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Bulgaria: Letter of Intent and Memorandum of Economic and Financial Policies

March 14, 2006

The following item is a Letter of Intent of the government of Bulgaria, which describes the policies that Bulgaria intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Bulgaria, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Sofia, Bulgaria, March 14, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato:

1. The attached Second Supplementary Memorandum of Economic and Financial Policies (SSMEFP) describes the performance under the economic program that is supported by the Stand-By Arrangement (SBA) approved by the International Monetary Fund on August 6, 2004 and the policies that the government and the Bulgarian National Bank (BNB) intend to pursue in 2006 as part of the 2004-06 economic and financial program outlined in the Memorandum of Economic and Financial Policies attached to the letter of July 21, 2004 and amended by the Supplementary Memorandum of Economic and Financial Policies attached to the letter of April 26, 2005. Notwithstanding the change of government in August 2005, the core objectives, supported by the policies described in the SSMEFP, remain the maintenance of macroeconomic stability and sustained high rates of economic growth in the run-up to EU membership in 2007. Rising external vulnerability has recently added to this policy challenge.

2. As described in the SSMEFP, macroeconomic stability in 2005 was adversely affected by rising excess demand and supply shocks, with the result that economic growth was somewhat faster while inflation and the external current account deficit were much higher than expected at the time of the first stand-by review. Nonetheless, all quantitative performance criteria for June 30 and September 30, 2005 -- as well as the indicative targets for December 31, 2005 -- have been observed. However, three structural performance criteria for September 30, 2005 were missed, and we request waivers for their nonobservance.

- The previous government selected the winning bidder for two of the three thermal power plants offered for privatization in May 2005 but it canceled the tender for the Bobov Dol power plant due to the unsatisfactory offers received. The new government is prepared to accept the highest bid for this plant and to start negotiations to that effect with the highest bidder provided that a suit brought to challenge the privatization has been successfully resolved. If this approach is unsuccessful, the plant will be re-offered for sale. However, as we cannot guarantee that the court will reach a decision in time for us to decide on the buyer before the end of the arrangement, we request that this structural performance criterion be waived. Our efforts to complete the privatization of the two other power plants have recently failed, in part because the competition agency ruled that both plants could not be sold to the same bidder and in part because we could not meet the additional demands of the successful bidder. We will now retender the two plants and intend to

select the winning bidders for these plants by June 30, 2006 (a structural performance criterion).

- The delay in forming a new government and the priority given to legislation related to EU accession made it impossible for parliament to approve the procedural code for the National Revenue Agency (NRA) before the end of September. In the event, parliament approved the NRA procedural code in December 2005, allowing the NRA to start operations at the beginning of 2006.
- The Ministry of Finance received all letters with the necessary information to incorporate the lev-denominated expenditure accounts of the judicial system in the budgetary payments system (SEBRA) by the September 30 deadline. However, because of technical requirements the accounts were incorporated into SEBRA only on October 17, 2005.

3. Because of the delay in completing the second review we are requesting that the third and fourth reviews be combined and completed by September 5, 2006.

4. Approval by parliament of legislation to introduce a new company registration system is a prior action for completion of the second review (SSMEFP, Annex I). In addition, new deadlines have been set for a number of missed structural benchmarks, including the conversion of one of them (parliamentary approval of a new VAT law) to a performance criterion because of its importance for the proper functioning of the NRA (ibidem).

5. The SSMEFP proposes quantitative performance criteria for March 31 and June 30, 2006 as well as indicative targets for September 30 and December 31, 2006, as described in its Annexes II – IV. In addition, program implementation is proposed to be monitored by the three structural performance criteria, the three continuous performance criteria and the eleven structural benchmarks listed in Annex I of the SSMEFP.

6. We believe that the policies set forth in the SSMEFP are adequate to attain the objectives of our program, but we will take any further measures that may become appropriate for this purpose. Bulgaria will consult with the Fund on the adoption of these measures, and in advance of any revisions to the policies contained in the SSMEFP, in accordance with the Fund's policies on such consultations. We will provide the Fund with such information as it requests on policy implementation and achievement of program objectives. The forthcoming third review will reconsider the stance of fiscal policy in light of external current account developments (as mentioned in ¶4 of the SSMEFP) and the credit restraint measures in light of the observed rate of credit expansion (as mentioned in ¶13 of the SSMEFP).

7. We would like to reaffirm our intention not to make the purchases under the SBA that will become available upon observance of its performance criteria and completion of its reviews and to make all outstanding repurchases to the Fund on the expectations schedule.

Indeed, as mentioned in ¶15 of the SSMEFP, we have made early repurchases to the Fund in December 2005 and February 2006 as part of our plan to reduce the public external debt.

Sincerely yours,

/s/

/s/

/s/

Plamen Oresharski
Minister of Finance
Republic of Bulgaria

Rumen Ovcharov
Minister of Economy and Energy
Republic of Bulgaria

Ivan Iskrov
Governor
Bulgarian National Bank

Attachment: Second Supplementary Memorandum of Economic and Financial Policies

Second Supplementary Memorandum of Economic and Financial Policies

I. Economic Developments in 2005 and Objectives for 2006

- 1. Economic growth is expected to have been stronger than expected in 2005 but the external current account deficit and inflation also exceeded expectations.** Led by rapidly growing domestic demand, real GDP is now expected to have grown by 5.6 percent in 2005, compared with 5.5 percent under the program. Although private consumption continued to provide the main contribution to growth, private investment was once more its most dynamic component. With higher incomes and credit sustaining the rise in consumption, private saving contracted and the financing requirements of the rising private investment led to a sharp deterioration of the external current account -- much of it due to higher-than-expected imports of investment goods -- notwithstanding a tighter fiscal stance. A dip in export growth -- which we believe to be mostly temporary -- in the second half of the year was also a key factor in the current account deterioration. As a result, the external current account reached 14.9 percent of GDP, compared with 7.6 percent at the time of the first review. Notwithstanding an FDI coverage of the deficit of 72.6 percent, external debt rose to 67.4 percent of GDP by year end. As a result of supply shocks, prices have increased faster in the second half of 2005. Reflecting higher gasoline and natural gas prices, food price hikes in the wake of summer floods, and adjustments in the regulated prices of electricity and heating, year-end consumer price inflation reached 6.5 percent year on year, compared with 3.5 percent under the program. However, wage pressures remained moderate as unit labor costs declined by 1 percent year on year in the first nine months of 2005, and the unemployment rate declined from 13.1 percent in January 2005 to 10.7 percent in December 2005, reaching a ten-year low of 10.4 percent in November.
- 2. Our main economic objectives for 2006 are to maintain the momentum of economic growth while reducing the current account deficit and the rate of inflation.** Fiscal tightening, credit restraint, higher food and energy prices, and excise tax increases are expected to reduce the growth of real domestic demand and imports, but export growth should rebound in response to recent investment to expand capacity and the reimposition of textile import restraints by the EU. As a result, we expect real GDP to grow by 5.5 percent. With the attendant recovery in domestic saving and a virtually stable investment ratio, the external current account deficit is projected to decline to 12.9 percent of GDP, compared with a program target of 7 percent. As almost three quarters of this deficit is expected to be covered by foreign direct investment, the net external debt ratio should increase only modestly to 22 percent of GDP. Notwithstanding advance repurchases of external public debt, freely available gross international reserves are expected to cover 4.5 months of prospective imports or nearly 170 percent of short-term external debt. Following an initial increase in response to energy and heating price increases in late 2005 and the January 2006 excise tax increases, consumer price inflation is expected to abate to 5.7 percent by year end.

II. The Economic Program Until the End of 2006

- 3. Our economic program aims at maintaining a stable policy framework to ensure smooth EU accession on January 1, 2007.** The currency board arrangement will remain the cornerstone of our economic policy until euro adoption in 2009-10, as agreed under a strategy prepared in late 2004 by the previous government and the Bulgarian National Bank (BNB) and presented to the EU institutions. The new government reaffirms Bulgaria's commitment to responsible macroeconomic policies and structural reforms to underpin the continued viability of the currency board arrangement. In line with this commitment and against the backdrop of a continued buildup of private excess demand and external debt, our economic program through the end of 2006 relies on fiscal restraint, prudent incomes policies, measures to reduce credit expansion, and structural reforms to strengthen competitiveness.

A. Fiscal Policy

- 4. To reverse the deterioration of the external current account, we have considerably tightened the fiscal stance in 2005-06.** In 2005, we achieved a general government surplus (defined to treat capital transfers and spending of the public investment projects company -- PIP -- as government expenditure, and adjusted for the net variation of arrears) of 2.3 percent of GDP, compared with a program objective of 1 percent. The tightening went slightly beyond what was called for under the automatic adjustor for tax revenue overperformance in paragraph 4 of the Supplementary Memorandum of Economic and Financial Policies attached to the letter of April 26, 2005 and reflected both revenue overperformance and expenditure restraint in response to the worsened external current account position. In 2006, we will further tighten our fiscal stance by raising the surplus target (defined as above) to 3 percent of GDP (a performance criterion). The budget approved by parliament is balanced at an expenditure level of BGN 17, 412 million¹. To achieve our fiscal surplus target, we have taken the following actions:

- The 2006 budget law stipulates that 7 percent of discretionary expenditure, which is being withheld until the fourth quarter, will be withheld permanently if the latest available twelve-month external current account deficit exceeds 12 percent of GDP.² To prevent the emergence of arrears when this provision

¹ In the national presentation that corresponds to BGN18,258 million, after adjustment for social security contribution payments (except those to the second pension pillar) for government workers.

² For example, in November such a decision would depend on the size of the current account deficit in the twelve months ended in August or September 2006. The current account deficit (continued...)

is enforced in late 2006, the government has adopted a decree instructing the recipients of the withheld discretionary funds not to incur any expenditure commitments against them. This measure is expected to improve the fiscal balance by 0.75 percent of GDP³.

- In addition, we will save the expected revenue overperformance relative to the level underlying the budget. This is expected to improve the fiscal balance by 2.25 percent of GDP.
- We will offset any slippage with respect to the targets in the two preceding bullets by additional expenditure cuts (especially for nonroad maintenance and operations) or revenue measures.

If total revenue increases beyond the program's quarterly targets in Annex II, we intend to save 50 percent of any such cumulative quarterly overperformance, and the performance criterion on the fiscal surplus will be raised accordingly. As the weakened external current account is the reason for the fiscal tightening, we are prepared to raise or lower this target at the time of the third review if the current account deviates from its current projection. We will seek to avoid the accumulation of new central government arrears (a performance criterion) and urge the municipalities to eliminate their arrears (which amounted to 0.1 percent of GDP on December 31, 2005).

- 5. Buoyant revenue growth allowed an increase in both expenditure and the overall surplus in 2005.** Revenue rose to 41 percent of GDP (compared with 38.8 percent under the program), as tax bases increased beyond expectations due to higher growth, imports and inflation, with all revenue categories benefiting except pension and unemployment contributions, which remained slightly below original projections as some employers reduced contribution payments in the wake of the summer floods. While most of the tax revenue overperformance has been saved in accordance with the program's adjustor, we had to use most of the balance remaining at the central government level for flood relief (humanitarian assistance and infrastructure repair) and to pay hospital arrears. However, we reduced Christmas bonuses to pensioners to about half the previous year's amount and refrained from making any allocation for such bonuses to government workers. The municipalities and other autonomous bodies also spent most of their extra revenue, much of it to repair flood damage, although perhaps

would be measured on the basis of the balance of payments methodology used by the BNB in January 2006.

³ In order to make room for spending committed in 2005 but not yet carried out by the PIP, spending is reduced by an additional 0.07 percent of GDP.

one third of the windfall was saved reflecting calls for restraint by the Ministry of Finance and a lack of projects ready for implementation. As a result, general government expenditure rose to 38.6 percent of GDP (compared with 37.8 percent of GDP under the program), representing a real increase of almost 9 percent year on year. At 2.3 percent of GDP, the overall surplus represented a tightening of the fiscal stance with respect to both the program and the 2004 outcome.

- 6. Tax reductions and lower nontax revenue will reduce the revenue ratio to 39.9 percent of GDP in 2006.** To lower nonwage labor costs and strengthen competitiveness, we have lowered social security contributions by 6 percentage points to 36.7 percent and reduced the employer's share in these contributions from 70 to 65 percent from January 1, 2006. At the same time, the portion of these payments for eligible contributors to the second pension pillar has been raised from 3 to 4 percent. In addition, we have raised the exemption threshold from the personal income tax from BGN 130 to BGN 180 a month, thus eliminating the lowest tax bracket. To reduce the revenue loss from these measures (and the full-year effect of last year's reduction of the corporate income tax and the introduction of family taxation legislated earlier), we have raised excise taxes by more than envisaged by our commitments to the EU. In addition to the scheduled increases for cigarettes and petroleum products, we have brought forward increases in excises on cigarettes and alcoholic beverages scheduled for 2007 and 2008. Bringing forward these tax increases will also help avoid inflationary pressures during the reference period for the assessment of the Maastricht criteria. As an interim step toward updating property assessments toward current market valuations, we have raised property valuations by some 20-30 percent, which should raise municipal property and property transfer tax revenue by about half of 0.1 percent of GDP in 2006. The net revenue loss from all these measures is estimated at 1.1 percent of GDP in 2006. This loss is more than outweighed by substantial gains from the growth of the tax bases and more modest ones from improved compliance. The start-up of the National Revenue Agency (NRA) on January 1, 2006 and the transfer of excise tax collections to the customs administration on July 1, 2006 have not been factored into the revenue projections. Over time, the NRA is expected to yield substantial revenue gains, but the risk of losses in the start-up phase cannot be excluded. However, early indications are that such losses have been avoided. We will not reduce any other tax rates or bases during 2006 (a performance criterion). Nontax revenue is projected to grow less rapidly than nominal GDP due to the loss of dividends in the wake of recent privatizations and the nonrecurrence of one-time revenue from real estate sales and the auctioning of UMTS licenses in 2005.

7. **After the large increase in 2005, expenditure is programmed to decline to 36.9 percent of GDP.**⁴ The budget was prepared to reflect the government's expenditure priorities (viz., EU integration, remaining flood repairs, and social spending including pensions and wages). In particular, in January 2006 pensions were increased by 5 percent on average (with relative increases an inverse function of the size of individual pensions) and teachers' salaries were increased by 4 percent. In July 2006, budget sector wages will be increased by 6 percent on average and teachers' salaries will be increased by the same percentage provided that a reform strategy for the education sector has been prepared by March 31, 2006 and structural reforms have begun to be implemented. Before then, state administration positions will be cut by 4,500 positions through the cancellation of vacancies and the elimination of obsolete structures and overlaps (a benchmark). The net reduction of positions in the state administration will, however, be less as we will hire about 2,000 people in the course of 2006, mainly related to EU accession requirements. As part of ongoing reforms, we are directing our efforts at optimizing the number of people working in education, healthcare, police and the armed forces. To make room for our budgetary priorities, we have kept all other expenditure constant in nominal terms except defense, which is maintained at 2.6 percent of GDP under NATO commitments, and interest, which is expected to decline despite increasing international interest rates because of debt prepayments and regular amortization. As noted in paragraph 4, we intend to realize additional expenditure savings of 0.75 percent of GDP by permanently withholding 7 percent of discretionary spending. All financial operations of the PIP will be concluded by March 31, 2006, and the PIP will be closed by December 31, 2006.
8. **We will strive to keep the finances of the public pension system sound and strengthen those of the health care system while initiating reform of the education system.** We have asked the World Bank for assistance in reforming the health and education sectors.
- The first (public) pension pillar is losing resources because of the reduction of contribution rates and the increase in contributions directed to the second (private) pillar to 4 percent in 2006 and 5 percent in 2007. Nonetheless, with a dependency ratio of now below 1, continued implementation of the 1999 pension reform (notably the gradual increase in the retirement age), and future

⁴ At 39.5 percent of GDP in the national presentation, the budget comes close to the 40 percent limit adopted by the new government. For presentational and program purposes, the government's social contributions for its employees (except those for the second pension pillar) of 1.8 percent of GDP and the cuts in discretionary expenditure and transfers to municipalities mentioned in paragraph 4 are excluded to arrive at 36.9 percent of GDP.

application of the legally enshrined indexation formula, we expect the public pension finances to remain under control. In accordance with a provision of the 2006 budget law, we are preparing a draft law on a Silver Fund to strengthen the financial stability of the first pension pillar in the context of an aging population which will be submitted to parliament by June 30, 2006.

- The public healthcare system suffers from excess capacity in the hospital sector and weak financial management that provides poor value for money and leads to the accumulation of hospital arrears. With World Bank assistance, we will speed up the development of a hospital reform strategy and its implementation. Finding possibilities for additional resources in the sector including privatization of some hospitals as well as a partial sale of buildings and land, higher copayments and increased voluntary insurance are likely to be part of this strategy. In the interim, we have shifted the balance of the resources for the reimbursement of medical services (except for those explicitly reserved for the central government) from the Ministry of Health to the NHIF in the 2006 budget (0.5 percent of GDP), thereby reducing the scope for double reimbursements of medical services. We have changed the managements of those of the 15 largest hospitals recently audited which have been found in violation of regulations and have accumulated substantial arrears, and have extended the audits to smaller hospitals. In addition, the National Framework Agreement for 2006 has strengthened control mechanisms and increased the sanctions for violating the provisions relating to the claim for reimbursement of medical services. The National Framework Agreement focuses on the preventive treatment by the general practitioners. The NHIF budget also empowers the parliament to impose the terms of the National Framework Agreement, including reimbursement rates for medical services, should the NHIF and doctors fail to reach agreement by the end of the preceding year. Finally, we have begun virtual reimbursement on the basis of diagnostically related groups (instead of clinical paths) in 9 hospitals of different size and type, with a view to assessing the advantages and disadvantages of this type of financing and taking a decision for its future pilot implementation.
- The recent settlement of a labor dispute with the teachers union has created an opportunity for reforming the education sector, which is overstaffed and suffers from deteriorating output against the backdrop of a secularly declining student population. Under the terms of the agreement with the teachers, we will submit to parliament by March 31, 2006 a strategy for reforming education from preschool to grade 12 that will involve an initial employment cut of at least 5,500 jobs by September 5, 2006 to make room for the cost of reform (two benchmarks). The 6 percent salary increase for teachers on July 1, 2006 is conditioned on the timely submission of this strategy. The basic principles of the reform, which should eventually extend to higher education

and should be financed by efficiency gains, are in line with the goal of optimizing the operation of the education system by way of reviewing the functions and tasks, avoiding overlap and improving the quality of education, strengthen the connectedness of education and the labor market, and increasing the efficiency of the education system. On the basis of this strategy, parliament will adopt in the course of 2006 a ten year reform program laying out a long and medium term vision and quantifiable targets to improve quality, participation, and cost effectiveness. The medium term (3-5 year) program will include policy actions and special measures to achieve these targets as well as medium term projections. The program will emphasize standardized national tests, school autonomy, student based financing, optimization of schools, and accountability for results by central and local government and schools.

9. We are taking steps to improve revenue administration.

- The long delayed legal base for unifying the collection of domestic taxes (except excises) and social security contributions was established with the adoption by parliament of the NRA procedural code in December 2005. In mid-2006, the collection of excise taxes will be transferred to the customs administration under a new excise tax law approved by parliament in November 2005. New CIT, PIT and VAT laws are expected to be adopted by parliament, the VAT law as a performance criterion by April 30, 2006 and the CIT and PIT laws as a benchmark by July 31, 2006. In order not to lose momentum and demotivate the staff selected for the NRA, we decided to launch the unified revenue collection on January 1, 2006 although the new software and new headquarters for the agency were not ready. We have adapted the NRA's business practices to cope with these temporary impediments. While launching the NRA has not led to immediate staff savings, we will strive to reduce its staffing once it has become fully operational.
- We will step up efforts to reduce revenue losses from the operation of duty free shops and gas stations. A law on duty free trade specifying limits on individual purchases of goods and fuels, and strengthened controls, will be submitted to parliament by March 31, 2006 with a view to passage by June 30, 2006 (a benchmark). As an immediate step, we have increased surveillance of these outlets to limit abuses of their duty-free status. We are also examining measures to close duty-free outlets within Bulgarian territory or to relocate them to customs areas along the border. The justification of duty free outlets along borders with EU members ceases with EU accession. Closing those along other borders should proceed on a reciprocal basis in close cooperation with the countries concerned. Over time, we believe that duty free outlets should be limited to international airport terminals.

10. **We intend to move toward the full implementation of the current pilot program budgeting system, in collaboration with the international donor community.** More specifically, we intend to expand program budgeting, introduced in the 2006 budget for the Ministry of Environment, to an additional 6-7 ministries with the 2007 budget.
11. **We remain committed to giving municipalities the autonomy to set their tax rates within certain limits.** Conferring this power to the municipalities requires a constitutional amendment, which cannot be initiated by the government and requires a 75 percent parliamentary majority. We will continue to work toward this end, with support from USAID and the European Commission.

B. Income and Labor Market Policies

12. **In the current excess demand situation the public sector's wage and labor market policies are crucial to help maintain competitiveness and enhance labor supply.**
 - The annual mid-year wage adjustment by 6 percent in the budget sector is expected to signal restraint for private sector wage bargaining. We will again limit the increase of the aggregate wage bill of the 58 largest public enterprises that are monopolies, received government subsidies, made losses, or had arrears in the third quarter of 2005. For 2006, the increase in the aggregate quarterly wage bill of these enterprises over its level in the third quarter of 2005 has been limited to 5 percent. Observance of this limit will be monitored on a cumulative quarterly basis (a performance criterion). Following its 25 percent increase in early 2005, the minimum wage has been raised by 6.7 percent to BGN 160 at the start of 2006 and it will be maintained at that level until the end of 2006 (a performance criterion). A further increase to BGN 170 is planned for 2007.
 - Due to the change in government the two measures to improve the functioning of the labor market have slipped beyond their envisaged completion dates. The government has resumed the discussions with the social partners and agreement has been reached to intensify the social dialog through reviving the National Council for Tripartite Cooperation. Within that framework, we expect to reach agreement by March 31, 2006 (i) to find a solution repealing the obligatory character of the portability of seniority bonuses in the case of unemployment, change of employer, or job position (a benchmark) and (ii) to increase work time flexibility by raising the legal limits on maximum working hours, lengthening (perhaps annualizing) calculation periods, and expanding the reasons for work outside regular hours (a benchmark). A decree implementing the former measure is expected to be issued by June 30, 2006 (a benchmark) and a draft law incorporating the second set of measures is expected to be submitted to parliament by June 30, 2006 (a benchmark). In addition, we intend to reach agreement with the social partners on including existing seniority bonuses in

workers' basic pay, allowing subsequent increases in wages to be negotiated by the social partners at the individual, sectoral or national levels.

C. Financial Sector and Public Asset and Liability Management

13. As a contribution to the reduction in excess domestic demand, the BNB has taken additional measures to slow the rate of bank credit expansion. Bank credit expansion slowed to 32.3 percent (11 percent of GDP) in 2005. An unexpected increase in late December reflected year-end considerations and was partly unwound in January 2006. Hence, the BNB's efforts to slow credit expansion to 30 percent in 2005 remained essentially on track. In October 2005 the BNB extended the existing credit expansion limits of 6 percent of the adjusted end-March 2005 base per quarter with the intention of slowing bank credit expansion further to 17.5 percent (7.1 percent of GDP) in 2006 while preventing banks from circumventing its credit restraint measures. To this effect, measures including the following have been taken or will be adopted:

- The BNB has extended the quarterly limits on the penalty-free growth of credit beyond March 31, 2006 to the end of 2006.
- The penalty deposit rate for banks exceeding the limit by 1-2 percent was raised from 200 to 300 percent, and to 400 percent for excesses of more than 2 percent.
- To make the credit limits more effective, the excess of local nongovernment nonbank sector bonds issued to banks over and above their stock outstanding on December 31, 2005 will be brought under the credit limits starting from the first quarter of 2006.
- The provisioning requirements for impaired household credits have been raised for loans overdue by 30–60 days from 10 percent to 20 percent and for loans overdue by 60–90 days from 50 percent to 75 percent and provisions made for such credits may not be released until six months after the credits have begun to be fully serviced again.
- The risk weighting used for calculating the capital adequacy ratio will be increased for mortgage loans by lowering the loan-to-value ratio from 70 percent to 50 percent from April 1, 2006.
- The BNB has issued a recommendation to the banks not to extend credit to households which do not have disposable income of at least BGN100 per household member per month after taxes and all debt service (including that for the requested loan) have been deducted from officially declared income. Where regular supervisory examinations reveal that this recommendation has not been followed, inspectors will reflect this in their reports and suggest appropriate supervisory measures.

- On the BNB's request, banks have agreed to disclose effective interest rates on their consumer loans. Such disclosure will be extended to all household loans following adoption of the new consumer protection law, expected by June 30, 2006.

With these measures, the BNB's prudential requirements exceed international best practice in many areas. It is the BNB's intention to establish a level playing field for domestic banks after all restrictions to the access of foreign banks to the domestic market have been lifted with EU accession on January 1, 2007. For this reason, the possibility of easing some of the restrictions in light of the evolution of domestic bank credit in relation to the projections will be examined at the time of the third review. If, however, bank credit expands more rapidly than envisaged, the BNB is prepared to take additional measures at the time of the third review.

- 14. We are undertaking a number of steps to strengthen supervision of nonbank financial intermediaries and improve their operations.** A new insurance law compliant with EU regulations and facilitating supervision was approved by parliament in December 2005. An amendment to the social security code was approved by parliament in February, 2006. It eliminated the geographical limitation on pension fund investments with respect to EU and European Economic Area member countries and lift the minimum thresholds for investment in government securities. An expansionary effect on the domestic private sector from the lifting of the minimum thresholds is not expected because of the small size and volatility of the domestic capital market. Leasing companies have been requested by the BNB under the foreign exchange law to report on their income statements and balance sheets on a quarterly basis with effect from September 30, 2005. Finally, a law on the consolidated supervision of financial conglomerates has been drafted and is expected to be submitted to parliament soon, with adoption envisaged by September 5, 2006 (a benchmark). This law assigns the supervision of such conglomerates to either the BNB or the Financial Supervision Commission depending the dominant activity of these conglomerates.
- 15. Public asset and liability management will continue to aim at reducing gross public debt.** Fiscal surpluses and privatizations have led to steady inflows into the Fiscal Reserve Account (FRA) in the BNB. We have used these inflows to buy back all of our Brady bonds (the last issue in July 2005), make early repurchases to the Fund in December 2005 and February 2006, and prepay a portion of World Bank loans in January 2006. These prepayments have contributed to lowering the public debt ratio to 32¼ percent of GDP at end-2005 and a projected 28½ percent at end-2006. A guarantee deposit with a foreign bank has additionally reduced our freely usable international reserves by 1 percent of GDP. We have no immediate plans for additional external debt prepayments, but such prepayments remain a policy objective subject to the maintenance of an adequate level of freely usable international reserves. We have again established ceilings on the contracting and guaranteeing of

external public debt, including two loans for the procurement of military equipment (performance criteria), and trust that these ceilings will ward off pressures for entering into other such contracts during the program period.

D. Other Structural Reforms

16. The new government is still in the process of firming up its structural reform agenda. We share the broad thrust of the previous government's reform efforts, directed at improving the business climate, reducing corruption, regulating natural monopoly prices, and restructuring and privatizing public enterprises. The elaboration of detailed plans will take time, but we hope to discuss more fleshed-out plans during the third stand-by review. In the meantime, we intend to complete the following reforms from the previous government's unfinished agenda.

- We have submitted to parliament draft legislation that transfers business registration from the courts to the Registration Agency, an agency under the Ministry of Justice, which will set up and operate the new unified national electronic register efficiently under simplified administrative procedures. Amendments to the draft aimed at eliminating ex-ante judicial review in the registration process. The law specifies that registration will be completed within 10 days in uncontested cases. Efficient operation would require reducing the staff of the current fragmented system from some 400 to no more than 100, allowing a reduction of registration and information access fees to about one half of the current level. We expect a law preserving the essential features of this draft to be approved by parliament before completion of the second review (a prior action), and plan to make the new registry operational, at least for all new business registrations, by June 30, 2006 at the latest (a performance criterion).
- We will support the State Electricity and Water Regulatory Commission (SEWRC) in its independence in setting the tariffs for electricity, heating, and water and sewerage. Following the phased increase in electricity tariffs for households to cost recovery levels in recent years, the SEWRC raised tariffs for commercial customers by 16 percent in the case of low voltage users in October 2005 to equalize them with household tariffs and by 9 percent for medium voltage users. Following natural gas price increases of 20 percent, the SEWRC raised district heating prices by 16-25 percent depending on the region of users, effective November 1, 2005. With these actions, the SEWRC has eliminated cross subsidies. It also eliminated preferential tariffs for usage up to social thresholds. Following the recent adoption by parliament of the water services law and secondary legislation approved by the council of ministers in late 2005, the SEWRC will initiate a regulatory review of the water sector with a view to setting prices that will attract investors to the sector, which is plagued by heavy water losses and decapitalization.

- We are aware of the close link between the control of corruption and competitiveness and economic growth and therefore reaffirm our commitment to the previous government's anti-corruption program and policies, as outlined in paragraph 15 of the Supplementary Memorandum of Economic and Financial Policies that is attached to the letter of April 25, 2005. The previous government's action plan for 2004-05 under the 2001 National Anti-Corruption Strategy contains 160 measures, 80 percent of which had been implemented by the end of the third quarter of 2005. We expect the implementation rate to have risen to 85-90 percent by the end of 2005. In the meantime, we are preparing a new action plan for 2006. As part of the new action plan, a special code of ethics for the highest government officials was adopted by the Council of Ministers in December, 2005 and is already in force. A separate code of ethics for members of parliament is currently under preparation in parliament's new ethics commission. Under the 2006 action plan, we intend to take measures to strengthen the capacity of the public administration to initiate procedures against civil servants under their existing code of ethics. A disciplinary commission under the Supreme Judicial Council is in charge of fighting corruption in the judiciary. We expect to make headway against high-level corruption with the aid of the recently adopted criminal procedures law that will enter into force in early 2006, after appropriate training of the magistrates. Finally, the Ministry of Interior and the Ministry of Finance are undertaking in-depth reviews of property and tax declarations. It is expected that their report to the asset forfeiture commission will lead to recommendations to the courts to take action under the asset forfeiture law adopted in February 2005.
- We are committed to further privatization of state assets and are currently examining how to proceed. After the recent failure of the privatization of the Rousse and Varna electricity generation companies, we will offer these companies for a renewed round of bidding and intend to select the winning bidders by June 30, 2006 (a structural performance criterion). As regards the third company (Bobov Dol), we are prepared to start negotiations with the bidder that has submitted the highest offer provided that the court proceedings will result in a court decision that is favorable for completing this transaction. If these negotiations are not successful, we will resubmit the plant to public tender. The remaining four district heating companies are expected to be privatized by September 30, 2006. With regard to Bulgartabac Holding, we have decided to liquidate the Haskovo plant and to privatize immediately the Plovdiv plant. As to the remainder of the holding, we will decide shortly on how to proceed on the basis of three options recently prepared for the restructuring and/ or privatization of the holding company. Privatization strategies for the airline and the maritime shipping company will be sent to parliament in the first and second quarters of 2006, respectively, with a view to privatizing both companies, along with the remainder of the river shipping

company, by the end of 2006. We plan to sell our minority stakes in a number of companies after completion of an ongoing review. Finally, we will examine whether some companies currently exempt from privatization as per the Annex to Article 3, paragraph 1 of the privatization law can be removed from that list for future privatization. Our provisional thinking is, however, that the electricity and gas transmission networks and the nuclear power plant should remain under state ownership. In this connection, we have decided to split Bulgargaz and the National Electricity Company each into a transmission operator and a supplier of gas and electricity, respectively.

- Existing capacity of ports and airports represents an increasing constraint on the expansion of economic activity and tourism. We have therefore decided to sell concessions for operating and expanding port and airport terminals to the private sector and will report on steps taken and plans for the remainder of 2006 at the time of the third stand-by review.

E. Statistical issues

- 17. We will collaborate with the National Statistical Institute to improve macroeconomic statistics.** There is an urgent need for a breakdown of national account data into household and business sectors to facilitate monitoring and addressing the risks arising from external vulnerability. There is also a need for more information on the sectoral breakdown and nature of investment to assess the likely supply response and for comprehensive corporate and household balance sheet data to assess vulnerabilities. Developing these data will take time and may require technical assistance in statistics.

Bulgaria: Conditionality Under the Stand-By Arrangement in 2006

Prior Action

1. Approval by parliament of legislation transferring business registration to the Registration Agency under the Ministry of Justice and establishing a unified national electronic register with limited judicial oversight and simplified administrative procedures.

Quantitative Performance Criteria

1. Floor on the overall surplus of the general government (Annex II).
2. Ceiling on central government arrears (Annex II).
3. Ceiling on the wage bill of the 58 largest SOEs in financial distress or monopoly situation (Annex III).
4. Ceiling on the contracting or guaranteeing of nonconcessional external public debt (short term, 1-5 years, longer) (Annex IV).

Structural Performance Criteria

1. Approval by parliament of the new VAT law (April 30, 2006).
2. Start-up of operations of the new business register, at least for all new business registrations (June 30, 2006).
3. Selection of the winning bidders for the Rousse and Varna electricity generation companies (June 30, 2006).

Continuous Performance Criteria

1. No imposition of new or intensification of existing restrictions on the making of payments and transfers for current international transactions, nor introduction or modification of multiple currency practices, nor conclusion of any bilateral payments arrangements that are inconsistent with Article VIII of the IMF Articles of Agreement, nor imposition or intensification of any import restrictions for balance of payments purposes, nor accumulation of any external payments arrears.
 2. No reduction of tax rates and bases (except for those described in ¶16 of the SSMEFP).
 3. The monthly minimum wage not to exceed BGN160.
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Bulgaria: Conditionality Under the Stand-By Arrangement in 2006 (Concluded)

Structural Benchmarks

1. No new extrabudgetary funds or state-owned enterprises to be created.
2. Agreement with social partners on a solution repealing the obligatory character of the portability of seniority bonuses in the case of unemployment, change of employer, or job position (March 31, 2006).
3. Agreement with social partners to increase work time flexibility by raising the legal limits on maximum working hours, lengthening calculation periods, and expanding the reasons for work outside regular hours (March 31, 2006).
4. Submission to parliament of an education reform strategy envisaging an initial employment cut of at least 5,500 (March 31, 2006).
5. Reduction of central administration employment by 4,500 positions (June 30, 2006).
6. Adoption of a decree repealing the obligatory character of the portability of seniority bonuses in the case of unemployment, change of employer, or job position (June 30, 2006).
7. Submission to parliament of legislation to increase work time flexibility, as agreed with the social partners (June 30, 2006).
8. Approval by parliament of a law on duty free trade specifying limits on individual purchases of goods and fuels and strengthened controls (June 30, 2006).
9. Approval by parliament of new CIT and PIT laws (July 31, 2006).
10. Approval by parliament of a law on consolidated supervision of financial conglomerates (September 5, 2006).
11. Implementation of an employment cut of at least 5,500 positions in the education sector (September 5, 2006).

Performance Criteria on the General Government Balance and Central Government Arrears and Indicative Revenue Targets for the General Government

	Fiscal Surplus Floor	Arrears Ceiling 1/	Overall Revenue Target 2/
	(In millions of leva)		
Cumulative change from January 1, 2006			
March 31, 2006	256	5	4,251
June 30, 2006	786	5	9,051
September 30, 2006 2/	1,099	5	13,554
December 31, 2006 2/	1,387	5	18,454

1/ Arrears ceiling is on the stock of central government arrears.

2/ Indicative target on general government revenue (including grants).

Quarterly limits in this Annex are cumulative with the exception of central government arrears.

The general government accounts are defined to comprise the consolidated budget (including the republican budget, the budgets of ministries and local governments, and the social security funds NSSI and NHIF) as well as all extrabudgetary funds and accounts at the central and local government levels, the public investment projects (PIP) enterprise, and the environment enterprise. The central government is defined as the general government minus the sum of the local government budgets and the extrabudgetary funds and accounts at the local government level.

For program monitoring purposes, the arrears of the central (general) government are all overdue obligations on the payment for central (general) government expenditure excluding items in dispute. The stock of central government arrears as of December 31, 2005 amounted to BGN 4.8 million.

For program monitoring purposes, the fiscal balance (surplus/deficit) will be defined as the difference between general government revenue (taxes, nontaxes, and grants) and general government expenditure, including net capital transfers (net acquisition of shares and net lending) and adjusted for the net change of the stock of general government arrears. In contrast with the national practice, in the program definition the government's social security contributions for its own workers (except those to the second pension pillar) are excluded from both revenue and expenditure. In 2006, the quarterly fiscal balance targets will be raised by 50 percent of the excess of actual over targeted cumulative general government revenue (including grants). If general government revenue (including grants) exceeds the

program's target of BGN 18,454 million, 50 percent of any such cumulative quarterly revenue overperformance will be saved and the fiscal surplus floor raised accordingly.

Reporting on the fiscal balance will be cross checked from the financing side as the sum of net credit from the domestic banking system to the general government, general government deposits and accounts abroad, net domestic nonbank credit to the general government, privatization receipts of the central and municipal government budgets, receipts from external loans for project implementation and direct budgetary support minus amortization due, net disbursement/repayment of loans whose final payee is an entity outside the general government consolidation (onlending operations), and the net increase/decrease of general government arrears, including those on the amortization of principal. For calculating the performance against this ceiling, all privatization receipts are treated as financing items. External flows will be converted into leva at the BNB daily exchange rate. Valuation changes in deposits and accounts that are denominated in foreign currencies will be recorded daily and reported by the BNB and the Ministry of Finance at the end of each quarter, and such changes will be netted out.

All data in this Annex will be reported quarterly by the Ministry of Finance (and by the BNB for some of the financing items in the preceding paragraph) within 60 days of the end of each calendar quarter.

Performance Criteria on the Wage Bill of 58 State-Owned Enterprises (SOEs)

Wage Bill of 58 SOEs

(In millions of leva)

Cumulative from 1 January 2006	
March 31, 2006	89.2
June 30, 2006	178.4
September 30, 2006 1/	267.7
December 31, 2006 1/	356.9

1/ Indicative Limit

The quarterly ceiling on the aggregate wage bill of the 58 state-owned enterprises closely monitored for their large losses or arrears, for receiving subsidies, or for being monopolies, is 5 percent above the level of the aggregate wage bill in the third quarter of 2005 and is accumulated by the same amount for each subsequent quarter. The wage bill is defined to include wages and payroll taxes paid by the employer but does not include additional compensation under Article 12 of the 2005 Incomes Ordinance.

Those enterprises that have been privatized or ceased operations will be excluded from the list for the respective test dates. Those enterprises that register profits in each of the first two quarters of 2006 will also exit the list in the second half of 2006 unless they are monopolies, have arrears, or receive state subsidies. If an enterprise is excluded from the list, the wage bill ceiling for each subsequent quarter will be adjusted down by the amount of that enterprise's wage bill in the third quarter of 2005 plus 5 percent times the number of quarters it has been excluded from the list. The 58 enterprises monitored are in the table below (enterprises numbers 1 to 4 are considered monopolies).

List of 58 Monitored State-Owned Enterprises

1 State Railways	30 Burgas Sea Port
2 Railway Infrastructure	31 Terem Khan Krum
3 BulgarGas	32 Terem Georgi Benkovsky
4 The National Electricity Company	33 Terem Ovech
5 Kozloduy Nuclear Powerstation	34 Terem Letetz
6 Varna Power Station	35 Terem Ivaylo
7 Bobov Dol Power Station	36 Khaskovo BT
8 Bobov Dol Coal Mine	37 Gotze Delchev BT
9 Pirin Coal Mine	38 Shumen BT
10 Russe Urban Heating Company	39 Kardjali Bulgartabak
11 Shumen Urban Heating Company	40 Yambol BT
12 Plovdiv Urban Heating Company	41 Sandansky BT
13 Sofia Urban Heating Company	42 Assenovgrad BT
14 Varna Urban Heating Company	43 Stroitelstvo and Vazstanovjavane (Construction and Refurbishing) Public Company
15 Sliven Urban Heating Company	44 Transport Construction and Repair Public Company
16 Pernik Urban Heating Company	45 Public Works
17 Sofia Urban Transport Company	46 Military Supplies Company
18 Plovdiv Urban Transport Company	47 Spatial and Urban Public Works
19 Varna Urban Transport Company	48 Copper Well
20 Sofia Electric Urban Transport Company	49 BalkanCar Sredetz
21 Pernik Trolley Bus Urban Transport Company	50 BalkanCar Dunav
22 Pleven Urban Bus Transport	51 BalkanCar Erma
23 Diana Bus Company	52 Dupnitza Supply Water and Wastewater Services
24 Passenger Transport	53 Supply Water and Wastewater Services
25 Aytos Bus Transport	54 Supply Water Engineering
26 Bus Transport	55 Vazov Mechanical Engineering Plants
27 Beltrans	56 Rudozem GORUBSO
28 Russe Urban Bus Transport	57 Land Geodetic Metrology
29 Roshen Express	58 Rope Ways

Performance Criteria and Indicative Targets on the Ceilings on Contracting or
Guaranteeing of Public Sector External Debt 1/2/
(In millions of euros)

	One year and under 3/	Over 1 year 4/	1-5 years 4/
Cumulative change from December 31, 2005			
March 31, 2006	0	293.0	0
June 30, 2006	0	331.4	0
September 30, 2006	0 5/	372.3 5/	0 5/
December 31, 2006	0 5/	496.3 5/	0 5/

1/ The public sector comprises the central government, the local government, the social security fund and all other extrabudgetary funds and the Bulgarian National Bank.

2/ The term “debt” has the meaning set forth in point No. 9 of the IMF Guidelines on Performance Criteria with Respect to Foreign debt adopted on August 24, 2000 (Executive Board Decision No. 12274-(00/85)). Excluded from this performance criterion are (i) normal import-related financing credits; and (ii) outstanding balances under bilateral payments arrangements. Debt and commitments falling within the ceilings shall be valued in euros at the program exchange rates of 1.21 US\$/€.

3/ The ceilings apply to debt with original maturities of up to and including one year. The actual stock of short-term debt outstanding (according to this definition) as of December 31, 2004 was zero.

4/ The ceilings apply not only to “debt,” but also to commitments contracted or guaranteed for which value has not been received.

5/ Indicative limits.