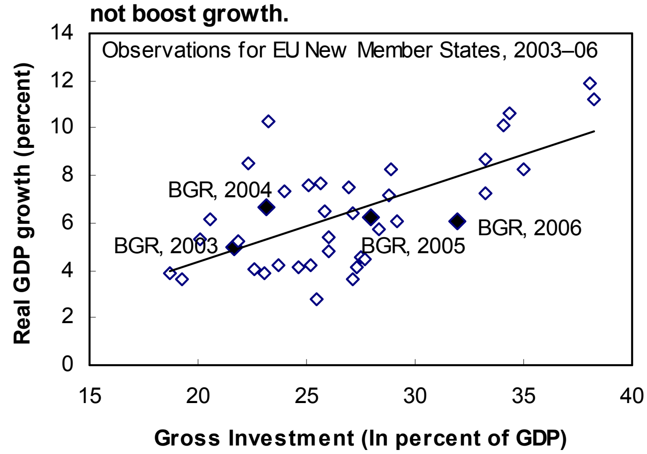
Sources: ILO; IFS; Eurostat; and Fund staff estimates.

8. **Domestic bank credit has started to boom again, but the banking sector maintains significant buffers against a credit-cycle downturn.** Since administrative limits on bank credit lapsed at end-2006, credit growth has accelerated to over 50 percent (Tables 6-7). In response, in September 2007 the BNB raised reserve requirements from 8 to 12 percent, noting that it would be ready to adopt additional measures to moderate credit growth if needed. Financial soundness indicators continue to suggest that the largely foreign-owned banking sector remains well capitalized and profitable (Figure 4, Table 8). Nonperforming loan ratios remain low, though this partly reflects rapid loan portfolio growth. Moreover, banks' exposures to the booming real estate market are still limited, as purchases by nonresidents have been the key market driver.

9. **Global credit fears have so far had moderate effects on Bulgaria.** Since late July, sovereign-bond spreads and credit-default swap rates have widened, albeit from a very low base and mirroring developments in other vulnerable transition economies (Figure 5). Local interbank markets, which are small, have been volatile but followed trends in euro markets.

10. **The private investment boom has provided surprisingly little boost to Bulgaria's growth performance, but the growth payoff may be underestimated or come with delay**.[3] Official figures indicate steady GDP growth at about 6 percent over recent years, notwithstanding the sharp increases in the investment-GDP ratio. Some investments are unlikely to have significant growth payoff, particularly residential construction and investments needed to comply with EU environmental and safety standards. However, there are also indications that growth effects could be underestimated in official data, for example owing to underreported activity in the booming construction sector. Finally, a large portion of investment has gone into replacing outdated capital equipment, and payoff from replacement investments may only accrue with a considerable lag.

Bulgaria's booming investment – GDP ratio did not boost growth.



Source: WEO.

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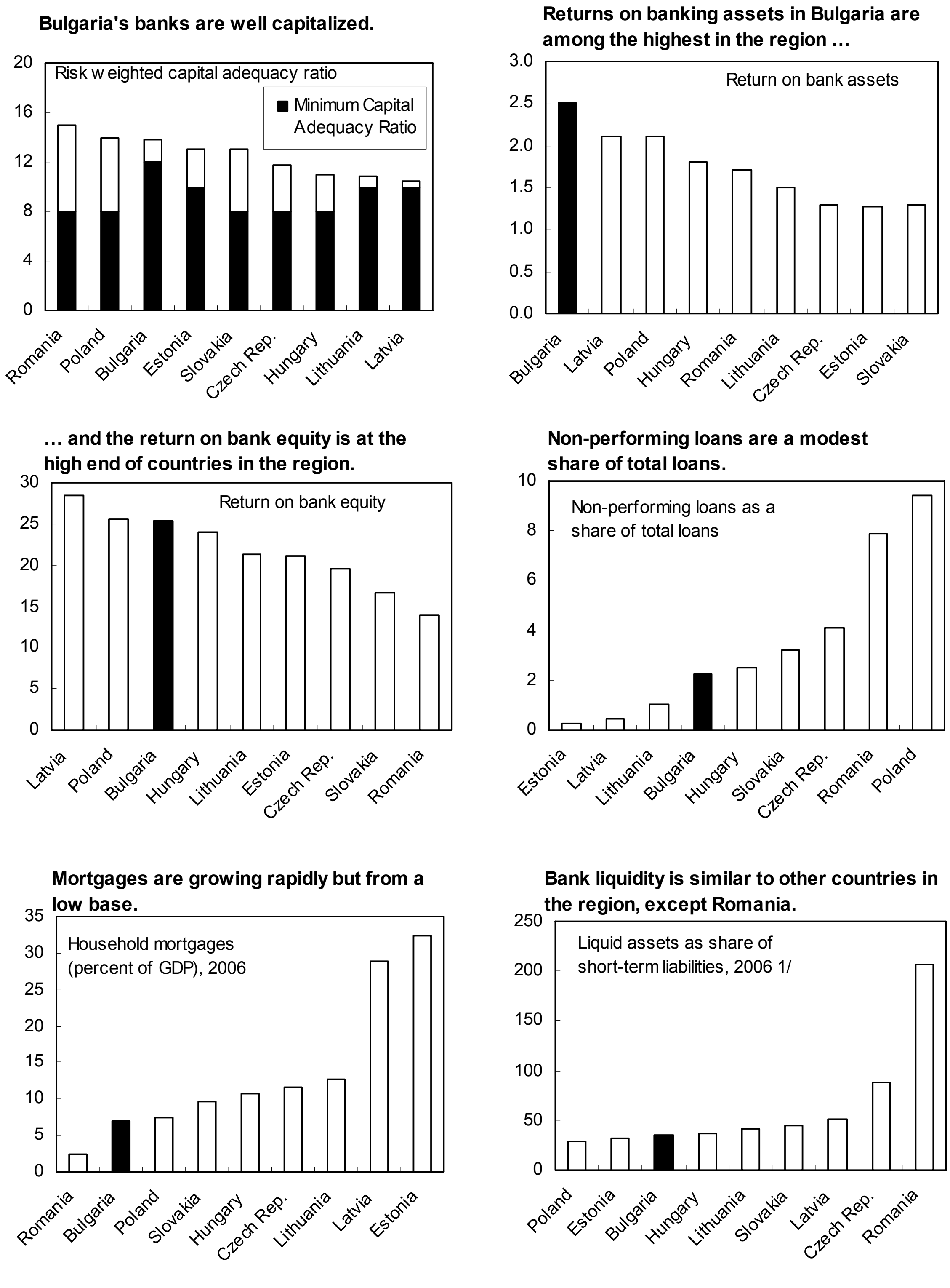
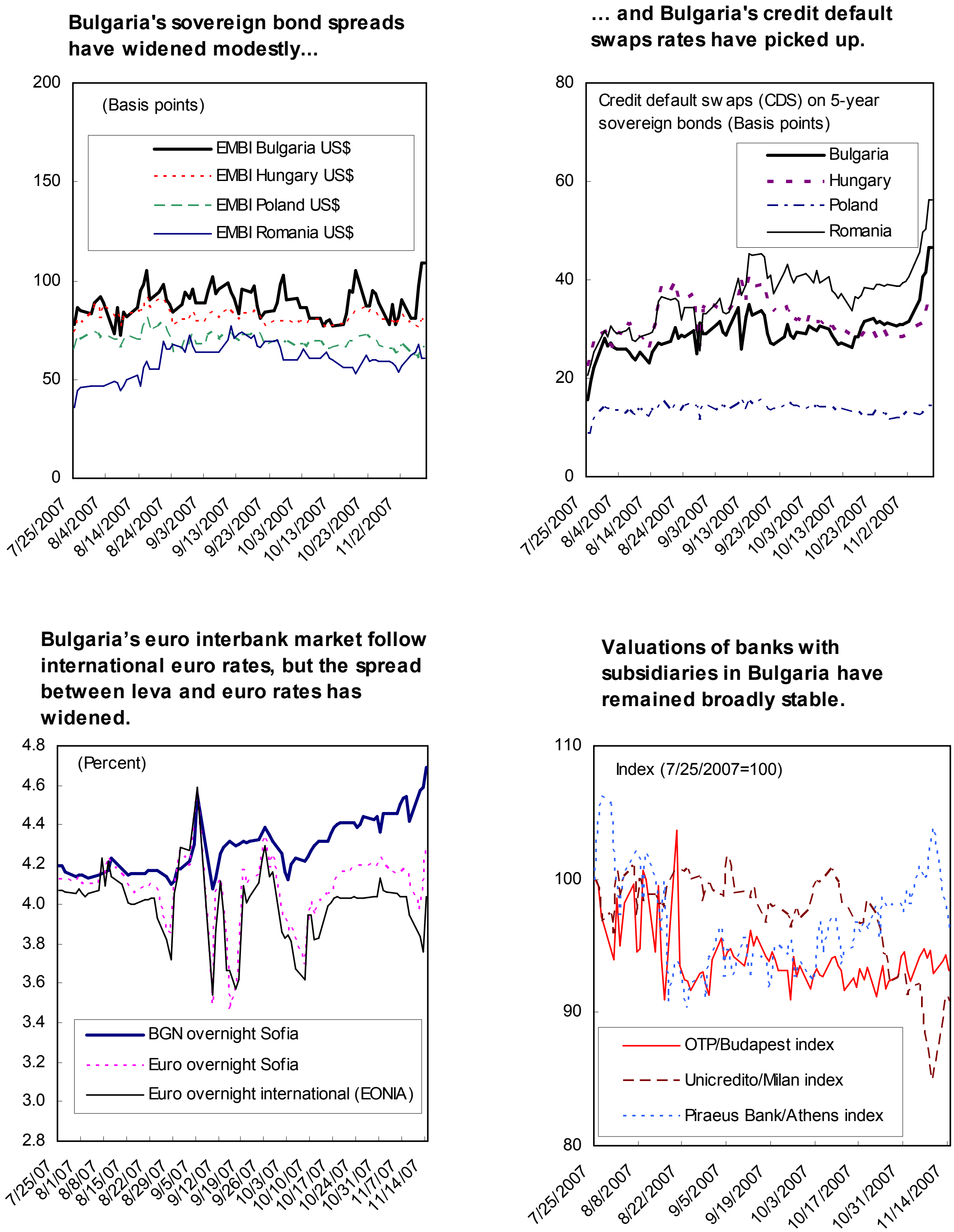
[3] See *Selected Issues* Chapter I "Bulgaria's Investment Boom: Drivers and Payoffs."

Figure 4. Selected EU Countries: Financial Soundness Indicators
(In percent)



Source: National authorities; IFS; Global Financial Stability Report.
1/ Data for Poland and Czech Republic are 2005.

Figure 5. Bulgaria: Global Credit Crunch Fears,
Developments in High-Frequency Indicators



Sources: BNB; and Bloomberg.

11. **Labor market slack is being eliminated at a rapid clip.** Unemployment has plummeted, but Bulgaria's employment rate remains relatively low (Figure 6). Public-sector employment has been cut back significantly, while private-sector employment has expanded considerably. Nominal wage growth, which was subdued in recent years, has accelerated across sectors, with the private sector in the lead.[4]

12. **Inflationary pressures are building up.** Recent increases in headline HICP inflation reflect in large part one-off effects from the summer drought, EU accession on food prices, and higher global energy prices (Figure 7). Money growth has been restrained by de facto sterilization through the government's build-up of a large fiscal reserve in the central bank (Table 6). But core inflation has picked up in response to rising labor cost, albeit at a much slower pace than headline inflation. Reflecting recent steady GDP growth, overall capacity pressures—as indicated by the small estimated output gap (some 1 percent in 2007)—remain still moderate.

13. **The fiscal policy stance has been broadly neutral over recent years.** Since 2004, fiscal policy has achieved progressively larger surpluses, mainly as the result of unspent revenue windfalls associated with the absorption boom. Staff calculations of the hypothetical fiscal balance that would obtain when the economy returns to internal and external balance suggest that the present underlying fiscal position is likely close to balance. Thus, the budgeted fiscal surplus of ¾ percent of GDP for 2007 was based on highly conservative revenue projections (Table 5). Notwithstanding recent decisions to raise (effective October 1) pensions by an additional 10 percent and cut the social contribution rate by 3 percentage points, the surplus is likely to reach 3½ percent of GDP. Reflecting the prudent fiscal policy stance, Bulgaria's general government balance sheet is strong, with gross public debt (about 20 percent of GDP) and other liabilities more than offset by the fiscal reserve and other assets.

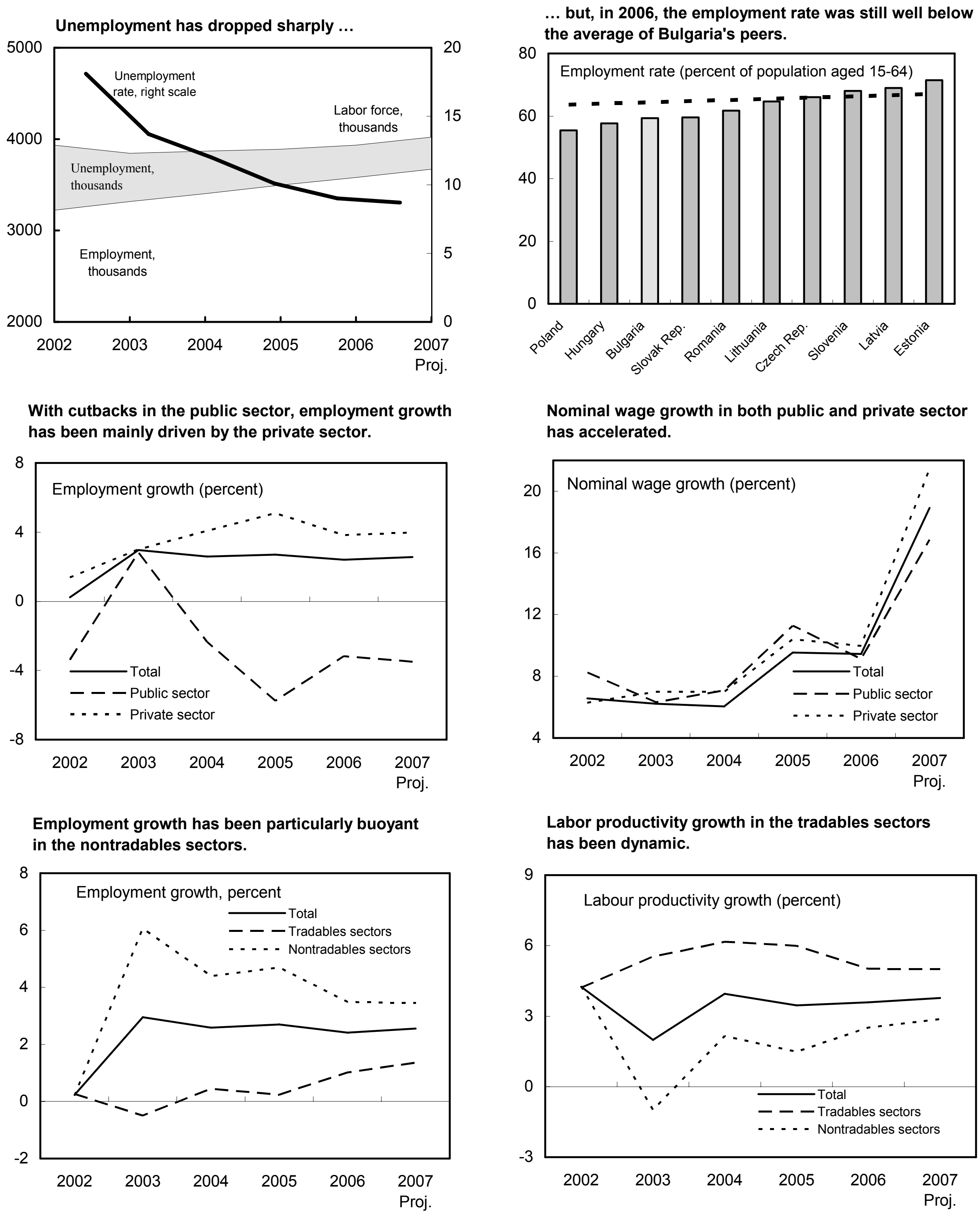
Bulgaria: General Government Operations, 2003–07
In percent of GDP

	2003	2004	2005	2006	2007 Proj.
Revenue	37.7	38.4	39.8	39.0	40.5
Expenditure	37.9	36.7	37.5	35.5	37.0
Fiscal balance	-0.2	1.7	2.3	3.5	3.5
Conventional structural fiscal balance 1/	0.8	2.2	2.3	3.3	3.1
Modified structural fiscal balance 2/	0.7	2.4	1.5	1.8	0.7

Sources: Ministry of Finance; and Fund staff estimates and projections.
1/ Actual fiscal balance adjusted for the automatic effects of internal imbalance (output gap).
2/ Actual fiscal balance adjusted for the automatic effects of both internal imbalance (output gap) and external imbalance (absorption gap) on fiscal position; see *Selected Issues* Chapter III.

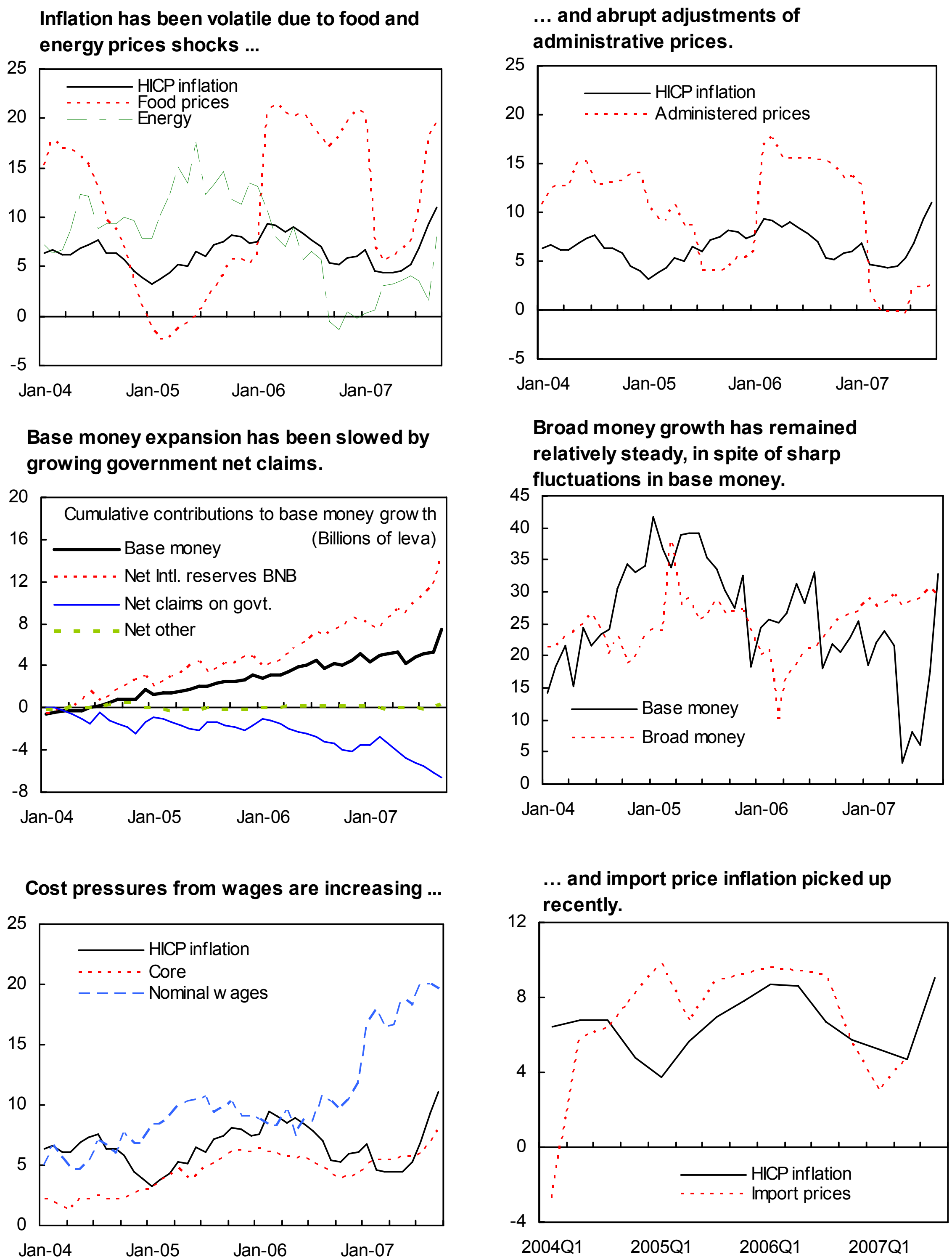
[4] However, Bulgaria's labor market data need to be interpreted with caution as increases in both employment and wage growth could partly reflect a shrinking grey economy.

Figure 6. Bulgaria: Labor Market Developments, 2002–07



Sources: NSI; World Bank; and Fund staff estimates.

Figure 7. Bulgaria: Inflation, 2004–07
(Percentage change, y-o-y, unless otherwise indicated)



Sources: BNB; and WEO.

14. **Tackling key structural reforms has proven difficult, given fragile party politics and entrenched special interests.** Bulgaria's scope for sustainable real convergence depends ultimately on raising the productivity of human and real resources (Figure 8).[5] Progress on structural reforms is at par with peers in areas where EU legislation tends to enforce regulatory homogeneity, including on price liberalization, trade, and the foreign exchange system (Table 9). However, where EU accession has provided only a weak reform anchor, progress has been slow:

- The public sector's efficiency is low, as reflected in indicators for corruption, red tape, quality of judiciary, education standards, and other performance measures.
- Businesses face costly administrative burdens, particularly the still complex registration system.
- Rigidities in the labor market hinder the reallocation of labor, particularly from low- to higher-productivity sectors, and there is a question whether the labor market could deliver the degree of wage flexibility needed to support the currency board under adverse shock scenarios.

III. Policy Discussions

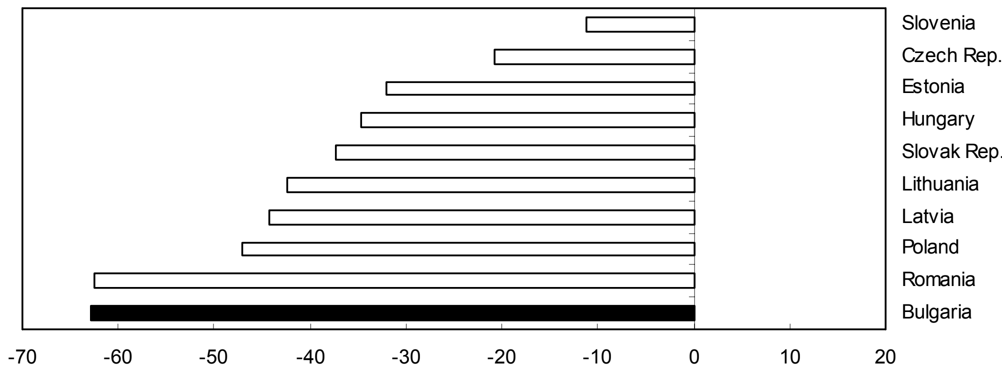
15. **Bulgaria's challenge is to maintain policies that will facilitate restoring external balance without a crisis, preserve internal balance in the face of growing inflation pressures, and achieve more rapid convergence growth.** The discussions focused on:

- What is the appropriate fiscal and incomes policy framework in Bulgaria's setting of an unsustainable absorption boom?
- What financial-sector policies could help insure against a possible hard landing given rapid credit growth and external vulnerabilities, both in the short and medium terms?
- What structural reforms could foster sustainable convergence growth and increase the economy's robustness to external shocks, given the currency-board constraint on relative price adjustment?

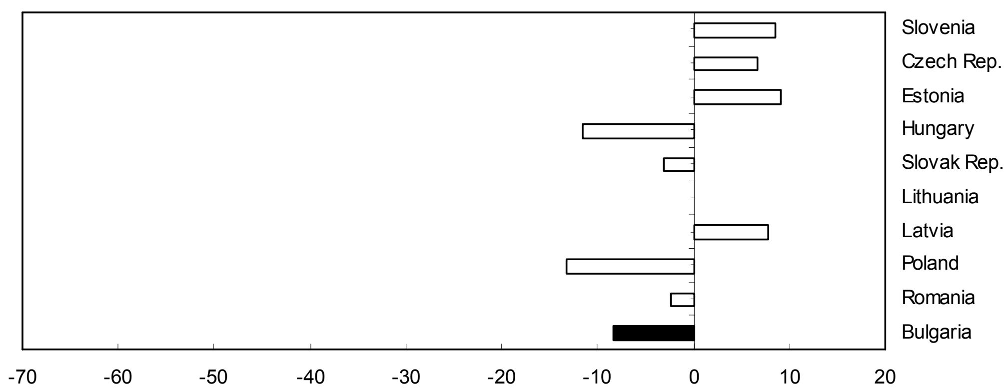
[5] World Bank (2007), *Accelerating Bulgaria's Convergence: The Challenge of Raising Productivity.*

Figure 8. Selected EU Countries: Real Income Convergence, Labor Utilization Versus Labor Productivity, 2006
(Percent deviation from EU27 average)

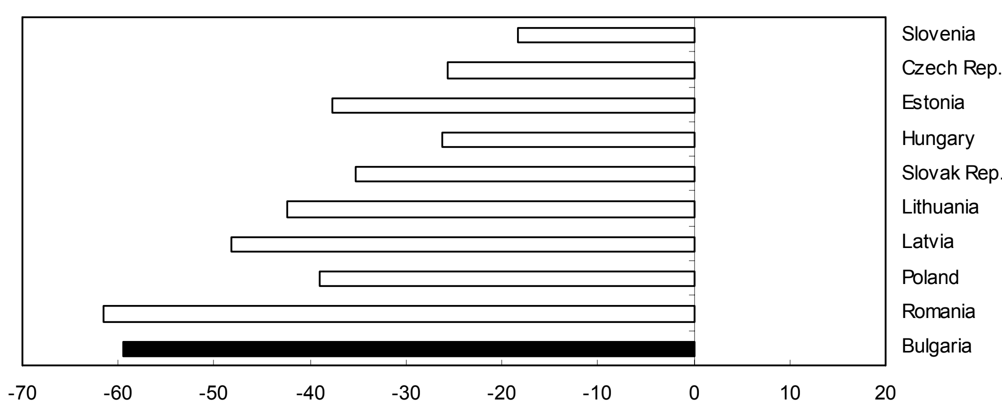
Bulgaria's GDP per capita is one of the lowest in the EU.



Catching up on labor utilization will not contribute much to achieving income convergence ... 1/



… the key will be to catch up on labor productivity. 2/



Sources: Eurostat; and Fund staff calculations.
1/ Employment as share of total population.
2/ GDP per capita per employed person.

A. Outlook and External Stability Risks

16. **There was agreement that a soft landing remains a viable baseline medium-term scenario.** In this baseline scenario, the external environment, including global growth, remains favorable, and capital inflows normalize as excess-return investment opportunities are exhausted, entailing sharply slowing investment spending and imports over the medium term (Table 10a). Absorption growth would gradually decline below GDP growth, lowering the current-account deficit to about 8 percent of GDP, broadly consistent with staff's estimates of Bulgaria's equilibrium current-account balance (Box 2). After the sharp increase this year, inflation is projected to recede gradually to some 3½ percent as the absorption boom dissipates, with lower inflation underpinned by stability-oriented fiscal and incomes policies, low import-price inflation, as well as steady progress on closing structural-reform gaps. External competitiveness would be preserved, with the real effective exchange rate appreciating in line with medium-term fundamentals, consistent with a sustainable currency board.

17. **But the economy would remain saddled with significant external balance-sheet vulnerabilities.** The net IIP would deteriorate further, albeit at a slowing pace, stabilizing at some 80 percent of GDP by 2012 (Table 10a). Gross external debt would only stabilize at about 93 percent of GDP, requiring the medium-term current-account deficit excluding interest payments to shrink to some 4 percent of GDP (Appendix I). Such a legacy of high external indebtedness would markedly increase Bulgaria's vulnerability to future adverse shocks, particularly if euro adoption were delayed beyond 2012. Moreover, the coverage of the current-account deficit by net FDI inflows is projected to decline to half its present level over the medium term, although coverage of short-term debt by international reserves would remain above 100 percent.

18. **Thus, staff cautioned that a soft landing may not necessarily materialize, even under prudent policies.** Given already significant external balance-sheet vulnerabilities, if in addition the investment boom reflects irrational exuberance with respect to expected risks and returns, a possible correction of capital and credit flows could be sharp and sudden, mimicking a boom-bust cycle. The authorities noted that as long as policies remain prudent, Bulgaria's vulnerabilities, including in the corporate sector, would be well matched by the large precautionary buffers built up in the balance sheets of the central bank, the government, and the banking system. The authorities also emphasized, and staff agreed, that the analytical and empirical understanding of what drives Bulgaria's high external deficits remains imperfect, adding that gloomy snap judgments based on historical analogies, including the 1990s Asian crisis, could be quite misleading.

19. **There was agreement that a significant deviation from prudent fiscal and incomes policies could easily result in a misaligned real exchange rate, likely putting the currency board under stress**. Under this alternative scenario, public-sector wages could be hiked well above productivity trends, in turn boosting private sector wages, and, with a lag,

social benefits, with the fiscal stance turning sharply expansionary (Table 10b, Figure 9). Rising labor cost would feed into higher domestic inflation, external cost and price competitiveness would deteriorate, undermining the tradables sectors' ability to export and to compete with imports. A consumption-driven boom in nontradables activities could overcompensate for a slump in the tradables sectors, resulting in temporarily higher GDP growth. However, on the external side, the nominal exchange-rate constraint imposed by the currency board would result in a significantly overvalued real exchange rate. Such a scenario could either entail an abrupt external adjustment or a prolonged period of slow growth to restore external competitiveness.

20. **Early euro adoption remains the authorities' umbrella objective.** The immediate goal is joining ERM2, and, to facilitate this, the authorities noted that they are willing to provide firm and detailed policy commitments to their European partners. While the authorities aim to adopt the euro on a fast-track basis after ERM2 entry, they also recognized that the road to euro adoption could be prolonged and difficult, with the Maastricht Treaty's low-inflation criterion presenting an especially formidable hurdle.

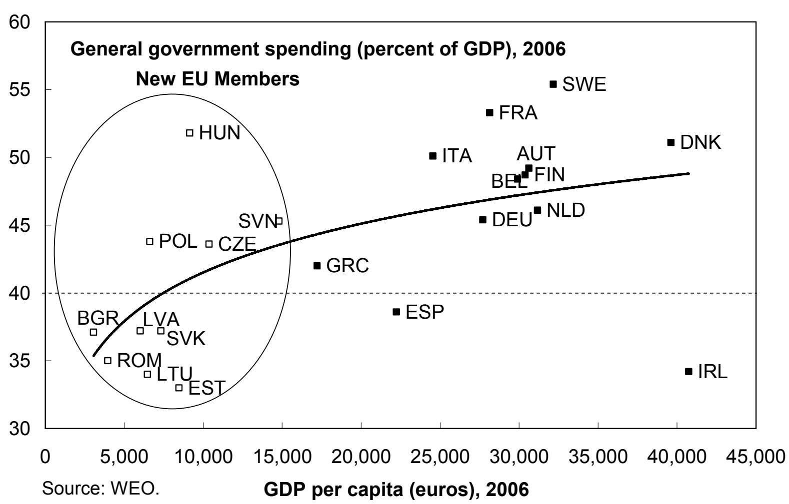
B. Fiscal Policy

21. **The authorities are strongly committed to a fiscal framework that avoids procyclical policies and restructures the budget to accelerate real income convergence:**

- ***Fiscal balance targets:*** The strategy would be to maintain a broadly balanced structural fiscal position over the medium term. Staff noted that this would strike a good compromise between the fiscal prudence requirements of a currency board and Bulgaria's unfavorable demographics on the one hand, and the large spending requirements of a lagging transition economy on the other.

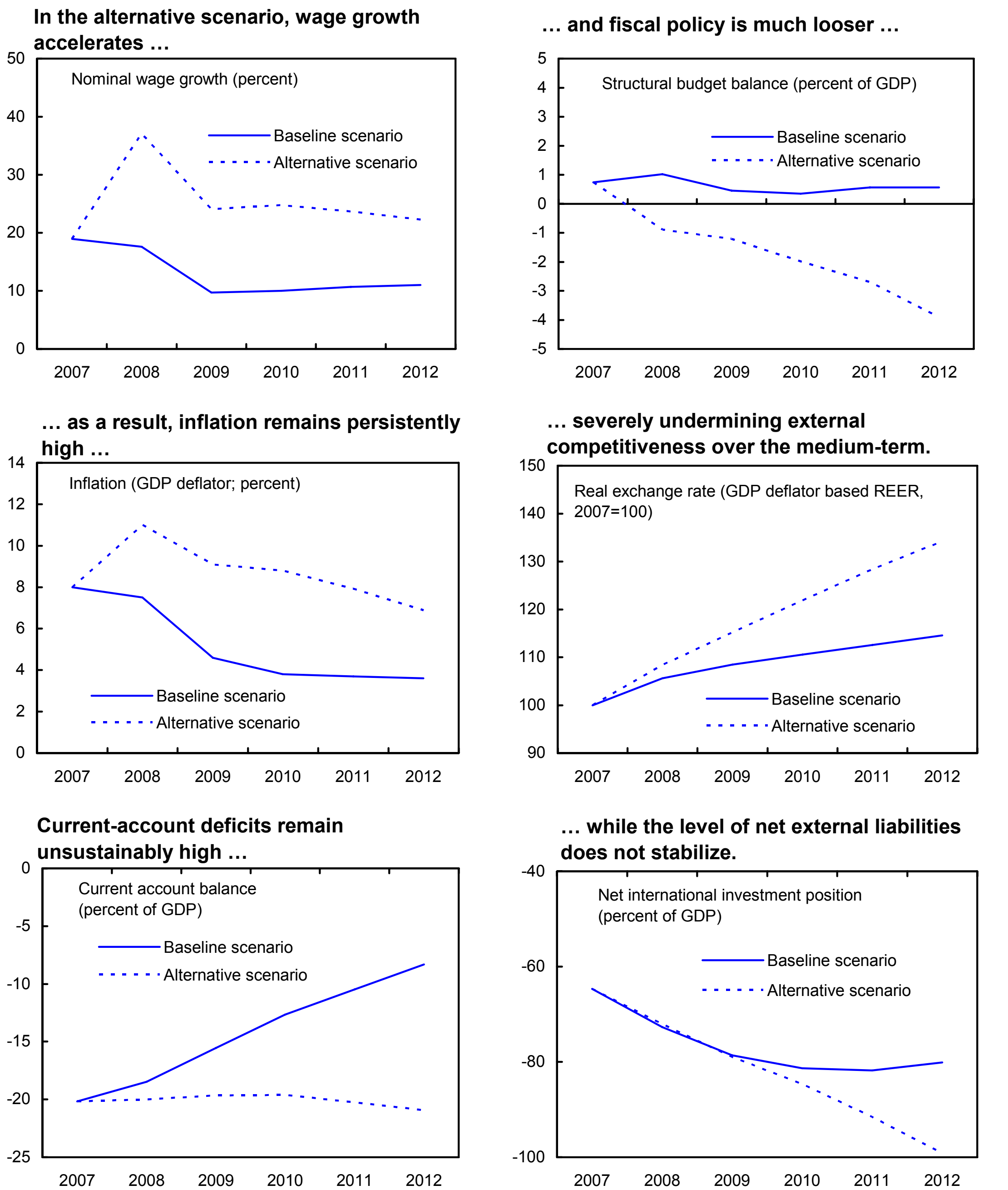
- ***Expenditure policies:*** The medium-term expenditure-GDP ratio would be kept below 40 percent of GDP, well below spending levels of many EU peers. The public sector's lagging efficiency calls for designing action plans for reviewing spending and programs in key budgetary sectors, notably education and health care. Moreover, with support from EU grants, the spending structure would be

Bulgaria plans to keep its spending-GDP ratio below 40 percent of GDP.



Source: WEO.

Figure 9. Bulgaria: Macroeconomic Prospects Under Loose Fiscal and Incomes Policies, 2007–12 1/



Source: Fund staff projections.

1/ The alternative scenario assumes loose incomes and fiscal policies relative to the baseline scenario. Specifically, compared with the baseline, average norminal wage growth is about 14 percentage points higher during 2008–12, mainly driven by rapid wage increases in the public sector.

shifted toward public infrastructure and human capital formation to accelerate real convergence.

- ***Revenue policies:*** The tax structure has already undergone a welcome shift toward indirect taxation. The authorities plan to continue to reduce direct tax rates, particularly on labor, while broadening tax bases to combat the grey economy and to increase further Bulgaria's attractiveness as an investment location. Staff cautioned that the recent surge in the tax-GDP ratio is likely to prove temporary and noted that the recent steep cuts in social contribution rates already require substantial budget transfers to keep the pay-as-you-go pension system afloat.

22. **In line with this framework, staff urged the authorities to allow automatic fiscal stabilizers to operate fully during the remainder of 2007.** With revenues potentially even more buoyant than presently projected, pressures to increase spending further should be resisted given rising inflationary pressures.

23. **Fiscal plans for 2008 envisage a broadly neutral stance, but sticking to this prudent stance could prove an uphill battle.** The authorities noted that running large fiscal surpluses was increasingly seen as a sign of excessive fiscal austerity by many stakeholders given the country's large social needs. Nevertheless, the 2008 draft budget approved by the cabinet projects a surplus of 3 percent of GDP, roughly in line with an unchanged fiscal stance. However, staff saw several risks and issues:

- ***Wages:*** Following a protracted strike, teachers were granted a wage increase of about 45 percent. Assuming there are no further public-sector strikes ending with similar hikes, average budget wages are still projected to increase by 16 percent. The authorities plan to limit the wage-bill impact of higher wages by stepping up cuts in public employment, but admitted that this could prove difficult.

- ***Personal income tax:*** The draft 2008 budget envisages a flat 10 percent personal income tax (a 10 percent corporate tax rate is already in place), while eliminating most exemptions to broaden the tax base. Staff estimated the likely revenue loss to amount to some ½ percent of GDP and suggested compensating measures, including by raising real-estate taxation. However, the authorities believe that revenue losses will be smaller because the flat tax will help shrink the grey economy, and higher excises on tobacco and fuel will partly compensate for revenue losses.

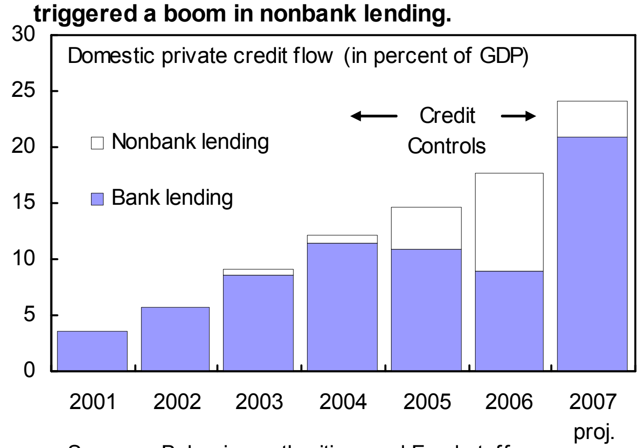
- ***Capital budget:*** The draft budget projects capital spending to rise to about 7 percent of GDP in 2008, up from 6 percent of GDP in 2007, financed by a similar increase in EU grants. Staff expressed concern that increased infrastructure spending could add undesirable demand impulses to an already overheated construction sector, but the authorities noted that there were early signs of slowing residential construction outside Sofia freeing up capacity.

24. **The authorities highlighted substantial progress on improving fiscal transparency.** The 2008 draft budget will be based on a single surplus target during budget preparation and authorization. Moreover, the previous practice of across-the-board spending sequestration depending on fiscal or external developments will be discontinued, and a contingency reserve will instead be included in the 2008 budget. Staff noted that it will be important to establish clear and transparent rules for the use of this contingency reserve.

C. Financial Sector Policies

25. **There was agreement that administrative limits on bank credit growth had proven ineffective in slowing private-sector credit growth.**[6] While banks observed the administrative limits on lending during 2005–06, corporations and households found alternative credit sources, and overall credit extension by the financial sector remained brisk. The BNB noted that there were strong a priori reasons suggesting that administrative credit controls would prove ineffective given Bulgaria's market-based financial sector and open capital account.

Credit controls on bank lending during 2005-06 triggered a boom in nonbank lending.



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

26. **The authorities agreed that rapid bank credit growth warrants careful monitoring**. The authorities envisage prudent implementation of Basel II, notably keeping the minimum capital-adequacy ratio at 12 percent, the highest ratio among new member states, and maintaining the standardized approach until sufficient data are available to allow fact-based internal ratings. However, bank credit growth was uncomfortably high, and may partly reflect the objective of large banks to maintain or expand market share. Against this backdrop, the authorities are re-evaluating banks' internal risk-management systems. They have also strengthened cross-border cooperation with parent supervisors of foreign banks, and intended to become active participants in future EU financial stability coordination exercises.[7]

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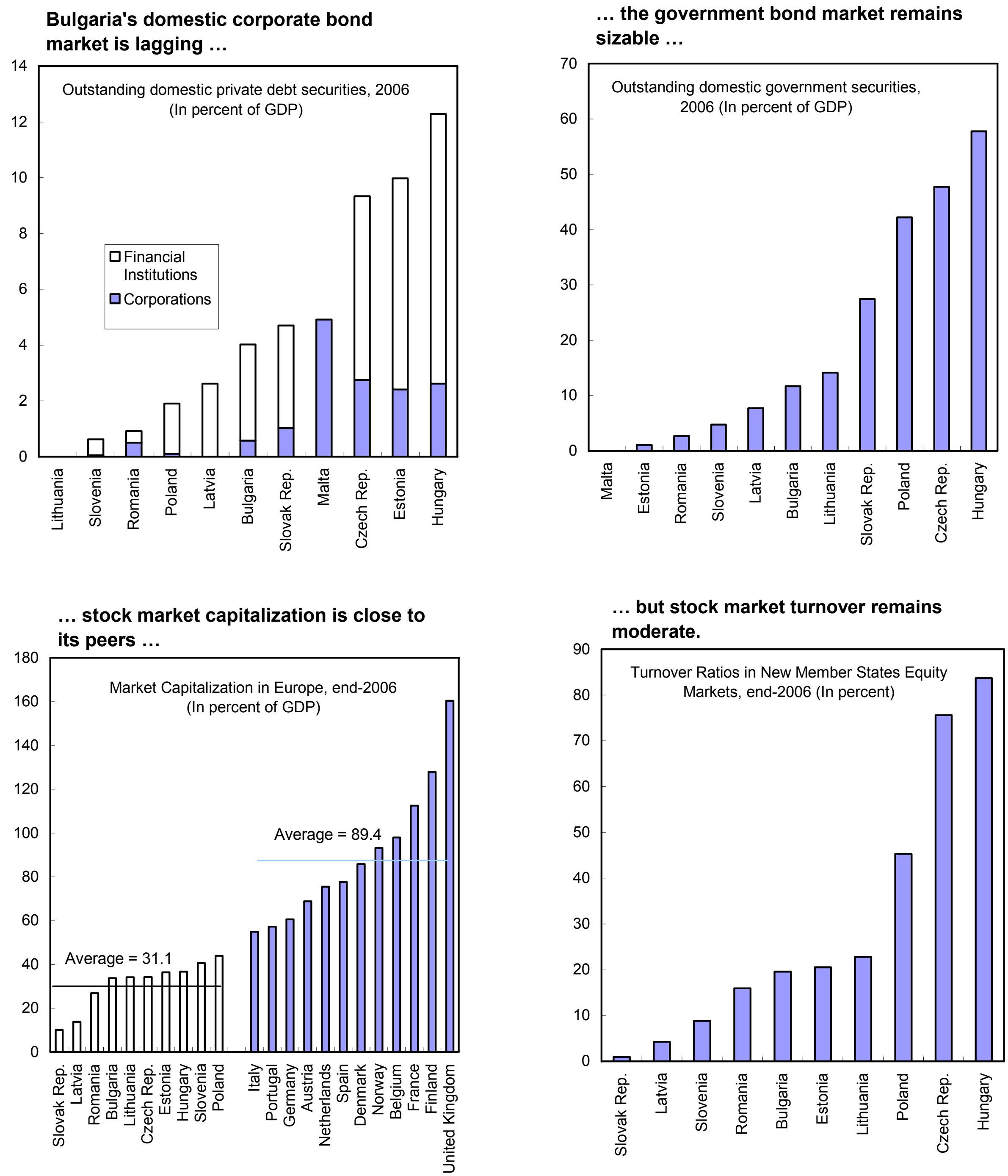
[6] See *Selected Issues* Chapter IV "Bulgaria's Credit Boom: After Credit Controls."

[7] An AML/CFT assessment by MONEYVAL is under way, with the final report expected in early-2008.

Figure 10. Selected EU Countries: Indicators of Capital Market Development



Sources: BIS; Standard & Poor's; Bloomberg; WEO; and Fund staff calculations.

27. **Capital market development faces significant local challenges.** There is undoubtedly scope for expanding the role of local private debt and stock markets in financial intermediation (Figure 10). The key incentives for raising funds in the domestic capital market are reducing maturity mismatch and reliance on foreign funding in the banking sector. Though nonfinancial enterprises were not expected to become major local bond issuers in the short term, the recent rise in local initial public offerings indicates that they are increasingly turning to the stock market for capital. Against this backdrop, the authorities shared staff's concern that a potentially large stock-market correction could be damaging for market development, given reputational costs and the adverse consequences for pension-fund performance.

D. Structural Reforms

28. **Improving the business climate and enhancing wage and labor market flexibility were seen as priorities.** A key step to improving the business climate will be the start-up of the electronic commercial register on January 1, 2008, and the authorities plan to further simplify licensing and permit systems. More progress on privatization, including of *Bulgartabak Holding AD*, and improving market competition, particularly in energy markets, were also priorities. In the labor market, limited intersectoral mobility in particular called for amending the overly prescriptive *Labor Code* to provide social partners with more flexibility to set wages, benefits, seniority bonuses, and overtime and part-time work. Improving incentives for education and training, as well as putting limits on the duration of social benefits to stimulate work effort, were seen as additional useful steps to improve labor-market functioning.

IV. Staff Appraisal

29. **At first sight, Bulgaria's economy is performing quite well.** Since 2003, against a backdrop of increasingly secure EU accession prospects and impressive macroeconomic stability gains, investment spending has boomed as investors sought to take advantage of Bulgaria's improved economic fundamentals. Official data suggest that real GDP growth averaged about 6 percent during 2003–06, while unemployment dropped sharply.

30. **But Bulgaria's policy makers are faced with several disquieting developments.** The current-account deficit has ballooned to unprecedented levels. It will have to be reduced eventually, otherwise the country's external net financial liabilities and payment obligations could increase to unsustainable levels. Moreover, the recent credit tensions in mature markets have highlighted the speed and scope at which financial markets can re-assess risk premia, and Bulgaria is widely viewed as vulnerable to such re-assessments. Adding to external concerns, inflationary pressures are also on the rise, in large part reflecting one-off shocks, but also accelerating wage increases as labor market conditions have tightened. Finally, much needed but difficult structural reforms were put on the

backburner for too long, particularly reforms that would raise the public sector's low efficiency.

31. **This challenging backdrop calls for maintaining a prudent policy framework while tackling difficult structural reforms.** Fiscal and incomes policies should continue to avoid adding procyclical demand pressures that could widen internal and external imbalances, while retooling the spending and tax levers of the budget to accelerate real convergence and productivity growth, including through the efficient absorption of EU funds. Banking supervisors should closely monitor banks' risk management and ensure that banks' have sufficient buffers to absorb large adverse shocks. And long-delayed structural reforms are needed to raise the efficiency of available human and real resources, while providing incentives to add to available resources. These policies should also provide a strong basis for achieving Bulgaria's ambition for deepening its EU integration, including by eventually adopting the euro.

32. **Prudent fiscal and incomes policies remain the authorities first line of defense.** The authorities have accumulated an admirable record in allowing automatic fiscal stabilizers to feed through to large fiscal surpluses. But prudent fiscal and incomes policies need to be upheld to preserve the sustainability of the currency board, notwithstanding popular sentiments that present budget surpluses are excessive and that the public purse strings should be loosened to address high social expectations following EU accession. Therefore, the authorities' intention to aim at a large budget surplus in 2008 is welcome. But it will also be important to maintain wage discipline in the public sector, and compensate already agreed large increases in public wages partly by stepping up reductions in public-sector employment. This would also help mitigate overheating pressures in the labor market. The envisaged steps to increase fiscal transparency in the 2008 budget are also welcome.

33. **Banking sector supervision and regulation is strong, and financial soundness indicators do not point to glaring weaknesses, but arrangements have yet to be tested by a credit-cycle downturn.** Basel II capital-adequacy standards apply since January and should help encourage more risk-based management of credit portfolios. Moreover, with Bulgaria's foreign banks increasingly centralizing their liquidity and risk management functions, cross-border cooperation with other supervisors needs to be strengthened further. Finally, Bulgaria's active participation in future efforts to improve the EU's cross-border crisis management arrangements is welcome.

34. **Notwithstanding major achievements, capital market regulation and supervision needs further strengthening to support sustainable market development.** The authorities have adopted relevant EU directives and made significant efforts to increase transparency and financial disclosure standards. To reduce the potential for boom-bust cycles in local asset prices, the authorities should further increase efforts to enforce regulations, educate the public about stock market risks, and consider tighter listing

requirements in the local stock market. The planned FSAP update in 2008 should provide a good opportunity to take stock of the strengths and vulnerabilities of Bulgaria's financial system.

35. **Several structural reform priorities should be addressed without delay.** First, public-sector efficiency should be raised, starting by designing action plans for reviewing spending and programs in key budget sectors, notably education and health care. It would also be useful to introduce effective systems for monitoring and evaluating policy implementation in the public sector. As regards the labor market, measures to activate labor supply should include amendments to the Labor Code to provide more flexibility to social partners to negotiate the terms of work contracts. Finally, there is a need to improve the investment climate by lowering the cost of doing business.

36. **While Bulgaria's statistical data are broadly adequate for surveillance, there are significant weaknesses.** The sectoral flow-of-funds data for households and nonfinancial corporates are sketchy, impeding the understanding of vulnerabilities in these sectors. Bulgaria's employment and wage data are also difficult to interpret, partly reflecting difficult-to-measure changes in the grey economy. And given the focus on Bulgaria's widening external imbalance, clarification of uncertainties regarding the trade data that have emerged since EU accession would be desirable.

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

Table 1. Bulgaria: Selected Economic and Social Indicators, 2004–08

	2004	2005	2006	2007 Proj.	2008 Proj.
Output, prices, and labor market			(Annual percentage change)		
Real GDP	6.6	6.2	6.1	6.4	6.3
Real domestic demand	8.1	12.2	12.5	11.0	5.4
Consumer price index (HICP, average)	6.1	6.0	7.4	7.2	7.8
Consumer price index (HICP, end of period)	4.0	7.4	6.1	9.5	4.9
Employment	2.6	2.7	2.4	2.6	1.9
Nominal wages	6.0	9.5	9.4	18.9	17.6
Public sector wages	7.1	11.3	9.1	16.9	16.2
Private sector wages	7.0	10.4	10.0	21.4	18.8
General government finances			(In percent of GDP)		
Revenue	38.4	39.8	39.0	40.5	40.5
Expenditure	36.7	37.5	35.5	37.0	37.0
Fiscal balance	1.7	2.3	3.5	3.5	3.5
Privatization proceeds	3.0	3.4	1.5	0.5	0.6
External financing	-1.6	-5.6	-1.9	-0.5	0.9
Domestic financing	-3.2	0.0	-3.1	-3.5	-5.5
Gross public debt	40.1	31.3	24.7	21.3	20.2
Financial net worth	8.8	9.3	11.8	13.8	15.6
Money and credit			(Annual percentage change)		
Broad money (M3)	23.1	23.9	26.9	28.5	24.3
Domestic credit	48.7	32.4	24.6	52.5	26.2
Interest rates			(In percent)		
Euro, six-month LIBOR	2.1	2.2	3.1	4.0	4.1
Interbank rate	2.6	2.0	2.7	…	…
Lending rate	8.8	8.7	8.9	…	…
Real lending rate (HICP adjusted)	2.6	2.5	1.4	…	…
Balance of payments			(In percent of GDP)		
Current account balance	-6.6	-12.0	-15.7	-20.2	-18.5
Merchandise trade balance	-14.9	-20.2	-22.2	-26.2	-25.5
Capital and financial account balance	14.3	15.1	21.5	30.6	26.0
Foreign direct investment balance	7.9	17.7	16.8	14.6	9.6
International investment position	-30.8	-43.1	-52.8	-64.7	-72.7
Gross official reserves	34.5	33.7	35.6	40.5	42.9
Gross external debt	63.8	69.0	78.4	87.6	92.7
Exchange rates					
Leva per euro			Currency board peg to euro at lev 1.956 per euro		
Leva per U.S. dollar (end of period)	1.46	1.65	1.48	…	…
Real effective exchange rate					
CPI based (percentage change)	5.0	0.6	4.3	5.3	5.7
GDP deflator based (percentage change)	3.6	1.8	6.3	6.3	5.6

Social Indicators (reference year in parentheses)
Per capita GNI (Atlas method, 2006)**:** US $3,990; **Poverty rate** (2001): 12.8 percent;
Life expectancy at birth (2005)**:** 72.6 years; **Infant mortality** per 1,000 live births (2005): 12;
Income distribution (Gini index, 2003): 29.2; **Primary education completion rate** (2005): 98.3

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

Table 2. Bulgaria: Real GDP by Expenditure Category and Implicit Deflators, 2004–08

	2004	2005	2006	2007 Proj.	2008 Proj.
	(Real growth rate, in percent)				
Real GDP	6.6	6.2	6.1	6.4	6.3
Domestic demand	8.1	12.2	12.5	11.0	5.4
Private demand 1/	8.2	12.5	14.0	9.8	4.8
Public demand 1/	7.3	10.2	4.0	18.1	8.6
Final consumption	5.5	5.5	6.7	8.5	5.2
Private consumption	5.9	6.1	7.5	8.4	5.7
Public consumption	3.8	2.5	2.4	8.9	2.3
Gross investment	13.5	23.3	17.6	19.7	6.4
Private investment 2/	12.6	21.4	20.0	16.0	3.2
Public investment	18.0	31.4	7.7	36.9	18.8
Net exports 3/	-4.5	-6.7	-9.3	-8.0	-1.3
Exports of goods and services	12.7	8.5	9.0	6.0	13.3
Imports of goods and services	14.5	13.1	15.1	11.0	9.8
	(Contribution to real GDP growth, in percent)				
Domestic demand	9.7	14.8	16.0	14.9	7.6
Private demand 1/	8.3	12.8	15.2	11.5	5.8
Public demand 1/	1.4	1.9	0.8	3.5	1.8
Final consumption	4.9	4.9	5.9	7.5	4.7
Private consumption	4.4	4.5	5.6	6.3	4.4
Public consumption	0.5	0.4	0.3	1.2	0.3
Gross investment	4.7	9.9	10.1	7.4	3.0
Private investment 2/	3.9	8.3	9.6	5.1	1.4
Public investment	0.8	1.6	0.5	2.3	1.5
Net exports 3/	-4.5	-6.7	-9.3	-8.0	-1.3
Exports of goods and services	9.2	6.5	7.0	4.8	10.6
Imports of goods and services	-13.6	-13.2	-16.2	-12.8	-11.9
Statistical discrepancy	1.4	-1.8	-0.7	-0.6	0.0
	(Percentage change in implicit deflators)				
GDP deflator	5.1	3.8	8.1	8.0	7.5
Domestic demand	3.6	3.0	4.0	7.0	7.1
Final consumption	4.4	5.0	5.5	7.2	7.8
Private consumption	4.4	5.2	5.2	7.2	7.8
Public consumption	4.8	5.1	8.2	7.2	7.8
Gross investment	4.8	5.3	5.9	5.4	5.8
Exports of goods and services	6.4	7.3	11.9	2.9	1.9
Imports of goods and services	4.7	8.7	8.2	3.8	3.0

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

1/ Private and public sector components based on staff calculations and not officially reported by the NSI.

2/ Including inventories.

3/ Contributions to GDP growth.

Table 3. Bulgaria: Balance of Payments, 2005–2012
(In millions of euros, unless otherwise indicated)

	2005	2006	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.
Current account balance	-2,622	-3,935	-5,817	-6,087	-5,681	-5,114	-4,679	-4,119
Merchandise trade balance	-4,410	-5,562	-7,549	-8,404	-8,407	-8,172	-8,230	-8,526
Exports (f.o.b.)	9,466	12,012	12,971	14,941	16,253	18,124	20,437	23,103
Imports (f.o.b.)	-13,876	-17,574	-20,520	-23,345	-24,660	-26,296	-28,666	-31,629
Services balance	818	971	1,268	1,726	2,313	2,865	3,454	4,279
Exports of non-factor services	3,564	4,143	4,657	5,418	6,248	7,109	8,099	9,222
Imports of non-factor services	-2,746	-3,172	-3,388	-3,692	-3,936	-4,244	-4,644	-4,944
Income balance	151	-6	-189	-313	-557	-607	-785	-845
Receipts	1,218	1,278	1,638	1,944	2,230	2,523	2,835	3,142
Payments	-1,067	-1,284	-1,827	-2,257	-2,787	-3,130	-3,620	-3,988
Current transfer balance	818	662	652	904	971	800	881	974
Capital and financial account balance	3,306	5,399	8,819	8,568	8,000	6,883	5,854	4,821
Capital transfer balance	209	180	387	797	905	985	988	988
Foreign direct investment balance	3,871	4,227	4,199	3,156	2,619	2,079	2,034	1,983
Portfolio investment balance	-1,298	114	-247	0	0	0	0	0
Other investment balance	1,104	878	4,480	4,614	4,476	3,820	2,832	1,850
General government	19	-304	108	423	463	308	11	274
Domestic banks	-210	-568	2,900	-169	-130	-744	-100	-294
Other private sector	1,295	1,750	1,473	4,360	4,143	4,256	2,921	1,871
Errors and omissions	-579.8	321.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	684	1,786	3,002	2,481	2,319	1,769	1,174	702
Financing	-684	-1,786	-3,002	-2,481	-2,319	-1,769	-1,174	-702
Gross international reserves (increase: -)	-324	-1,506	-2,747	-2,481	-2,319	-1,769	-1,174	-702
Use of Fund credit, net	-359.5	-279.9	-254.8	0.0	0.0	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-359.5	-279.9	-254.8	0.0	0.0	0.0	0.0	0.0
Memorandum items:				(In percent of GDP)				
Current account balance	-12.0	-15.7	-20.2	-18.5	-15.5	-12.7	-10.5	-8.3
Foreign direct investment balance	17.7	16.8	14.6	9.6	7.2	5.1	4.5	4.0
Merchandise trade balance	-20.2	-22.2	-26.2	-25.5	-23.0	-20.2	-18.4	-17.2
Exports	43.3	47.9	45.0	45.3	44.5	44.9	45.7	46.6
Imports	-63.4	-70.0	-71.1	-70.8	-67.5	-65.1	-64.1	-63.8
Gross external financing requirement	40.5	40.2	45.9	46.9	48.3	48.7	48.4	46.8
				(Annual percentage change)				
Terms of trade (merchandise)	-2.5	3.5	-3.2	-1.6	2.0	1.3	0.8	0.3
Merchandise export volume	10.5	11.3	8.5	13.6	11.1	13.3	14.0	13.9
Merchandise import volume	15.3	15.0	13.5	10.5	10.0	9.8	11.1	11.5
Merchandise export prices	7.3	14.0	-0.5	1.4	-2.1	-1.6	-1.1	-0.8
Merchandise import prices	10.0	10.1	2.9	3.0	-3.9	-2.9	-1.9	-1.1
GDP	21,882	25,100	28,849	32,963	36,543	40,397	44,699	49,542

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

Table 4. Bulgaria: External Financial Assets and Liabilities, 2005–12
(In millions of euro, unless otherwise indicated)

	2005	2006	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.
International investment position	-9,427	-13,240	-18,666	-23,956	-28,732	-32,861	-36,552	-39,684
Financial assets	13,391	16,880	18,950	21,962	24,861	27,261	29,124	30,578
Foreign direct investment	154	261	562	906	1,287	1,708	2,175	2,692
Portfolio investment	662	879	879	879	879	879	879	879
Other investments	5,205	6,814	5,836	6,023	6,222	6,432	6,653	6,888
Gross international reserves	7,370	8,926	11,674	14,154	16,474	18,243	19,417	20,120
Financial liabilities	22,818	30,120	37,616	45,918	53,593	60,122	65,676	70,261
Foreign direct investment	11,499	15,723	20,223	23,723	26,723	29,223	31,723	34,223
Equity	7,724	10,335	12,135	14,585	16,685	18,435	20,185	21,935
Intercompany debt	3,775	5,388	8,088	9,138	10,038	10,788	11,538	12,288
Portfolio investment	2,017	2,343	2,095	2,095	2,095	2,095	2,095	2,095
Loans	6,712	8,651	11,895	16,696	21,371	25,400	28,455	30,540
BNB	559.5	258.9	0.0	0.0	0.0	0.0	0.0	0.0
General government	2,172	1,834	1,942	2,365	2,828	3,136	3,147	3,420
Banks	920	1,312	3,233	3,252	3,321	2,787	2,909	2,849
Other sectors	3,061	5,247	6,720	11,079	15,222	19,478	22,399	24,270
Other liabilities	2,589	3,403	3,403	3,403	3,403	3,403	3,403	3,403
Memorandum items:								
GIR (in percent of GDP)	33.7	35.6	40.5	42.9	45.1	45.2	43.4	40.6
GIR (in percent of short-term debt, at remaining maturity)	118.0	145.1	157.3	150.8	137.4	125.2	114.5	105.4
GIR (in percent of short-term debt and FX deposits of banks)	54.4	57.4	57.5	...	...	...	...	...
GIR (in months of next year's imports)	4.3	4.4	5.1	5.9	6.4	6.6	6.4	...
NIR (in percent of GDP)	31.2	34.6	35.3	36.0	36.8	36.1	33.9	30.7
Gross external debt (in percent of GDP)	69.0	78.4	87.6	92.7	97.7	99.2	97.2	93.3
Public	23.6	17.9	14.6	14.1	13.9	13.2	11.8	11.3
Private	45.4	60.4	73.0	78.6	83.8	86.0	85.4	82.0
Short-term	17.2	24.0	28.9	32.0	34.7	35.6	35.6	34.1
Long-term	28.2	36.4	44.1	46.6	49.1	50.4	49.8	47.9
Gross external debt (in percent of exports of GNFS)	115.8	121.8	143.3	150.1	158.7	158.9	152.2	143.0
Net international investment position (in percent of GDP)	-43.1	-52.8	-64.7	-72.7	-78.6	-81.3	-81.8	-80.1
GDP	21,882	25,100	28,849	32,963	36,543	40,397	44,699	49,542

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

Table 5a. Bulgaria: General Government Operations and Balance Sheet, 2004–08
(In millions of leva)

	2004	2005	2006	2007 Budget	2007 Proj.	2008 Budget	2008 Proj.
Revenue	14,918	17,030	19,140	20,411	22,851	26,210	26,100
Taxes	11,869	13,579	15,513	16,583	18,558	21,117	20,979
Taxes on profits	973	1,028	1,334	1,411	1,790	2,262	2,045
Taxes on income	1,248	1,249	1,325	1,446	1,785	2,190	1,941
Value-added taxes	3,891	4,798	5,824	6,301	6,983	8,110	8,031
Excises	1,885	2,188	2,498	3,173	3,287	3,798	4,012
Customs duties	292	372	455	240	194	195	204
Social security contributions	3,171	3,505	3,496	3,601	3,880	3,817	4,017
Other taxes	409	440	582	412	638	745	729
Nontax revenues	2,595	2,935	3,002	2,740	3,206	3,193	3,432
Grants	455	516	625	1,088	1,087	1,900	1,689
Expenditure	14,249	16,056	17,416	20,060	20,871	24,389	23,831
Current expenditure	12,640	13,569	14,742	16,957	17,209	19,437	18,970
Compensation of employees	2,381	2,505	2,773	3,160	3,471	3,596	3,513
Maintenance and operations	3,178	3,475	3,835	4,035	4,065	4,776	4,534
Interest	697	686	640	730	677	668	671
Subsidies	869	870	726	937	941	1,343	1,300
Contribution to EU budget	…	…	...	634	634	660	660
Social benefits	5,445	5,987	6,766	7,425	7,386	8,341	8,249
Pensions	3,457	3,715	4,149	4,390	4,498	5,277	5,235
Unemployment	941	1,032	1,153	1,393	1,233	1,578	1,249
Health care	778	947	1,185	1,314	1,354	1,486	1,436
Other	269	293	279	328	301	0	330
Other spending	71	46	2	35	35	53	43
Capital expenditure	1,473	2,039	2,325	2,797	3,355	4,258	4,219
Contingency	219	439	293	307	307	694	642
Fiscal balance	670	974	1,724	351	1,979	1,821	2,269
Financing	-670	-974	-1,724	-351	-1,979	-1,821	-2,269
Privatization proceeds	1,180	1,447	738	274	274	400	400
External	-622	-2,411	-933	-278	-278	588	906
Domestic	-1,228	-11	-1,530	-347	-1,975	-2,809	-3,575
Financial assets	20,790	18,954	19,442	…	21,289	…	24,544
Fiscal reserve	4,715	4,552	5,435	…	6,800	…	8,959
Shares and other equity	7,605	6,783	6,171	…	6,000	…	6,856
Other assets	10,636	9,197	7,495	…	8,489	…	8,730
Financial liabilities	17,391	14,982	13,647	…	13,515	…	14,501
Gross public debt	15,559	13,387	12,120	…	12,015	…	13,001
Foreign	12,878	10,544	9,164	…	8,719	…	9,343
Domestic	2,681	2,843	2,956	…	3,296	…	3,658
Other liabilities	1,832	1,595	1,527	…	1,500	…	1,500
Net financial worth	3,399	3,972	5,795	…	7,774	…	10,043

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

Table 5b. Bulgaria: General Government Operations and Balance Sheet, 2004–08
(In percent of GDP)

	2004	2005	2006	2007 Budget	2007 Proj.	2008 Budget	2008 Proj.
Revenue	38.4	39.8	39.0	39.9	40.5	42.5	40.5
Taxes	30.6	31.7	31.6	32.4	32.9	34.2	32.5
Taxes on profits	2.5	2.4	2.7	2.8	3.2	3.7	3.2
Taxes on income	3.2	2.9	2.7	2.8	3.2	3.5	3.0
Value-added taxes	10.0	11.2	11.9	12.3	12.4	13.1	12.5
Excises	4.9	5.1	5.1	6.2	5.8	6.2	6.2
Customs duties	0.8	0.9	0.9	0.5	0.3	0.3	0.3
Social security contributions	8.2	8.2	7.1	7.0	6.9	6.2	6.2
Other taxes	1.1	1.0	1.2	0.8	1.1	1.2	1.1
Nontax revenues	6.7	6.9	6.1	5.4	5.7	5.2	5.3
Grants	1.2	1.2	1.3	2.1	1.9	3.1	2.6
Expenditure	36.7	37.5	35.5	39.2	37.0	39.5	37.0
Current expenditure	32.6	31.7	30.0	33.2	30.5	31.5	29.4
Compensation of employees	6.1	5.9	5.6	6.2	6.2	5.8	5.4
Maintenance and operations	8.2	8.1	7.8	7.9	7.2	7.7	7.0
Interest	1.8	1.6	1.3	1.4	1.2	1.1	1.0
Subsidies	2.2	2.0	1.5	1.8	1.7	2.2	2.0
Contribution to EU budget	…	…	…	1.2	1.1	1.1	1.0
Social benefits	14.0	14.0	13.8	14.5	13.1	13.5	12.8
Pension	8.9	8.7	8.5	8.6	8.0	8.6	8.1
Pensions	2.4	2.4	2.3	2.7	2.2	2.6	1.9
Health care	2.0	2.2	2.4	2.6	2.4	2.4	2.2
Other	0.7	0.7	0.6	0.6	0.5	0.0	0.5
Other spending	0.2	0.1	0.0	0.1	0.1	0.1	0.1
Capital expenditure	3.8	4.8	4.7	5.5	5.9	6.9	6.5
Contingency	0.6	1.0	0.6	0.6	0.5	1.1	1.0
Fiscal balance	1.7	2.3	3.5	0.7	3.5	3.0	3.5
Financing	-1.7	-2.3	-3.5	-0.7	-3.5	-3.0	-3.5
Privatization proceeds	3.0	3.4	1.5	0.5	0.5	0.6	0.6
External	-1.6	-5.6	-1.9	-0.5	-0.5	1.0	0.9
Domestic	-3.2	0.0	-3.1	-0.7	-3.5	-4.6	-5.5
Financial assets	53.6	44.3	39.6	…	37.7	…	38.1
Fiscal reserve	12.1	10.6	11.1	…	12.1	…	13.9
Shares and other equity	19.6	15.8	12.6	…	10.6	…	10.6
Other assets	29.3	23.0	17.5	…	15.0	…	13.5
Financial liabilities	44.8	35.0	27.8	…	24.1	…	16.4
Gross public debt	40.1	31.3	24.7	…	21.3	…	20.2
Foreign	33.2	24.6	18.7	…	14.6	…	14.5
Domestic	6.9	6.6	6.0	…	6.8	…	5.7
Other liabilities	4.7	3.7	3.1	…	2.7	…	2.3
Net financial worth	8.8	9.3	11.8	…	13.8	…	15.6
Memorandum items:							
Conventional structural fiscal balance	2.2	2.3	3.3	…	3.1	…	3.0
Modified structural fiscal balance 1/	2.4	1.5	1.8	…	0.7	…	1.0
Output gap 2/	-1.1	0.1	0.5	…	1.0	…	1.4
Absorption gap 3/	-2.1	3.7	7.9	…	12.8	…	11.1
Nominal GDP (in millions of leva)	38,823	42,797	49,091	51,141	56,424	61,711	64,470

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

1/ Actual fiscal balance adjusted for the automatic effects of both internal imbalance (output gap) and external imbalance (absorption gap) on fiscal position; see *Selected Issues* Chapter III.

2/ Percentage deviation of actual from potential GDP.

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

Table 6. Bulgaria: Monetary Accounts, 2005–12
(In millions of leva, unless otherwise stated)

	2005 Dec.	2006 Dec.	2007 Sept.	2007 Dec. Proj.	2008 Dec. Proj.	2009 Dec. Proj.	2010 Dec. Proj.	2011 Dec. Proj.	2012 Dec. Proj.
Monetary Survey									
Net foreign assets	13,221	18,634	19,860	18,819	24,001	28,790	33,706	36,198	38,146
Net foreign reserves (millions of euro)	6,760	9,528	10,154	9,622	12,272	14,720	17,234	18,508	19,504
Net domestic assets	12,039	13,427	18,373	22,366	27,206	33,631	40,832	49,093	58,751
Domestic credit	18,300	21,091	28,091	31,325	37,042	44,442	52,726	62,192	73,193
General government	-363	-2,165	-5,073	-4,140	-7,715	-10,207	-11,923	-12,930	-13,197
Non-government	18,663	23,256	33,164	35,465	44,757	54,649	64,649	75,122	86,391
Other items, net	-6,261	-7,664	-9,718	-8,959	-9,836	-10,811	-11,894	-13,100	-14,443
Broad money (M3)	25,260	32,061	38,233	41,185	51,207	62,421	74,538	85,291	96,896
Currency outside banks	5,396	6,231	6,931	7,215	8,059	8,934	9,827	10,780	11,817
Deposits	19,864	25,831	31,302	33,970	43,148	53,487	64,711	74,511	85,080
Accounts of the Bulgarian National Bank									
Net foreign assets	13,343	16,976	22,881	22,832	27,684	32,220	35,680	37,977	39,350
Net foreign reserves (millions of euro)	6,822	8,680	11,699	11,674	14,154	16,474	18,243	19,417	20,120
Net domestic assets	-4,992	-6,494	-10,197	-9,668	-12,556	-15,416	-17,406	-18,710	-19,233
Net claims on government	-2,219	-3,962	-7,136	-5,931	-9,527	-12,045	-13,692	-14,653	-15,031
Claims on government	1,094.4	506.3	0.0	...	...	...	...	...	...
Liabilities of government	3,313	4,468	7,136	...	...	...	...	...	...
Net claims on economy	-907	-557	-842	-1,745	-995	-1,295	-1,595	-1,895	-1,995
Fixed assets and other items, net	-1,866	-1,975	-2,218	-1,992	-2,033	-2,075	-2,118	-2,162	-2,206
Base money	8,351	10,482	12,684	13,163	15,128	16,804	18,275	19,267	20,118
Currency in circulation	5,396	6,231	6,931	7,215	8,059	8,934	9,827	10,780	11,817
Banks reserves	2,956	4,251	5,753	5,948	7,069	7,870	8,448	8,487	8,301
Deposit money banks									
Net foreign assets	-122	1,658	-3,021	-4,013	-3,683	-3,429	-1,974	-1,779	-1,205
Gross foreign assets	5,424	8,268	6,110	6,355	6,721	7,109	7,519	7,953	8,412
Gross foreign liabilities	5,546	6,609	9,131	10,367	10,404	10,539	9,494	9,733	9,617
Net domestic assets	19,831	24,667	34,869	37,481	47,303	57,351	67,125	76,789	87,102
Domestic credit	20,443	24,978	35,150	37,182	46,496	56,413	66,344	76,771	88,150
Credit to government	1,856	1,797	2,063	1,791	1,812	1,839	1,769	1,723	1,833
Credit to non-government	18,587	23,181	33,087	35,391	44,683	54,575	64,575	75,048	86,317
Memorandum items:				Annual percentage change					
Base money	18.3	25.5	32.9	25.6	14.9	11.1	8.8	5.4	4.4
Broad money	23.9	26.9	29.1	28.5	24.3	21.9	19.4	14.4	13.6
Domestic credit	32.4	24.6	55.9	52.5	26.2	22.1	18.3	16.2	15.0
Domestic deposits	26.0	30.0	32.1	31.5	27.0	24.0	21.0	15.1	14.2
Domestic currency	24.0	27.2	30.3	29.7	25.9	22.9	19.9	14.1	13.1
Foreign currency	28.6	33.6	34.2	33.7	28.3	25.2	22.2	16.3	15.3
					Ratio				
Money multiplier	3.0	3.1	3.0	3.1	3.4	3.7	4.1	4.4	4.8
Velocity (M3)	1.7	1.5	…	1.4	1.3	1.1	1.1	1.0	1.0
GDP (in millions of leva)	42,797	49,091	…	56,424	64,470	71,472	79,010	87,423	96,896

Sources: Bulgarian National Bank, National Statistics Institute, and Fund staff estimates.

Table 7. Bulgaria: Private Sector Credit Flows, 2003–07
(In percent of GDP)

	2003	2004	2005	2006	2007 Proj.
Domestic private sector credit	9.1	12.1	14.6	17.7	24.3
Non-financial corporations	5.8	7.3	8.2	10.2	15.0
Lending by commercial banks, on balance sheet	5.3	6.6	5.0	4.6	12.7
Overdraft	0.7	1.3	1.2	4.6	…
Short-term loans (up to one year)	0.1	0.6	0.1	-0.3	…
Medium-term (maturity between one and five years)	3.5	2.3	1.6	-1.4	…
Long-term loans (maturity over five years)	1.0	2.2	1.8	1.2	…
Overdue and restructured	0.0	-0.1	0.0	0.3	…
Loans sold by commercial banks	…	…	1.5	3.6	0.1
Leasing companies 1/	…	0.5	1.5	1.8	2.0
Corporate bonds	…	0.2	0.1	0.2	0.2
Households	3.2	4.8	6.4	7.5	9.3
Lending by commercial banks, on balance sheet	3.2	4.8	6.0	4.3	8.4
Overdraft	0.2	0.4	0.7	0.6	…
Consumer loans	2.1	2.4	2.6	0.5	…
Mortgages	0.5	1.5	2.3	3.0	…
Other household loans	0.5	0.5	0.4	0.3	…
Loans sold by commercial banks	…	…	0.0	3.0	0.7
Leasing companies	…	…	…	0.2	0.1
Financing of domestic private sector credit	9.1	12.1	14.6	17.7	24.3
Commercial banks	8.5	11.4	11.0	8.9	21.1
Private deposits	5.3	9.1	11.1	13.5	12.7
Government deposits	0.7	-0.6	-0.8	0.1	0.0
BNB, net lending to commercial banks	-0.7	-2.7	-1.2	-2.6	-3.0
Foreign borrowing (net)	4.1	4.8	-0.6	-3.6	10.1
Change in gross assets	-2.3	3.8	2.2	5.8	-3.4
Change in gross liabilities	1.7	8.7	1.6	2.2	6.7
Capital and reserves	1.0	1.1	1.6	2.0	1.9
Other	-1.8	-0.4	0.9	-0.4	-0.5
Purchases of bank loans by residents	…	…	0.1	2.9	0.6
Purchases of bank loans by non-residents	…	…	1.4	3.6	0.2
Leasing companies 1/	…	0.5	2.0	2.0	2.2
Corporate bonds	0.1	0.2	0.1	0.2	0.2
Memorandum items:					
Domestic private sector credit, stock	27.0	36.2	47.4	59.1	75.7
Non-financial corporations	19.8	24.9	30.8	37.1	47.3
Households	7.2	11.3	16.7	22.0	28.4

Sources: BNB, NSI and staff calculations and projections.

1/ Staff estimates for 2004 and 2005.

Table 8. Bulgaria: Financial Soundness Indicators, 2004–07
(In percent)

	2004	2005	2006	2007 1/
Core indicators				
Capital adequacy				
Capital to risk-weighted assets	16.6	15.3	14.5	14.4
Tier 1 capital to risk-weighted assets	14.4	12.5	11.8	11.6
Asset quality				
Nonperforming loans to total gross loans	2.0	2.2	2.2	2.2
Nonperforming loans net of provisions to capital	1.8	2.9	2.5	2.4
Large exposures to capital	129.8	90.8	87.3	73.1
Earnings and profitability				
Return on assets	2.1	2.0	2.2	2.2
Return on equity	19.6	21.4	25.0	24.4
Net interest income to gross income	68.1	68.5	69.4	71.4
Noninterest expense to gross income	58.3	55.3	56.0	49.9
Personnel expense to total income	21.4	19.5	18.8	18.1
Trading and fee income to total income	30.1	29.8	27.3	26.2
Liquidity				
Liquid assets to total assets	30.1	28.7	31.0	24.9
Liquid assets to short-term liabilities	34.7	33.1	35.7	29.0
Encouraged indicators				
Deposit-taking institutions				
Capital to assets	10.2	7.4	7.3	8.3
Trading income to total income	8.4	8.0	2.7	3.7
Personnel expenses to noninterest expenses	36.7	35.3	33.7	36.3
Customer deposits to total (non-interbank) loans	121.2	111.3	121.1	109.9
Foreign currency denominated loans to total loans	48.2	47.8	45.6	48.6
Foreign currency denominated liabilities to total liabilities	56.0	55.0	54.5	56.7
Net open foreign-exchange position	-5.9	-5.6	…	…

Source: Bulgarian National Bank.
1/ Data for 2007 as of end June.

Table 9. Bulgaria: Rankings of Selected Competitiveness and Structural Indicators 1/

	Bulgaria			New EU members 2/			Distance from other new EU members 2/
	2005	2006	2007	2005	2006	2007	2007 3/
EBRD transition indicators	79	80	80	84	85	85	-5
Large scale privatization	92	92	92	86	86	86	6
Small scale privatization	85	92	92	98	98	98	-6
Enterprise restructuring	62	62	62	75	76	76	-14
Price liberalization	100	100	100	99	99	99	1
Trade and foreign exchange system	100	100	100	100	100	100	0
Competition policy	62	62	62	70	72	73	-11
Banking reform	85	85	85	85	85	86	-2
Non-bank financial institutions	54	62	62	72	74	76	-14
Overall infrastructure reform	69	69	69	74	74	74	-4
World Bank Doing Business survey							
Starting a business	…	50	43	…	62	61	-18
Dealing with licenses	…	52	41	…	55	57	-16
Employing workers	…	67	68	…	39	38	30
Registering property	…	64	65	…	64	64	1
Getting credit	…	89	93	…	83	81	12
Protecting investors	…	82	82	…	67	66	16
Paying taxes	…	30	50	…	48	49	1
Trading across borders	…	34	49	…	80	78	-28
Enforcing contracts	…	49	49	…	75	75	-27
Closing a business	…	63	59	…	64	66	-7
World Bank governance indicators	55	54	…	64	64	…	-10
Voice and accountability	60	61	…	68	69	…	-7
Political stability	54	56	…	64	64	…	-8
Government effectiveness	55	53	…	65	65	…	-13
Regulatory quality	63	61	…	69	69	…	-8
Rule of law	47	47	…	60	60	…	-14
Control of corruption	50	49	…	58	58	…	-9
Transparency international							
Corruption Perception Index	40	40	41	46	49	51	-10

Sources: EBRD; World Bank; Transparency International; and Fund staff calculations.

1/ For comparability, all indices normalized so that they range from 0 (lowest) to 100 (best).

2/ Average score of EU members that joined since May 2004 other than Bulgaria, Malta, and Cyprus.

3/ 2006 figures for World Bank governance indicators.

Table 10a: Bulgaria: Macroeconomic Framework, Baseline, 2005–2012

	2005	2006	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.
GDP and prices (annual percent change)								
Real GDP	6.2	6.1	6.4	6.3	6.0	6.5	6.7	7.0
Real domestic demand	12.2	12.5	11.0	5.4	5.4	4.9	6.0	6.4
GDP deflator	3.8	8.1	8.0	7.5	4.6	3.8	3.7	3.6
Domestic demand deflator	3.0	4.0	7.0	7.1	2.1	2.2	2.1	2.2
Consumer price index (HICP, average)	6.0	7.4	7.2	7.8	4.5	3.8	3.6	3.5
Consumer price index (HICP, end of period)	7.4	6.1	9.5	4.9	4.0	3.6	3.5	3.5
Nominal wages	9.5	9.4	18.9	17.6	9.7	10.0	10.7	11.0
Public sector wages	11.3	9.1	16.9	16.2	5.9	6.0	6.3	6.4
Private sector wages	10.4	10.0	21.4	18.8	11.8	11.9	12.6	12.8
Real effective exchange rate, CPI based	0.6	4.3	5.3	5.7	2.5	1.9	1.7	1.6
Real effective exchange rate, GDP deflator based	1.8	6.3	6.3	5.6	2.7	1.9	1.8	1.8
Monetary aggregates (annual percent change)								
Broad money	23.9	26.9	28.5	24.3	21.9	19.4	14.4	13.6
Domestic credit	32.4	24.6	52.5	26.2	22.1	18.3	16.2	15.0
Saving and investment (in percent of GDP)								
Foreign saving	12.0	15.7	20.2	18.5	15.5	12.7	10.5	8.3
Gross national saving	16.0	16.2	14.7	15.7	17.6	18.9	19.5	20.3
Government	7.0	8.2	9.5	10.1	8.8	8.1	7.8	7.3
Private	8.9	8.0	5.2	5.6	8.8	10.8	11.8	13.0
Gross domestic investment	28.0	31.9	34.8	34.2	33.1	31.5	30.0	28.6
Government	4.8	4.7	5.9	6.5	6.5	6.5	6.5	6.5
Private	23.2	27.2	28.9	27.6	26.6	25.0	23.5	22.1
General government (in percent of GDP)								
Revenue	39.8	39.0	40.5	40.5	40.9	40.0	39.0	38.9
Expenditure	37.5	35.5	37.0	37.0	38.6	38.4	37.8	38.1
Fiscal balance	2.3	3.5	3.5	3.5	2.3	1.6	1.3	0.8
Gross public debt	31.3	24.7	21.3	20.2	20.2	19.3	18.1	14.8
Net financial worth	9.3	11.8	13.8	15.6	16.3	16.4	16.1	15.3
Balance of payments (in percent of GDP)								
Current account	-12.0	-15.7	-20.2	-18.5	-15.5	-12.7	-10.5	-8.3
Trade balance	-20.2	-22.2	-26.2	-25.5	-23.0	-20.2	-18.4	-17.2
Services balance	3.7	3.9	4.4	5.2	6.3	7.1	7.7	8.6
Income balance	0.7	0.0	-0.7	-0.9	-1.5	-1.5	-1.8	-1.7
Transfers balance	3.7	2.6	2.3	2.7	2.7	2.0	2.0	2.0
Capital and financial account balance	15.1	21.5	30.6	26.0	21.9	17.0	13.1	9.7
Foreign direct investment, balance	17.7	16.8	14.6	9.6	7.2	5.1	4.5	4.0
Memorandum items:								
Gross international reserves (in millions of euros)	7,370	8,926	11,674	14,154	16,474	18,243	19,417	20,120
Gross international reserves (in months of next year's imports)	4.3	4.4	5.1	5.9	6.4	6.6	6.4	...
International investment position (in percent of GDP)	-43.1	-52.8	-64.7	-72.7	-78.6	-81.3	-81.8	-80.1
External debt (in percent of GDP)	69.0	78.4	87.6	92.7	97.7	99.2	97.2	93.3
Short-term external debt (in percent of GDP)	17.2	24.0	28.9	32.0	34.7	35.6	35.6	34.1
Export volume (percent change)	10.5	11.3	8.5	13.6	11.1	13.3	14.0	13.9
Import volume (percent change)	15.3	15.0	13.5	10.5	10.0	9.8	11.1	11.5
Terms of trade (percent change)	-2.5	3.5	-3.2	-1.6	2.0	1.3	0.8	0.3
Nominal GDP (in millions of leva)	42,797	49,091	56,424	64,470	71,472	79,010	87,423	96,896
Nominal GDP (in millions of euros)	21,882	25,100	28,849	32,963	36,543	40,397	44,699	49,542

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

Table 10b: Bulgaria: Macroeconomic Framework, Alternative Scenario, 2005–2012

	2005	2006	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.
GDP and prices (annual percent change)								
Real GDP	6.2	6.1	6.4	7.9	8.1	9.1	7.9	7.8
Real domestic demand	12.2	12.5	11.0	9.0	11.1	11.5	11.2	10.9
GDP deflator	3.8	8.1	8.0	10.3	8.2	7.8	7.3	6.4
Domestic demand deflator	3.0	4.0	7.0	9.1	4.3	4.5	3.9	3.4
Consumer price index (HICP, average)	6.0	7.4	7.2	10.6	8.1	7.8	7.2	6.3
Consumer price index (HICP, end of period)	7.4	6.1	9.5	8.0	11.0	7.8	7.2	6.3
Nominal wages	9.5	9.4	18.9	37.1	24.1	24.8	23.7	22.3
Public sector wages	11.3	9.1	16.9	44.0	19.7	19.8	19.2	18.3
Private sector wages	10.4	10.0	21.4	34.2	26.8	27.3	25.7	24.0
Real effective exchange rate, CPI based	0.6	4.3	5.3	8.4	6.1	5.8	5.2	4.4
Real effective exchange rate, GDP deflator based	1.8	6.3	6.3	8.4	6.3	5.9	5.3	4.5
Monetary aggregates (annual percent change)								
Broad money	23.9	26.9	28.5	29.4	28.7	27.1	19.7	17.6
Domestic credit	32.4	24.6	52.5	31.4	28.9	25.9	23.7	17.0
Saving and investment (in percent of GDP)								
Foreign saving	12.0	15.7	20.2	20.0	19.7	19.6	20.2	20.8
Gross national saving	16.0	16.2	14.7	14.2	13.3	12.1	10.9	9.7
Government	7.0	8.2	9.5	8.5	7.9	7.2	6.2	5.0
Private	8.9	8.0	5.2	5.7	5.5	4.9	4.7	4.7
Gross domestic investment	28.0	31.9	34.8	34.2	33.0	31.7	31.1	30.5
Government	4.8	4.7	5.9	6.6	6.4	6.4	6.2	6.2
Private	23.2	27.2	28.9	27.6	26.6	25.3	24.9	24.3
General government (in percent of GDP)								
Revenue	39.8	39.0	40.5	41.7	42.7	42.9	41.6	41.5
Expenditure	37.5	35.5	37.0	39.8	41.2	42.0	41.6	42.6
Fiscal balance	2.3	3.5	3.5	1.9	1.5	0.8	0.0	-1.1
Gross public debt	31.3	24.7	21.3	19.4	18.3	16.5	14.8	11.7
Net financial worth	9.3	11.8	13.8	13.5	13.0	11.9	10.2	7.8
Balance of payments (in percent of GDP)								
Current account	-12.0	-15.7	-20.2	-20.0	-19.7	-19.6	-20.2	-20.8
Trade balance	-20.2	-22.2	-26.2	-25.8	-24.2	-22.7	-22.1	-21.7
Services balance	3.7	3.9	4.4	4.1	3.7	3.3	2.9	2.6
Income balance	0.7	0.0	-0.7	-0.9	-1.6	-1.8	-2.5	-3.0
Transfers balance	3.7	2.6	2.3	2.6	2.4	1.6	1.5	1.4
Capital and financial account balance	15.1	21.5	30.6	26.3	26.7	24.5	22.4	20.7
Foreign direct investment, balance	17.7	16.8	14.6	9.2	6.4	4.2	3.5	2.9
Memorandum items:								
Gross international reserves (in millions of euros)	7,370	8,926	11,674	13,837	16,674	18,965	20,191	20,131
Gross international reserves (in months of next year's imports)	4.3	4.4	5.0	5.5	6.1	6.2	5.9	...
International investment position (in percent of GDP)	-43.1	-52.8	-64.7	-72.1	-79.0	-84.7	-91.5	-99.0
External debt (in percent of GDP)	69.0	78.4	87.7	92.1	99.4	104.6	109.2	112.8
Short-term external debt (in percent of GDP)	17.2	24.0	29.1	32.4	37.3	40.9	44.9	47.1
Export volume (percent change)	10.5	11.3	8.5	12.5	9.6	11.7	12.5	12.7
Import volume (percent change)	15.3	15.0	13.5	11.9	12.7	13.2	14.0	13.4
Terms of trade (percent change)	-2.5	3.5	-3.2	-1.6	2.0	1.3	0.8	0.3
Nominal GDP (in millions of leva)	42,797	49,091	56,424	67,122	78,544	92,399	106,978	122,718
Nominal GDP (in millions of euros)	21,882	25,100	28,849	34,319	40,159	47,243	54,697	62,744

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

APPENDIX I: BULGARIA: DEBT SUSTAINABILITY

Bulgaria: External Debt Sustainability Framework, 2005–12
(In percent of GDP, unless otherwise indicated)

		Actual		Projections						
		2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	69.0	78.4	87.6	92.7	97.7	99.2	97.2	93.3	-9.5
2	Change in external debt	5.2	9.4	9.2	5.2	5.0	1.5	-2.0	-3.9	
3	Identified external debt-creating flows (4+8+9)	0.4	-2.1	4.0	5.2	4.2	2.6	0.7	-1.2	
4	Current account deficit, excluding interest payments	10.1	13.9	18.1	15.9	12.4	9.0	6.5	4.3	
5	Deficit in balance of goods and services	-135.5	-147.0	-144.0	-143.8	-139.8	-138.1	-138.4	-139.1	
6	Exports	59.5	64.4	61.1	61.8	61.6	62.5	63.8	65.2	
7	Imports	-76.0	-82.7	-82.9	-82.0	-78.3	-75.6	-74.5	-73.8	
8	Net non-debt creating capital inflows (negative)	-5.9	-7.3	-12.1	-8.6	-6.3	-4.3	-3.8	-3.5	
9	Automatic debt dynamics 1/	-3.8	-8.7	-2.0	-2.1	-1.8	-2.1	-1.9	-2.1	
10	Contribution from nominal interest rate	1.9	1.8	2.1	2.6	3.2	3.7	4.0	4.0	
11	Contribution from real GDP growth	-3.6	-3.6	-4.1	-4.7	-5.0	-5.7	-6.0	-6.1	
12	Contribution from price and exchange rate changes 2/	-2.1	-6.9	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	4.8	11.6	5.2	0.0	0.8	-1.1	-2.7	-2.7	
	External debt-to-exports ratio (in percent)	115.8	121.8	143.3	150.1	158.7	158.9	152.2	143.0	
	Gross external financing need (in billions of US dollars) 4/	11.0	12.6	17.3	21.1	24.3	27.2	30.1	32.6	
	in percent of GDP	40.5	40.1	44.4	46.5	48.2	48.5	48.1	46.5	
	Scenario with key variables at their historical averages 5/	…	…	87.6	85.9	81.9	76.0	69.1	62.6	-10.1
	Key Macroeconomic Assumptions Underlying Baseline									
	Real GDP growth (in percent)	6.2	6.1	6.4	6.3	6.0	6.5	6.7	7.0	
	GDP deflator in US dollars (change in percent)	3.4	11.2	16.1	9.4	5.1	4.5	4.6	4.6	
	Nominal external interest rate (in percent)	3.2	3.0	3.3	3.4	3.8	4.2	4.5	4.6	
	Growth of exports (US dollar terms, in percent)	16.1	25.0	17.3	17.5	11.0	12.9	14.1	14.3	
	Growth of imports (US dollar terms, in percent)	23.0	25.8	23.9	15.1	6.2	7.5	10.1	10.8	
	Current account balance, excluding interest payments	-10.1	-13.9	-18.1	-15.9	-12.4	-9.0	-6.5	-4.3	
	Net non-debt creating capital inflows	5.9	7.3	12.1	8.6	6.3	4.3	3.8	3.5	

Sources: WEO; and Fund 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

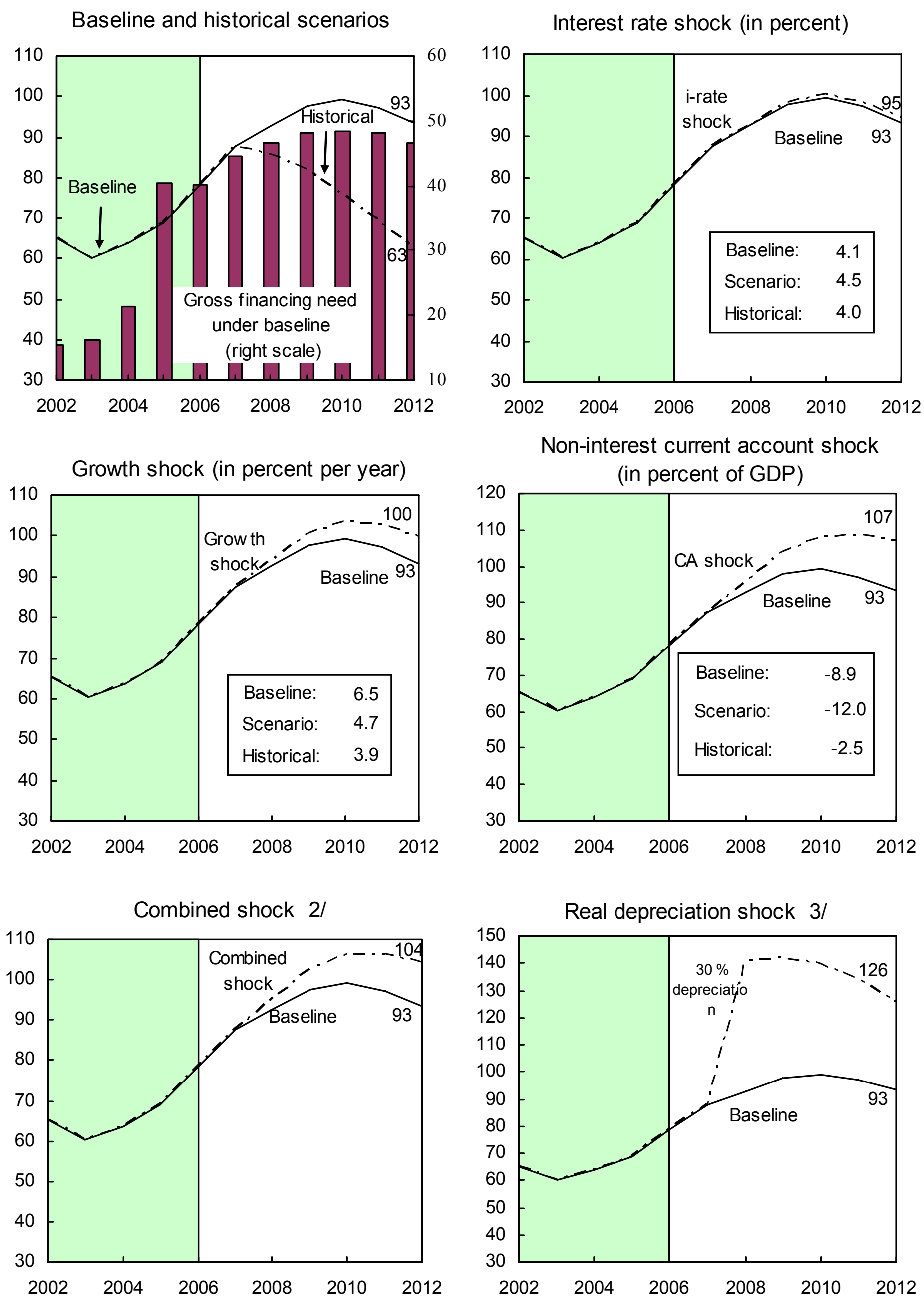
3/ For projection, line includes the impact of price and exchange rate changes.

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.

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 2008.

Bulgaria: Public Sector Debt Sustainability Framework, 2005–12
(In percent of GDP, unless otherwise indicated)

		Actual		Projections						
		2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing primary balance 9/
1	**Baseline: Public sector debt 1/**	31.3	24.7	21.3	20.2	20.2	19.3	18.1	14.8	0.2
	Of which foreign-currency denominated	26.7	20.3	17.6	16.0	14.7	13.0	11.4	9.8	
2	Change in public sector debt	-8.8	-6.6	-3.4	-1.1	0.0	-0.9	-1.2	-3.3	
3	Identified debt-creating flows (4+7+12)	-2.6	-9.3	-4.7	-4.3	-2.4	-1.9	-1.8	-1.5	
4	Primary deficit	-3.9	-4.8	-4.7	-4.6	-3.4	-2.6	-2.2	-1.7	
5	Revenue and grants	39.8	39.0	40.5	40.5	40.9	40.0	39.0	38.9	
6	Primary (noninterest) expenditure	35.9	34.2	35.8	35.9	37.5	37.4	36.8	37.2	
7	Automatic debt dynamics 2/	2.3	-5.2	-2.0	-1.6	-0.9	-0.9	-0.9	-0.9	
8	Contribution from interest rate/growth differential 3/	-2.1	-2.7	-2.0	-1.6	-0.9	-0.9	-0.9	-0.9	
9	*Of which* contribution from real interest rate	0.2	-1.0	-0.6	-0.4	0.2	0.3	0.3	0.2	
10	*Of which* contribution from real GDP growth	-2.3	-1.7	-1.4	-1.2	-1.1	-1.2	-1.2	-1.1	
11	Contribution from exchange rate depreciation 4/	4.4	-2.5	...	...	...	...	...	...	
12	Other identified debt-creating flows	-1.0	0.7	2.0	1.9	1.9	1.6	1.3	1.0	
13	Privatization receipts (negative)	-3.4	-1.5	-0.5	-0.3	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	2.4	2.2	2.5	2.2	1.9	1.6	1.3	1.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	-6.2	2.7	1.3	3.1	2.3	1.0	0.6	-1.7	
	Public sector debt-to-revenue ratio 1/	78.6	63.3	52.6	49.8	49.3	48.2	46.3	38.1	
	Gross financing need 6/	7.0	-0.2	-0.6	-2.4	-1.3	-0.6	-0.4	0.2	
	in billions of U.S. dollars	1.9	-0.1	-0.2	-1.1	-0.6	-0.3	-0.3	0.2	
	Scenario with key variables at their historical averages 7/	...	...	21.3	22.1	22.1	20.5	18.3	13.2	0.6
	Scenario with no policy change (constant primary balance) in 2007-2012	...	...	21.3	20.0	18.7	15.7	12.2	6.2	0.7
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline									
	Real GDP growth (in percent)	6.2	6.1	6.4	6.3	6.0	6.5	6.7	7.0	
	Average nominal interest rate on public debt (in percent) 8/	4.4	4.8	5.6	5.6	5.8	5.5	5.5	5.4	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.6	-3.3	-2.4	-1.9	1.2	1.7	1.8	1.8	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-11.6	11.4	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	3.8	8.1	8.0	7.5	4.6	3.8	3.7	3.6	
	Growth of real primary spending (deflated by GDP deflator, in percent)	8.3	0.9	11.5	6.7	10.7	6.2	4.9	8.2	
	Primary deficit	-3.9	-4.8	-4.7	-4.6	-3.4	-2.6	-2.2	-1.7	

Sources: WEO; and Fund staff estimates and projections.

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

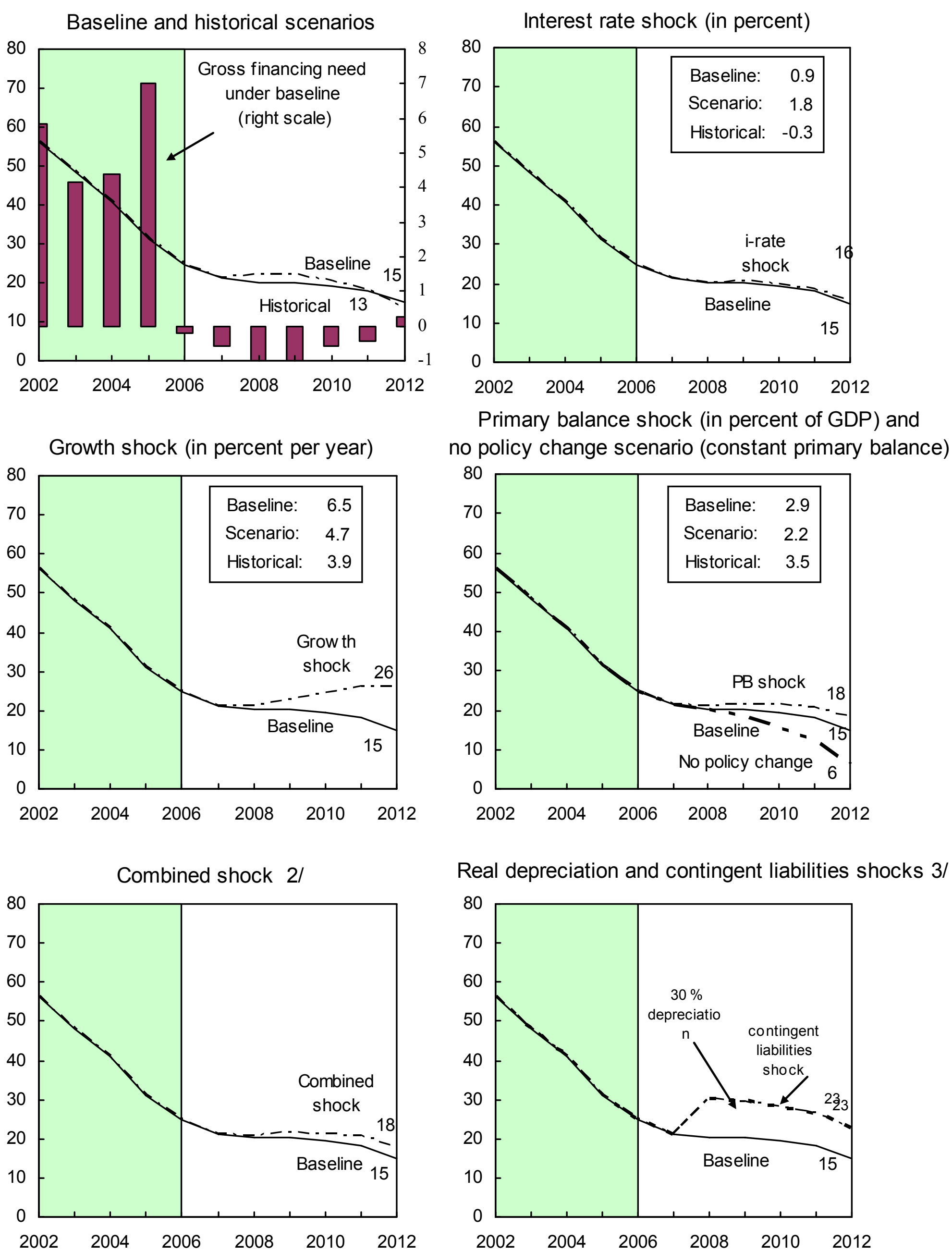
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Bulgaria: Public Debt Sustainability: Bound Tests 1/
(Public 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 primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

APPENDIX II: BULGARIA: FUND RELATIONS

As of October 31, 2007

Date and place of Article IV mission: October 4–16, 2007, in Sofia. The concluding statement of the mission was posted at www.imf.org on October 16, 2007.

Country interlocutors: Prime Minister Stanishev, Minister of Finance Oresharski, Minister of Economy and Energy Dimitrov, Minister of Labor and Employment Maslarova, BNB Governor Iskrov, other senior officials, representatives of parliament, international organizations including the European Commission and European Central Bank, financial sector, and think tanks. Mr. Yotzov (OED) attended the discussions.

IMF team: Messrs. Jaeger (head) and Herderschee, Ms. Zhou (all EUR), Ms. Rahman (PDR), Ms. Arvai (MCM), Mr. Fernandez-Ansola (Senior Regional Resident Representative), and Ms. Mihaylova (Resident Economist).

Political developments: In recent local elections, a new party Citizens for Bulgaria's European Development (GERB) performed strongly. Parliamentary elections are scheduled for 2009, but the GERB party has called for early parliamentary elections.

Previous Article IV consultation: The previous consultation was concluded on August 2, 2006, and the reports were posted at www.imf.org on August 8, 2006.

Data: Bulgaria subscribes to the SDDS, and economic data are adequate to conduct effective surveillance (Appendix III).

Exchange rate arrangement: The currency of Bulgaria is the Bulgarian lev. Since July 1, 1997, the Bulgarian National Bank has operated a currency board arrangement. The peg currency is the euro at the rate of lev 1.95583 per €1. Bulgaria maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions that are maintained for security reasons and that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51)

I.	**Membership Status**: Joined 09/25/1990;		Article VIII
II.	**General Resources Account**:	SDR million	%Quota
	Quota	640.20	100.00
	Fund holdings of currency	606.95	94.81
	Reserve position	33.28	5.20
III.	**SDR Department**:	SDR million	%Allocation
	Holdings	0.58	N/A

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	08/06/2004	03/31/2007	100.00	0.00
Stand-by	02/27/2002	03/15/2004	240.00	240.00
EFF	09/25/1998	09/24/2001	627.62	627.62

VI. **Projected Payments to Fund:** None.

VII. **Implementation of HIPC Initiative:** Not Applicable.

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

APPENDIX III. 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 CPS focus 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, health, social investment and employment promotion, district heating, and environment, the CPS includes a three-year program of three development policy loans (DPLs) of up to US$150 million each that will support institutional reforms in the social sectors. In addition, the CPS program includes a pipeline of investment lending in road and municipal infrastructure, trade and transport facilitation for South East Europe, social inclusion, and regional development. The Bank continues to undertake diagnostics providing a solid base for policy dialogue and design and implementation of its lending operations in Bulgaria.

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, and 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 and an update is scheduled for 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, and the Public Finance Policy Review[2] of 2006, and a forthcoming second Public Finance Policy Review.

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 first DPL, which was approved by the Bank's Board in March 2007, supports the deepening of education reforms, in particular strengthening of the institutional capacity of the Ministry of Education and Sciences to assess the quality of education, and improve school governance and financing system. In addition, a second Public Finance Policy Review, that is currently being finalized, outlines options for reforms aimed at improving quality of vocational education and training as well as the quality of and access to tertiary education.

7. **Health.** The Bank has supported the government program in health through two investment operations and the DPL program. The Bank's first DPL focused on strengthening the financial sustainability of the national health insurance system and enhancing the efficiency of public spending on 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 first DPL supports 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 will change eligibility criteria of some social assistance programs.

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. This work will also provide a feedback loop so that policy adjustments can be made as appropriate to take account of findings. In addition, the Bank and government are preparing a Social

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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).

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[3],** 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.

11. **The World Bank's assistance program in Bulgaria to date comprises 41 IBRD operations with a total original commitment of US$2,314 million equivalent**, consisting of 13 adjustment loans (US$1,225.8 million), 21 investment projects (US$750.7 million), one debt reduction loan (US$125.0 million), four Bank-managed Global Environmental Fund (GEF) grants, and two Bank-managed Prototype Carbon Fund (PCF) operations. Of these 41 operations, 29 have been completed, of which eleven have been partially cancelled during implementation, and 11 operations are currently under implementation (see Table 1 below).

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

	Operation	US$ million	Board Date
1.	Health Sector Reform	63.3	2000
2.	Registration and Cadastre	30.0	2001
3.	Wetlands Restoration and Pollution Reduction (GEF Grant)	7.5	2002
4.	Social Investment and Employment Promotion	50.0	2002
5.	Revenue Administration Reform Project	34.2	2003
6.	District Heating Project	34.2	2003
7.	District Heating Project (PCF)	5.0	2003
8.	Energy Efficiency (GEF Grant)	10.0	2005
9.	First Social Sectors Institutional Reform Development Policy Loan (SIR DPL 1)	150.0	2007
10.	Second Trade and Transport Facilitation in Southeast Europe (TTFSE 2)	52.8	2007
11.	Road Infrastructure Rehabilitation	122.5	2007

12. **Economic and Sector Work.** The country diagnostic work recently completed by the Bank includes a Public Finance Policy Review focused on leveraging EU structural funds for productivity and growth. Various pieces of country diagnostic work are now being finalized. These include a second Public Finance Policy Review focusing on reforms in labor and

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[3]*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.

product markets, education and R&D aimed to boost productivity and employment; a benchmarking study on product market regulation in Bulgaria compared with OECD countries; and a regulatory impact assessment study. In addition the following studies are under way: a justice sector expenditure review, programmatic poverty monitoring, and an investment climate assessment.

13. **IFC, as of July 2007, has 12 projects in its portfolio with total commitments of US$204 million for its own account and an additional US$60 syndicated from partner banks.** In the financial sector, IFC has supported two specialized SME banks, established Bulgaria's first micro lending bank, and has invested in a venture capital fund that also targets the SME sector. IFC has invested in a number of key manufacturing projects to support a cement plant modernization, the expansion and modernization of an electronic assembly facility, the rehabilitation and capacity increase of a wood panel production facility, revamping of a copper processing facility, and a project in retail sector to establish discount stores, hypermarkets and distribution centers in the country. As a good example of South-South investments, IFC has committed about US$90 million to support post-privatization restructuring of a steel mill and two glass processing plants.

Questions may be referred to Ms. Myla Taylor Williams (202-473-6997), or Ms. Stella Ilieva (3592-9697-251).

APPENDIX IV: BULGARIA: STATISTICAL ISSUES

1. Data provision is adequate for surveillance purposes. In January 2003, an STA mission visited Bulgaria and prepared the data module of the Report on the Observance of Standards and Codes (ROSC). Later that year, Bulgaria moved from participation in the GDDS to SDDS subscription, marking a major step forward in the development of the country's statistical system.

2. Despite a comprehensive database, some problems need to be addressed. Further improvements in national accounts are desirable, particularly in the coverage of the private sector, as well as in the balance of payments statistics, where frequent and substantial revisions have hampered economic analysis. In addition, work remains to be done to fully reconcile high frequency data on economic activity with quarterly and annual national accounts data. Moreover, to enhance assessments of economic developments and vulnerabilities, it would be desirable to develop sectoral flow-of-funds accounts for the household sector and, in particular, for the non-financial corporation sector, improve the quality of employment and wage data, and clarify uncertainties regarding trade data that have emerged since EU accession.

Real sector

3. 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, financial corporations, nonfinancial corporations, nonprofit institutions serving households, and households). Work is underway on compiling financial accounts and balance sheets.

4. The NSI has compiled estimates of quarterly GDP by the production and expenditure approaches in current and constant prices since 1994. The preliminary data are disseminated 80 days after the end of the reference quarter with final figures disseminated after approximately 5 quarters. Problems remain in the coverage of private sector activities as well as regarding constant price estimates of capital formation and external trade. However, significant progress has been made in the development of export and import deflators. The estimates at constant prices, which follow international standards, use chain-linked indices.

5. 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. The geographical coverage of the index is restricted to 27 urban areas which account for an estimated 65 percent of sales.

6. 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.

7. The lack of comprehensive labor statistics hampers the assessment of developments in employment and wages, especially in the private sector, though there have been some recent improvements. Annual data are collected by the NSI, using a census of all establishments. 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 main shortcomings of these data include: (i) under-reporting of private sector wages; (ii) reporting of average gross earnings only, not wages for time worked and wages by occupation; and (iii) lack of coverage of the self-employed and employment in small firms. However, the National Social Security Institute (NSSI) administrative data are used to estimate wages by occupation and age and 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. Regarding employment, 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.

8. 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

9. 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 central government operations are routinely reported for publication in the *GFS Yearbook* and in *IFS.* For the *GFS Yearbook 2006*, 2005 data for the general government sector and its subsectors were reported on a cash basis. The Ministry of Finance prepares data on the execution of the consolidated government budget on a monthly basis. These data do not conform to *GFS* standards and,

while not published in a bulletin format, they are posted on the Ministry of Finance's website. 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. In 2002, the BNB began to harmonize progressively its data collection and compilation methods in line with the ECB's framework for monetary statistics. The revised data for June 1995 and onward resulting from these efforts are published in IFS. Recent work in mid-2006 aimed at fully meeting the remaining ECB requirements beginning in February 2007, in accordance with 1995 ESA, the institutional coverage of monetary financial institutions includes money market funds. Consistency in the coverage of the BNB's claims on banks (which included claims on liquidated banks) and the banks' liabilities to the BNB improved in January 2003 after the BNB wrote off most of the claims on the liquidated banks.

Balance of payments

11. Bulgaria reports monthly balance of payments and external debt data on a regular and timely basis, but data on reinvested earnings by foreign-owned companies are subject to large revisions due to incomplete responses on surveys used for preliminary estimates. In early 2006, the authorities revised the methodology for estimating trade-related transportation receipts and payments to align it more closely with actual costs. Since joining the EU in January 2007, the trade data with EU countries are being collected following the INTRASTAT system. The new system has created considerable data uncertainties as 40 percent of those who reported trade data for the first half of the year reported a value of zero. The authorities therefore expect that some revisions in the 2007 trade data later in the year will be needed as more complete information becomes available.

Table 1. Bulgaria: Common Indicators Required for Surveillance

As of November 13, 2007

	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]	Data Quality Accuracy and reliability[8]
Exchange Rates	Nov 2007	11/13/2007	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sep 2007	10/23/2007	M	W	D		
Reserve/Base Money	Sep 2007	10/23/2007	W/M	M	D and M	O, O, LO, LO	O, O, O, O, O
Broad Money	Sep 2007	10/23/2007	W/M	M	W/M		
Central Bank Balance Sheet	Sep 2007	10/23/2007	W/M	W/M	W and M		
Consolidated Balance Sheet of the Banking System	Sep 2007	10/23/2007	M	M	M		
Interest Rates[2]	Oct 2007	11/02/2007	W and M	W and M	W and M		
Consumer Price Index	Oct 2007	11/13/2007	M	M	M	O, LO, O, O	LO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2006	1/31/2007	A	A	A	O, LO, O, LO	LO, O, O, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Sep 2007	10/31/2007	M	M	M		
Stocks of General Government and General Government-Guaranteed Debt[5]	Sep 2007	10/31/2007	M	M	M		
External Current Account Balance	Sep 2007	11/13/2007	M	M	M	LNO, LO, O, LO	LNO, LNO, LNO, LO, LO
Exports and Imports of Goods and Services	Sep 2007	11/13/2007	M	M	M		
GDP	2007 Q2 (Quarterly); 2006 (Annual)	9/19/2007	Q/A	Q/A	Q	O, LO, O, LO	O, O, O, O, O
Gross External Debt	Aug 2007	10/23/2007	M	M	M		

[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.

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

December 17, 2007

The Bulgarian authorities appreciate the continued constructive dialogue with the management and staff that has been extremely helpful over the last decade. Over that period, Bulgaria has implemented a comprehensive reform agenda and successfully completed several Fund-supported programs that helped the country to stabilize and make progress in the run-up to the EU accession. Decisive reforms and continued prudent macroeconomic policy eventually paid off – as of the beginning of 2007, Bulgaria is a full-fledged member of the EU.

For the years to come, Bulgaria's overriding policy priority remains speeding up real convergence and raising living standards. Notwithstanding the enormous progress made in this direction over the last years, important challenges remain as external imbalances proved persistent along with higher than expected inflationary pressures. Against this background, the authorities remain committed to achieving high and sustainable economic growth while maintaining a stable and predictable macroeconomic environment. With a view to the fulfillment of this objective, keeping public finances in check is regarded crucial. The government intends to keep running budget surpluses to help curb domestic demand as well as to moderate the external account imbalance.

Recent developments

The confidence inspired by the good economic performance over the last several years, as well as the recent accession to the EU, has continued to attract substantial amounts of capital inflows, mostly in the form of FDI. As a result, real GDP has accelerated in the first half of 2007 to 6.4 percent, led primarily by fixed capital investment and to a much lesser extent by private consumption. It is widely expected that this trend will hold throughout the year, and the previously expected growth rate of 6 percent for the year as a whole will most likely be exceeded. The current pattern of growth has been repeatedly observed over the last years. The private investment-to-GDP ratio has been surging, while the private consumption-to GDP ratio remains broadly stable, suggesting that consumption has not been the main driver of recent high growth rates. Such a conclusion is also supported by the structure of imports, that shows a growing share of investment goods and a broadly stable share of consumer goods.

Inflation has picked up in 2007, reflecting to a large extent one-off factors caused by a severe summer draught that triggered a significant increase in food prices. This came on top of a more general increase in food prices that has been observed in other countries in the region and elsewhere, prompting a possible price correction. After the summer shock, during which CPI increased by almost 7 percent, conditions are now expected to return to normal, while the disinflationary momentum is expected to gain strength. Nevertheless, headline inflation in 2007 is expected to exceed earlier projections. Core inflation, however, has picked up at a significantly slower pace, reflecting a modest rise in labor cost and only limited overall capacity pressures.

On the back of strong growth, liberalized market conditions, and overall positive expectations, employment has been on an upward trend for the last couple of years. Accordingly, the unemployment rate has fallen (and continues to fall) considerably from about 20 percent in 2000 to less than 7 percent now. As parliament has recently passed amendments to the Labor Code to increase working time flexibility, it is expected that employment, which is still below the average of Bulgaria's peers, will continue to rise.

Buoyant economic growth, steady capital inflows, and a prudent fiscal policy with sizable surpluses over the last four years, resulted in a significant increase of the Fiscal Reserve Account. Accumulated reserves were used to buy back and retire all outstanding Brady bonds, to make early repurchases to all outstanding loans to the Fund, as well as to prepay a portion of World Bank loans. These prepayments have contributed to significantly lowering the external public debt ratio, which is expected to fall below 15 percent of GDP by the end 2007. Gross external debt, however, has been on the rise since 2003 as the private sector debt has begun to grow rapidly, in line with the investment boom that the country has been experiencing. This trend is expected to reverse in a couple of years, along with an overall moderation of capital inflows. Meanwhile, external debt indicators show that risks are fairly contained as short-term debt is fully covered by reserves. Moreover, a significant part of the private external debt (more than one third) is in fact inter-company debt owned to mother companies.

External Sector

Rapid catch-up economic growth is often, if not always, associated with strong private investment, exceeding – sometimes by far – private savings. Despite continued increase in public savings, the private sector's saving-investment imbalance has translated into a sizable current account deficit. Exacerbated by high oil and other key commodity prices, in 2007 the external current account deficit may well reach 20 percent of GDP.

The size of the deficit itself is high enough to raise concerns about external stability. While the authorities share the legitimacy of these concerns, there are a lot of uncertainties regarding the nature, the cause, and the implications of the external imbalance. Similar processes can be observed in other countries that recently joined the EU which are equally characterized by real income convergence, substantial amounts of EU grants, financial system deepening, high future income expectations, a declining risk premium, and the overall effects of globalization. The phenomenon of high and persistent current account deficits under such circumstances is a rather unique one, presenting the authorities (and the Fund) with the big challenge of how to react in such cases. The challenge becomes even larger when the authorities, given their monetary framework, have only limited tools to tackle the problem. In particular, this applies to the degree to which external imbalances, emanating from a private saving-investment imbalance, can be counterbalanced by moving and keeping the public finances in large imbalance as well.

Notwithstanding all the difficulties and surrounding uncertainty, Bulgaria has taken up this challenge. The authorities are thankful to staff for the candid and constructive dialogue on the matter during the Article IV mission. They especially appreciate the selected issues paper that provides good quality analyses and recommendations.

Despite high current account deficits, competitiveness does not appear to have been hurt, as evidenced by the continued solid export growth and rising market shares. REER appreciation over the last years has been moderate when benchmarked against conventional relationships between the exchange rate and the current account deficit. As underscored by staff, purchasing power parity and dollar-wage comparisons across countries suggest that Bulgaria's prices and production costs remain competitive – a suggestion also supported by regression-based estimates of the real equilibrium exchange rate. Moreover, official foreign reserves have been growing in line with the higher imports and the reserve coverage has remained broadly stable over the last couple of years. In general, the authorities and staff share the view that a one-off private investment boom is the main driver of the large current account deficit. Once this boom dissipates, the current account deficit is expected to start approaching its equilibrium levels under present policy settings.

Although the soft-landing scenario is the likely one, the authorities have proved sensitive to external vulnerabilities. They have applied extremely prudent fiscal policies, and taken measures intended to restrain credit growth. When assessing the external imbalance though, full account must be taken of its context. Bulgaria's catching-up shows the usual combination of a current account deficit financed by massive capital inflows. In itself this is precisely desirable, and policy is carefully attuned to keeping the catching-up process stable, while identifying and controlling its potential vulnerabilities.

Fiscal policy

Under a currency board arrangement, fiscal policy remains key to maintaining macroeconomic stability and reducing vulnerabilities. This said, the main challenge for the authorities is to strike the right balance between two competing objectives. On the one hand, maximization of EU funds' utilization must be given priority, as it provides the country with the unique opportunity to speed-up real convergence, deepen EU integration, and substantially increase living standards in a relatively short period of time. On the other hand, the authorities do acknowledge the need to offset sustained private sector saving-investment imbalances. As the latter objective has become more important over the last years, the fiscal stance has strengthened remarkably and every year marks another record-high surplus. 2007 will be no exception from this trend. By applying this policy, the authorities reaffirm their strong commitment to sound macroeconomic policies, acknowledging the paramount importance of a prudent fiscal stance in the context of the currency board arrangement.

On the back of growing economic activity, increased employment, higher imports, and higher inflation, as well as due to improved tax collection, revenue in 2007 soared significantly above what was budgeted. The revenue windfall from the absorption boom, along with just a modest increase in expenditures, resulted in an unprecedented surplus that, according to the end-November data, was approaching 7 percent of GDP. Given the already strong fiscal position, both social partners and the private sector have expressed objections to such restrictive fiscal policy. There is marked pressure from academic circles, NGOs, and various industry associations for lower tax rates while (on top of that) trade unions are strongly backing rising demands for wage increases.

Against this background, the authorities have decided to use part of the revenue windfall and to step up the investment program in the most needed sectors. The bulk of the supplementary fiscal expenditures is mainly allocated for infrastructural projects like road construction and rehabilitation, and construction of water purification stations and sewerage systems. A big part relates to co-financing of EU-financed projects, and constitutes mostly advance payments for projects under the operational programs in the area of regional development, environment, rural development, and transport. Another significant part is allocated for building-up strategic oil-reserves and oil-storage facilities. Given the recent incidents of massive floods, funds were earmarked for river-bed corrections and preventing landslides. The authorities have taken the necessary steps to ensure the transparency of the extraordinary spending which was given high publicity within the country and was approved by parliament. The most important, however, is the fact that even after this extra spending, the overall budget surplus will again be higher than the 3.5 percent recorded in the previous year, and far beyond the 2 percent of GDP that was initially budgeted.

With regard to the 2008 budget, the authorities are firmly committed to continuing with their prudent fiscal stance. The budget, which is still under consideration in parliament, envisages a surplus of at least 3 percent of GDP which is basically in line with an unchanged fiscal stance. With the new budget the authorities are introducing a flat 10 percent personal income tax along with a 10 percent corporate tax rate that is already in place since the beginning of 2007. In order to minimize the revenue loss, the authorities plan to eliminate most of the existing exemptions, thus broadening the tax base. It is the authorities' belief that such a step will help shrink the grey economy, while higher excises on tobacco and fuel will compensate to a great extent for the revenue loss.

The 2008 budget has already passed the first reading and is expected to be approved pretty soon. The authorities have undertaken another step in improving fiscal transparency by eliminating the previous practice of across-the-board spending sequestration and introducing a contingency reserve instead. As usual, the authorities are prepared to allow automatic fiscal stabilizers to operate by saving most of a possible revenue overperformance.

Financial Sector

Like in many other countries in the region, a rapid bank credit expansion has been observed over the last years. In many respects this was, and still is, a welcome development as it symbolizes growing financial intermediation. The pace of the bank credit growth, however, remained too high for too long which could be associated with an increase in macroeconomic vulnerabilities. It should be stressed, however, that the rapid bank credit growth is hardly surprising given the extremely low initial base, declining nominal interest rates, rising income expectations, and a stable, well capitalized, and highly profitable banking system. Moreover, in contrast to other countries with a similar pace of growth, the credit expansion in Bulgaria has been financed mostly by a strong increase in deposits instead of relying on foreign borrowing. All this suggests that the currently experienced rapid credit growth is a healthy one, reflecting the overall strong economic performance – a suggestion also supported by the financial soundness indicators showing no signs of deterioration.

No matter the mitigating factors, the authorities are fully cognizant of the macroeconomic and financial stability risks associated with rapid credit growth and are strongly committed to dealing with the situation. They have undertaken various measures in trying to moderate the pace of growth, including by enhancing information; strengthening the prudential and regulatory framework; and lowering liquidity by introducing administrative limits to bank credit growth. Unfortunately, all these measures proved insufficient and credit growth still remains high. In a repeated attempt to moderate the pace, the central bank raised the minimum reserve requirements from 8 to 12 percent in September, and signaled that it would be ready to adopt additional measures, including by further raising the reserve requirements, if needed.

Finally, with regard to the ERM II, the authorities maintain their long stated position that they will seek to joining at the earliest possible date. 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 EMU. The Bulgarian government and the central bank have committed to unilaterally maintain a zero deviation of the exchange rate after Bulgaria joins the ERM II.

INTERNATIONAL MONETARY FUND
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December 19, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Bulgaria

On December 14, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bulgaria.[1]

Background

Bulgaria's large external imbalance has continued to widen. Driven by massive capital inflows, particularly foreign direct investment (FDI) inflows, the current account deficit could reach a record level of 20 percent of GDP in 2007. While the present level of the current account deficit is clearly above sustainable levels, external competitiveness has remained adequate. But, underscoring growing external vulnerabilities, the net international investment position is projected to deteriorate to about 65 percent of GDP, while gross external debt could soar to about 88 percent of GDP. At the same time, accumulation of international reserves has continued at a rapid clip, with reserves likely to top 40 percent of GDP by end-2007.

Real GDP growth in 2007 is likely to remain relatively steady at just over 6 percent, but underlying inflation pressures are building up. Investment spending has continued to boom, likely reflecting a one-off re-assessment of Bulgaria as an investment location. While FDI inflows have been mainly absorbed by nontradables sectors, the tradeables sectors share in real investment has held up well during the investment boom. Private consumption growth has remained relatively subdued over recent years, in part reflecting restrained fiscal and income

[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.

policies. Labor market conditions have tightened: unemployment declined sharply and wage pressures have picked up. In this setting, headline HICP inflation has increased sharply to over 10 percent, mainly owing to food and energy price shocks. While underlying core inflation has also risen in response to higher labor cost, it has done so at a much slower pace than headline inflation.

Since 2004, fiscal policy has achieved progressively larger fiscal surpluses, mainly as the result of unspent revenue windfalls associated with the domestic demand boom. The 2007 fiscal surplus is projected to reach at least 3½ percent of GDP, while the underlying fiscal surplus position is significantly more moderate. Reflecting the prudent fiscal policy stance, the government's balance sheet is strong, with gross public debt (about 20 percent of GDP) and other liabilities more than offset by a growing fiscal reserve and other assets.

Bank credit has again started to expand rapidly after the administrative credit limits imposed during 2005-06 lapsed. With hindsight, the limits helped stimulate nonbank financial flows and did not much constrain overall private-sector credit. Banks remain well capitalized, partly reflecting the highest minimum capital adequacy ratio among the EU New Member States. Credit quality has been stable, as indicated by low nonperforming loan ratios, but this may partly reflect rapid loan portfolio growth.

Bulgaria's progress on structural reforms is at par in areas where EU legislation tends to enforce regulatory homogeneity. However, where EU accession has provided only a weak reform anchor, progress has been slow, including on raising the public sector's low efficiency, reducing costly administrative burdens on businesses, and increasing labor market flexibility.

Executive Board Assessment

Executive Directors commended the authorities for their strong record of stability-oriented macroeconomic policies, which have contributed to steady GDP growth, progress in income convergence with other EU countries, and falling unemployment. In particular, Directors considered that fiscal and incomes policies have responded prudently so far to the widening current account deficit and the investment boom, which is being driven by large foreign direct investment inflows related to Bulgaria's EU accession. Directors emphasized nevertheless that the current account deficit is unsustainable and will need to be reduced significantly over the medium term in order to contain external vulnerabilities. They also noted that, although competitiveness appears not to have been affected, domestic price pressures are rising, in large part because of region-wide increases in food and energy prices, but also because of accelerating wage increases as the labor market tightens.

Directors considered that, assuming that a strong policy framework is sustained and the requirements of the currency board arrangement continue to be met, the current account deficit will gradually normalize to a more sustainable level over the medium term. In that connection, there was strong support for the authorities' strategy of maintaining the exchange rate peg until euro adoption. Directors advised the authorities to guard against a loss of external competitiveness, which could likely entail a severe external adjustment or a prolonged period of slow growth.

Against this background, Directors commended the authorities for their commitment to maintain a fiscal framework that avoids procyclical fiscal impulses and supports sustainable convergence to EU income levels. They welcomed in particular the authorities' intention to target a large budget surplus in 2008 consistent with avoiding a loosening of the fiscal stance. Several Directors observed that an even more restrictive fiscal policy may be needed to contain demand pressures effectively and limit downside risks. It will also be important to maintain wage discipline in the public sector by keeping wage increases in line with productivity growth. Directors welcomed the planned further reductions in public sector employment, which will also help mitigate labor market overheating. They called on the authorities to review carefully spending priorities in key budget sectors, notably education and health care, with external technical assistance, if needed. They concurred with the authorities' plans to increase fiscal transparency, including by discontinuing across-the-board spending sequestration.

Directors agreed that Bulgaria's banking sector remains well supervised and regulated and that, with buffers against a possible credit cycle downturn being well maintained, the adverse spillovers from the recent tremors in global credit markets have been moderate. They nevertheless encouraged the authorities to monitor banks' risk management mechanisms closely, as bank credit growth has surged following the lapsing of administrative credit limits at the beginning of 2007. Directors considered that the predominance of subsidiaries of foreign banks in Bulgaria's financial system calls for a further strengthening of cooperation with the supervisory authorities of the parent banks. They therefore welcomed the authorities' participation in efforts to improve the EU's cross-border crisis management arrangement. Directors looked forward to the update in 2008 of Bulgaria's FSAP.

Directors encouraged the authorities to move forward decisively with much-needed structural reforms, in particular to raise public sector efficiency. They supported measures to promote labor market participation and adaptability, including by giving the social partners additional legal leeway to negotiate flexible work contracts. They welcomed the plans to activate the electronic commercial register on January 1, 2008 and to further simplify the licensing and permit systems, which would help lower the cost of doing business.

Directors concluded that Bulgaria's statistical data are broadly adequate for surveillance. Nevertheless, they encouraged further enhancements in employment, wage, and trade data. Moreover, compiling flow of funds for households and nonfinancial corporations would help deepen the understanding of sectoral vulnerabilities.

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Bulgaria: Selected Economic Indicators, 2002-07

	2002	2003	2004	2005	2006	2007 1/
Output, prices, and labor market			(Annual percentage change)			
Real GDP	4.5	5.0	6.6	6.2	6.1	6.4
Consumer price index (average)	5.8	2.3	6.1	6.0	7.4	7.2
Consumer price index (end of period)	3.8	5.6	4.0	7.4	6.1	9.5
Employment	0.2	3.0	2.6	2.7	2.4	2.6
Public Finance			(In percent of GDP)			
General government overall balance	-0.8	-0.2	1.7	2.3	3.5	3.5
Gross public debt	56.2	48.1	40.1	31.3	24.7	21.3
Financial net worth	-10.4	6.1	8.8	9.3	11.8	13.8
Money and credit			(Annual percentage change)			
Broad money (M3)	11.9	19.6	23.1	23.9	26.9	28.5
Credit claims on non-government sector	44.0	48.3	48.7	32.4	24.6	52.5
Balance of payments			(In percent of GDP)			
Merchandise trade balance	-11.3	-13.7	-14.9	-20.2	-22.2	-26.2
Current account balance	-2.4	-5.5	-6.6	-12.0	-15.7	-20.2
Gross international reserves	27.6	30.5	34.5	33.7	35.6	40.5
Exchange rates						
Exchange rate regime			Currency board arrangement			
Leva per euro			Lev 1.956 per Euro			

Sources: Bulgarian authorities; and IMF staff estimates.
1/ Projection.