June 2004
IMF Country Report No. 04/176

Bulgaria: 2004 Article IV Consultation and Ex Post Assessment of Longer-Term Program Engagement—Staff Reports; Staff Statement; and Public Information Notice on the Executive Board Discussion

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 Article IV consultation with Bulgaria, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 13, 2004,** 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 May 27, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff report on ex post assessment of longer-term program engagement, which was completed on **May 19, 2004**.

- a staff statement of **June 9, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its June 14, 2004 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Bulgaria.

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

Selected Issues and Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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BULGARIA

Staff Report for the 2004 Article IV Consultation

Prepared by the European Department
(In consultation with other departments)

Approved by Carlo Cottarelli and John Hicklin

May 27, 2004

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EXECUTIVE SUMMARY

Background: Macroeconomic developments have generally been favorable, although a surge in credit growth and a related sharp widening of the external current account deficit point to possible economic overheating. Bank claims on the nongovernment sector rose by nearly 8 percentage points of GDP in 2003, and their growth shows no signs of easing. Nevertheless, bank prudential indicators remain strong. A credit-induced import boom widened the external current account deficit to 8½ percent of GDP. However, FDI inflows have been strong, reserves are rising, and competitiveness appears broadly adequate. Fiscal policy was tightened in 2003, as the government saved half of the revenue overperformance and reduced the deficit to 0.4 percent of GDP. The pace of structural reform has slowed, with two large privatizations and fiscal structural measures delayed. The government's popularity has stabilized at low levels, but it retains some latitude in policy implementation due to a general wariness to hold early elections.

Discussions: The discussions focused on policies to contain the risks associated with the widening current account deficit and rapid credit growth, and on advancing structural reforms. Staff and authorities concurred that the widening external imbalance had increased macroeconomic risks, and that a mix of short-run demand containment and medium-run supply enhancement would be the appropriate way of addressing these risks. To this end, the authorities indicated they would target a deficit of ½ percent of GDP this year, rather than 1¼ percent of GDP as originally planned. Moreover, they agreed to use any revenue overperformance (likely in light of collections so far) to achieve balance. They also intend to achieve budgetary balance in 2005-06, although EU-related expenditures were likely to produce a deficit in 2007. In addition, they plan to reduce bank liquidity by tightening reserve requirements and shifting government deposits from commercial banks to the central bank. There was agreement that, in order to raise output and export capacity, structural reforms needed to be revitalized, with staff underscoring the need for policies that spur FDI, critical for growth in the medium term and for short-term external financing. The authorities broadly agreed with Bulgaria's ex post assessment, which concluded that a program-based engagement with Bulgaria would be the most effective way of supporting the government's economic program in the run-up to EU accession in 2007.

Staff appraisal: The authorities' macroeconomic program for 2004 represents an adequate response to the heightened risks. However, the implied fiscal adjustment is small, and the authorities should stand ready to tighten fiscal policy further if the external situation does not improve as expected. Fiscal flexibility is particularly important as the planned measures to reduce bank liquidity may be limited in their effect on credit growth due to the open capital account. To provide room to respond to possible shocks, the authorities are right to aim at fiscal balance in 2005–06 but they should take steps to contain fiscal deficits upon EU accession in 2007. The authorities' intention to complement demand management policies with structural reforms aimed at enhancing supply is appropriate; in this regard, creation of a new privatization pipeline for 2005-06 is particularly important.

I. Introduction

1. **A staff team[1] visited Sofia during March 25-April 13, 2004 to conduct the 2004 Article IV consultation and discuss the Ex Post Assessment (EPA) of Bulgaria's longer-term program engagement with the Fund**. The mission also updated the 2001/02 FSAP. Bulgaria's relations with the Fund and IMF-World Bank collaboration in Bulgaria are described in Appendices I and II, respectively.

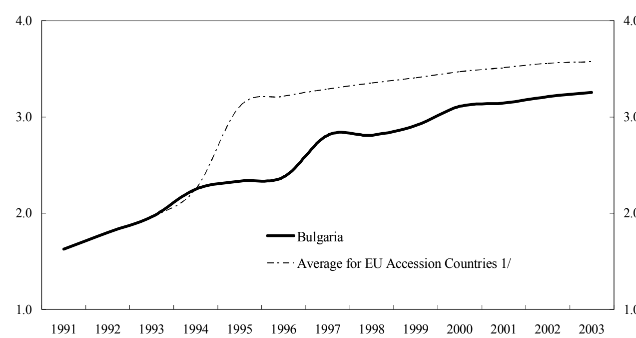
2. **A two-year SBA expired on March 15, 2004, and the authorities have expressed interest in a successor arrangement which they intend to treat as precautionary**. All purchases under the previous SBA were made. During the Article IV mission, negotiations on a successor program were begun. The SBA discussions are expected to be finalized in light of the Board's discussion of the EPA.

3. **Support for the governing coalition appears to have stabilized at low levels, but reform commitment is firmly anchored in the broadly shared goal of EU accession**. After losing last year's local elections, pressures on the government to weaken economic policies ahead of the mid–2005 parliamentary election have increased. However, all political parties are wary of early elections, which might delay the closing of remaining EU accession chapters. Therefore, despite losing its majority in parliament in March, the government has retained some latitude in policy implementation.

II. Economic Developments

4. **Following the 1996-97 crisis, Bulgaria's macroeconomic performance improved dramatically**. The crisis triggered a change not only in government, but also a switch to a new policy strategy centered on a currency board arrangement (CBA), tight fiscal and incomes policies, and comprehensive structural reforms. This strategy succeeded in restoring macroeconomic stability and reducing—though not closing—the reform gap with more advanced European transition countries. Thus, despite anemic growth in Bulgaria's principal export markets in

EBRD Transition Index, 1991-2003



Source: EBRD.
1/ Countries acceding to the EU in May 2004, excluding Malta and Cyprus.

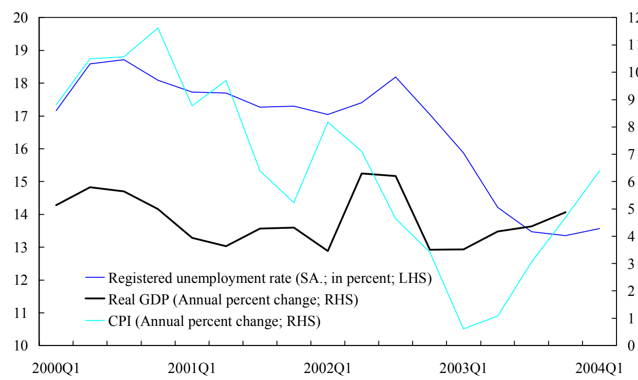
[1] Messrs. Flickenschild (head), Duenwald, Egoumé-Bossogo, Joshi (all EUR), Pitt (PDR), Ms. Maechler (MFD), and Ms. Bernal (assistant, EUR). Mr. Roaf, the resident representative, assisted the mission. Mr. Cottarelli (EUR) participated in the Article IV, and led the EPA, discussions during March 29-April 5. The mission met with the Prime Minister, key economic ministers, the Governor of the Bulgarian National Bank (BNB), parliamentarians (including the main opposition party), and representatives of trade unions and the private sector, and coordinated its work with World Bank staff.

the EU, output growth in recent years has been at 4-5½ percent, unemployment has begun to decline, inflation has fallen to modest levels, and the external and public debt ratios have declined markedly.

5. **In concluding the 2002 Article IV consultation, Executive Directors emphasized the need for continued sound macroeconomic policies and further structural reforms to prepare the economy for EU accession**. As discussed in the EPA, the government has broadly adhered to this policy advice (including by tightening the fiscal stance in light of changed circumstances), although the pace of structural reform has slackened reflecting political obstacles, and improving social indicators remains a key challenge (Table 1). The government intends to reinvigorate structural reform, in the context of prudent macroeconomic policies, with the support of Programmatic Adjustment Loans (PALs) from the World Bank.

6. **Recent macroeconomic developments have been generally favorable, although surging credit growth and a related sharp widening of the external current account deficit point to possible economic overheating**:

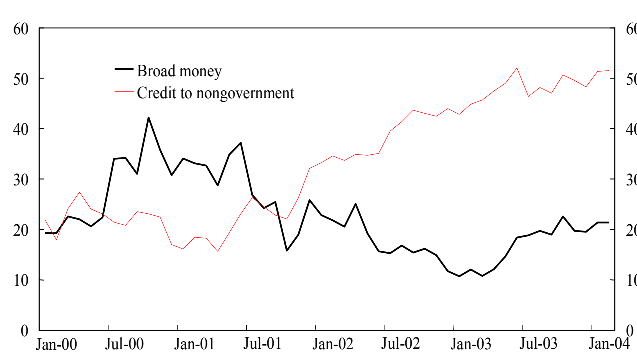
Real Sector Indicators, 2000-04



- **Real GDP grew by 4¼ percent in 2003—after nearly 5 percent in 2002**—as strong domestic demand was partly offset by a deterioration in net exports (Tables 2 and 3). Private consumption and fixed investment rose rapidly, underpinned by credit growth. On the production side, growth was negatively affected by a drought-related decline in agricultural output. Reflecting in equal measure active labor market policies and private sector job creation, the unemployment rate dropped by 3½ percentage points between end-2002 and the first quarter of 2004, but remained high at 13½ percent (seasonally adjusted). High-frequency indicators point to continued robust growth in Q1/2004 (Figure 1).

- **Inflation has increased due to temporary factors**. While consumer price inflation averaged 2¼ percent in 2003, a drought-related jump in food prices raised 12-month CPI inflation to 5½ percent at end-2003. Inflation accelerated further to 6¼ percent in March 2004, mainly reflecting higher excise taxes.

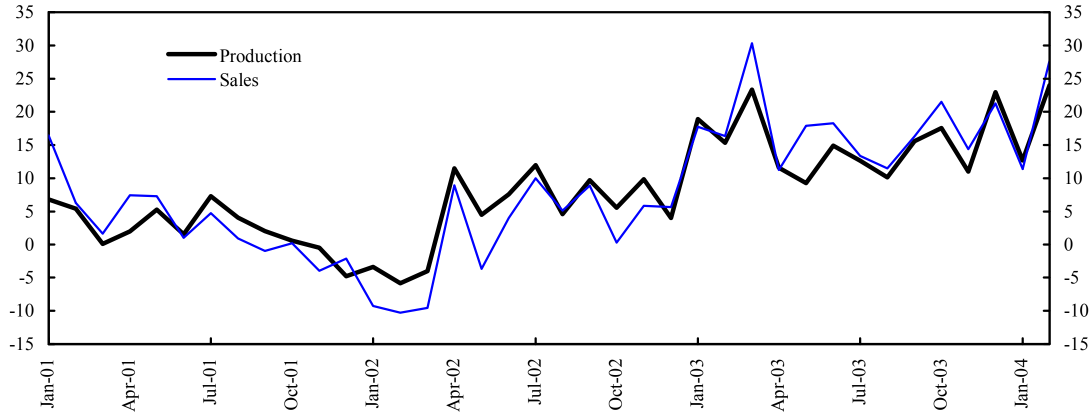
Nominal Broad Money and Credit Growth, 2000-04
(Year-on-year percent change)



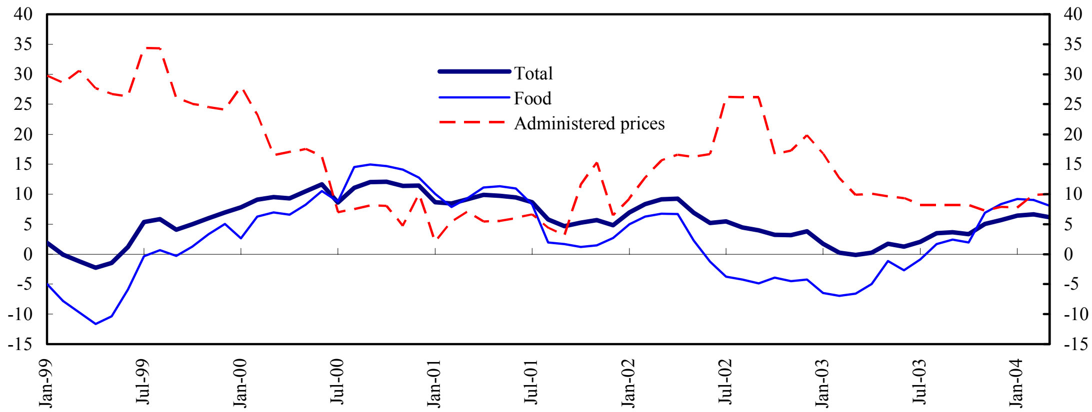
- **Bank credit growth surged, and has not shown signs of easing in 2004**. Claims on the nongovernment sector rose by nearly 50 percent in 2003, or by nearly 8 percentage points of GDP (Table 4 and Figure 2). With the level

Figure 1. Bulgaria: Real Sector Developments, 1999-2004

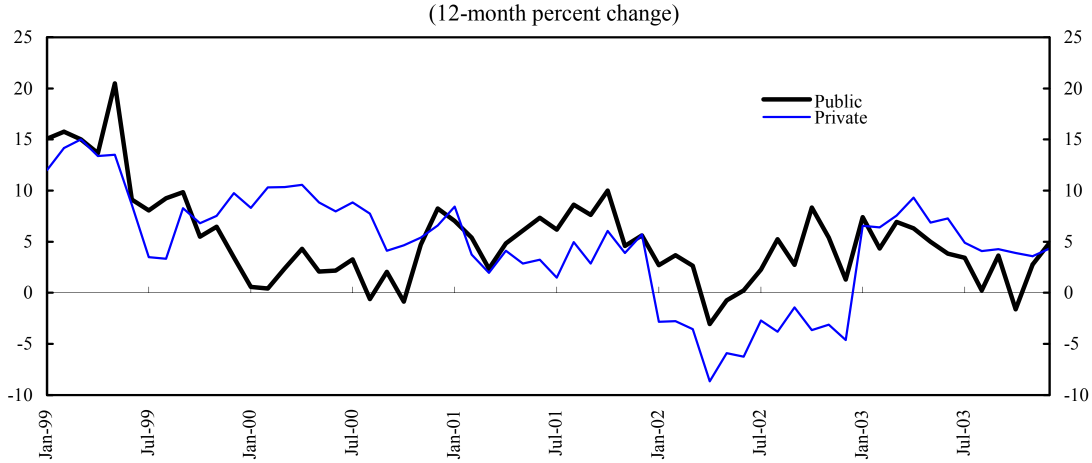
INDUSTRIAL ACTIVITY
(12-month percent change)



CONSUMER PRICES
(12-month percent change)

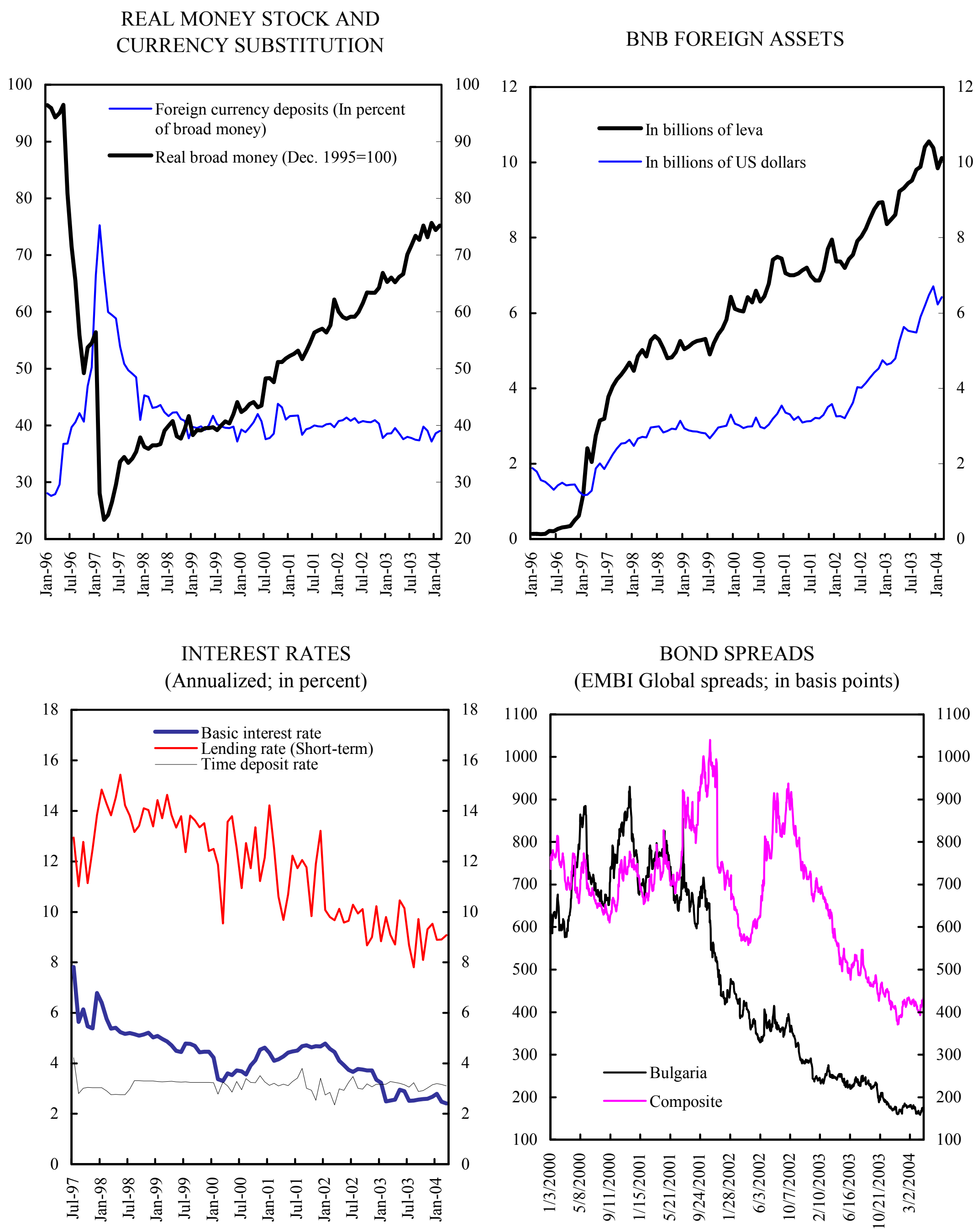


REAL WAGES
(12-month percent change)



Source: Bulgarian authorities.

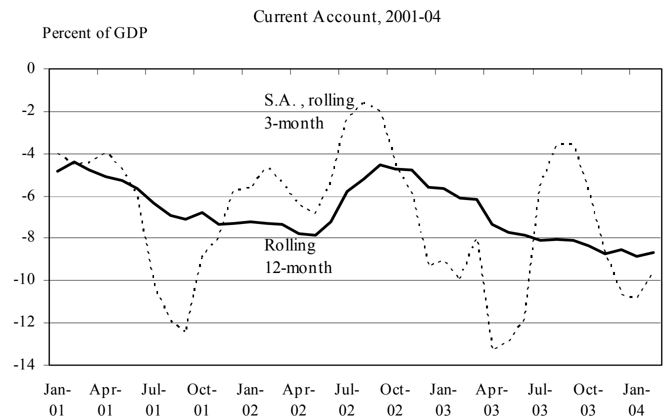
Figure 2. Bulgaria: Money and Financial Indicators, 1996-2004



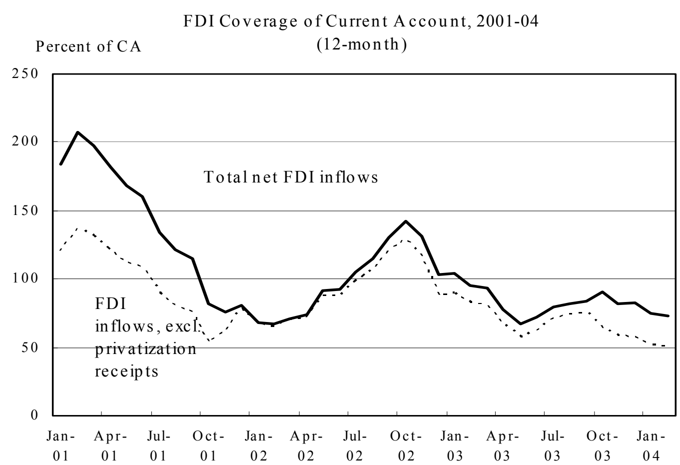
Sources: Bulgarian National Bank; Bloomberg; and Fund staff calculations.

of financial intermediation still relatively low, this credit boom reflects a catch-up from a low base and has continued in 2004, with the 12-month rate remaining above 50 percent in March 2004.[2] Prudential indicators remain strong (Table 5). Broad money growth accelerated to nearly 20 percent in 2003, reflecting the continued remonetization of the economy. Interest rates on loans and deposits were broadly stable last year. Meanwhile, the credit boom may have boosted real estate prices. Residential real estate prices—essentially flat during 2000–02—increased by 12¼ percent in 2003.

- **The external current account deficit widened to 8½ percent of GDP in 2003** (Table 6 and Figure 3). Although exports grew by 10 percent, imports surged by 14¼ percent. The resulting deterioration of the trade balance accounted for almost 90 percent of this widening, with the remainder reflecting a wider deficit on factor incomes, largely due to higher profit remittances. Although it is too early to be definitive, data for early 2004 suggest the deterioration of the current account in terms of GDP may have peaked.



- **However, strong FDI and other capital inflows produced an overall balance of payments surplus**. FDI covered 82½ percent of the current account deficit in 2003 and international reserves rose to over 2½ times short-term debt. External debt declined by 6½ percentage points to 58¾ percent of GDP, although 5½ percentage points of this reduction reflected valuation effects. In parallel, sovereign spreads have fallen to some 190 basis points and Bulgaria's sovereign rating has been upgraded to one notch below investment grade.



- **Balance sheet vulnerabilities remain fairly sizable at the sectoral level** (Appendix III). However, the private sector's large net short-term foreign-currency liabilities are more than offset by the excess of the BNB's international reserves over base money.

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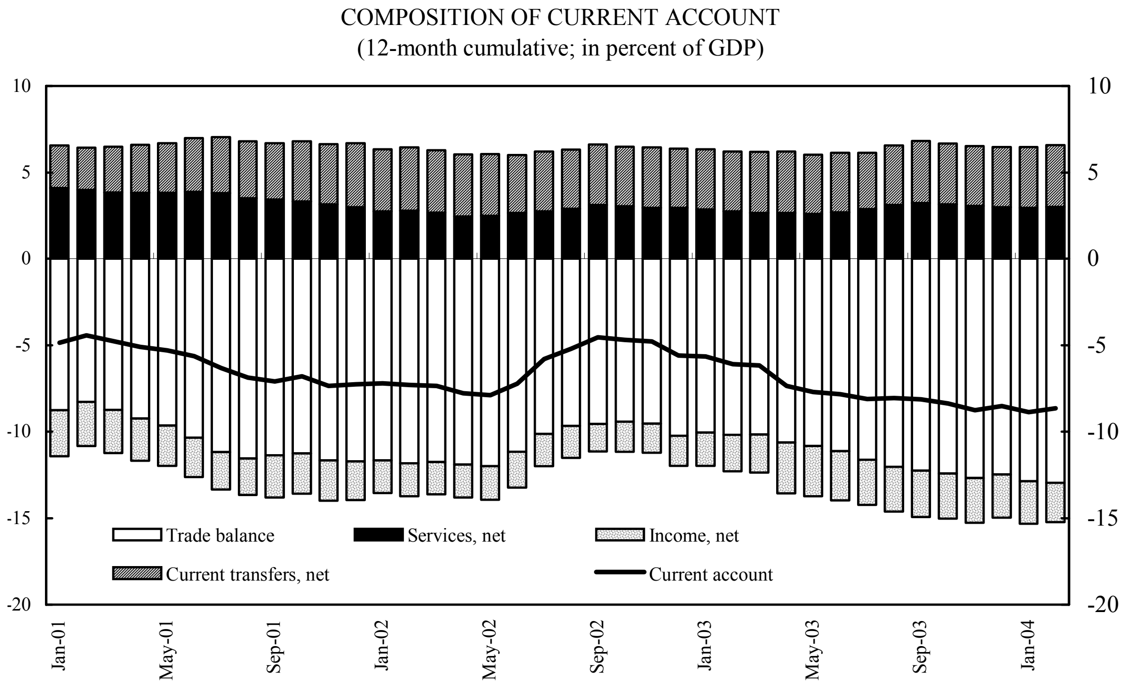
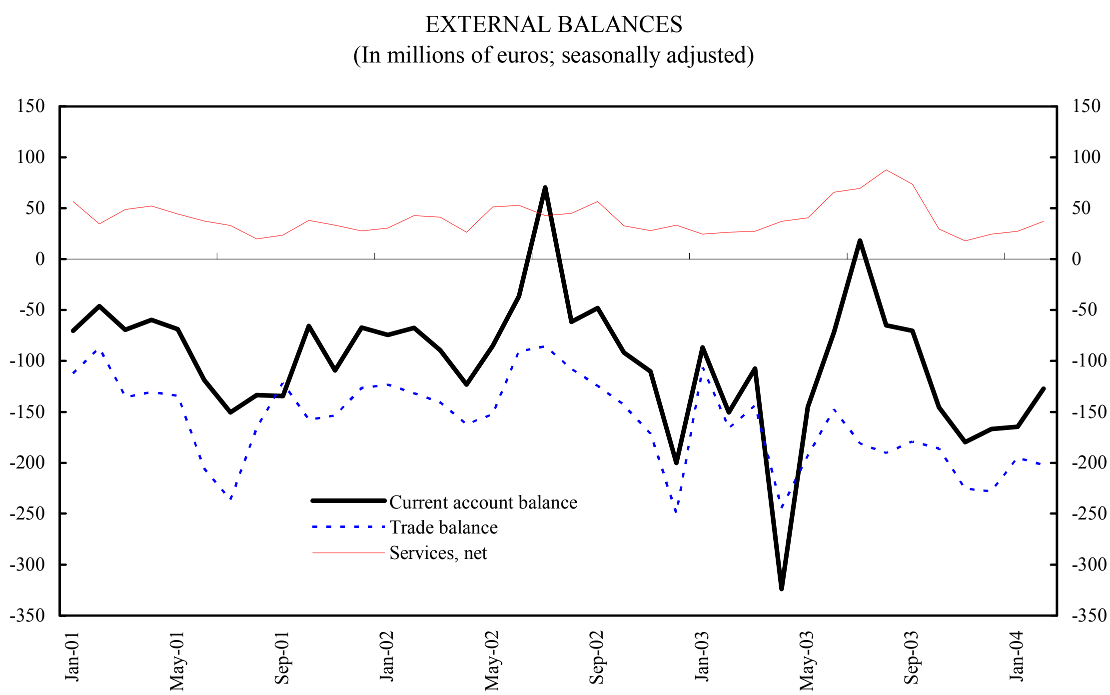
[2] Chapter I of *Selected Issues and Statistical Appendix* (to be issued) analyzes Bulgaria's credit boom.

Figure 3. Bulgaria: External Sector Developments, 2001-04





Source: Bulgarian authorities.

7. **Fiscal policy was tighter than programmed in 2003, owing to revenue over-performance** (Tables 7 and 8). As the current account deficit widened, the government saved half of the revenue overperformance and balanced the budget in 2003,[3] against a programmed deficit of 0.7 percent of GDP. Notwithstanding a shortfall in grants of ½ percent of GDP, revenue was 1½ percent of GDP higher than expected, mainly due to the import boom (accounting for 80 percent of the overperformance) and improved tax collection. Expenditure was 0.7 percent of GDP higher than budgeted, as government-mandated municipal spending was, for the first time, fully funded and hospital arrears were cleared. Year-end wage and pension bonuses and other nonbudgeted spending also limited fiscal savings.

8. **Notwithstanding progress in certain areas, the pace of structural reform has slowed**. Bank privatization was virtually completed in 2003. A new energy law was passed and retail electricity and district heating prices were raised further toward cost-recovery levels. The restructuring of district heating companies advanced, cutting subsidies to that sector, and railway payrolls were reduced by 10 percent, while subsidies were better targeted. In the fiscal area, the large taxpayer office was expanded, and program budgeting and better budget preparation practices were initiated. However, crucial reforms experienced delays, including selling the tobacco holding (Bulgartabac), finalizing the sale of the telecoms company (BTC),[4] operationalizing the National Revenue Agency (NRA), and reforming the health, education, and railway sectors.

III. Report on the Discussions

A. Key Strategic Issues

9. **Despite a generally strong policy record and improved fundamentals, the Bulgarian economy faces some key challenges and vulnerabilities on its way to EU accession**:

- The surge in credit growth and the related weakening of the external current account are the most apparent and unexpected developments since the last Article IV consultation. To what extent do these developments involve macroeconomic risks and how could policies minimize them?

- Maintaining a tight fiscal stance may become difficult in the run-up to the election, particularly given the reduced support for the government. Will the authorities resist pressures to increase spending?

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[3] The deficit was 0.4 percent of GDP under the new definition discussed in paragraph 18.

[4] The long-awaited sale of a 65 percent stake in BTC was signed in February, but a dispute about granting BTC a GSM license has again delayed the completion of the sale.

- Growth performance is satisfactory but further progress is needed to reduce the income gap vis-à-vis the most advanced European transition countries and to reduce poverty. How can this be achieved and what are the priorities in this area?

The Article IV discussions focused on these questions. Based on the EPA, the discussions also covered the nature of future IMF engagement in Bulgaria.

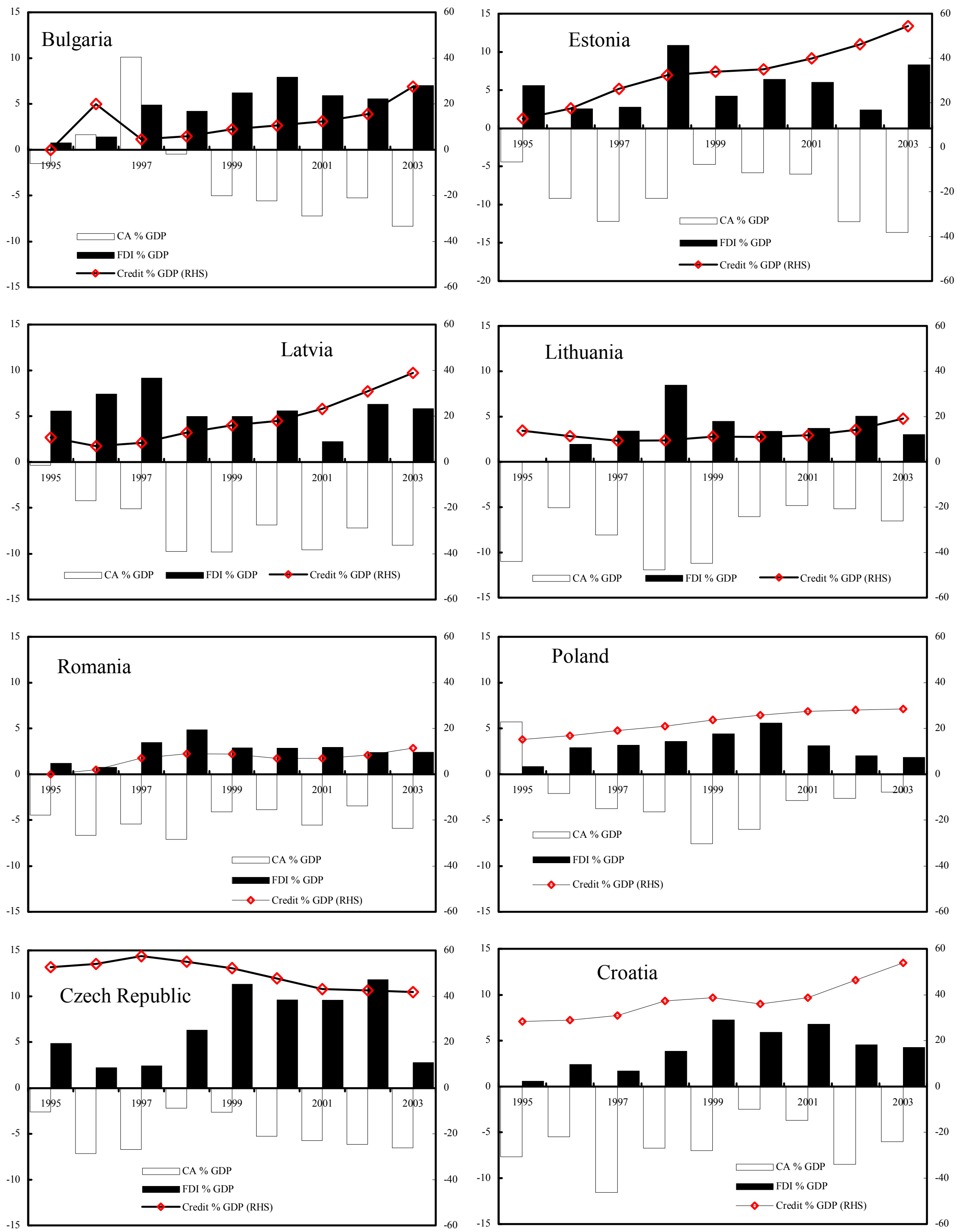
10. **Staff and authorities concurred that the widening external current account deficit had increased macroeconomic risks**. The credit expansion did not raise immediate financial stability issues (see below), but had spurred imports, moving the external deficit into dangerous territory. Stabilizing the external debt ratio with a current account deficit of 8-9 percent of GDP over the medium term would require inflows of FDI in excess of those projected. Moreover, in view of its level, a decline in the debt ratio would reduce external risks.[5] Therefore, over the medium term, with privatization inflows shrinking, staff and authorities concurred that a deficit higher than some 7 percent of GDP would likely involve an increase in the external debt ratio from still sizable levels. Thus, the current external position involved some risks. The authorities noted that, to some extent, these risks were mitigated by the rising export capacity associated with higher investment goods imports. However, staff pointed out that consumer goods imports had also risen rapidly, and that a significant share of investment—two thirds in 2003—was in the nontradable sector and would thus not raise export capacity. Altogether, while markets so far had taken a benign attitude, there was a need to minimize risks, particularly in the context of the CBA, and policies had to be adjusted to gradually reduce the deficit to levels consistent with a medium-term reduction of the external debt ratio.

11. **The current account weakening was seen primarily as reflecting a credit-induced rise in private domestic demand in excess of potential growth**. Competitiveness remained broadly adequate (Box 1 and Figure 5). The CPI-based REER suggested some loss of competitiveness vis-à-vis some non-EU members, but unit labor costs in manufacturing had continued to decline and Bulgaria's share in EU and world imports had risen.

12. **Thus, there was broad agreement that economic policies should aim, in the short run, to contain domestic demand; and in the medium term, to boost export and output capacity**. The authorities noted that focusing only on restrictive policies would not be sustainable over the medium term. Staff agreed, but underscored that relieving the external constraints and accelerating growth would require revitalizing structural reform. In this context, policies to spur FDI would be particularly important, as FDI would support the growth process over the medium term, while financing the external deficit over the short run.

[5] Chapter II of *Selected Issues and Statistical Appendix* (to be issued) discusses external sustainability. Similar trends—rapid credit growth combined with sizable current account deficits financed largely by FDI—were observed in other accession countries (Figure 4).

Figure 4. Economic Indicators in Selected Transition Countries, 1990-2003

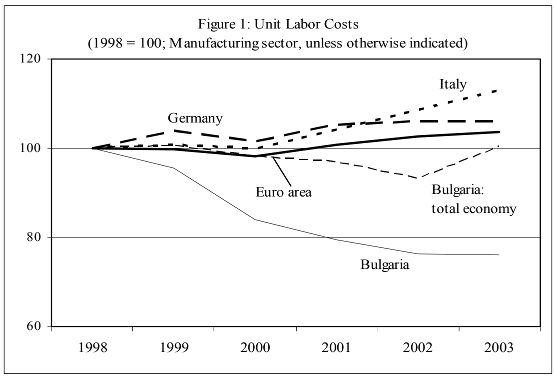


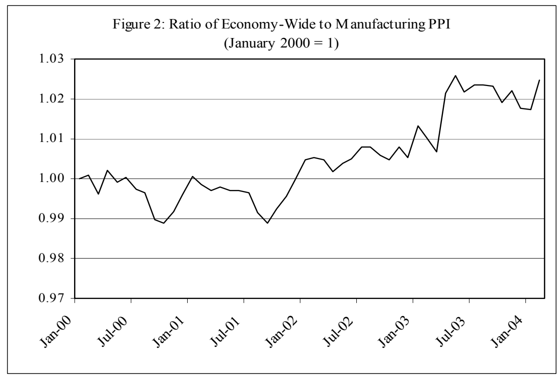
Source: WEO database.

Box 1. Competitiveness Indicators

Bulgaria's competitiveness remains broadly adequate, but warrants close monitoring.

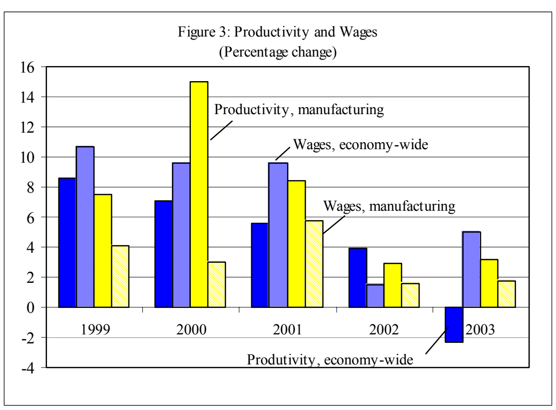
Real effective exchange rate (REER) and unit labor costs (ULCs): Bulgaria's CPI-based REER has recently appreciated more rapidly than the currencies of other CEE countries whose exchange rates are not rigidly pegged to the euro (Figure 5). However, a comparison with the Eurozone indicates that ULCs in manufacturing have declined strongly (Box Figure 1). Also, ULCs in manufacturing decreased while the manufacturing producer price index (PPI) increased, suggesting increasing profitability of Bulgarian producers of tradables. On the other hand, the total PPI recently increased more strongly than the manufacturing PPI, pointing to a shift in relative profitability towards nontradables (Box Figure 2), though this effect is weakened as economy-wide unit labor costs have remained flat while they were falling in manufacturing.

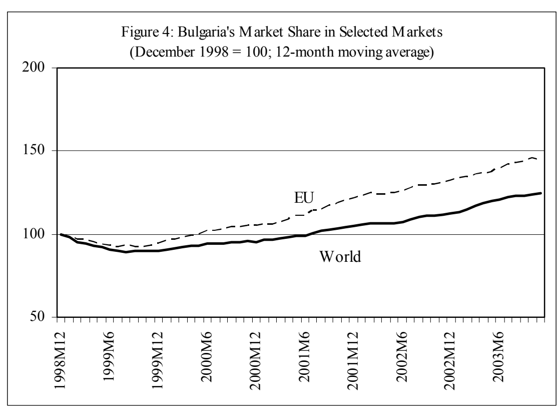




Productivity and wage growth: While economy-wide productivity growth turned negative in 2003, this partly reflected government-sponsored employment creation. Productivity declined only in the services sector, while it has continued to increase in manufacturing, above the rate of real wage growth (Box Figure 3).[1] However, low wages are also a reflection of Bulgaria's apparent lag behind other CEE countries in qualitative productivity indicators, as suggested for example in the recent Lisbon review of competitiveness. [2]

Exports: Despite the appreciation of the euro (and with it, the lev), exports grew rapidly during 2003, and Bulgaria's market share in the EU increased, broadly in line with other CEE countries (with flexible exchange rates) (Figure 5). Bulgaria's share in world imports also increased (Box Figure 4).

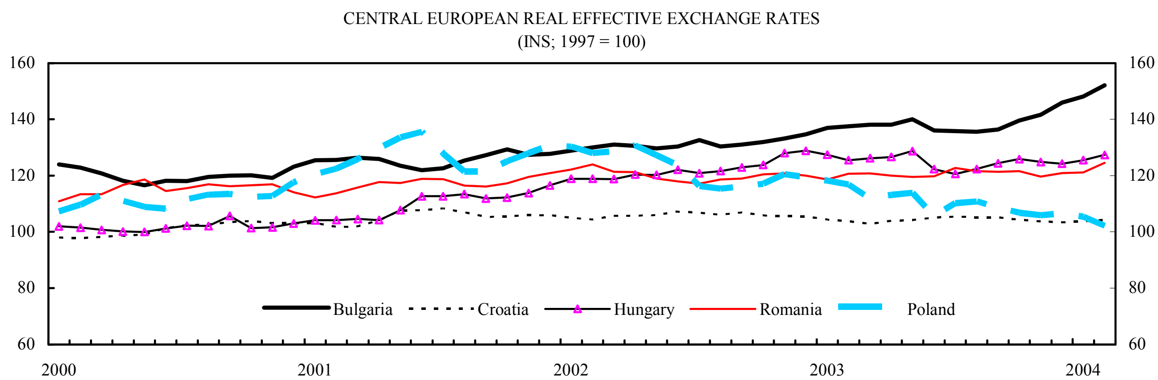


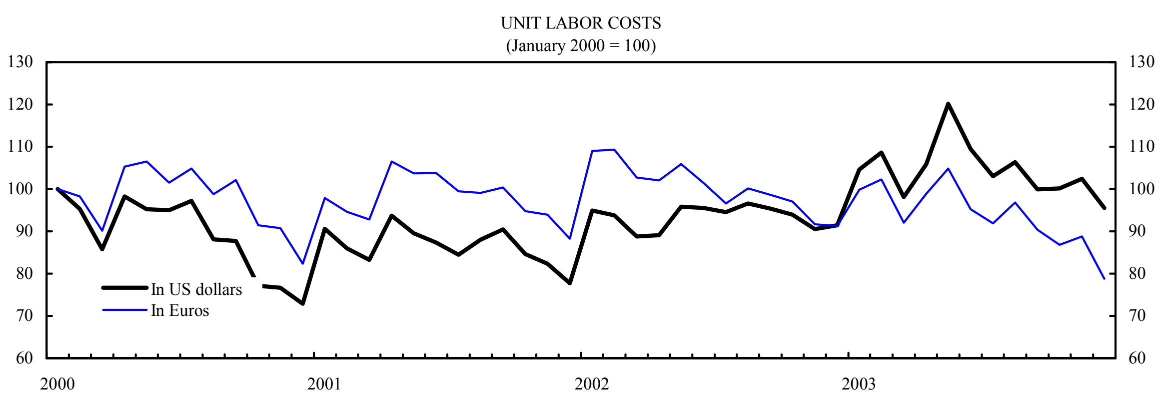


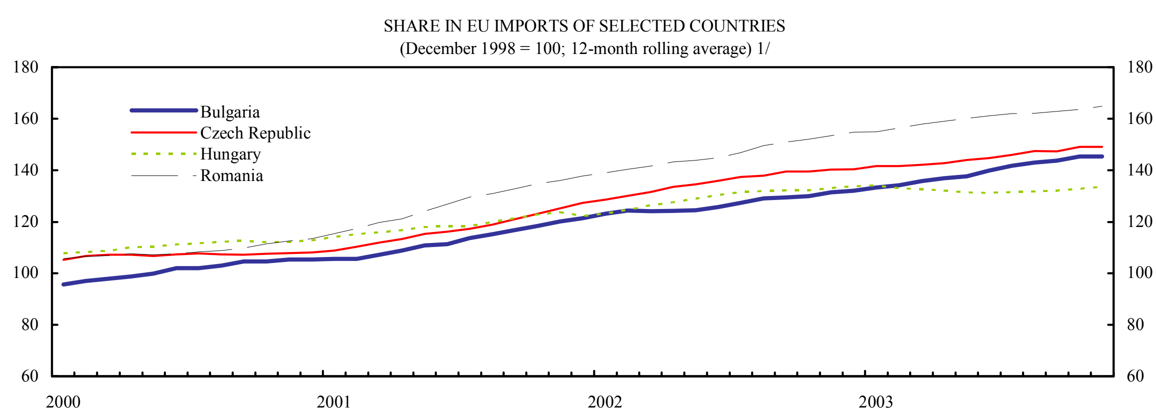
[1] Real wages are calculated by deflating nominal wages by the Eurozone CPI.

[2] World Economic Forum, "The Lisbon Review 2004: An Assessment of Policies and Reforms in Europe."

Figure 5. Bulgaria: Indicators of Competitiveness, 2000-2004







Sources: National Statistical Institute; Direction of Trade Statistics; and Fund staff estimates.

1/ Bulgaria, Czech Republic, and Hungary: Authorities' data; and Romania: Direction of Trade Statistics.

13. **On the tools to contain domestic demand, views were more nuanced**. Staff regarded fiscal policy as the key tool to restrain demand, as the CBA constrained monetary policy actions. The authorities concurred that fiscal policy was critical, but noted that its flexibility during the budget year was limited. Moreover, considerable uncertainty remained on the cyclical strength of demand going forward, and the immediate risks to the external account did not seem excessive. Finally, fiscal policy was constrained by the political difficulty of running surpluses when this was not justified by long-term fiscal needs. Such political constraints were even more acute in the run-up to next year's election. Altogether, their strategy to contain demand involved tightening fiscal policy with respect to initial plans, but also moderating credit growth by draining banking system liquidity. It was agreed that the effectiveness of this policy would depend on the elasticity of capital inflows to domestic monetary conditions. Nonetheless, it was a strategy worth trying, also in light of the difficulties of centering all the adjustment on fiscal policy. However, the authorities should stand ready to tighten fiscal policy and/or implement credit measures beyond current plans if needed.

B. Macroeconomic Framework

14. **Authorities and staff broadly concurred that the 2004 macroeconomic outlook was favorable, assuming appropriate policies** (Figure 6 and Table 9):

- Real GDP growth would increase to 5 percent, as a reduction in the negative external sector contribution—reflecting slower import growth owing to reduced credit expansion—was expected to more than offset the slowdown in domestic demand. From the supply side, output growth should benefit from a recovery in agriculture and high investment.

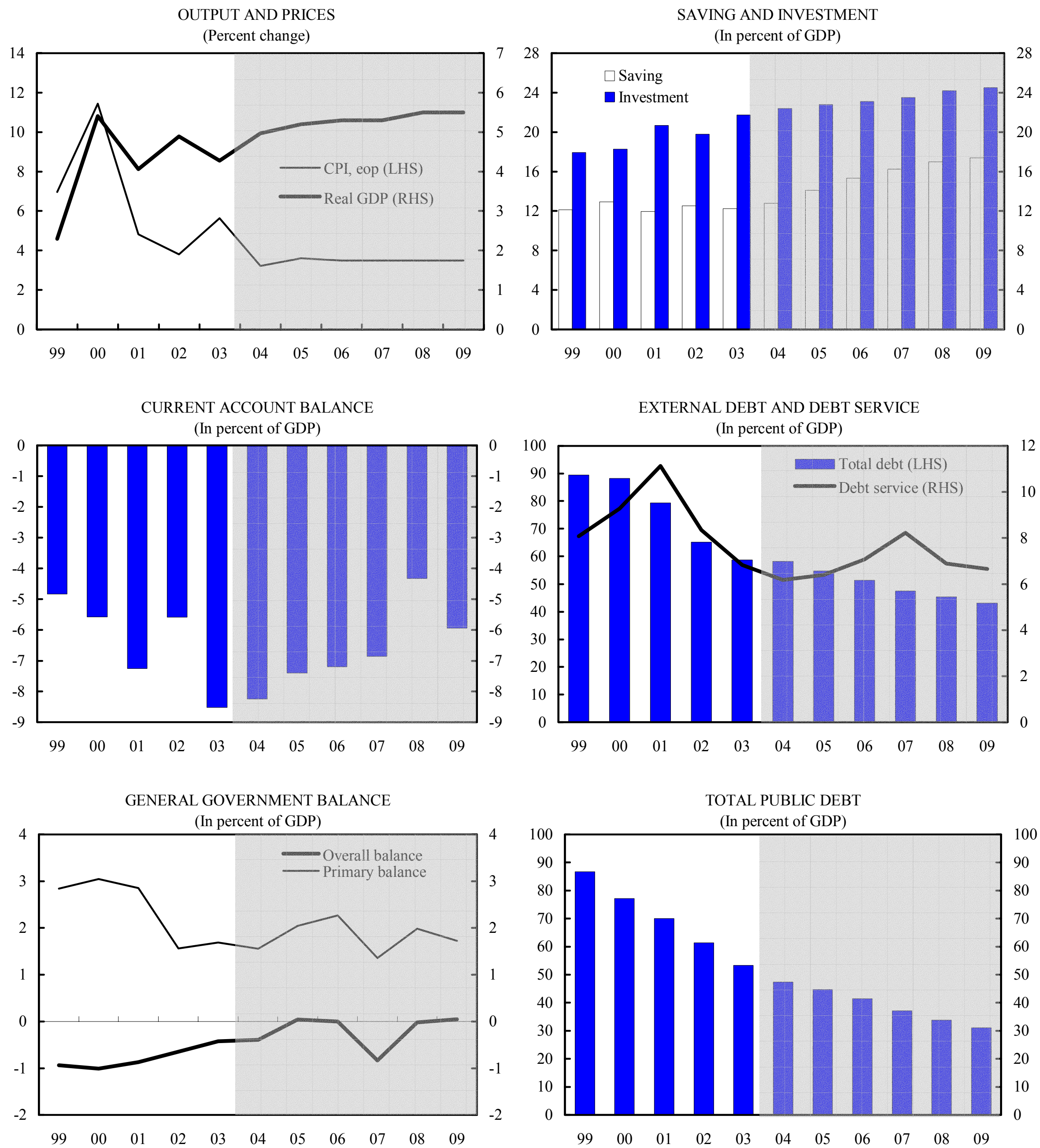
- Average consumer price inflation, at 5¾ percent, would be higher than in 2003, but the 12-month inflation rate should fall to 3½ percent by year-end as the temporary factors driving recent price increases unwind.

- With measures to restrain bank liquidity, growth in credit to the nongovernment sector should fall to 26 percent year on year by end-2004.

- After widening further in the first quarter, the 12-month current account deficit should narrow as credit decelerated, although the deficit was likely to be broadly unchanged for the year as a whole (at 8.2 percent of GDP). A further increase in FDI—owing partly to privatization receipts—should ensure 82 percent coverage of the deficit and, combined with other capital inflows, a further rise in international reserves. The gross external debt ratio would decline by half a percentage point of GDP.

15. **There was also agreement about the risks to this favorable scenario**: (i) credit and import growth might not slow as expected, as capital inflows might replace reduced domestic liquidity; (ii) external demand might be softer than projected, e.g., reflecting a weaker-than-expected recovery in the EU; and (iii) FDI might not develop as expected,

Figure 6. Bulgaria: Baseline Medium-Term Projections, 1999-2009 1/



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

1/ 2003 onward: projections.

e.g., reflecting implementation risk ahead of the election. If these risks materialize, the external position would weaken, possibly requiring further policy adjustment. Another key risk, of a more medium-term nature, is that continued rapid credit expansion might in time lead to increased financial vulnerabilities, including deteriorating bank asset quality and an asset price bubble, with potentially disruptive macroeconomic implications.

16. **The authorities' medium-term outlook envisaged robust growth, low inflation, and a gradual narrowing of the current account deficit** (Table 9).

- Staff concurred that medium-term growth of 5-5½ percent was achievable. This would require an increase in the investment ratio, reforms to boost productivity, and increases in labor force participation and employment in the face of a declining working age population.[6] Inflation should fall to 3½ percent, slightly above EU levels owing to productivity catch-up effects.

- Higher investment needs would be met by a rise in the private saving rate, reflecting higher per capita income, rising corporate profitability, financial deepening, and other structural (e.g., legal) reforms. Public saving would rise due to a shift from current to capital expenditure.

- Reflecting these developments—and in the later years, EU transfers—the current account deficit would decline gradually to 6 percent of GDP by 2009. Initially, relatively high deficits would mostly be covered by FDI, boosted by privatization receipts. Subsequently, declining deficits are expected to be largely financed by greenfield FDI. The external debt ratio would decline to 43 percent, with international reserves remaining at a comfortable level.

- A sustainability exercise shows that only in a scenario featuring lower exports, higher imports and smaller FDI inflows would the external debt ratio rise to 64 percent in 2009 (Tables 10-13).[7]

C. Fiscal Policy

17. **Staff proposed a reclassification of some below-the-line capital transfers as expenditure to reflect the true underlying fiscal stance**. Such transfers were similar to subsidies and had an expansionary demand effect. Staff also urged the authorities to move to accrual accounting in line with international standards.

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[6] See "Bulgaria's Growth Experience and Prospects" IMF Country Report No. 02/173.

[7] For details, see Chapters II and III of *Selected Issues and Statistical Appendix* (to be issued).

18. **The authorities concurred, and presented their fiscal plans for 2004 under the new methodology**. The 2004 budget envisaged a deficit (after reclassification) of 1¼ percent of GDP, a fiscal expansion with respect to the 2003 outcome. In light of the weaker external position, they no longer regarded this expansion as appropriate, and thus intended to implement the budget more restrictively by cutting spending by ¾ percent of GDP this year, bringing the deficit down to ½ percent of GDP.

The Fiscal Balance Under Alternative Definitions

	2003	2004	
	Actual	Budget	Rev. Budget
	(In percent of GDP)		
Overall fiscal balance	**0.0**	**-0.8**	**0.0**
Reclassified below-the-line (B-T-L) operations	0.4	0.4	0.4
Overall fiscal balance including B-T-L operations	**-0.4**	**-1.2**	**-0.4**

19. **Staff would have preferred a more ambitious fiscal adjustment, and suggested saving any revenue overperformance.** Staff argued that it was particularly important that revenue overperformance, which appeared likely given the outcome of the first few months, be saved rather than spent. The authorities acknowledged that the revenue projections, which reflect only a partial offset of lower direct taxes by higher indirect taxes, were conservative. However, they noted that revenue buoyancy would not necessarily mean that domestic demand was rising faster than expected. Altogether, they intended to save up to ½ percent of GDP of any revenue overperformance, potentially bringing the budget into balance this year and achieving a fiscal tightening vis-à-vis 2003. A more ambitious target would be considered only if external developments deviated from their baseline. Staff warned that additional fiscal adjustment could be needed, and that fiscal policy therefore should remain flexible.

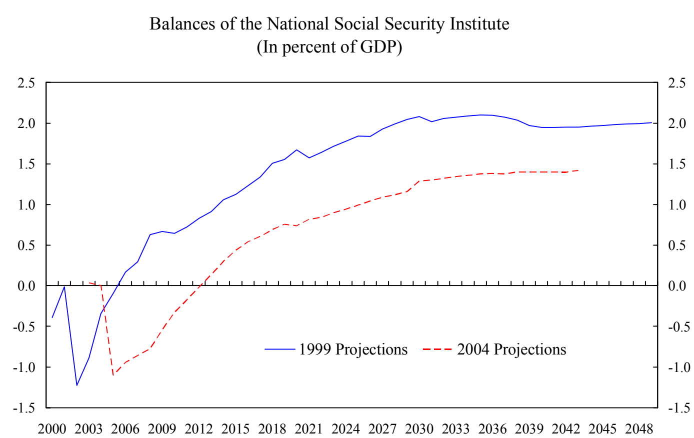
20. **Staff welcomed the intention to focus the fiscal correction on the expenditure side, given inefficiencies in public spending**. To achieve the fiscal tightening, the authorities intended to limit late-year unbudgeted spending by cutting the wage bill (mainly by sequestering unfilled vacancies) and reducing to more realistic levels projections for capital spending and interest payments. Staff welcomed this adjustment, but argued that larger reductions in the wage bill and other current spending would have been preferable. As a precaution, the authorities would continue to cap discretionary spending at 93 percent of the downward revised levels through the third quarter. Given the macroeconomic situation and the need to clarify the scheme for building motorways, the authorities said that the transfer to the road enterprise proposed in the budget would not take place in 2004.

21. **Improved tax administration and expenditure management would help achieve fiscal objectives in 2004 and beyond**. The authorities intended to maintain a tax system with low rates and few exemptions while continuing to shift from direct to indirect taxation. Tax administration would be improved with the implementation of the NRA in 2005. Efforts to combat tax evasion and fraud were being stepped up with the establishment of a "tax police." The 2005 budget preparation was being brought forward, while program budgeting was being introduced in additional ministries. The incorporation of the lev-denominated accounts of all autonomous budgetary entities in the Treasury Single Account as well as the deployment of the Financial Management Information System (FMIS) in all ministries would further enhance expenditure management. Finally, the authorities planned to strengthen local

government finances through closer monitoring. Staff welcomed these measures and urged their expeditious implementation, noting that the NRA and FMIS reforms were well behind schedule.

22. **The authorities were targeting budget balance in 2005-06, but deficits would reemerge from 2007**. Regarding 2005, they noted that if the external position were to improve faster than expected, a small deficit may be envisaged. Detailed policies were still being developed, but the authorities planned to further lower the corporate and personal income tax rates and introduce tax breaks for families. The revenue shortfall was expected to be only partially offset by raising excise taxes toward minimum EU levels and improved tax collection. Staff cautioned that the envisaged changes may threaten the achievement of fiscal balance in 2005. On the expenditure side, better targeted social spending and outlays related to EU accession and infrastructure remained priorities. The wage bill increase in 2005 would be limited to projected inflation, and subsidies further reduced. However, the authorities felt that EU-related expenditure would lead to a deficit of 2-3 percent of GDP from 2007.[8] Staff cautioned that a deficit of this size would reduce the scope for countercyclical fiscal policy, particularly as Bulgaria was likely to be subject to the Maastricht rules soon after EU accession. Staff therefore recommended adjusting priorities to make room for EU-related spending, while allowing a small temporary deficit in 2007 reflecting the pre-payment of agricultural subsidies related to the EU's Common Agricultural Policy.

23. **The authorities concurred on the need to maintain the sustainability of the pension and health insurance systems**. The long-term outlook for the balance of the National Social Security System (NSSI), while weakened since the 1999 reform by various measures that had raised spending, remained favorable. The authorities projected that the deficit would disappear by 2013, with rising surpluses thereafter. But these surpluses would likely be used to strengthen the fully-funded second pillar of the pension system and reduce the high contribution rates. Moreover, the outlook assumed that the current pension indexation practice (¼ wages, ¾ prices) would be maintained. To reduce discretion, staff recommended that this indexation formula be enshrined in law. Also, the certification process for disability pensions needed to be strengthened. The authorities saw merit in staff's suggestions, which they intended to implement soon. Health care faces long-term sustainability risks, and needed reforms include expanding the activity-based financing of hospitals to induce restructuring



[8] Chapter III of *Selected Issues and Statistical Appendix* (to be issued) explores the fiscal requirements of EU accession.

and stricter controls over claims and reimbursements. While generally committed to these reforms, the authorities pointed to the difficulty of overcoming political resistance.

D. Incomes Policy and Labor Market Flexibility

24. **The authorities believed that continued implementation of a strict incomes policy and increasing labor market flexibility were needed to strengthen competitiveness**. They noted that a restrained public sector wage policy would provide guidance to private sector wage bargaining. Along with restraint on the government wage bill, the nominal increase in the aggregate wage bill of the 60 largest public enterprises that are monopolies, were subsidized, or made losses in the third quarter of 2003 would be limited to 4 percent in 2004. The authorities intended, in collaboration with the World Bank, to amend the labor law with a view to making entry to and exit from work more flexible. They planned to continue active labor market policies to reintegrate the long-term unemployed. Staff cautioned that care should be taken to ensure that these policies do not result in prolonged hidden public sector employment.

E. Financial and External Sector Policies

25. **Staff and authorities agreed that increased financial intermediation was good from a structural perspective, after years of depressed bank lending in the wake of the 1996-97 crisis**. Moreover, as confirmed by the FSAP follow-up (Box 2), financial stability and prudential risks did not seem to constitute a major concern at this stage. Staff commended the BNB for tightening loan classification and provisioning requirements, increasing the frequency and focus of on-site inspections, extending its credit register, and restricting the conditions under which current profits can be included in regulatory capital.

26. **However, high credit growth was more problematic from a macroeconomic perspective, and discussions focused on how a deceleration could be achieved.** A reduction in some banks' liquidity and the increasing share of loans in banks' portfolios would likely lead to some deceleration of bank credit even in the absence of new measures. However, in order to minimize risks on the external side, the authorities concurred that credit could be decelerated by (i) transferring certain government deposits held in commercial banks to the BNB; and (ii) tightening reserve requirements by broadening the coverage of liabilities subject to reserve requirements to instruments with maturities of two years or above and excluding part of banks' cash in vault from the reserve requirement calculation. Altogether, these measures—which would be implemented in the second and third quarters of 2004—amount to 13¾ percent of reserve money. While sizable, the efficacy of these measures would depend on the responsiveness of capital flows to domestic monetary conditions, and their effect on credit growth would need to be monitored closely. Staff pointed to the need for further measures—including minimum liquid asset ratios—if these measures did not produce the expected decline in credit growth.

Box 2. FSAP Follow-Up[1]

Bulgaria's banking sector continues to operate in an environment of sound supervision, and high capital, profitability and liquidity levels. So far, financial sector vulnerabilities remain contained, a result supported by the authorities' stress tests. Rapid credit growth remains the key concern. Credit expansion was strongest in new markets, such as consumer and mortgage lending, which, if sustained, could give rise to new sources of vulnerabilities:

- **Credit risk must be monitored closely**. So far, asset quality remains adequate. However, asset quality indicators do not necessarily provide early warnings of future problems and the authorities need to strengthen their ability to monitor the overall indebtedness of the private sector, as credit activities may increasingly shift to the nonbank financial sector.
- **Foreign borrowing may generate foreign exchange risk.** With the exclusion of euros from the prudential open foreign currency position limit, banks may borrow disproportionately from abroad in euros in an effort to sustain credit growth, potentially producing large currency mismatches. However, as balance sheet analyses indicate, this risk is mitigated by large foreign reserves of the BNB.
- **New credit products may introduce liquidity risk and raise interest rate risk**. As banks are increasingly extending longer-term credit, their balance sheets may exhibit wider maturity mismatches, which may need to be regulated. Furthermore, the limited shift to fixed interest rates on longer-term contracts could raise interest rate risk.

The authorities have implemented several FSAP recommendations, including:

- **Creation of a financial sector supervisory coordination committee, and, on its recommendation, a single supervisory agency for nonbank financial institutions**, the Financial Sector Commission. Its supervisory capacity, regulatory framework, and enforcement powers, however, need further strengthening, with a focus on the insurance sector.
- **Introduction of a more effective bank insolvency regime**. However, its implementation remains either largely untested (no new bank insolvency) or slow (in resolving old problem banks).
- **Progress in identifying and assessing the soundness of banks' ownership structure.** Where necessary, a process of capital restructuring and replacement of off-shore shareholders was initiated.
- **Creation of a Council for Financial Stability**. While important for improving inter-agency cooperation, the authorities need to strengthen their ability to monitor and assess how cross-sectoral linkages affect financial stability.
- **Updated payment system,** including the launch of a new real-time interbank gross-settlement system.

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[1]For details, see Chapter IV of *Selected Issues and Statistical Appendix* (to be issued).

27. **The government's financial asset and liability management would also take into account the need to withdraw liquidity from the banking system.** The government's strategy of shifting from external to domestic borrowing would help absorb bank liquidity, and contribute to developing the domestic capital market. Indeed, domestic borrowing could be stepped up for this purpose. As part of their debt management strategy, the authorities are considering prepaying some of their obligations to the Fund, and may buy back or prepay some other external obligations, subject to maintaining an adequate level of international reserves, in excess of base money as required by the CBA.

28. **The authorities' trade policies continue to follow guidance from the European Commission prior to EU accession**. In response to the poor 2003 harvest and the consequent increase in food prices, the authorities introduced a temporary ban on exports of wheat and flour, which is scheduled to expire on July 31, 2004.

F. Other Structural Reforms

29. **The authorities concurred that an improved business climate was essential to stimulate investment and growth.** They were reforming company registration and dispute resolution procedures, judgment enforcement, collateral law, and corporate governance. Furthermore, laws simplifying investment procedures and providing assistance to investors had been submitted to parliament. Staff noted that these laws should avoid special tax incentives. The authorities reported that corruption had been declining and corruption indicators (e.g., Transparency International) placed Bulgaria favorably among other countries in the region. Nevertheless, they remained committed to implementing the 2001 anti-corruption strategy, focusing on reducing corruption in the civil service.

30. **Staff stressed the need to complete pending privatizations and create a new pipeline for 2005-06**. The authorities indicated that the BTC sale was nearly completed, that final bids for the power distribution companies would be accepted by end-June, and that, after a long delay, a new privatization advisor was preparing the companies of Bulgartabac for sale, possibly as early as this year. Looking to 2005-06, staff urged the authorities to develop privatization plans (including for the electricity generation sector), in cooperation with the World Bank, which would allow maintaining a sustained FDI flow and increase efficiency in the energy and transport sectors.

31. **The authorities agreed that further reforms in the railway and energy sectors were critical to the government's medium-term fiscal strategy and to removing impediments to sustained higher growth**. Reform of the energy sector was proceeding well: the energy regulator would announce a 10 percent increase in the average household electricity and district heating prices to take effect on July 1, 2004, thus allowing these utilities to achieve short-term cost recovery—based on estimates made two years ago—and reducing their need for subsidies. Staff recommended articulating a strategy for the electricity sector, in consultation with the World Bank. The authorities reiterated their commitment, in collaboration with the World Bank, to make the railway sector sustainable, by further reducing payroll and increasing tariffs.

IV. Relations with the Fund

32. **Discussions with the authorities and former government officials revealed no major disagreements with the analysis and conclusions of the EPA paper**. Current and former officials had two main comments on the assessment which are reflected in its final version: (i) they emphasized that the recent slowdown of reform reflected greater obstacles compared to the period immediately after the crisis when the case for key reforms was apparent; and (ii) they stressed the critical role of the CBA in restoring the credibility of the economic policy framework.

33. **Looking ahead, the EPA concludes that a program-based engagement would be the most effective way of supporting the government's economic program, given that economic risks are nontrivial and that a program could help mobilize support for appropriate policies on the way to EU accession**. The EPA notes that, following the successful stabilization in 1997, the longer-term program engagement with Bulgaria had not reflected a lack of receptivity to Fund advice, but rather the authorities' appreciation for that advice. As a result, most of the drawbacks usually associated with longer-term program engagement—diminished incentives, loss of credibility for the Fund in supporting weak programs, poor ownership, and a weakening of the surveillance function of the Fund—do not apply to Bulgaria.

V. Other Issues

34. **The authorities reported on further progress in improving data quality and complying with international standards and codes**. Data quality and timeliness are generally adequate for surveillance and program monitoring, but some deficiencies remain (Appendix IV). In December 2003, Bulgaria subscribed to the Special Data Dissemination Standard. The authorities have implemented all but one of the recommendations of the 2002 safeguards assessment—the establishment within the BNB of an audit committee—a function they feel is already performed by the BNB's monetary board. The authorities' efforts to combat money laundering and financing of terrorism have continued since the 2001/02 FSAP, including by bringing the anti-money laundering law into compliance with EU standards and enacting a new law to counter terrorism financing.

VI. Staff Appraisal

35. **Bulgaria's economic performance has remained solid, reflecting prudent macroeconomic policies and progress with structural reforms, but external vulnerability has increased**. The authorities' policy framework, centered on a CBA, has helped to deliver robust growth—despite weak external demand—modest inflation, and falling external and public debt ratios. Significant progress has been made in establishing a flexible market economy, and falling unit labor costs in manufacturing have supported competitiveness. The authorities are committed to continuing this policy approach, which includes maintaining the CBA until euro adoption, implementing prudent fiscal and incomes policies, and reinvigorating structural reforms. While this strategy continues to be well-suited

to Bulgaria's needs, rising external vulnerability highlights the need for vigilance and steadfast policy implementation, especially in the area of structural reform.

36. **Thus, the authorities face considerable challenges, both on the macroeconomic and structural fronts**. The expansion of bank credit is a healthy phenomenon from a structural perspective, and there appears at present to be little threat to financial stability, given strong supervisory practices of the BNB and banks' sound financial position. However, the credit boom has led to an import surge and a sharp widening of the external current account deficit. If left unchecked, rapid credit growth may further exacerbate the external imbalance, possibly leading to a reversal of the favorable external debt dynamics of recent years. On the structural front, progress has slowed: remaining large state monopolies—in particular, BTC and Bulgartabac—have still not been privatized; little progress in reforming the health, education, and railway sectors has been made recently; and further progress is needed to improve the business climate. Reform in these areas is critical to unleash the economy's potential and help reduce vulnerabilities.

37. **To address these challenges, the authorities should tighten macroeconomic policies and advance structural reform more forcefully**. The heightened macroeconomic risks accompanying the credit boom and the widening external imbalance should be countered by a mix of policies—within the constraints of the CBA—to moderate demand and enhance the economy's supply response and export capacity: (i) a more prudent fiscal stance; (ii) draining liquidity from the banking system while pursuing the recommendations of the FSAP follow-up; and (iii) accelerating structural reforms. The timely adoption of such policies would also support maintaining the CBA until euro introduction.

38. **Against this background, the authorities' macroeconomic program for 2004/05 represents an adequate response, although a more ambitious fiscal adjustment would have been preferable, particularly this year**. The authorities should be commended for reversing the expansionary stance underlying the 2004 budget, and for envisaging a tightening in 2005. In this respect, with tax revenues likely to exceed the conservative budget projections, it will be critical that the lowered spending ceilings are not exceeded until budget balance is reached. Thereafter, the authorities should consider saving a portion of any continued revenue overperformance. Without such additional savings, the fiscal target for 2004 involves a broadly neutral stance vis-à-vis 2003, with little dampening effect on domestic demand. A more ambitious fiscal target would haven been preferable, and any deterioration of the current account or inflation would warrant further adjustment. The authorities' willingness to introduce measures to reduce credit growth is also welcome. However, while sizable, their effectiveness remains to be seen in the context of an open capital account. Thus, fiscal flexibility needs to be maintained to respond promptly should credit growth continue to fuel excessive growth in domestic demand and imports.

39. **Considerable pressures threaten the medium-term fiscal position**. The authorities' strategy of shifting from direct to indirect taxation is appropriate, but care needs to be taken that its implementation does not worsen the fiscal balance. The planned reforms to strengthen tax administration and expenditure management are welcome but need to be implemented without delay. Of particular importance are measures to ensure the medium-

term sustainability of the pension and health care systems. As entering ERM2 with a solid fiscal position is important, the authorities should take timely steps to contain the fiscal deficits upon EU accession. The fiscal expansion currently envisaged for 2007 involves significant risks.

40. **The authorities are right in complementing demand management policies with structural reforms aimed at enhancing supply**. Their focus on measures to strengthen the business climate to attract FDI is appropriate in this context. Among these measures, privatization is also critical to meeting Bulgaria's external financing requirements in the next few years and to increasing productivity. For these reasons, the authorities' plans to complete the long-delayed sales of BTC and Bulgartabac are welcome, and they are encouraged to adhere to the schedule for the sale of the electricity distributors. For 2005-06, they should create a new privatization pipeline. These measures need to be supplemented with further reforms in the labor market—in particular, to facilitate entry to and exit from work.

41. **As important macroeconomic risks remain, continued Fund engagement under a successor stand-by arrangement would be appropriate provided that sufficiently strong policies can be agreed**. Fund support would facilitate internal consensus on policy implementation, including in the run-up to next year's election, and provide confidence to foreign investors and lenders. Given the long-term program engagement and the absence of an imminent financing need, a new SBA should have lower access and be precautionary. EU accession, expected in early 2007, would serve as a natural exit from a program-based relationship with the Fund.

42. **Given the strong international reserve position, the authorities' intention to make repayments to the Fund on the expectations schedule is appropriate**. Maintenance of an adequate reserve cover should guide the authorities' plans to prepay external obligations.

43. **Data quality and transparency have improved substantially**. Data are adequate for surveillance and program monitoring, and the BNB's safeguards practices are broadly adequate.

44. **It is proposed that Bulgaria return to the standard 12-month consultation cycle**.

Table 1: Bulgaria: Millennium Development Goals

	1990	1995	2001	2002
Goal 1. Eradicate extreme poverty and hunger				
Target 1: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.				
1. Population below $1 a day (%)	...	4.7	4.7	...
2. Poverty gap at $1 a day (%)	...	1.4	1.4	...
3. Percentage share of income or consumption held by poorest 20%	...	...	6.7	...
Target 2: Halve, between 1990 and 2015, the proportion of people who suffer from hunger.				
4. Prevalence of child malnutrition (% of children under 5)	...	...	...	...
5. Population below minimum level of dietary energy consumption (%)	...	...	...	...
Goal 2. Achieve universal primary education				
Target 3: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.				
6. Net primary enrollment ratio (% of relevant age group)	86.1	89.9	94.3	...
7. Percentage of cohort reaching grade 5 (%)	90.6	93.0	...	...
8. Youth literacy rate (% ages 15-24)	99.4	99.6	99.7	99.7
Goal 3. Promote gender equality				
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.				
9. Ratio of girls to boys in primary and secondary education (%)	94.5	93.6	97.5	...
10. Ratio of young literate females (% ages 15-24)	99.8	99.7	99.8	99.8
11. Share of women employed in the nonagricultural sector (%)	...	...	...	...
12. Proportion of seats held by women in the national parliament (%)	21.0	13.0	11.0	26.0
Goal 4. Reduce child mortality				
Target 5: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.				
13. Under-five mortality rate (per 1,000)	18.7	19.0	16.0	17.1
14. Infant mortality rate (per 1,000 live births)	14.8	14.8	14.0	14.0
15. Immunization , measles (% of children under 12 months)	98.0	94.0	96.0	...
Goal 5. Improve maternal health				
Target 6: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.				
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	23.0	...	...
17. Births attended by skilled health staff (% of total)	...	...	...	...

Table 1: Bulgaria: Millennium Development Goals (Continued)

	1990	1995	2001	2002
Goal 6. Combat HIV/AIDS, malaria and other diseases				
Target 7: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.				
18. Prevalence of HIV, female (% ages 15-24)	...	...	...	...
19. Contraceptive prevalence rate (% of women ages 15-49)	...	...	...	...
20. Number of children orphaned by HIV/AIDS	...	...	...	...
21. Incidence of tuberculosis (per 100,000 people)	...	...	41.0	...
22. Tuberculosis cases detected under DOTS (%)	...	...	22.0	...
Goal 7. Ensure environmental sustainability				
Target 8: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.				
23. Forest area (% of total land area)	31.5	...	33.4	...
24. Nationally protected areas (% of total land area)	...	4.4	4.5	4.5
25. GDP per unit of energy use (PPP $ per kg oil equivalent)	1.8	2.1	2.7	...
26. CO2 emissions (metric tons per capita)	8.6	6.7	5.1	...
27. Access to an improved water source (% of population)	...	...	100.0	...
28. Access to improved sanitation (% of population)	...	...	100.0	...
29. Access to secure tenure (% of population)	...	...	...	...
Goal 8. Develop a global partnership for development				
Target 9: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.				
30. Youth unemployment rate (% of total labor force ages 15-24)	4.7	26.3	34.2	...
31. Fixed line and mobile telephones (per 1,000 people)	...	307.2	550.6	...
32. Personal computers (per 1,000 people)	10.5	16.6	44.3	...
General indicators				
Population	8.7 million	8.4 million	7.9 million	7.9 million
Gross national income ($)	19.7 billion	11.5 billion	13.2 billion	14.1 billion
GNI per capita	$2,260	$1,370	$1,670	$1,790
Adult literacy rate (% of people ages 15 and over)	97.2	97.9	98.5	98.6
Total fertility rate (births per woman)	1.8	1.2	1.3	1.3
Life expectancy at birth (years)	71.4	70.9	71.7	71.8
Aid (% of GNI)	0.1	0.9	2.6	...
External debt (% of GNI)	57.1	81.2	72.6	...
Investment (% of GDP)	25.6	15.7	20.4	20.5
Trade (% of GDP)	69.8	90.9	118.9	110.8

Source: World Development Indicators database, April 2002.

Table 2. Bulgaria: Selected Economic Indicators, 2000-2004

	2000	2001	2002	2003	2004
Output, prices, and employment	(Annual percent change, unless otherwise stated)				
Real GDP	5.4	4.1	4.9	4.3	5.0
Real industrial sales	...	2.8	1.3	17.4	...
Consumer price index (average)	10.4	7.5	5.8	2.3	5.8
(end-of-period)	11.4	4.8	3.8	5.6	3.2
Unemployment rate (in percent)					
Registered unemployment	18.1	17.5	17.4	14.3	...
Labor force survey	16.9	19.8	17.8	16.8	...
Real public sector wages	2.4	6.3	2.5	3.9	...
Real private sector wages	7.8	4.1	-4.1	5.7	...
General government	(In percent of GDP)				
Revenue	38.7	37.6	36.5	37.9	35.4
Noninterest expenditure	35.7	34.7	34.9	36.2	33.9
Primary balance	3.0	2.8	1.6	1.7	1.6
Interest payments	4.0	3.7	2.2	2.1	1.9
Overall balance	-1.0	-0.9	-0.6	-0.4	-0.4
Privatization receipts	1.3	2.9	0.9	1.1	4.1
External financing	-1.5	-0.3	1.5	0.0	0.9
Domestic financing	1.2	-1.7	-1.9	-1.8	-4.6
Public debt (end of period) 1/	77.0	69.9	61.4	53.4	47.3
Domestic public debt (end of period) 1/	6.6	6.2	6.6	6.6	7.2
Money and credit 2/	(Annual percent change, unless otherwise stated)				
Broad money (end of period; millions of leva)	9,857	12,401	13,857	16,566	19,585
Broad money (M3)	30.8	25.8	11.7	19.6	18.2
Lev money	21.4	30.1	13.5	19.5	0.0
Claims on nongovernment	17.0	32.1	44.0	48.3	25.9
FX deposits (euro millions)	2,068	2,516	2,678	2,684	3,944
FX deposits (percent of M3)	41.0	39.7	37.8	37.2	39.4
Broad money to FX reserves ratio	1.3	1.6	1.5	2.0	1.7
Interest rates (annualized)	(In percent)				
BNB basic rate	4.6	4.7	3.4	2.7	...
Time deposit (leva)	3.3	3.4	3.2	3.2	...
Balance of payments	(In millions of Euro, unless otherwise stated)				
Current account balance	-761	-1,102	-924	-1,498	-1,601
(In percent of GDP)	-5.6	-7.3	-5.6	-8.5	-8.2
Trade balance	-1,280	-1,779	-1,692	-2,196	-2,478
Exports, fob	5,253	5,714	6,063	6,663	7,436
Imports, fob	-6,533	-7,493	-7,755	-8,859	-9,914
Gross official reserves (end of period)	3,719	4,063	4,575	5,309	5,775
(In months of prospective imports of GNFS)	4.7	5.0	4.9	5.1	5.1
External debt (end of period) 3/	12,038	12,049	10,769	10,330	11,214
(In percent of GDP)	88.2	79.4	65.1	58.7	58.2
Exchange rates					
Leva per euro	Currency board, peg to euro at lev 1.95583 per euro				
Leva per U.S. dollar (end of period)	2.102	2.219	1.885	1.611	1.614
(yoy percent change, + means depreciation)	8.0	5.6	-15.1	-14.5	0.2
REER (end of period; CPI based)					
(yoy percent change, + means appreciation)	2.7	3.7	5.5	8.3	...

Sources: Bulgarian authorities; and staff estimates.

1/ Domestic debt as reported by Ministry of Finance and external debt as reported by BNB.

2/ Starting in 2002, a new format was adopted for monetary data resulting in revisions to historical series.

3/ Includes trade credits.

Table 3. Bulgaria: Real GDP by Expenditure Category, 1999-2003

	1999	2000	2001	2002	2003
	(Percentage change)				
Real GDP	**2.3**	**5.4**	**4.1**	**4.9**	**4.3**
Final consumption	**8.8**	**5.7**	**4.4**	**3.6**	**6.6**
Private consumption	9.6	4.3	5.2	3.6	6.4
Public consumption	5.0	11.6	1.3	4.1	7.2
Gross capital formation	**10.3**	**13.1**	**20.1**	**4.4**	**16.3**
Gross fixed capital formation	20.8	15.4	23.3	8.5	13.8
Changes in inventories	-25.4	0.2	0.4	-25.8	46.5
Net exports	**59.5**	**34.3**	**64.6**	**-10.6**	**69.7**
Exports of goods and services	-5.0	16.6	10.0	7.0	8.0
Imports of goods and services	9.3	18.6	14.8	4.9	14.8
	(Contribution to real GDP growth) 1/				
Final consumption	**7.3**	**5.0**	**3.8**	**3.2**	**5.7**
Private consumption	6.5	3.1	3.6	2.5	4.4
Public consumption	0.8	1.9	0.2	0.7	1.3
Gross capital formation	**1.7**	**2.3**	**3.7**	**0.9**	**3.2**
Gross fixed capital formation	2.7	2.3	3.7	1.5	2.5
Changes in inventories	-1.0	0.0	0.0	-0.6	0.7
Net exports	**-6.7**	**-2.0**	**-3.5**	**0.8**	**-4.6**
Exports of goods and services	-2.4	7.4	5.6	3.9	4.3
Imports of goods and services	-4.3	-9.4	-9.0	-3.1	-8.9
	(Percentage change in implicit deflators)				
GDP	**3.7**	**6.7**	**6.7**	**3.8**	**2.1**
Final consumption	**3.4**	**5.4**	**6.2**	**4.9**	**1.3**
Gross capital formation	**2.1**	**1.5**	**4.5**	**-0.1**	**0.4**
Net exports	**-5.4**	**-22.4**	**-4.5**	**6.4**	**-7.6**
Exports of goods and services	5.7	20.6	0.7	-2.8	-1.3
Imports of goods and services	4.3	15.0	0.1	-1.8	-2.3
Memorandum items					
Share of domestic demand in nominal GDP	105.8	105.4	107.6	106.6	109.8
Share of net exports in nominal GDP	-5.8	-5.4	-7.6	-6.6	-9.8
Nominal GDP (in millions of leva)	23,790	26,753	29,709	32,335	34,410

Sources: National Statistical Institute and staff estimates.

1/ Sum of contributions to real GDP growth may not add up to total growth due to statistical discrepancy in the official data.

Table 4. Bulgaria: Monetary Survey, 1999-2004
(End-period; in millions of leva unless otherwise stated)

	1999	2000	2001	2002	2003	2004 Proj.
Broad Money 1/	**7,536**	**9,857**	**12,401**	**13,857**	**16,566**	**19,585**
Currency outside banks	1,962	2,374	3,081	3,335	3,874	4,305
Deposits	5,574	7,483	9,319	10,519	12,591	15,098
Lev	2,772	3,438	4,400	5,302	6,514	7,681
Foreign currency	2,802	4,044	4,919	5,218	6,077	7,417
Other	0	0	0	3	102	182
Other Longer-Term Liabilities (not incl. in broad money)	**2,303**	**2,684**	**2,888**	**3,402**	**3,982**	**4,475**
Deposits	0	0	15	94	202	604
Lev	0	0	12	74	118	307
Foreign currency	0	0	2	20	84	297
Other	2,303	2,684	2,874	3,309	3,780	3,871
o/w capital and reserves	2,303	2,684	2,867	3,293	3,726	3,846
Net Foreign Assets	**6,566**	**8,196**	**9,454**	**9,892**	**10,049**	**11,106**
BNB	3,996	4,661	5,485	6,982	8,545	10,005
DMB	2,570	3,535	3,969	2,910	1,504	1,101
Net Domestic Assets	**3,273**	**4,345**	**5,835**	**7,368**	**10,499**	**12,954**
Domestic credit	3,640	4,770	6,009	7,656	10,251	12,736
General government	766	1,408	1,566	1,259	764	792
Non-government	2,874	3,362	4,443	6,397	9,487	11,944
Other items, net	-1,042	-1,185	-1,052	-1,239	-935	-1,002
Fixed assets	674	759	879	951	1,183	1,221
			(12-month percent change)			
Broad Money	13.4	30.8	25.8	11.7	19.6	18.2
Reserve Money	14.1	10.9	33.5	11.2	17.5	13.4
Claims on Nongovernment	21.4	17.0	32.1	44.0	48.3	25.9
Claims on nonfinancial corporations	24.3	16.2	27.1	42.3	37.1	...
Claims on households	9.7	18.5	51.0	48.3	80.7	...
Deposits 2/	13.7	34.2	24.6	12.9	19.7	19.9
Lev	15.7	24.1	28.0	20.5	22.9	17.9
Foreign currency	11.7	44.3	21.6	6.1	16.5	22.1
			(In percent of GDP)			
Broad Money	31.7	36.8	41.7	42.9	48.1	51.6
Claims on Nongovernment	12.1	12.6	15.0	19.8	27.6	31.5
Claims on nonfinancial corporations	9.8	10.1	11.6	15.2	19.6	...
Claims on households	2.2	2.3	3.1	4.3	7.3	...
Memorandum items:						
Reserve money	2,725	3,021	4,033	4,482	5,266	5,970
Currency outside banks	1,962	2,374	3,081	3,335	3,874	4,305
Banks' reserves	763	647	952	1,147	1,392	1,664
Money multiplier (M3/reserve money)	2.8	3.3	3.1	3.1	3.1	3.2
BNB foreign assets/Reserve money (in percent)	236	246	197	200	197	274
Foreign currency deposits (percent of broad money)	37.2	41.0	39.7	37.7	36.7	37.9
DMB NFA/Foreign currency deposits (in percent)	91.7	87.4	80.7	55.8	24.8	14.8
Claims on nongovernment/deposits (in percent)	51.6	44.9	47.7	60.8	75.4	79.1

Sources: Bulgarian National Bank; National Statistical Institute; and staff estimates

1/ In February 2004, monetary data were recast to further harmonize with ECB requirements. Among the changes is the creation of a new category outside the money supply called long-term liabilities (see category immediately below). This includes deposits and securities with a maturity over 2 years, deposits redeemable at notice over three months, and capital and reserves.

2/ Deposits included in M3.

Table 5. Bulgaria: Selected Vulnerability Indicators, 2000-2003

	2000	2001	2002	2003	
Key Economic and Market Indicators					
Real GDP growth (in percent)	5.4	4.1	4.9	4.3	Q4-03
CPI inflation (period average, in percent) 1/	10.4	7.5	5.8	2.3	Q4-03
Short-term (ST) interest rate (in percent)	4.6	4.7	3.4	2.7	Dec-03
EMBI + secondary market spread (bps; end of period)	772	433	291	177	Dec-03
Exchange rate NC/US$ (end of period)	2.1	2.2	1.9	1.5	Dec-03
External Sector					
Exchange rate regime	Currency board, peg to euro at lev 1.95583 per euro				
Current account balance (percent of GDP) 2/	-5.6	-7.3	-5.6	-8.5	Q4-03
Net FDI inflows (percent of GDP) 3/	8.1	5.9	5.8	7.0	Q4-03
Export growth (Euro value, GNFS) 4/	40.6	6.3	5.5	10.7	Q4-03
Real effective exchange rate (1995 = 100; end of period))	127.5	132.1	139.4	151.0	Dec-03
Gross international reserves (GIR) in Euro billion	3.7	4.1	4.6	5.3	Dec-03
GIR in percent of ST debt at remaining maturity	238.6	293.8	258.1	269.2	Dec-03
Total gross external debt in percent of GDP	88.2	79.4	65.1	58.7	Dec-03
o/w ST debt (original maturity in percent of GDP)	11.4	9.1	10.7	11.2	Dec-03
Private sector debt (in percent of GDP)	14.9	14.9	17.0	18.0	Dec-03
Total gross external debt in percent of exports of GNFS	158.0	148.8	126.1	109.3	Dec-03
Gross external financing requirement (in Euro billion)	...	...	2.6	3.3	Q4-03
Public Sector 5/					
Overall balance (percent of GDP)	-1.0	-0.9	-0.6	-0.4	Dec-03
Primary balance (percent of GDP)	3.0	2.8	1.6	1.7	Dec-03
Public sector gross debt (in percent of GDP)	80.5	69.6	60.2	52.2	Dec-03
o/w External debt from official creditors (in percent of total)	38.8	36.1	36.2	37.6	Dec-03
External debt from private creditors (in percent of total)	50.2	52.6	48.6	44.1	Dec-03
Domestic debt linked to foreign currency (in percent of total)	3.5	3.5	3.5	4.5	Dec-03
Domestic debt linked to ST interest rate or inflation (in percent of total)	0.0	0.0	0.0	0.0	
Public sector net debt (in percent of GDP) 6/	76.3	65.4	49.4	40.7	Dec-03
Financial Sector 7/					
Capital adequacy ratio (in percent)	35.6	31.3	25.2	22.0	Q4-03
NPLs in percent of total loans 8/	17.3	13.1	8.6	7.3	Q4-03
Provisions in percent of NPLs 8/	65.8	61.6	65.0	53.0	Q4-03
Return on average assets (in percent)	3.1	2.9	2.1	2.4	Q4-03
FX deposits (in percent of total deposits)	54.0	52.7	49.3	48.2	Dec-03
FX deposits (in percent of gross international reserves)	55.6	61.9	58.5	59.3	Dec-03
FX loans (in percent of total loans)	35.4	35.5	41.3	42.8	Dec-03
Net open forex position (sum of on- and off- balance sheet exposure) (in percent of capital) 9/	-5.2	-5.2	-4.2	-4.9	Q4-03

Sources: Bulgarian authorities; and Fund staff estimates.

1/ The latest figure is the 12-month rate of inflation as of the indicated period.
2/ 12-month current account in percent of 12-month GDP.
3/ 12-month net FDI inflows in percent of 12-month GDP.
4/ Year-on-year growth rate.
5/ General government.
6/ Public sector gross debt minus balance of the fiscal reserve account.
7/ Commercial banks.
8/ Total loans exclude interbank loans. Non-performing loans including watch, substandard, doubtful, and loss.
9/ Does not include off-balance sheet items.

Table 6. Bulgaria: Balance of Payments, 2000-2009
(In millions of euros)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
					Projections					
CURRENT ACCOUNT	-761	-1,102	-924	-1,498	-1,601	-1,561	-1,651	-1,709	-1,172	-1,755
Trade balance	-1,280	-1,779	-1,692	-2,196	-2,478	-2,534	-2,653	-2,784	-2,972	-3,218
Exports (f.o.b.)	5,253	5,714	6,063	6,663	7,436	8,244	8,973	9,920	11,014	12,212
y-o-y change (in percent)	40.7	8.8	6.1	9.9	11.6	10.9	8.8	10.6	11.0	10.9
Imports (f.o.b.)	-6,533	-7,493	-7,755	-8,859	-9,914	-10,778	-11,625	-12,705	-13,986	-15,430
y-o-y change (in percent)	37.8	14.7	3.5	14.2	11.9	8.7	7.9	9.3	10.1	10.3
Services, net	547	454	486	524	615	702	871	977	1,013	1,123
Of which: Exports of travel services	1,168	1,084	1,203	1,460	1,613	1,706	1,824	1,934	2,030	2,135
Income, net	-345	-340	-285	-439	-410	-540	-741	-911	-1,049	-1,212
Of which: Income to direct investors	-116	-166	-242	-343	-308	-423	-518	-640	-738	-847
Current transfers, net	316	562	567	613	671	811	872	1,010	1,837	1,552
CAPITAL AND FINANCIAL ACCOUNT	950	1,527	1,656	2,280	2,052	1,696	1,730	1,628	2,068	2,094
Capital transfers, net	25	0	0	0	0	0	0	0	0	0
Foreign direct investment, net 1/	1,100	893	951	1,235	1,314	1,366	1,186	1,280	1,435	1,522
Of which: Privatization receipts	396	21	144	323	360	330	50	50	0	0
Portfolio investment, net	-192	94	-99	-192	-139	-137	-67	-348	-85	-116
Other investment, net	-9	-232	979	883	794	466	612	696	718	688
General government	-235	-341	-144	55	282	271	160	157	126	120
Domestic banks	-389	-92	437	552	173	-157	-26	-59	-71	-48
Other private sector	614	201	686	275	340	353	478	598	663	617
Errors and omissions	26	772	-174	354	83	0	0	0	0	0
OVERALL BALANCE	188	426	732	781	451	135	80	-81	896	339
FINANCING	-188	-426	-732	-781	-451	-135	-80	81	-896	-339
Gross international reserves (increase: -) 2/	-492	-318	-578	-817	-406	79	192	305	-773	-277
Use of Fund credit, net	151	-185	-155	35	-45	-214	-272	-224	-123	-63
Purchases	294	141	117	128	62	0	0	0	0	0
Repurchases 3/	-143	-326	-271	-92	-107	-214	-272	-224	-123	-63
Exceptional financing	153	78	0	0	0	0	0	0	0	0
MEMORANDUM ITEMS										
Gross international reserves (stock, e.o.p.) 4/	3,719	4,063	4,575	5,309	5,715	5,636	5,444	5,139	5,912	6,189
In months of prospective GNFS imports	4.7	5.0	4.9	5.1	5.0	4.6	4.1	3.5	3.7	...
In percent of short-term debt	238.6	293.8	259.8	268.9	265.9	253.9	234.6	203.0	211.2	201.3
Excess international reserves (stock, e.o.p.) 5/	2,178	2,002	2,282	2,617	2,662	...	...	...	...	...
In percent of short-term debt	139.8	144.7	129.6	132.6	123.9	...	...	...	...	...
Current account + FDI	338	-209	27	-263	-287	-195	-465	-429	263	-233
(in percent of GDP)	2.5	-1.4	0.2	-1.5	-1.5	-0.9	-2.0	-1.7	1.0	-0.8
Current account (in percent of GDP)	-5.6	-7.3	-5.6	-8.5	-8.2	-7.4	-7.2	-6.9	-4.3	-5.9
Merchandise trade account (in percent of GDP)	-9.4	-11.7	-10.2	-12.5	-12.8	-12.0	-11.6	-11.2	-11.0	-10.9
Merchandise exports (in percent of GDP)	38.5	37.6	36.7	37.9	38.3	39.1	39.2	39.9	40.6	41.4
Merchandise imports (in percent of GDP)	-47.9	49.3	46.9	50.4	51.1	51.1	50.8	51.0	51.6	52.3
Export volume (year-on-year change)	16.6	11.8	9.8	16.6	11.9	11.1	10.8	10.6	10.4	10.2
Import volume (year-on-year change)	2.1	19.8	6.7	20.1	14.6	11.4	9.8	9.7	10.1	9.8
FDI (net) in percent of current account	144.4	81.0	102.9	82.4	82.1	87.5	71.8	74.9	122.5	86.7
Gross external debt (stock, e.o.p.)	12,038	12,049	10,769	10,330	11,305	11,550	11,751	11,822	12,273	12,722
(In percent of GDP)	88.2	79.4	65.1	58.7	58.2	54.8	51.3	47.5	45.3	43.1
Public	10,006	9,792	7,961	7,156	7,745	7,872	7,906	7,629	7,635	7,630
Private	2,032	2,257	2,808	3,174	3,560	3,678	3,844	4,193	4,638	5,092
Short-term debt (in percent of total debt, e.o.p.)	12.9	11.5	16.4	19.1	19.0	19.2	19.8	21.4	22.8	24.2
GDP	13,646	15,184	16,533	17,594	19,416	21,079	22,906	24,892	27,101	29,507

Sources: Bulgarian authorities, and Fund staff estimates.

1/ All FDI is assumed non-debt creating.
2/ Excluding valuation changes.
3/ According to expectations schedule.
4/ Historical number include valuation changes.
5/ Gross international reserves minus reserve money.
6/ External debt minus gross foreign assets of the banking system.

Table 7. Bulgaria: General Government, 2000-2007
(In millions of leva)

	2000	2001	2002	2003	2004	2005	2006	2007
					Projections			
Total revenue and grants	10,361	11,164	11,799	13,052	13,450	14,441	15,692	17,639
Tax revenue	8,005	8,517	8,873	10,214	10,622	11,487	12,489	13,531
Profit taxes	736	1,150	976	1,032	937	948	1,030	1,120
Nonfinancial enterprises	619	812	871	899	815	866	941	1,022
Financial enterprises	117	339	105	133	122	82	90	97
Income taxes	1,098	1,063	1,052	1,140	1,109	1,237	1,344	1,461
VAT	2,359	2,454	2,688	3,101	3,336	3,589	3,901	4,239
Excise and fuel duties	1,131	1,107	1,314	1,544	1,747	1,938	2,150	2,337
Customs duties	221	195	188	231	204	224	241	261
Social insurance contributions	2,241	2,311	2,352	2,806	2,945	3,179	3,417	3,673
Pension and unemployment contributions 1/	1,795	1,822	1,839	2,192	2,309	2,495	2,682	2,883
Health Insurance Fund	446	489	513	614	636	684	735	790
Other taxes	218	236	303	359	344	373	405	441
Nontax revenues	2,153	2,284	2,625	2,527	2,364	2,407	2,604	2,818
BNB transfers	137	175	173	133	156	140	140	140
Other	2,016	2,109	2,452	2,394	2,208	2,267	2,464	2,678
Grants and donations	204	363	301	312	465	546	599	1,290
Total expenditure and net lending	10,631	11,423	12,009	13,197	13,602	14,424	15,694	18,046
Noninterest expenditure, net lending, contingency	9,547	10,317	11,296	12,473	12,862	13,599	14,678	16,980
Current noninterest expenditure	8,050	8,812	10,061	11,190	11,385	11,639	12,467	14,287
Compensation	1,283	1,196	1,379	1,552	1,547	1,601	1,656	1,712
Wages and salaries	1,256	1,159	1,338	1,506	1,504	1,558	1,613	1,669
Scholarships	28	37	41	45.4	43	43	43	43
Maintenance and operations	2,073	1,876	2,200	2,389	2,260	2,391	2,598	2,824
Defense and security	896	957	1,066	1,107	1,181	1,237	1,331	1,480
Subsidies	250	709	772	887	683	618	605	974
Social expenditures	3,548	4,074	4,634	5,106	5,546	5,792	6,277	6,772
Pension fund	2,372	2,586	2,944	3,161	3,376	3,578	3,808	4,138
Assistance and unemployment	901	858	1,007	1,004	1,147	1,072	1,165	1,217
Health Insurance Fund	103	404	498	720	770	890	986	1,071
Other social expenditures 2/	172	225	185	221	254	251	319	346
Transfers 3/	...	...	...	149	167	...	...	525
Capital expenditures	1,125	1,198	1,046	1,189	1,275	1,732	1,971	2,483
Contingency	311	245	189	95	202	228	240	210
Enterprise restructuring	110	18	0	0	146	168	170	140
Budget	165	188	143	48				
Natural disaster	36	39	46	46	56	60	70	70
Primary balance	814	847	503	579	589	841	1,014	660
Interest	1,083	1,106	713	724	740	825	1,016	1,067
External	818	853	544	561	550	671	828	834
Domestic	265	253	169	163	191	154	188	232
Overall balance 4/	-269	-259	-210	-145	-152	16	-3	-407
Financing	269	259	210	145	152	-16	3	407
Privatization 5/	345	861	286	387	1,549	646	98	98
External (net)	-404	-96	481	-2	338	125	-846	-1,626
Domestic (net)	328	-506	-558	-240	-1,735	-787	750	1,935
Banking system	...	...	...	...	-1,750	-907	600	1,775
Nonbank	...	...	...	...	137	120	150	160
Acquisition of assets	...	...	...	...	-122	...	...	...
Memorandum item:								
Nominal GDP in millions of leva	26,753	29,709	32,335	34,410	37,973	41,226	44,801	48,685

Sources: Ministry of Finance; and staff projections.

1/ Pension and unemployment contributions were combined in January 2002.
2/ Includes additional compulsory social security contributions (for the second pillar of the pension system) for public sector employees.
3/ Under the 2003 and 2004 budget, these transfers were envisaged to be made below the line for various purposes. From 2007 includes contribution to EU budget.
4/ The deficit is 2007 is due to the pre-payment of subsidies related to the Common Agricultural Policy to farmers, which are expected to be refunded to the government the following year through a transfer from the EU.
5/ Slight differences between privatization receipts in the balance of payments and the fiscal accounts are due to domestic privatization. In 2004, however, 500 million leva (1.3 percent of GDP) of previously completed bank privatizations will be transferred to the government upon the closure of the Bank Consolidation Company.

Table 8. Bulgaria: General Government, 2000-2007
(In percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
					Projections			
Total revenue and grants	38.7	37.6	36.5	37.9	35.4	35.0	35.0	36.2
Tax revenue	29.9	28.7	27.4	29.7	28.0	27.9	27.9	27.8
Profit taxes	2.8	3.9	3.0	3.0	2.5	2.3	2.3	2.3
Nonfinancial enterprises	2.3	2.7	2.7	2.6	2.1	2.1	2.1	2.1
Financial enterprises	0.4	1.1	0.3	0.4	0.3	0.2	0.2	0.2
Income taxes	4.1	3.6	3.3	3.3	2.9	3.0	3.0	3.0
VAT	8.8	8.3	8.3	9.0	8.8	8.7	8.7	8.7
Excise and fuel duties	4.2	3.7	4.1	4.5	4.6	4.7	4.8	4.8
Customs duties	0.8	0.7	0.6	0.7	0.5	0.5	0.5	0.5
Social insurance contributions	8.4	7.8	7.3	8.2	7.8	7.7	7.6	7.5
Pension and unemployment contributions 1/	6.7	6.1	5.7	6.4	6.1	6.1	6.0	5.9
Health Insurance Fund	1.7	1.6	1.6	1.8	1.7	1.7	1.6	1.6
Other taxes	0.8	0.8	0.9	1.0	0.9	0.9	0.9	0.9
Nontax revenues	8.0	7.7	8.1	7.3	6.2	5.8	5.8	5.8
BNB transfers	0.5	0.6	0.5	0.4	0.4	0.3	0.3	0.3
Other	7.5	7.1	7.6	7.0	5.8	5.5	5.5	5.5
Grants and donations	0.8	1.2	0.9	0.9	1.2	1.3	1.3	2.7
Total expenditure and net lending	39.7	38.4	37.1	38.4	35.8	35.0	35.0	37.1
Noninterest expenditure, net lending, contingency	35.7	34.7	34.9	36.2	33.9	33.0	32.8	34.9
Current noninterest expenditure	30.1	29.7	31.1	32.5	30.0	28.2	27.8	29.3
Compensation	4.8	4.0	4.3	4.5	4.1	3.9	3.7	3.5
Wages and salaries	4.7	3.9	4.1	4.4	4.0	3.8	3.6	3.4
Scholarships	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Maintenance and operations	7.7	6.3	6.8	6.9	6.0	5.8	5.8	5.8
Defense and security	3.3	3.2	3.3	3.2	3.1	3.0	3.0	3.0
Subsidies	0.9	2.4	2.4	2.6	1.8	1.5	1.4	2.0
Social expenditures	13.3	13.7	14.3	14.8	14.6	14.0	14.0	13.9
Pension fund	8.9	8.7	9.1	9.2	8.9	8.7	8.5	8.5
Assistance and unemployment	3.4	2.9	3.1	2.9	3.0	2.6	2.6	2.5
Health Insurance Fund	0.4	1.4	1.5	2.1	2.0	2.2	2.2	2.2
Other social expenditures 2/	0.6	0.8	0.6	0.6	0.7	0.6	0.7	0.7
Transfers 3/	...	...	...	0.4	0.4	...	...	1.1
Capital expenditures	4.2	4.0	3.2	3.5	3.4	4.2	4.4	5.1
Contingency	1.2	0.8	0.6	0.3	0.5	0.6	0.5	0.4
Enterprise restructuring	0.4	0.1	0.0	0.0	0.4	0.4	0.4	0.3
Budget	0.6	0.6	0.4	0.1	0.0	0.0	0.0	0.0
Natural disaster	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.1
Primary balance	3.0	2.8	1.6	1.7	1.6	2.0	2.3	1.4
Interest	4.0	3.7	2.2	2.1	1.9	2.0	2.3	2.2
External	3.1	2.9	1.7	1.6	1.4	1.6	1.8	1.7
Domestic	1.0	0.9	0.5	0.5	0.5	0.4	0.4	0.5
Overall balance 4/	-1.0	-0.9	-0.6	-0.4	-0.4	0.0	0.0	-0.8
Financing	1.0	0.9	0.6	0.4	0.4	0.0	0.0	0.8
Privatization 5/	1.3	2.9	0.9	1.1	4.1	1.6	0.2	0.2
External (net)	-1.5	-0.3	1.5	0.0	0.9	0.3	-1.9	-3.3
Domestic (net)	1.2	-1.7	-1.7	-0.7	-4.6	-1.9	1.7	4.0
Banking system	...	...	...	...	-4.6	-2.2	1.3	3.6
Nonbank	...	...	...	...	0.4	0.3	0.3	0.3
Acquisition of assets	...	...	...	...	-0.3	...	...	...
Memorandum item:								
Nominal GDP in millions of leva	26,753	29,709	32,335	34,410	37,973	41,226	44,801	48,685

Sources: Ministry of Finance; and staff projections.

1/ Pension and unemployment contributions were combined in January 2002.
2/ Includes additional compulsory social security contributions (for the second pillar of the pension system) for public sector employees.
3/ Under the 2003 and 2004 budget, these transfers were envisaged to be made below the line for various purposes. From 2007 includes contribution to EU budget.
4/ The deficit is 2007 is due to the pre-payment of subsidies related to the Common Agricultural Policy to farmers, which are expected to be refunded to the government the following year through a transfer from the EU.
5/ Slight differences between privatization receipts in the balance of payments and the fiscal accounts are due to domestic privatization. In 2004, however, 500 million leva (1.3 percent of GDP) of previously completed bank privatizations will be transferred to the government upon the closure of the Bank Consolidation Company.

Table 9. Bulgaria: Macroeconomic Framework, 2000-2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
				prel.			Projections			
GDP and prices (annual percent change)										
Real GDP	5.4	4.1	4.9	4.3	5.0	5.2	5.3	5.3	5.5	5.5
GDP deflator	6.7	6.7	3.8	2.1	5.1	3.2	3.2	3.2	3.2	3.2
CPI (end of period)	11.4	4.8	3.8	5.6	3.2	3.6	3.5	3.5	3.5	3.5
(period average)	10.4	7.5	5.8	2.3	5.8	3.6	3.5	3.5	3.5	3.5
Monetary aggregates (annual percent change)										
Broad money (nominal, end of period)	30.8	25.8	11.7	19.6	18.2	16.3	12.2	13.4	13.7	12.5
Credit to non-government (nominal, end of period)	17.0	32.1	44.0	48.3	25.9	20.1	14.4	12.0	13.1	12.5
Saving and investment (in percent of GDP)										
Foreign saving 1/	5.4	8.7	7.3	9.5	9.6	8.7	7.8	7.3	7.2	7.1
Gross national saving	12.7	13.4	14.2	13.2	14.1	15.4	15.9	16.6	19.9	18.6
Gross domestic saving 2/	12.9	12.0	12.5	12.2	12.8	14.1	15.3	16.2	17.0	17.4
Government	6.3	6.0	4.3	4.7	4.4	5.9	6.2	6.0	7.2	6.8
Non-government	6.7	5.9	8.2	7.6	8.4	8.2	9.1	10.3	9.8	10.6
Gross domestic investment	18.3	20.7	19.8	21.7	22.4	22.8	23.1	23.5	24.2	24.5
Government	4.2	4.0	3.2	3.5	3.4	4.2	4.4	5.1	5.7	5.5
Non-government	14.1	16.6	16.6	18.3	19.0	18.6	18.7	18.4	18.5	19.0
General government (in percent of GDP)										
Revenue	38.7	37.6	36.5	37.9	35.4	35.0	35.0	36.2	37.8	37.2
Non-interest expenditure	35.7	34.7	34.9	36.2	33.9	33.0	32.8	34.9	35.8	35.5
Primary balance	3.0	2.8	1.6	1.7	1.6	2.0	2.3	1.4	2.0	1.7
Interest payments	4.0	3.7	2.2	2.1	1.9	2.0	2.3	2.2	2.0	1.7
Overall balance 3/	-1.0	-0.9	-0.6	-0.4	-0.4	0.0	0.0	-0.8	0.0	0.0
Total public debt	77.1	69.9	61.3	53.4	47.3	44.6	41.5	37.1	33.8	31.1
Of which : External	70.5	63.7	54.8	46.8	40.1	37.0	33.5	29.1	25.9	23.4
Balance of payments (in millions of euros)										
Current account	-761	-1,102	-924	-1,498	-1,601	-1,561	-1,651	-1,709	-1,172	-1,755
Trade balance	-1,280	-1,779	-1,692	-2,196	-2,478	-2,534	-2,653	-2,784	-2,972	-3,218
Exports	5,253	5,714	6,063	6,663	7,436	8,244	8,973	9,920	11,014	12,212
Imports	6,533	7,493	7,755	8,859	9,914	10,778	11,625	12,705	13,986	15,430
Services, net	547	454	486	524	615	702	871	977	1,013	1,123
Receipts	2,366	2,385	2,479	2,790	3,221	3,540	3,870	4,218	4,580	4,995
Payments	1,819	1,930	1,993	2,267	2,606	2,837	2,999	3,241	3,567	3,873
Income, net	-345	-340	-285	-439	-410	-540	-741	-911	-1,049	-1,212
Memorandum items										
Gross official reserves (in millions of euros)	3,719	4,063	4,575	5,309	5,715	5,636	5,444	5,139	5,912	6,189
(in months of prospective imports of GNFS)	4.7	5.0	4.9	5.2	5.0	4.6	4.1	3.5	3.7	...
Current account balance (in percent of GDP)	-5.6	-7.3	-5.6	-8.5	-8.2	-7.4	-7.2	-6.9	-4.3	-5.9
External debt/GDP (in percent)	88.2	79.4	65.1	58.7	58.2	54.8	51.3	47.5	45.3	43.1
External debt/exports of GNFS (in percent)	158.0	148.8	126.1	109.3	106.1	98.0	91.5	83.6	78.7	73.9
External debt service/exports of GNFS (in percent)	16.6	20.8	16.4	12.5	11.2	11.7	13.0	15.0	12.8	12.5
Export growth (percent change)	40.7	8.8	6.1	9.9	11.6	10.9	8.8	10.6	11.0	10.9
Import growth (percent change)	37.8	14.7	3.5	14.2	11.9	8.7	7.9	9.3	10.1	10.3
Terms of trade (percent change)	-10.6	1.8	-0.6	-1.1	2.3	2.2	0.0	0.4	0.6	0.1
Nominal GDP (in millions of leva)	26,753	29,709	32,335	34,410	37,973	41,226	44,801	48,685	53,006	57,711
Nominal GDP (in millions of euros)	13,646	15,184	16,533	17,594	19,416	21,079	22,906	24,892	27,101	29,507

Sources: Bulgarian authorities; and staff projections.

1/ Net imports of goods and nonfactor services.

2/ Gross domestic saving equals gross national saving less net factor income and transfers from abroad. The government contribution to gross domestic saving equals revenues less current expenditures, excluding external interest payments.

3/ From 2003 onwards, includes below-the-line transfers. In 2003, balance excluding below-the-line transfers was 0.0 percent of GDP.

Table 10. Bulgaria: External Debt Sustainability Framework, 1998-2009
(In percent of GDP, unless otherwise indicated)

		Actual							Prel.	Projections						
		1998	1999	2000	2001	2002			2003	2004	2005	2006	2007	2008	2009	
										I. Baseline Projections						Debt-stabilizing non-interest current account 6/
1	**External debt**	83.1	89.5	88.2	79.4	65.1			**58.7**	**58.2**	**54.8**	**51.3**	**47.5**	**45.3**	**43.1**	**-6.4**
2	Change in external debt	-17.3	6.3	-1.2	-8.9	-14.2			-6.4	-0.5	-3.4	-3.5	-3.8	-2.2	-2.2	
3	Identified external debt-creating flows (4+8+9)	-13.3	-7.8	-12.6	-7.0	-5.0			-1.2	-4.0	-3.7	-2.3	-2.4	-4.8	-2.9	
4	Current account deficit, excluding interest payments	-4.0	1.1	1.5	3.4	3.4			6.4	6.3	5.5	5.0	4.5	2.0	3.6	
5	Deficit in balance of goods and services	-0.2	5.8	5.4	8.7	7.3			9.5	9.6	8.7	7.8	7.3	7.2	7.1	
6	Exports	47.6	44.6	55.8	53.3	51.7			53.7	54.9	55.9	56.1	56.8	57.5	58.3	
7	Imports	47.4	50.4	61.2	62.1	59.0			63.2	64.5	64.6	63.8	64.1	64.8	65.4	
8	Net non-debt creating capital inflows (negative)	-5.8	-6.3	-8.3	-5.3	-4.2			-5.7	-6.7	-6.5	-5.2	-5.1	-5.3	-5.2	
9	Automatic debt dynamics 1/	-3.5	-2.5	-5.8	-5.1	-4.2			-1.8	-3.6	-2.7	-2.1	-1.7	-1.5	-1.3	
10	Contribution from nominal interest rate	4.2	3.7	4.1	3.9	2.2			2.1	1.9	1.9	2.2	2.4	2.3	2.4	
11	Contribution from real GDP growth	-3.7	-1.8	-4.3	-3.2	-3.6			-2.6	-2.7	-2.8	-2.7	-2.5	-2.4	-2.3	
12	Contribution from price and exchange rate changes 2/	-4.0	-4.5	-5.5	-5.7	-2.9			-1.3	-2.9	-1.8	-1.7	-1.6	-1.5	-1.4	
13	Residual, incl. change in gross foreign assets (2-3)	-4.0	14.1	11.3	-1.9	-9.2			-5.3	3.5	0.2	-1.2	-1.4	2.6	0.7	
	External debt-to-exports ratio (in percent)	174.5	200.4	158.0	148.8	126.1			109.3	106.1	98.0	91.5	83.6	78.7	73.9	
	Gross external financing need (in billions of euros) 3/	1.8	2.5	2.7	3.8	3.3			4.1	4.4	4.7	5.0	5.6	5.1	6.0	
	in percent of GDP	16.2	20.3	20.0	24.8	20.1	5-Year Historical Average	5-Year Standard Deviation	23.1	22.7	22.2	21.9	22.3	18.7	20.4	Projected Average
	Key Macroeconomic Assumptions															
	Real GDP growth (in percent)	4.0	2.3	5.4	4.1	4.9	4.1	1.2	4.3	5.0	5.2	5.3	5.3	5.5	5.5	5.2
	Exchange rate appreciation (Euro value of local currency, change in percent)	-15.8	1.9	-0.1	0.2	0.0	-24.9	31.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	GDP deflator in euros (change in percent)	4.2	5.7	6.6	6.9	3.8	5.4	1.4	2.1	5.1	3.2	3.2	3.2	3.2	3.2	3.3
	Nominal external interest rate (in percent)	4.5	4.9	5.1	4.9	3.1	4.5	0.8	3.5	3.6	3.6	4.4	5.0	5.4	5.7	4.5
	Growth of exports (Euro terms, in percent)	-23.7	1.3	40.6	6.3	5.5	6.0	22.9	10.7	12.7	10.6	9.0	10.1	10.3	10.3	10.5
	Growth of imports Euro terms, in percent)	-8.9	15.0	36.4	12.8	3.4	11.8	16.7	14.1	12.5	8.8	7.4	9.0	10.1	10.0	10.3
	Current account balance, excluding interest payments	4.0	-1.1	-1.5	-3.4	-3.4	-1.1	3.0	-6.4	-6.3	-5.5	-5.0	-4.5	-2.0	-3.6	-4.7
	Net non-debt creating capital inflows	5.8	6.3	8.3	5.3	4.2	6.0	1.5	5.7	6.7	6.5	5.2	5.1	5.3	5.2	5.7
										II. Stress Tests for External Debt Ratio						Debt-stabilizing non-interest current account 6/
	A. Alternative Scenario															
	A1. Key variables are at their historical averages in 2004-09 4/								**58.7**	**54.5**	**47.2**	**38.9**	**30.7**	**26.9**	**21.4**	**-5.8**
	A2. Country-specific Scenario -- Higher trade deficit and lower FDI 2004-2009 5/								**58.7**	**60.4**	**61.1**	**60.4**	**60.8**	**62.9**	**64.1**	**-5.6**
	B. Bound Tests															
	B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005								**58.7**	**59.6**	**57.5**	**53.9**	**50.0**	**47.7**	**45.5**	**-6.5**
	B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**58.7**	**59.9**	**57.9**	**53.9**	**49.5**	**47.1**	**44.6**	**-6.8**
	B3. Change in euro GDP deflator is at historical average minus two standard deviations in 2004 and 2005								**58.7**	**59.5**	**56.1**	**52.4**	**48.4**	**46.0**	**43.7**	**-6.6**
	B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005								**58.7**	**59.0**	**57.1**	**53.5**	**49.6**	**47.3**	**45.1**	**-6.5**
	B5. Combination of 2-5 using one standard deviation shocks								**58.7**	**58.5**	**55.1**	**51.5**	**47.6**	**45.4**	**43.2**	**-6.7**
	B6. One time 30 percent nominal depreciation in 2004								**58.7**	**80.5**	**73.3**	**66.4**	**59.3**	**55.6**	**51.2**	**-8.9**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in euro terms, g = real GDP growth rate, e = nominal appreciation (increase in euro 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/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

5/ Nominal export growth at 95 percent of baseline scenario, nominal import growth at 105 percent of baseline scenario, net FDI (excluding privatization) at 80 percent of baseline scenario, and no privatization of energy generation companies and Bulgartabac.

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

Table 11. Bulgaria: External Sustainability Framework--Gross External Financing Need, 1998-2009

	Actual					Prel.	Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
						I. Baseline Projections						
Gross external financing need in billions of euros 1/	1.8	2.5	2.7	3.8	3.3	4.1	4.4	4.7	5.0	5.6	5.1	6.0
in percent of GDP	16.2	20.3	20.0	24.8	20.1	23.1	22.7	22.2	21.9	22.3	18.7	20.4
						II. Stress Tests						
Gross external financing need in billions of euros 2/												
A. Alternative Scenario												
A1. Key variables are at their historical averages in 2004-08						4.1	3.4	3.6	3.5	3.5	3.2	3.2
B. Bound Tests												
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005						4.1	4.7	5.1	5.2	5.8	5.3	6.3
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						4.1	4.4	4.6	4.9	5.4	4.9	5.8
B3. Change in euro GDP deflator is at historical average minus two standard deviations in 2004 and 2005						4.1	4.4	4.6	5.0	5.5	5.0	5.9
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005						4.1	4.6	5.1	5.2	5.8	5.3	6.2
B5. Combination of 2-5 using one standard deviation shocks						4.1	4.1	4.4	4.9	5.4	4.9	5.8
B6. One time 30 percent nominal depreciation in 2004						4.1	4.0	4.2	4.4	4.8	4.3	5.0
Gross external financing need in percent of GDP 2/												
A. Alternative Scenario												
A1. Key variables are at their historical averages in 2004-09						23.1	17.7	16.8	15.1	13.6	11.3	10.2
A2. Country-specific Scenario -- Higher trade deficit and lower FDI 2004-2009 3/						23.1	23.7	25.6	28.7	33.0	33.3	38.2
B. Bound Tests												
B1. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005						23.1	24.1	24.2	22.8	23.3	19.6	21.3
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						23.1	23.2	23.3	22.9	23.2	19.4	21.0
B3. Change in euro GDP deflator is at historical average minus two standard deviations in 2004 and 2005						23.1	23.0	22.7	22.3	22.7	19.0	20.7
B4. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005						23.1	23.5	24.2	22.7	23.1	19.4	21.2
B5. Combination of 2-5 using one standard deviation shocks						23.1	21.7	22.0	22.2	22.6	18.8	20.6
B6. One time 30 percent nominal depreciation in 2004						23.1	29.5	28.4	27.5	27.3	22.7	24.0

1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/Nominal export growth at 95 percent of baseline scenario, nominal import growth at 105 percent of baseline scenario, net FDI (excluding privatization) at 80 percent of baseline scenario, and no privatization of energy generation companies and Bulgartabac.

Table 12. Bulgaria: Public Debt Sustainability Framework, 1998-2009
(In percent of GDP, unless otherwise indicated)

	Actual 1998	1999	2000	2001	2002			Prel. 2003	Projections 2004	2005	2006	2007	2008	2009	
									I. Baseline Projections						Debt-stabilizing primary balance 9/
1 **Public sector debt 1/**	83.2	86.7	77.1	69.9	61.3			**53.4**	**47.3**	**44.6**	**41.5**	**37.1**	**33.8**	**31.1**	**2.2**
o/w foreign-currency denominated	78.8	78.8	70.1	66.5	58.0			49.3	43.3	39.7	36.2	31.9	28.1	25.4	
2 Change in public sector debt	-30.3	3.5	-9.6	-7.1	-8.6			-7.9	-6.1	-2.7	-3.2	-4.3	-3.3	-2.8	
3 Identified debt-creating flows (4+7+12)	-11.8	2.1	-5.6	-5.5	-2.6			-2.4	-6.7	-3.5	-2.0	-1.1	-1.6	0.2	
4 Primary deficit	-5.2	-2.8	-3.0	-2.8	-1.6			-1.7	-1.6	-2.0	-2.3	-1.4	-2.0	-1.7	
5 Revenue and grants	35.4	38.5	38.7	37.6	36.5			37.9	35.4	35.0	35.0	36.2	37.8	37.2	
6 Primary (noninterest) expenditure	30.2	35.7	35.7	34.7	34.9			36.2	33.9	33.0	32.8	34.9	35.8	35.5	
7 Automatic debt dynamics 2/	-12.3	-0.9	-5.6	-3.9	-3.5			-1.6	-3.1	-1.7	-1.3	-1.1	-1.0	-1.1	
8 Contribution from interest rate/growth differential 3/	-21.0	-1.0	-5.6	-3.9	-3.5			-1.6	-3.1	-1.7	-1.3	-1.1	-1.0	-1.1	
9 Of which contribution from real interest rate	-17.5	0.8	-1.4	-1.1	-0.3			0.9	-0.7	0.5	0.9	0.9	0.8	0.6	
10 Of which contribution from real GDP growth	-3.5	-1.8	-4.2	-2.8	-3.1			-2.5	-2.4	-2.3	-2.2	-2.0	-1.9	-1.7	
11 Contribution from exchange rate depreciation 4/	8.8	0.1	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	
12 Other identified debt-creating flows	5.6	5.9	3.0	1.3	2.5			0.9	-2.1	0.3	1.5	1.3	1.4	3.0	
13 Privatization receipts (negative)	-1.5	-2.1	-1.3	-2.9	-0.9			-1.1	-4.1	-1.6	-0.2	-0.2	0.0	0.0	
14 Recognition of implicit or contingent liabilities	7.1	8.0	4.3	4.2	3.3			2.0	2.0	1.9	1.7	1.5	1.4	1.3	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	1.7	
16 Residual, including asset changes (2-3)	-18.5	1.4	-4.0	-1.6	-6.1			-5.6	0.6	0.8	-1.1	-3.2	-1.7	-3.0	
Public sector debt-to-revenue ratio 1/	235.1	225.0	199.0	186.1	168.0			140.7	133.5	127.4	118.3	102.5	89.5	83.5	
Gross financing need 5/	8.9	7.6	7.0	6.1	4.8			4.1	2.4	2.5	2.9	4.7	2.8	2.5	
in billions of euros	1.0	0.9	1.0	0.9	0.8			0.7	0.5	0.5	0.7	1.2	0.7	0.7	
Key Macroeconomic and Fiscal Assumptions						5-Year Historical Average	5-Year Standard Deviation								Projected Average
Real GDP growth (in percent)	4.0	2.3	5.4	4.1	4.9	4.1	1.2	4.3	5.0	5.2	5.3	5.3	5.5	5.5	5.2
Average nominal interest rate on public debt (in percent) 6/	4.8	4.8	5.3	5.4	3.4	4.7	0.8	3.7	4.0	4.6	5.5	5.7	5.9	5.4	5.0
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-18.9	1.1	-1.4	-1.3	-0.3	-4.2	8.3	1.6	-1.1	1.4	2.3	2.5	2.7	2.2	1.7
Nominal appreciation (increase in euro value of local currency, in percent)	-9.1	-0.1	0.0	0.0	0.0	-1.8	4.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	23.7	3.7	6.7	6.7	3.8	8.9	8.4	2.1	5.1	3.2	3.2	3.2	3.2	3.2	3.3
Growth of real primary spending (deflated by GDP deflator, in percent)	25.9	20.7	5.4	1.3	5.5	11.8	10.8	8.2	-1.9	2.5	4.6	12.1	8.3	4.6	5.5
Primary deficit	-5.2	-2.8	-3.0	-2.8	-1.6	-3.1	1.3	-1.7	-1.6	-2.0	-2.3	-1.4	-2.0	-1.7	-1.8
									II. Stress Tests for Public Debt Ratio						Debt-stabilizing primary balance 9/
A. Alternative Scenario															
A1. Key variables are at their historical averages in 2004-09 7/								**53.4**	**44.7**	**39.2**	**33.4**	**25.8**	**20.4**	**15.7**	**1.9**
B. Bound Tests															
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005								**53.4**	**53.8**	**56.3**	**52.8**	**48.2**	**44.5**	**41.4**	**1.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**53.4**	**49.9**	**51.0**	**49.8**	**47.5**	**46.3**	**45.4**	**1.8**
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005								**53.4**	**48.4**	**47.2**	**43.9**	**39.5**	**36.1**	**33.3**	**2.0**
B4. Combination of 2-4 using one standard deviation shocks								**53.4**	**50.6**	**50.5**	**47.1**	**42.6**	**39.1**	**36.2**	**2.0**
B5. One time 30 percent real depreciation in 2004 8/								**53.4**	**72.2**	**68.6**	**64.7**	**59.8**	**55.8**	**52.3**	**1.4**
B6. 10 percent of GDP increase in other debt-creating flows in 2004								**53.4**	**57.3**	**54.3**	**50.8**	**46.2**	**42.7**	**39.6**	**1.8**

1/ This represents gross public sector debt, and thus is different from general government debt figures shown elsewhere.
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 euro).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (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/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).
9/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table 13. Bulgaria: Public Debt Sustainability Framework--Gross Public Sector Financing Need, 1998-2009
(In percent of GDP, unless otherwise indicated)

	Actual					Prel.	Projections					
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
						I. Baseline Projections						
Gross financing need 1/	8.9	7.6	7.0	6.1	4.8	4.1	2.4	2.5	2.9	4.7	2.8	2.5
in billions of euros	1.0	0.9	1.0	0.9	0.8	0.7	0.5	0.5	0.7	1.2	0.7	0.7
						II. Stress Tests						
Gross financing need 2/												
A. Alternative Scenario												
A1. Key variables are at their historical averages in 2003-08						4.1	-0.7	-1.2	-1.1	-0.7	-1.6	-1.9
B. Bound Tests												
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005						4.1	9.1	8.9	4.2	6.4	4.2	3.9
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						4.1	3.6	5.2	5.9	8.4	6.7	6.7
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005						4.1	3.5	4.3	3.2	5.0	3.0	2.8
B4. Combination of 2-4 using one standard deviation shocks						4.1	4.9	4.6	3.6	5.5	3.5	3.2
B5. One time 30 percent real depreciation in 2004						4.1	3.3	4.9	5.7	8.2	5.7	5.4
B6. 10 percent of GDP increase in other debt-creating flows in 2004						4.1	2.8	3.5	4.0	6.1	4.0	3.7
Gross financing need in billions of euros 2/												
A. Alternative Scenario												
A1. Key variables are at their historical averages in 2004-09						0.7	-0.1	-0.3	-0.2	-0.2	-0.4	-0.5
B. Bound Tests												
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005						0.7	1.8	1.9	1.0	1.6	1.1	1.2
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005						0.7	0.7	1.0	1.3	2.0	1.7	1.8
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005						0.7	0.7	0.9	0.7	1.2	0.8	0.8
B4. Combination of 2-4 using one standard deviation shocks						0.7	0.9	0.9	0.8	1.3	0.9	0.9
B5. One time 30 percent real depreciation in 2004						0.7	0.4	0.7	0.8	1.3	1.0	1.0
B6. 10 percent of GDP increase in other debt-creating flows in 2004						0.7	0.5	0.7	0.9	1.5	1.1	1.1

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

BULGARIA: FUND RELATIONS
As of March 31, 2004

I. **Membership Status**: Joined 09/25/1990; Article VIII 09/24/1998

II. **General Resources Account**:	SDR million	%Quota
Quota	640.20	100.0
Fund holdings of currency	1,445.52	225.79
Reserve position in Fund	32.78	5.12

III. **SDR Department**:	SDR million	%Allocation
Holdings	80.20	N/A

IV. **Outstanding Purchases and Loans**:	SDR million	%Quota
Stand-by	240.00	37.49
EFF	588.40	91.91
STF	9.69	1.51

V. **Financial Arrangements**:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
Stand-by	02/27/2002	03/15/2004	240.00	240.00
EFF	09/25/1998	09/24/2001	627.62	627.62
Stand-by	04/11/1997	06/10/1998	371.90	371.90

VI. **Projected Payments to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):[9]

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	76.13	178.07	225.76	186.01	102.39
Charges/Interest	13.35	15.64	11.22	6.54	3.04
Total	89.48	193.71	236.97	192.55	105.42

[9] On expectation basis.

VII. **Safeguards Assessment**:

Under the Fund's safeguards assessment policy, the Bulgarian National Bank (BNB) was subject to an assessment with respect to the SBA arrangement which was approved on February 27, 2002. The assessment, which was completed on June 12, 2002, identified certain weaknesses and made appropriate recommendations, as reported in IMF Country Report No. 02/174. The BNB has implemented most of the safeguards recommendations and committed to implementing the remaining ones. Currently, the BNB is subject to a subsequent assessment with respect to the expected new arrangement. The necessary documentation has been provided by the authorities and the assessment is underway.

VIII. **Exchange Arrangement**:

An amendment to the Law on the Bulgarian National Bank (BNB) effectively established a currency board arrangement from July 1, 1997. The deutsche mark was chosen as the peg currency, which has since been replaced with the euro at the rate of lev 1.95583 per € 1 at par. The BNB is required to sell and purchase on demand and without restriction currencies of EU member countries for leva on the basis of spot exchange rates that may not differ from the official exchange rate by more than 0.5 percent. Bulgaria has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement, and maintains an exchange rate system that is free of restrictions on the making of payments and transfers for current international transactions.

IX. **Article IV Consultation**:

The last Article IV consultation was concluded on July 22, 2002 (see IMF Country Report No. 02/174). Bulgaria is on a 24-month cycle. The Acting Chairman's summing-up of the discussion was circulated as SUR/02/80.

X. **FSAP Participation and ROSCs**:

Bulgaria participated in an FSAP held from October 29 to November 14, 2001. Table 14 provides information on the production of ROSCs.

XI. **Technical Assistance**

Table 15 provides information on IMF technical assistance activities in Bulgaria.

Table 14. Bulgaria: ROSCs

Standard/code assessed	Date of issuance	Document number
ROSC update – Data dissemination and fiscal transparency.	08/07/2002	IMF Country Report No. 02/172
ROSC – Monetary and financial policy transparency, banking supervision, securities regulation, insurance regulation, and payment systems	07/15/2002	IMF Country Report No. 02/188
ROSC update – Data dissemination, fiscal transparency, transparency of monetary and financial policies, banking supervision, deposit insurance, insurance supervision, securities market supervision	03/08/2001	www.imf.org
ROSC – Data dissemination, fiscal transparency, transparency of monetary policy, banking supervision, system of deposit insurance, insurance supervision, securities market supervision	03/17/2000	www.imf.org
Experimental ROSC – Data transparency, fiscal transparency, transparency of monetary policy, banking supervision, system of deposit insurance, insurance supervision, securities market supervision, insurance supervision, accounting and auditing practices	08/27/1999	www.imf.org

XII. **Resident Representatives**:

Mr. James Roaf took up the resident representative position on August 24, 2003.

Table 15. Bulgaria: Technical Assistance, 1998–2003

Dept.	Subject/Identified Need	Action	Timing	Counterpart
MAE	Banking supervision/debt management	Mission	Apr. 98	BNB
MAE	Organization and management	Expert	Jun., Sep., Dec. 98	BNB
MAE	Information technology	Expert	Nov. 98	BNB
MAE	Cash processing	Expert	Dec. 98	BNB
MAE	Foreign exchange	Expert	98-99 various visits	BNB
MAE	Payment system	Expert	Jan. 99	BNB
MAE	Banking supervision, organization and management	Mission	Mar.-Apr. 99	BNB
MAE	Accounting	Expert	Jun. & Aug./Sep.99	BNB
MAE	Transparency Report/Based Core Principles	Mission	Jul. 99	BNB
MAE	Deposit insurance	Mission	Oct. 99	BNB
MAE	Payment system/liquidity management/ bank bankruptcy legislation	Mission	May 00	BNB
MAE	Bank bankruptcy legislation	Expert	Jun. 00	BNB
MAE	Foreign exchange	Mission	Nov. 00	BNB
MAE	Accounting	Mission	Dec. 00	BNB
MAE	Short-term advisor payment system	Expert	Jun. 01	BNB
MAE	Review of TA needs resulting from FSAP	Mission	May 02	BNB
FAD	Tax administration	Expert	Feb.-Aug. 98	MOF
FAD	Public expenditure management	Mission	Mar. 98	MOF
FAD	Tax administration	Mission	Aug. 98	MOF
FAD	Resident treasury advisor	Expert	Since Oct. 98	MOF
FAD	Collection of tax and social security contributions	Mission	May 99	MOF
FAD	Treasury system	Mission	Sep. 99	MOF
FAD/WB	Implementation strategy	Mission	Jan. 00	MOF
FAD	Unified revenue agency (URA)	Mission	Jan.-Feb. 00	MOF
FAD	National revenue agency	Expert	Apr-Jun. 00	MOF
FAD	Tax administration	Mission	May 00	MOF
FAD	Short-term resident advisor on the URA	Expert	May-Jun. 00	MOF
FAD	National revenue agency	Mission	Jun. 00	MOF
FAD	Social security administration	Expert	Jun. 00	MOF
FAD	Long-term resident advisor	Expert	Sep. 00-Sep. 01	MOF
FAD	National revenue agency	Mission	Jan. 01	MOF
FAD	Budget reform	Mission	Jan.-Feb. 01	MOF
FAD	Budget and treasury reform	Mission	Jun. 01	MOF
FAD	Tax administration - follow-up	Mission	Sep. 01	MOF
FAD	National revenue agency	Expert	Oct.-Sep. 01	MOF
FAD	Customs administration	Mission	Oct.-Nov. 01	MOF
FAD	Tax administration	Mission	Sep. 01	MOF
FAD	Revenue administration	Mission	Apr. 02	MOF
FAD	Long-term resident advisor	Expert	Apr. 02- Mar. 03	MOF
FAD	Tax policy	Mission	Apr. 02	MOF
FAD		Advisor Visit	Sep.-Oct. 02	MOF
FAD		Advisor Visit	Mar.-Apr. 03	MOF
STA	Producer prices	Mission	Apr. -May 98	NSI
STA	BOP statistics	Mission	Jun.-Jul. 99	BNB
STA	GDDS	Mission	Jul. 99	BNB
STA	National accounts	Mission	Nov. 99	NSI
STA	Price statistics	Mission	Jun. 00	NSI
STA	BOP statistics	Mission	Dec. 00	BNB
STA	Producer prices	Mission	Nov. 01	NSI
STA	Producer prices	Mission	Apr. 02	NSI
STA	Price statistics	Mission	May 02	NSI
STA	Producer prices	Mission	Jan 03	NSI
STA	SDSS	Mission	Sep. 03	BNB

Bulgaria: IMF-World Bank Relations

A. Partnership in Bulgaria's Development Strategy

1. The government's economic program has been underpinned by a conservative fiscal policy and significant progress with structural reforms. So far Bulgaria has made substantial progress towards long-term macroeconomic stability—an important step along the way to its ultimate goals of improving living standards and accession to the EU. The wide-ranging reforms in the government's agenda hinge on the continuing challenge of macroeconomic stability in the context of the Currency Board Arrangement (CBA), sustaining structural reforms and establishing a business environment conducive to growth, together with improved governance, a deeper financial system, and investment in human capital and physical infrastructure.

2. The IMF has been leading in supporting Bulgaria's medium-term program in maintaining macroeconomic stability. Building on the achievements of the three-year Extended Fund Facility (EFF) arrangement with Bulgaria, in February 2002 the IMF Board approved a two-year Stand-By Arrangement (SBA) with Bulgaria. The SBA, with a reduced scope and detail of structural conditionality compared to the EFF, focused on medium-term fiscal challenges and structural reforms with significant macroeconomic, typically fiscal, implications. Currently the IMF and the government are discussing a new 2-year precautionary program.

3. The World Bank has been leading the policy dialogue in structural and institutional reforms aiming at (i) promoting competitive private sector-led growth; (ii) strengthening market institutions and improving both corporate and public sector governance; and (iii) mitigating the social impact of restructuring and delivering social services more effectively. In May 2002 the Board of Directors discussed the Country Assistance Strategy (CAS) of the Bank which outlined the roadmap for the Bank's country support for the period 2002–04. In addition to the Bank's ongoing lending operations in areas such as health, child welfare, water, trade and transport, environment, land registration and cadastre, the CAS includes a three-year programmatic adjustment lending (PAL) program of up to three PALs of up to US$150 million each. In February 2003, the Board of Directors approved the first PAL operation—it aimed at advancing structural, regulatory, and institutional reforms in the real and financial sectors. The second PAL, PAL-2, aims at supporting improvements in public sector governance. The Bank continues to undertake substantive country 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

4. In general, 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, typically fiscal, aspects of the reforms. There are a number of areas where the IMF leads and its analyses serve as inputs into World Bank policy formulation and advice, including policies to maintain

macroeconomic stability, fiscal policies, income policies and external sector policies. There are other areas in which the Bank and the Fund share responsibility and are coordinating closely their policy advice to the Bulgarian authorities such as in the financial sector, public expenditure management and budgeting, and tax administration. In some areas, the Bank has taken the lead but its analysis, country diagnostic work, and policy recommendations served as inputs into the Fund's policy advice on the fiscal front such as education, health care, pensions, social protection, energy, and railways. In areas such as private sector development, strengthening market institutions (including entry and exit policies, regulatory reform to enhance the business climate, judicial reform, labor market reform), and improving governance the Bank has the lead and there has been no conditionality under Fund programs. In addition to consultations early in the process of formulating and adjusting each institution's program with Bulgaria, the Bank and Fund staff teams interact extensively during the review of the progress achieved in the country and coordinate closely their policy advice to the Bulgarian authorities.

B.1. Areas where the IMF leads and its analyses serve as inputs into the World Bank policy formulation and advice.

5. To achieve the objectives of its economic program, the Bulgarian authorities are fully committed to maintain sound and flexible macroeconomic policies centered on a Currency Board Arrangement (CBA) and implement an ambitious reform agenda. In particular, the authorities have maintained a very tight fiscal policy since 1998 and, attaining a deficit of 0.4 percent of GDP in 2003. The aim is to eliminate the deficit by 2005, conduct fiscal policy flexibly in the face of shocks, and maintain a high level of fiscal reserve assets. Given the constraints of the CBA, the authorities see labor market policies as another key component of the broad policy strategy. A strict incomes policy for the state enterprise sector is enforced and measures aimed at facilitating the adjustment of labor markets are being implemented. The structural and institutional reforms, which constitute the third pillar of the policy strategy, are focused on creating a fully functioning market economy that is competitive and can flexibly adjust to shocks.

6. In the context of a 24-month Stand-By Arrangement that expired on March 15, 2004, the IMF took the lead in assisting Bulgaria in safeguarding macroeconomic stability and promoting structural reforms in areas that are macro-critical and fall within the Fund's core expertise. To safeguard the CBA and ensure that it can continue to serve as the macroeconomic policy anchor, the IMF set ceilings on the size of the overall deficit of the general government and quantitative floors on the balance of the fiscal reserve account. To prevent threats to the currency board and macroeconomic stability that could arise from a loss in competitiveness or excessive external financing requirements, Fund conditionality also included ceilings on the wage bill of those state enterprises that have the largest losses and arrears, are monopolies, and receive subsidies, and on the contracting and guaranteeing of public sector external debt. A new 2-year precautionary program is currently being discussed.

B.2. Areas of shared responsibility.

7. **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 are conditionalities on financial sector policies under both the SBA and the PAL program. The IMF has emphasized aspects related to the banking sector—mainly on policies under the mandate of BNB and supervisory agencies—while the World Bank is focusing on policies that affect market performance and development of the financial sector such as improving the legal and institutional framework for lending, restructuring of the banking sector, strengthening creditor rights, corporate insolvency and governance, and non-banking financial sector issues. A focused update of the FSAP was undertaken by Fund staff in the context of the 2004 Article IV consultation mission in March–April 2004.

8. Since 1997, in the context of two Finance and Enterprise Adjustment Loans (FESALs), and now with the PAL program, the Bank has supported the government in sector restructuring of the financial sector. Privatization of commercial banks has been a major component of the FESALs, while the Fund provided support for the institution building efforts of the BNB and its Banking Supervision Department in particular. In the financial sector, the Bank has focused on banking, insurance, pension funds, and capital markets while the Fund has continued its focus on the BNB, banking supervision, and the payments system.

9. **Revenue Administration.** The IMF and the World Bank have been carrying out a joint effort since 1996 to assist Bulgaria in reforms aimed at the establishment of an efficient revenue collection agency. Diagnostics consistently pointed to revenue collection deficiencies including weak management, and problematic audit and enforcement of collection, which in turn facilitates low compliance. Supporting reform efforts, the World Bank implemented a project to modernize the Social Security Institute, including its revenue collection activities. The IMF provided a long-term advisor to the Ministry of Finance, and focused advisory services through consulting assignments. Joint World Bank-IMF efforts resulted in a proposal for "Implementing a Modern Revenue Collection Agency" in March 2000, which is now moving forward. The World Bank's Board approved on June 5, 2003 the Revenue Administration Reform Project (RARP, €31.9 million), developed with technical assistance of the IMF, to support the establishment of the national revenue agency (NRA), which seeks to maximize the level of voluntary taxpayer compliance, promote effectiveness and efficiency, establish a professional workforce and approach to collection, and help reduce the scope for corruption. The RARP became effective on August 7, 2003.

10. **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 (PEIR)[10] which are being

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

further supported by the PAL program. The PEIR has also been a useful input to the IMF program. The PEIR notes that notwithstanding progress to date, important challenges remain in: (i) improving management and accountability in the use of public resources; (ii) restructuring and rationalizing intersectoral public expenditure—particularly energy and railways, economic services, defense and security, and general services; (iii) reallocation of intrasectoral priorities—especially in health, education, and social protection; and (iv) higher investment requirements in many sectors—infrastructure and environment—some of which are priorities for EU accession, and some of which should involve the private sector. The PEIR notes that Bulgaria's main fiscal challenges include working towards an improved allocation of expenditures, while gradually reducing the overall level of expenditures over the medium term in tandem with Bulgaria's fiscal targets of easing the overall tax burden, especially payroll taxes.

11. The IMF has provided long-term technical assistance on budgeting and expenditure management. To ensure the fiscal discipline necessary to support the CBA, the government has already initiated a number of public expenditure management reforms. New budget procedures were introduced in early 2002 and were implemented for the 2003 budget. Despite this important progress, the PEIR notes that there is a need to continue and broaden the reform effort—capital expenditure proposals should be prepared under hard budget constraints and as an integral part of the medium-term budget frameworks; and the financial management at the local level should be strengthened. These reforms are also supported by the Bank through the PAL program.

B.3. Areas where the World Bank leads and its analyses serve as inputs into the IMF policy formulation and advice.

12. **Energy sector.** The Bank has played the lead role in assisting the government in the design of the reform program in the sector, and more importantly on its implementation. After the completion of the Energy Project at end-2000, the Bank has continued to support the developmental objectives of the sector to increase the energy efficiency. Under the PAL program, the government has strengthened the legal and regulatory framework and initiated steps to enable the private sector to assume an increasing share of commercial risks. Policy recommendations have been outlined in the Bank Energy and Environment Review completed in 2003, which aimed at also evaluating alternative strategies to balance the need for economic development and environmental protection. The Fund's and the Bank's teams have worked collaboratively in close consultations with the government, and the SBA included a performance criterion focusing on implementation of the schedule for bringing electricity prices to full cost recovery level, and two benchmarks—one on implementation of the new regulatory pricing regime, and the other on preparing a new Energy Act to harmonize Bulgaria's legislation with EU Directives. In addition, in June 2003 the Bank's Board approved two district heating projects to support the rehabilitation of the Sofia and the Pernik District Heating Companies.

13. **Railways.** The Bank has been the government's main external partner in the transformation of the railway sector, particularly through the Railway Rehabilitation Project, which was completed in June 2002. This transformation is at present only half way achieved.

Some essential measures have been implemented under the PAL program, especially the divestiture of all railway ancillary activities, securing a major reduction in staffing, and completing the institutional separation of the national company into two new infrastructure and rail services enterprises together with the opening of rail services to private operators. Key remaining steps include tariff reform, reduction of loss making services to only those that can be socially justified and supported by state contracts (public service obligations), further reduction of staff, and improved corporate governance. They were refined in the context of the recent PEIR and are being supported by the Bank through the PALs. Detailed assistance with the design of these reforms will be further provided through transport sector work in the near future.

14. **Education.** The reform efforts in the education sector aim at improving expenditure management in view of the declining population, especially in school age, and at enhancing quality and access to education. The main priority in the education sector, including universities, is to reallocate expenditures from surplus capacity in teaching staff and underused facilities toward modernization and upgrading of curricula, textbooks, teaching materials, schools, and other quality-enhancing education inputs. The Bank has supported the government program in education through the Education Modernization Project loan (closed on March 31, 2004), the PALs, and the analytical work done for the Poverty Assessment, the PEIR, and the Inter-governmental Finance study[11]. Under PAL-2 the government has developed a concept for an education reform strategy and action plan, the implementation of which would be supported though PAL-3.

15. **Health care.** Key reform priorities in the health sector include addressing the concurrent problems of surplus capacity issues in health facilities, the serious deterioration in the quality of facilities and health services, and the inadequate modernization of equipment. At the same time, the government needs to ensure the financial integrity of the NHIF, which is the central point of the reforms in the sector. For a long time the Bank has been supporting the restructuring of the health sector through the Health Sector Restructuring Project which was closed at end- 2001. The follow-up Health Sector Reform project approved in late 2000 is under implementation and focuses on the administrative and information systems of the NHIF, and supports the ambulatory care sector and the hospital sector.

16. **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. On pensions, one reform priority is to improve compliance with, and coverage of, the public pillar, and define a clear rule for indexing pensions. During FY04, the preparation of a policy-oriented note will support the pension policy dialogue. On labor market programs, there is a need to monitor these closely to improve their effectiveness and long-term impact in stimulating labor demand. Subject to progress in key reforms, consideration should be given to reduce the tax burden related to labor market policies in

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[11] *Issues in Intergovernmental Relations*, the World Bank, January 27, 2004, Report No. 25821-BUL.

order to curtail labor costs.[12] Some social assistance and benefit programs have become more pro-poor since the mid-1990s and are playing a major role in alleviating poverty. However, given the plethora of these programs, and the complexity of program design in many cases, a constant challenge of the social protection system as a whole is to examine opportunities for consolidation and engage in systematic monitoring of the programs, their costs and effectiveness.

17. The Bank has been the main partner of the government in its efforts to address poverty reduction and meet its social development objectives. The main findings of the Poverty Assessment and the PEIR contribute significantly to the enhanced policy dialogue with the government on its policy options to improve living standards in the country, and increase the effectiveness and adequacy of its social protection programs. The Bank is assisting these important reforms in the social protection system through providing grants amounting to US$2.2 million. The latter focus on poverty monitoring and evaluation, integration of ethnic minorities, child development and building social capital in disadvantaged communities. A Bank-financed Child Welfare Reform project helps address the needs of children in public care, while a Bank-financed Social Investment and Employment Promotion (SIEP), which supports community and employment creation and strengthening of ALMPs, was approved in 2002. Although not subject to structural performance criteria or benchmarks, the IMF has been also monitoring the sustainability of the pension system and the advancing of the labor market reforms in terms of their relevance for the Fund's program objectives.

B.4. Areas where the World Bank leads and there is no direct IMF involvement.

18. **Private Sector Development.** Bulgaria has completed the divestiture of about 95 percent (based on value of assets) of its non-infrastructure state-owned enterprises (SOEs) since 1995. To encourage the entry of new firms and the expansion of existing ones, the business climate will have to be improved focusing on reducing barriers to entry, reducing compliance cost of the regulatory regime, developing a competitive environment, eliminating the constraints to bank lending, and establishing an efficient exit mechanism for non-viable enterprises. Under the PAL program, major changes in the basic legislation have been initiated - notably the Commercial Code, the Civil Procedure Code, and the Labor Code, and the passage of legislation on how the State will regulate economic activity to ensure stability and predictability of regulatory regimes

19. In the context of the two Finance and Enterprise Adjustment Loans (FESALs) and the PAL program, the Bank has supported the government in sector restructuring of the non-infrastructure enterprise sector. Privatization of SOEs has been a major component of the FESALs. Under PAL-1 and PAL-2, the Bank has led the dialogue on

[12] However, such fiscal adjustment requires lowering public expenditures to GDP before implementing tax reductions.

reforms covering the regulatory regimes, the insolvency process, labor markets, and competition**.**

20. **Public sector governance**. The government is pursuing a broad program to improve public sector governance including strengthening the capacity of the public administration, improving service delivery, reducing corruption, and reforming the judiciary. The support of this program has been the main focus of PAL-2. The policy, legal and institutional framework has been developed and put in pace to strengthen merit and depolitization. Performance standards for service delivery have been developed and one-stop shop principles have been introduced in five central administrations and six regional administrations, the system of performance appraisal and professional development within the state administration has been enhanced. Concrete steps have been undertaken to increase accountability and transparency – the conflict of interest and asset declaration regime has been strengthened; a monitoring system to track progress in meeting the anti-corruption objectives has been designed; key ministries and agencies have prepared detailed and practical anticorruption action plans.

C. The World Bank Group Strategy and Lending Operations

The Country Assistance Strategy (CAS) for Bulgaria[1] discussed by the Bank's Board on May 9, 2002, focuses on three main themes: (i) promotion of competitive private sector led growth, (ii) strengthening public administration reforms and anti-corruption initiatives, and (iii) mitigating the social impact of restructuring and delivering social services more effectively.

Programmatic Adjustment Lending. Up to three Programmatic Adjustment Loans (PALs), the first one approved by the Board in February 2003, [2] support the government's reforms aiming at: (a) completion of privatization and restructuring in energy and infrastructure; (b) improving the environment for private sector led growth; (c) deepening the financial sector; (d) reducing poverty and improving human capital, and better delivery of social services; and (e) support public administration reform and anti-corruption programs.[3]

Bank Assistance Program in Bulgaria to date comprises 33 operations for a total original commitment of US$1,820.9 million equivalent. This includes eleven adjustment loans (US$1050.8 million), 19 investment projects (US$750.7 million), and two Bank-managed Global Environmental Fund (GEF) grants and one Bank-managed Prototype Carbon Fund (PCF) operation—Wood Residue to Energy. Of these 33 operations, 24 have been completed, of which two have been restructured and partially cancelled during implementation, and nine operations are currently under implementation.

IFC's Activities in Bulgaria IFC's Activities in Bulgaria comprise 17 projects (totaling US$213 million) in the support of financial sector development, infrastructure and restructuring of post-privatized companies. Of those, 15 projects were approved from 1999-on. In the financial sector, IFC has supported two specialized SME banks and established Bulgaria's first micro lending bank. In addition, IFC has invested in a leasing company and in a venture capital fund which targets the SME sector.

Economic and Sector Work. The country diagnostic work recently completed includes Bulgaria: Country Financial Accountability Assessment (2004) and Bulgaria: Inter-governmental Finances (2004). Other country diagnostic work being completed includes a study on environmental sequencing, an infrastructure and energy study, a national energy efficiency study, and an expenditure needs for roads study. Going forward, the Bank plans additional country diagnostic work on pension funds, on gender and ethnicity issues, rural development assessment, a private sector assessment, and a CEM (Country Economic Memorandum) focused on policy reforms for growth.

	Operation	US $ million	Board Date
1.	Trade and Transport Facilitation in Southeast Europe	7.4	2000
2.	Health Sector Reform	63.3	2000
3.	Child Welfare Reform	8.0	2001
4.	Registration and Cadastre	30.0	2001
5.	Wetlands Restoration and Pollution Reduction (GEF Grant)	7.5	2002
6.	Social Investment and Employment Promotion	50.0	2002
7.	Programmatic Adjustment Loan (PAL 1)	150.0	2003
8.	Revenue Administration Reform Project	34.2	2003
9.	District Heating Project	34.2	2003
10.	Wood Residue to Energy	2.0	2003

[1] *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, 2002.
[2] *Program Document for a Proposed Programmatic Adjustment Loan to the Republic of Bulgaria*, The World Bank, January 23, 2003.

Questions may be referred to Ms. R. Quintanilla (202-473-7673), Ms. Myla Taylor Williams (202-437-6997), or Ms. Stella Ilieva (359-2-9697-251).

BULGARIA: AN AGGREGATE BALANCE SHEET ANALYSIS[13]

1. At end-2003 currency and maturity mismatches in Bulgaria, while contained at the aggregate level, are considerable in individual sectors. While in the private sector (both financial and nonfinancial) short-term external liabilities in foreign currency exceed liquid external foreign-currency assets, this is more than outweighed by the public sector's liquid foreign assets. Therefore, the public sector's large international reserves, combined with a public debt structure that limits official demands on the foreign currency reserves of the central bank, insure the private sector's balance sheet mismatches.

- *The nonfinancial private sector (NFPS),* while posting a sizable overall short foreign currency position (medium- and long-term as well as short-term), has a long position in *short-term* foreign-currency assets and liabilities. However, short-term *external* liabilities in foreign currency exceed liquid external foreign-currency assets by a sizable margin (about 6 percent of GDP; Appendix Figure 1). This implies that potential pressures on the short-term external position of the NFPS—e.g. arising from reduced rollover of credit lines—would be transmitted to the domestic banking sector, as foreign currency denominated liquid liabilities of the banking sector to the NFPS are very large as a result of the substantial degree of euroization of the banking system (48 percent of the sector's liabilities are in foreign currency, mostly euros).

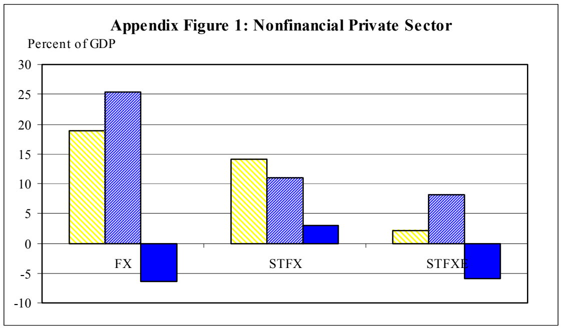
- *The public sector's* short overall foreign currency position derives from its large (though falling) external debt. However, this debt is all medium and long-term (by original maturities[14]), and there is thus little short-term refinancing risk. This is reflected in liquid foreign-currency assets exceeding short-term foreign-currency liabilities by a wide margin: including coverage of the monetary base by foreign exchange (required by the currency board) as a foreign-currency liability, liquid foreign currency-denominated assets exceed short-term foreign-currency liabilities by a margin of more than 11 percent of GDP. The situation is similar for the external short-term foreign currency position (Appendix Figure 3).

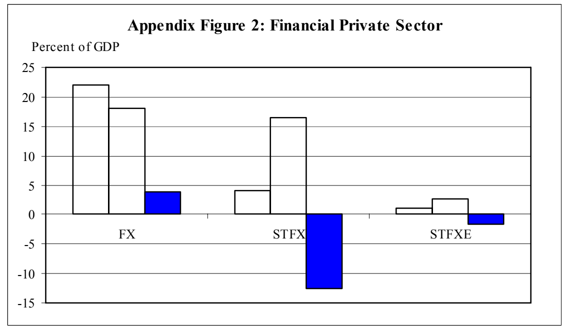
- *The financial private sector (FPS)* has a long overall foreign currency position, but its short-term foreign-currency liabilities exceed liquid foreign-currency assets by a wide margin (12½ percent of GDP), deriving from the financial intermediation role of the sector, and the considerable degree of euroization. Meanwhile, short-term *external* liabilities in foreign currency exceed liquid external foreign-currency assets only by a

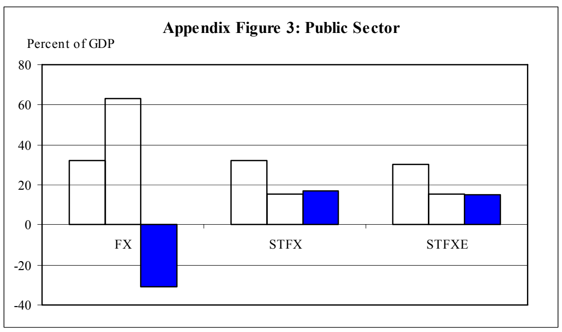
[13] More detailed analysis is provided in Chapter II of *Selected Issues and Statistical Appendix* (to be issued).

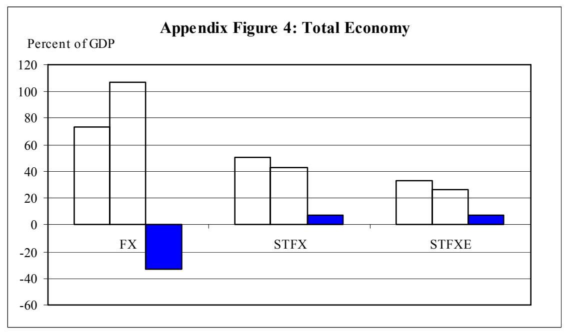
[14] Amortizations of external debt falling due in 2004 are about €241 million (1.4 percent of GDP), which does not make a significant dent in the public sector's net foreign currency or external positions.

limited amount (Appendix Figure 2). This suggests that, though weaknesses in the banking sector's own balance sheet do exist, the larger risk to the banking system arises from the domestic NFPS, with its sizable potential demand on banks' foreign exchange.









FX: Foreign currency; STFX: Short-term position in foreign currency; STFXE: Short-term external position in foreign currency.
FX columns: Assets, liabilities, and mismatch;
STFX columns: Liquid foreign currency-denominated assets, short-term foreign currency-denominated liabilities, mismatch;
STFXE columns: Liquid external assets, short-term external liabilities, mismatch.

2. **Overall, therefore, the public external short-term foreign currency position is strong enough to offset weaknesses in the private sector** (Appendix Figure 4). This reduces the risk of potential rollover difficulties of firms in the NFPS (which is unlikely to be uniform across firms) being transmitted via the banking system the entire economy. In the banking sector itself, this reduces the ultimate risks from one of foreign-currency positions to one of the usual maturity mismatches that financial intermediation creates, regardless of currency.

3. **In summary, the strength of the short-term external foreign currency position in Bulgaria depends on the public sector.** At present, the cushion of official reserves is sufficient to counterbalance weaknesses in the private sector's balance sheets, but this comes at a cost, including moral hazard. In addition, credit developments are likely to weaken private sector balance sheets further, putting greater demands on public reserves and

requiring continued reserve build-up through inflows on non-debt creating financing, while at the same time aggravating moral hazard, as well as political and budgetary costs.

Table 16. Bulgaria: Intersectoral Asset and Liability Position (end-December 2003, in millions of euros)

Issuer of Liability (Debtor) ↓	Holder of Liability (Creditor): Government Sector (I)	Financial Private Sector (II)	Nonfinancial Private Sector (III)	Rest of the World (IV)
Government and BNB				
Monetary Base		1,981	712	0
Total Other Liabilities		1,049	1,132	7,201
Short-term		27	88	0
Domestic Currency		27	88	0
Foreign Currency		0	0	0
Medium- and Long-Term		1,022	1,044	7,201
Domestic Currency		575	248	0
Foreign Currency		447	796	7,201
Financial Private Sector				
Total Liabilities	934		4,978	766
Short-term	907		4,909	536
Domestic Currency	553		2,812	68
Foreign Currency	354		2,097	468
Medium- and Long-Term	27		69	230
Domestic Currency	24		28	0
Foreign Currency	3		41	230
Equity	0		0	0
Nonfinancial Private Sector				
Total Liabilities	...	4,532		2,514
Short-term	...	1,162		1,418
Domestic Currency	...	634		0
Foreign Currency	...	528		1,418
Medium- and Long-Term	...	3,370		1,096
Domestic Currency	...	1,959		0
Foreign Currency	...	1,411		1,096
Equity	...	14		4,785
Rest of the World				
Total Liabilities	6,999	1,503	389	
Currency and Short-term	6,999	185	389	
Medium- and Long-Term	0	1,318	0	
Equity	...	1	...	

Sources: BNB, MoF, and Fund staff estimates.

Bulgaria: Statistical Issues

1. Bulgaria compiles and submits data to the Fund of sufficient quality and in a regular timely manner to adequately permit program monitoring and surveillance (Table 17). Despite a comprehensive economic database, problems remain in national accounts and price statistics, particularly in the coverage of the emerging 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 in fully reconciling high frequency data on economic activity with quarterly and annual national accounts data. Annual international investment position statistics are compiled and reported to STA for publication.

2. On December 1, 2003, Bulgaria subscribed to the International Monetary Fund's Special Data Dissemination Standard (SDDS), marking a major step forward in the development of the country's statistical system.

Real sector

3. The National Statistical Institute (NSI), with technical assistance from the OECD, has established a system to compile national accounts according to the recommendations of the European System of Accounts, 1995. GDP by activity and expenditure categories are compiled and reconciled within an annual supply and use framework. Government output and final consumption are estimated on a cash rather than an accrual basis. In addition, Bulgaria publishes national accounts including current and capital accounts for the five main domestic sectors (general government, financial corporations, nonfinancial corporations, nonprofit institutions serving households, and households). As for most countries, the financial account and the balance sheets are missing.

4. A monthly industrial production index is compiled. An IMF STA national accounts statistics mission found problems with the quality of inventories data and the deflation method used to construct the industrial production index, and the mission made recommendations for their resolution.

5. The NSI has also compiled estimates of quarterly GDP by expenditure categories for the period beginning with first quarter of 1994 through the third quarter of 2002, based on significantly improved quarterly surveys. Problems remain in the methods for the deflation of some components of the national accounts, such as household consumption, capital formation, and external trade, and in the coverage of private sector activities. However, significant progress has been made in the development of export and import deflators.

6. The producer price index (PPI) is being revised. Detailed product specifications and transaction prices are being introduced gradually during the rotation of samples by branch classes. The NSI is in the process of expanding the collection of transaction prices throughout the industrial sector with 83 percent of domestic industry sales now covered. The new work

program calls for completing the PPI revision process by June 2004. Publication of the rebased PPI began in March 2003, with the weights and reference period updated to 2000 and linked at December 2002 to form a continuous monthly series for the period January 2000 to January 2003.

7. The consumer price index (CPI) provides a reasonable measure of inflation and price developments in Bulgaria. The recommendations provided by STA missions have been broadly implemented. The NSI has completed the exercise to link annual Laspeyres price indices together, producing a time series that begins in 1995. This series also follows the new classifications and index methods recommended by Eurostat and STA, and has been published as the official CPI. The coverage of the index was extended, although it still does not include owner-occupied housing. A new method for imputing missing observations of new products is being applied, but quality adjustment procedures are only applied in a few particular cases (e.g., the heating component).

8. The flow of customs data has improved significantly since the April-May 1998 STA mission 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 can be used effectively as deflators for the import and export components of the national accounts. The Import and Export Division meets monthly with the Bulgarian National Bank to review data issues and ensure consistency between the NSI export and import data and the balance of payments data.

9. The lack of comprehensive labor statistics hampers the assessment of developments in employment and wages, especially in the private sector. Annual data are collected by the NSI, using a census of all establishments. The NSI also obtains current estimates from a monthly survey of establishments using all public employers and a sample of private employers (excluding establishments with less than 5 employees, and including about 10,000 private employers out of approximately 69,000 qualifying establishments). The main shortcomings of these data include: (i) the under-reporting of private sector wages; (ii) the reporting of only average gross earnings, not wages for time worked and wages by occupation; and (iii) the lack of coverage of the self-employed and employment in small firms. Plans for improvement include using National Social Security Institute (NSSI) data 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 also needs to be conducted on a consistent schedule, semi-annually or quarterly. It has been conducted twice a year since 1993 (three times a year since 1999), but at irregular intervals. From 2001 onward, the NSI intended to conduct the survey on a quarterly basis. Also, Eurostat has been providing support since mid-2000 in the context of a pilot project ending in mid-2001 to improve the labor force survey's compliance with Eurostat recommendations.

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

Government finance

11. A combined STA/FAD mission in September 1999 reviewed progress under the budget execution reform program, assisted the MoF with the development of a new chart of accounts for the government sector, and provided advice on the implementation of accrual accounting for government, budgetary, and the statistical system. The mission also examined possible actions to improve fiscal transparency in line with the Experimental Report on the Implementation of Standards and Codes prepared in August 1999; key recommendations are to improve the fiscal data to meet fiscal reporting requirements for EU accession, in particular, implementing the new chart of accounts and the Financial Information Management System; disseminate information on arrears of central and local governments, local government debt, and details of financing; compile and disseminate discrete monthly and quarterly data; and update the MOF website monthly. Consolidated data on central government operations are routinely reported for publication in the *GFS Yearbook* and in *IFS.* For the *GFS Yearbook 2003*, 2002 data for the general government sector and its subsectors were reported on an accrual basis in accordance with *GFSM 2001*. The Ministry of Finance prepares data on the execution of the consolidated government 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.

Money and banking statistics

12. Statistical methods conform with the key classification and valuation principles in the IMF's *Monetary and Financial Statistics Manual, 2000.* To address remaining deviations, the authorities reported that starting in January 2003, positions on financial derivatives, which at present are small, would be included in the balance sheets. Further, the consistency in the coverage of the BNB's claim on banks (which included claims on liquidated banks) and the banks' liabilities to the BNB had improved in January 2003 after the BNB had written off most of the claims on the liquidated banks. With respect to its near-term statistical program, the BNB is progressively harmonizing its data collection and compilation methods in line with the European Central Bank's framework for monetary statistics. In particular, a significant number of enhancements in sectoral and instrument detail and classification were made in the data for 1995 and onward. These were reflected in the revised monetary statistics published in the August 2002 and November 2003 issues of *IFS*.

Balance of payments

13. Bulgaria reports monthly balance of payments data on a regular and timely basis, but data are subject to frequent and substantial revisions. An IMF technical assistance mission in December 2000 made a number of recommendations to strengthen the balance of payments and external debt compilation systems, which included the development of a closed-type of international transactions reporting system, the development of estimates of “shuttle trade” with countries bordering Bulgaria, strengthening the methodology for travel transactions, and compiling data on trade credit liabilities. The treatment of the license to operate a mobile telephone service has been clarified and agreed with the BNB. The GSM license purchase has been recorded under foreign direct investment, in Bulgaria’s equity capital component in the first quarter of 2001. As there is no repayment obligation, the transaction does not change the country’s external debt position. Balance of payments transactions related to the mobile phone license are no longer recorded for the subsequent periods. In 2003, the ROSC mission identified the following problems in the balance of payments statistics: i) residents’ foreign currency accounts with resident banks are incorrectly included; ii) merchandise trade data are prone to errors and are not timely; and iii) most data are collected on a cash basis.

Table 17. Bulgaria: Core Statistical Indicators as of May 11, 2004

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Govt. Balance	GDP	External Public Debt/ Debt Service
Date of Latest Observation	May 11 2004	Apr 30 2004	Mar 2004	Mar 2004	Mar 2004	Mar 2004	Mar 2004	Feb 2003	Feb 2003	Feb 2003	Q4 2003 (qtrly) 2001-03 (annual)	Feb 2003
Date Received	May 11 2004	May 11 2004	May 3 2004	May 3 2004	May 3 2004	May 3 2004	Apr 14 2003	Apr 15 2004	Apr 27 2004	Apr 9 2004	Mar 29 2003	Mar 31 2004
Frequency of Data	Daily	Daily	Weekly and Monthly	Weekly and Monthly	Weekly and Monthly	Weekly and Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly Annually	Monthly
Frequency of Reporting	Daily	Weekly	Weekly and Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly Annually	Monthly
Source of Update	BNB	BNB	BNB	BNB	BNB	BNB	NSI	NSI	BNB	MoF	NSI	MoF and BNB
Mode of Reporting	Email from BNB	Email from BNB	Email from BNB	Email from BNB	Email from BNB	BNB website	Email from NSI	NSI website	Email from BNB	Email/fax from RR	Email from NSI	Email from BNB
Confidentiality	No	Yes	Yes	Yes	No	No	No	No	No	No	No	No
Frequency of Publication	Daily	Daily	Weekly	Daily	Weekly and Monthly	Weekly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

INTERNATIONAL MONETARY FUND

BULGARIA

Ex Post Assessment of Longer-Term Program Engagement

Prepared by a Staff Team from EUR, MFD, PDR, and RES

Authorized for Distribution by EUR and PDR

May 19, 2004

- Bulgaria has had a longer-term engagement with the Fund, based on the definition in IMF (2003), thus requiring an Ex Post Assessment (EPA) of its relationship with the Fund. This paper provides such an assessment, focusing primarily on the last ten years (1994-2003), and on the strategy for any future engagement.

- The EPA team comprised Mr. Cottarelli (head, EUR), Mr. Dell'Ariccia (RES), Mr. Duenwald (EUR), Mr. Nystedt (PDR), and Mr. Teo (MFD).

- The EPA is based on the analysis of available documents, as well as on "EPA interviews" conducted in Washington and Sofia with current and former Fund staff members, World Bank staff members, as well as with current and former representatives of the authorities.

- The preparation of the EPA is estimated to have required about 0.3 person year. This includes the EPA team and related assistance, but not the time spent by reviewing departments nor by the staff met during the EPA interviews.

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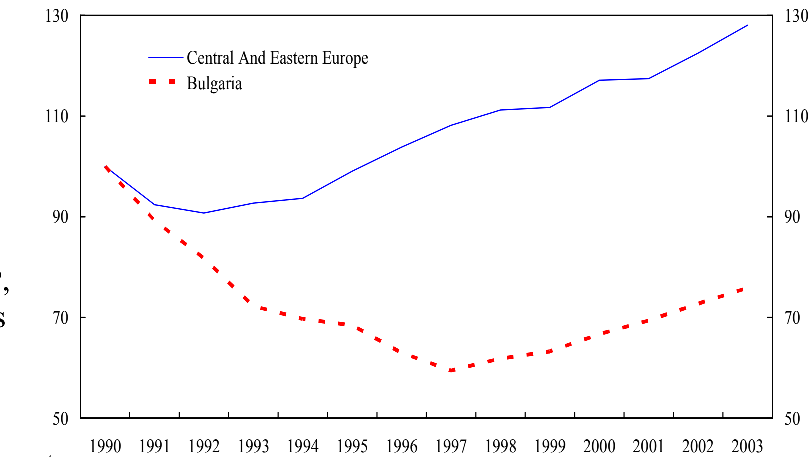
Tables

I. Introduction

1. **Bulgaria's transition from central planning was initially difficult**. In the context of loose macroeconomic policies and slow structural reform, GDP fell almost steadily through 1997, when it was 40 percent below its 1990 level (Figure 1). Inflation averaged 233 percent per year during 1990-97, and turned into hyperinflation in late 1996-early 1997, at the peak of a major banking and exchange rate crisis (Table 1 and Figure 2). In the same period, the fiscal deficit averaged 8½ percent of GDP, and large quasi-fiscal deficits were also recorded. The external current account deficit, in the context of a managed float, was small, except in 1992-93, reflecting compressed domestic demand and financing constraints.

Figure 1. Real GDP, 1990-2003
(1990=100)

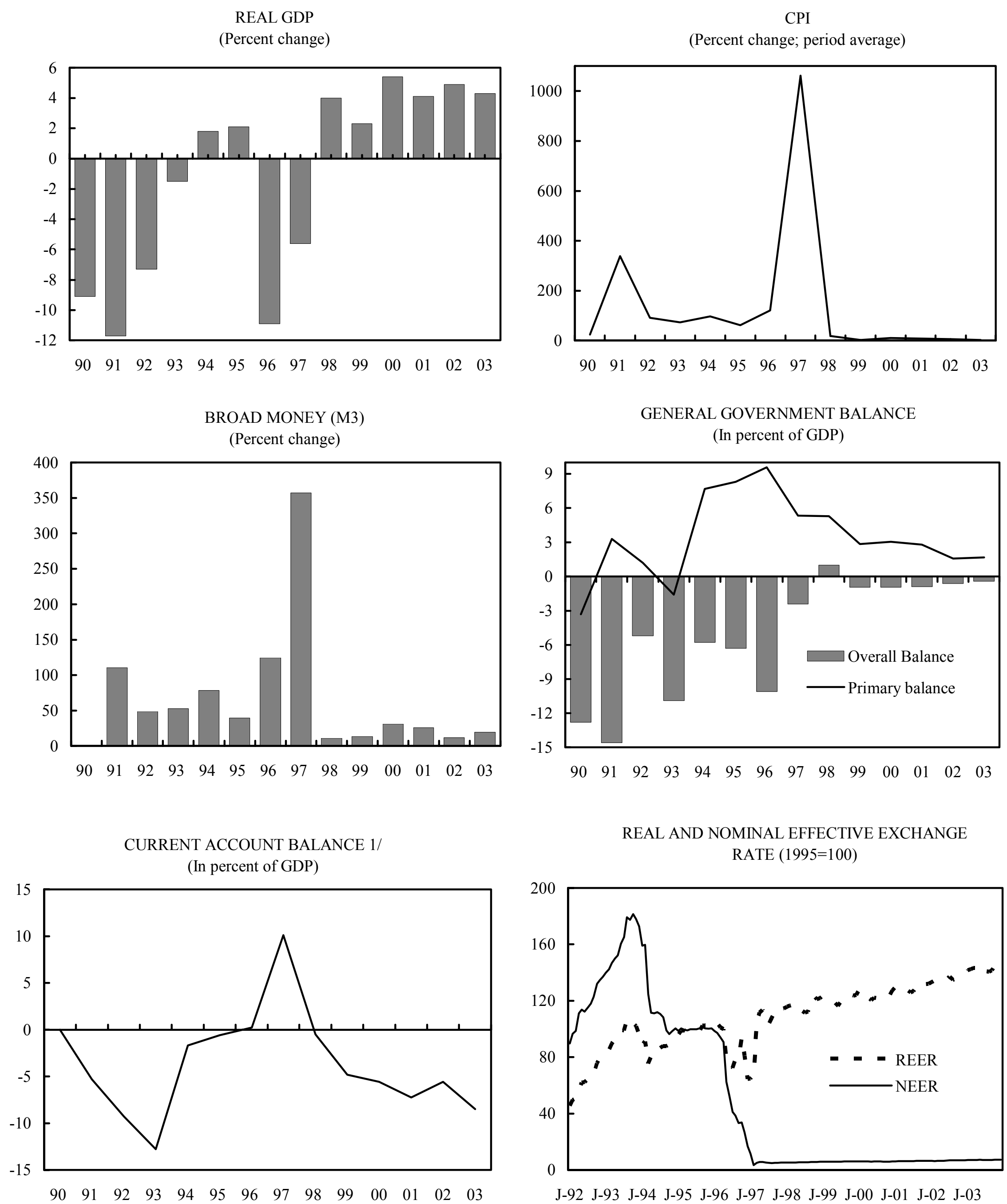


Sources: Bulgarian authorities; World Economic Outlook.

2. **However, since the 1996-97 crisis, macroeconomic performance has dramatically improved**. In that year, Bulgaria embarked on a comprehensive reform agenda, anchored by a currency board arrangement (CBA) that yielded high and stable growth (in the 4-5½ percent range during 2000–2003) and low inflation. But risks remain. Unemployment and poverty are still high and signs of reform fatigue have emerged. The macroeconomic outlook is also not without risks: the external current account deficit has recently widened and bank credit is booming, two possible signs of overheating.

3. **Bulgaria's transition was supported by Fund resources both during the early difficult years, and during the later more successful period**. In the first period, after the completion of a one-year SBA, three consecutive SBAs went off track (Table 2). In contrast, starting in 1997 two SBAs and one EFF were successfully completed. Alongside, other facilities were also used. Altogether, Bulgaria was engaged with Fund-supported programs for 118 out of 168 months during 1990–2003, and for 94 out of 120 months during the last ten years.

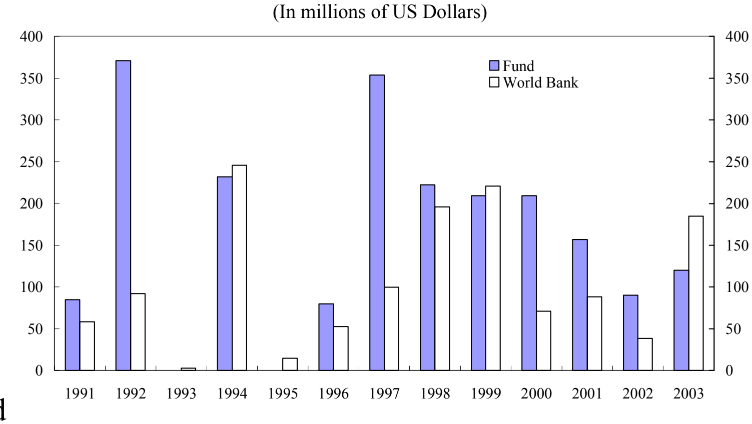
Figure 2. Bulgaria: Selected Economic Indicators, 1990-2003



Sources: Bulgarian authorities; and Fund staff estimates.
1/ Data are US dollar-based ratios before 1999 and euro-based from 1999 onwards.

4. **World Bank support started in 1990, but, owing to flagging interest in reforms, was scaled down in the mid-1990s** (Figure 3). Later, the Bank started to become reengaged, supporting the reforms through 29 operations. IFC investments also increased markedly.

Figure 3. Bulgaria: IMF versus World Bank Disbursements, 1991-2003
(In millions of US Dollars)



Source: World Bank, IMF.

5. **Against this background, following a bird's eye view of Bulgaria's economic record since the start of the transition, three key issues are discussed**:

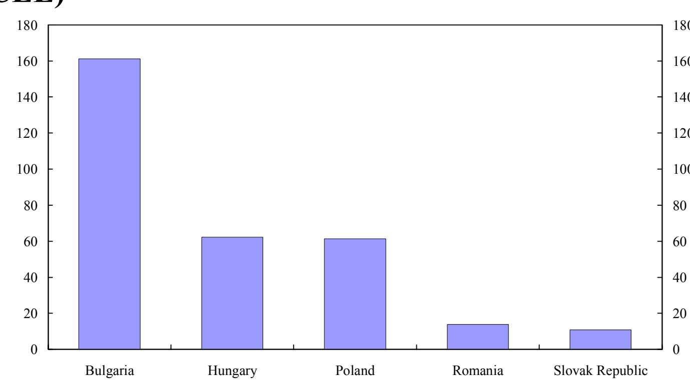
- Why did the pre-1997 programs fail and why did the later programs succeed?
- Why was Fund support needed for seven years after the successful stabilization?
- What are now the risks, and does Bulgaria still need Fund support?

II. The Facts

A. Transition to Crisis: 1990-Early 1997

6. **Bulgaria's transition started under more difficult circumstances than in most other central and eastern European (CEE) countries**, reflecting a legacy of stricter central planning,[1] higher exposure to Comecon trade,[2] and a larger external debt burden (Figure 4). The latter, in the context of weakening external conditions, forced Bulgaria to declare a debt moratorium in 1990. Political factors were also less favorable. Under communism, Bulgaria had reduced the gap with other CEE

Figure 4. Bulgaria: External Debt to GDP, 1991



Source: World Economic Outlook.

[1] State ownership was near complete. Moreover, Bulgaria's exposure to market institutions, which helped promote reforms in other CEE countries, was limited (World Bank 2002a).

[2] At over 70 percent of GDP in 1990, Comecon imports and exports were higher than in other CEE countries (Bristow, 1996).

countries. Thus, the old leadership was not as discredited as elsewhere, and there was no organized opposition to the regime (Giatzidis 2002).[3] While many Bulgarians supported reforms, the socialist party (the offspring of the communist party) remained a viable political force, and a rapid succession of governments during 1990-97 (Table 3) suggests a lack of reform consensus.

7. **In this context, early programs, aimed primarily at stabilizing the economy, soon ran into problems**. While a first SBA was completed in March 1992, a second SBA went off track in late 1992. In parallel, GDP dropped, unemployment surged, and the external current account deficit approached 13 percent of GDP in 1993. After the failure of the second SBA, a hiatus followed during which, in the context of persistently lax monetary and fiscal policies and little progress in structural reform, macroeconomic conditions deteriorated further, leading to a first currency crisis in late 1993-early 1994. A new stabilization effort supported by a third SBA in April 1994 was derailed in the Fall, when the government fell.

8. **In this period, at the core of Bulgaria's instability was the poor state of public enterprises, and their dangerous symbiosis with banks**. The unreformed state-owned enterprises (SOEs) were problematic in two ways. First, their large deficits were financed by state (and private) banks and, indirectly, the central bank, fueling inflation, and undermining the population's trust in the banking system. Second, lack of reform depressed output, thus making any stabilization attempt difficult to sustain over time. Finally, weak governance in both public and private firms fostered corruption and a rent-seeking culture (Box 1).

Box 1. SOEs and Banks in Bulgaria Before 1997: A Dangerous Symbiosis

Until the middle of 1996, no large- to medium-sized loss-making SOEs had been declared bankrupt, and by end-1996, less than 6 percent of the assets of SOEs had been privatized. The cumulative losses of SOEs averaged 22 percent of GDP during 1993-95 (OECD, 1997). These losses were financed by arrears (to suppliers and the government) and bank loans, which in turn were refinanced by the central bank. Periodically, the state took over the related banks' bad loans: bonds issued for this purpose amounted to half of domestic debt in 1993-95 (OECD, 1997). This subjugation of banks to SOEs' needs was facilitated by poor accounting, auditing, reporting, and disclosure standards. Indeed, in a climate characterized by insufficient protection against insiders' interests, private banks also extended credit irresponsibly. Moreover, the unstable macroeconomic conditions, and the absence of adequate supervision, encouraged banks to take speculative positions, including in the foreign exchange market. In early 1996, 70 percent of outstanding loans were classified as nonperforming, and the negative net worth of the banking system was estimated at 10 percent of GDP.

[3] Bulgaria's demographic structure (an "older" population compared to other CEE countries) may also have slowed down the political transition.

9. **However, pre-1997 programs did not successfully address the SOEs/banks problem.** Supported by an SBA, a remarkable attempt was made in 1994 to strengthen the central budget position through major cuts in public spending. This yielded large primary surpluses averaging 8½ percent of GDP during 1994-96. In those years, the central budget, adjusted for inflation, was much lower than the headline figure (Feyzioğlu et al., 1999, p. 37). But, without SOE and bank reform, the adjustment fell disproportionately on some population groups and, in the midst of further political instability, was ultimately unsustainable. A last-ditch attempt at stabilization—probably too little and certainly too late—was launched in mid-1996, with the support of a fourth SBA. The 1996 program responded to a rapid surge in inflation and depreciation, and a collapse of confidence. It involved a further fiscal adjustment in the central budget (with the primary surplus rising to 9¼ percent of GDP that year), a strengthening of bank supervision, and *commitments* to launch SOE reforms. But, Fund endorsement failed to catalyze support,[4] as the government continued to be seen as lacking reform credentials. Indeed, implementation of structural reforms was once more too hesitant.[5] Eventually, a simultaneous loss of confidence in the lev and in the banking system led to the 1996/97 financial crisis.[6] By September 1996, one-third of banks had been closed, but through a disorderly process, and by year-end, Bulgaria was experiencing hyperinflation, international reserves had collapsed, and support for the government had dissipated.[7]

B. Stabilization and Growth: 1997 Onwards

10. **The severity of the crisis made it clear that a new policy strategy and a pro-reform government were needed**. Under the weight of the crisis, the socialist government resigned in December 1996, and a reform-minded caretaker government was established to resolve the crisis. Thereafter, the reformists won the April 1997 elections in a landslide, and, in the same month, a new 14-month SBA was approved.

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[4] The gap between Bulgaria's spread and the EMBI remained about unchanged at the inception of the program, and rose dramatically a few weeks later.

[5] Following board approval of the SBA, NDA growth was well above targets, triggering a renewed worsening of the crisis after a brief pause. Corrective measures discussed during the first review were never implemented and the review was not completed.

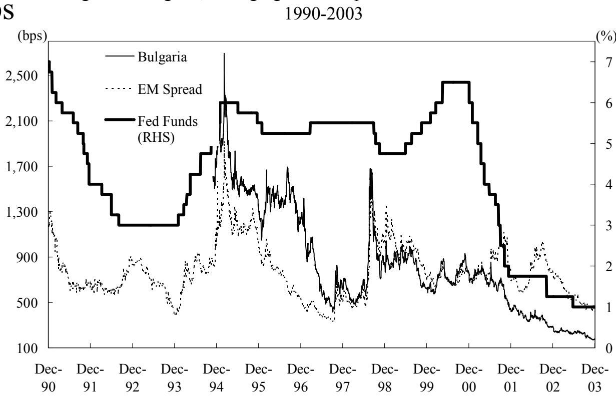
[6] Confidence in banks may have been weakened by the proposal in December 1995 to introduce a partial deposit insurance scheme, while previously bank deposits had been regarded as implicitly covered fully by the state (the Fund had recommended not introducing partial deposit insurance as public confidence in banks was low). Finally, public confidence was also shaken by the collapse of pyramid schemes in mid-1995.

[7] The closure of some banks contributed to the panic, partly because of lack of full deposit insurance. Another contributing factor may have been the leak of a side letter to the Fund committing the authorities to close more banks if the initial strategy proved insufficient.

11. **The new program envisaged bold reforms underpinned by a CBA**. While no major measures were envisaged at the central budget level, and indeed the primary surplus was allowed to decline over time as the burden of interest payments fell, the critical link between SOEs and banks was severed by acting on both sides of the problem. On the one hand, the new currency board—whose introduction was preceded by a wide-ranging public debate that enhanced ownership—prevented the central bank from financing banks and the budget. On the other hand, key upfront steps were taken to reform SOEs and banks. This was achieved by closing and restructuring the loss-making SOEs,[8] and, following the closure of problem banks in late 1996, by strengthening bank supervision (by increasing the independence of bank supervision and its power to intervene in banks, and by making the prudential framework consistent with international standards). Incomes policy for SOEs was also strengthened to harden their budget constraints and guide wage expectations. Moreover, the privatization program was revived.

12. **The program was immediately well received by markets**. Bulgaria's gap against the EMBI fell by 250 basis points the week after the socialist government resigned, and by 100 bps after the IMF board approved the new program (Figure 5). It continued to fall later as markets became increasingly convinced that reforms would continue. By 1998 the gap was approaching zero. Bulgaria's rating was upgraded in early 1998. Domestic interest rates fell from 400 percent in 1996 to 7 percent in 1997, and international reserves surged.

Figure 5. Bulgaria, Emerging Market Spreads and US Fed Funds Rate 1990-2003



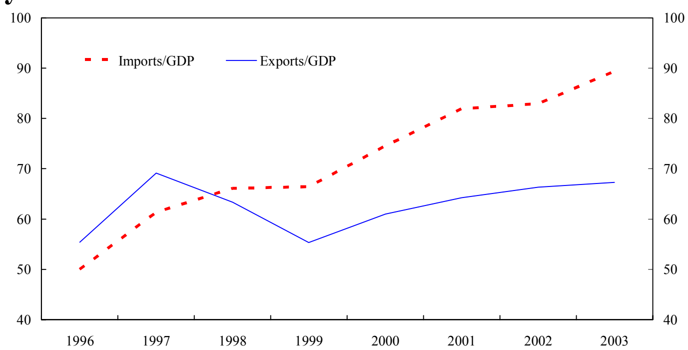
Source: Bloomberg.

13. **The 1997 SBA was successfully completed and followed by two new arrangements**. The latter, in the context of a stable political environment, focused on continued fiscal prudence—with falling interest payments permitting a reduction in the primary surplus—and further reforms. A virtuous circle was set in motion: with macroeconomic stabilization achieved, the government could focus on addressing remaining structural problems. This in turn put macroeconomic policies on a sounder footing. Privatization was accelerated (especially in 1999-2000), SOE restructuring pushed further ahead, banking sector laws strengthened, price liberalization continued, and the process of land restitution completed. Throughout this period, and increasingly, Bulgaria's desire to join the EU provided an additional incentive to keep reforms on track. Performance also improved with respect to Fund conditionality. Some waivers were needed after 1997, but this partly reflected the rising number of actions subject to conditionality (Table 4). However,

[8] Sixty four SOEs responsible for 29 percent of the losses in 1995 were to be shut down; 79 SOEs responsible for 55 percent of losses were put on an "isolation" list and denied new credit.

under the most recent SBA the number of structural conditions met with delay or not met increased in relative terms. More generally, the structural reform process has slowed down.

Figure 6. Bulgaria: Exports and Imports, 1996-2003 1/
(In percent of GDP)



Source: Bulgarian authorities.
1/ In real terms from National Accounts.

14. **Output has recovered significantly since 1997**, rising by 22½ percent in the last five years, despite adverse external shocks—the Asian, Russian, and Kosovo crises. Inflation fell to single digits, and external debt declined. On the external front, in the context of significant trade liberalization,[9] imports picked up rapidly, while the rise in exports was more contained (Figure 6). Correspondingly, the external current account deficit increased with respect to pre-crisis years, but to levels (about 4¼ percent of GDP during 1998-2002) easily financed by FDI. However, as discussed below, the external current account deficit rose to 8½ percent of GDP in 2003, as imports, spurred by a credit boom, accelerated.

III. The Causes of Failure and Success

15. **This section focuses on three questions**: (i) What changed in 1997? (ii) Why did the change not occur earlier? (iii) Why did the Fund support programs that were too weak?

A. What Changed in 1997?

16. **There was broad consensus during the EPA interviews that, in terms of policy implementation, the 1997 program succeeded because it credibly severed the SOEs/banks link**. Earlier programs did involve sizable adjustments in the central budget, but this approach was too narrowly based, and, thus, unsustainable. Severing the SOEs/bank link broadened the scope of the adjustment and hit at the core of Bulgaria's inflationary spiral.

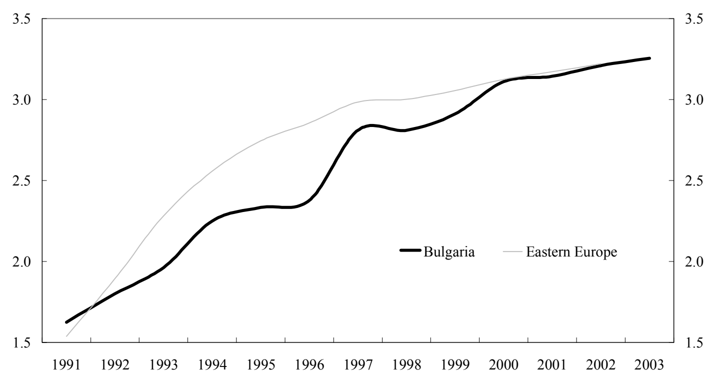
17. **Both components of the strategy to sever that link (structural reform and the CBA) were critically important:**

- SOE/bank structural reform and privatization were covered in the 1997 SBA and in the following EFF by very detailed conditionality. The EPA interviews highlighted that the Fund's conditionality became the blueprint for reform and greatly facilitated policy coordination within Bulgaria. It was also noted that it would have been significantly more difficult, at least *de facto*, to have such a detailed conditionality, had the 2002 guidelines on streamlining conditionality been in place.

[9] Average tariffs dropped from about 17 percent in 1997 to 11½ percent in 2003.

- The CBA played two roles. First, it provided a strong institutional barrier against the risk that money growth would be subordinated to the needs of SOEs and banks. Second, as a communication tool, it provided a "banner" around which virtually all components of society seemed to coalesce. Since 1997, consistency with the CBA has become the ultimate litmus test for assessing the key economic policy decisions. Its importance, vis-à-vis the structural reforms steps, in stabilizing expectations should not be underestimated. While key structural measures were taken early on, the reform agenda was far from completed in 1997. Remarkably, the EBRD transition index, while improving in 1997 more than in any other year, remained well below the average of transition countries, and improved further only after 1998 (Figure 7). Also, some gradualism that had failed to impress markets in 1996 (e.g., putting some SOEs in "isolation," rather than closing them) was well received in 1997. The CBA increased the credibility of the reform process, avoiding the need for an excessive front-loading. However, the EPA interviews also underscored that the CBA would not have worked in isolation. The two components of the strategy were mutually reinforcing.

Figure 7. Average EBRD Transition Index, 1991-2003



Source: EBRD.

18. **Equally important in stabilizing expectations was the change in the political landscape**. The government formed in mid-1997 was homogeneously reformist and was supported by a wide parliamentary majority. This reassured markets that the period of political instability was over and that the reforms would continue over time.

19. **There was less agreement on the extent to which other factors may have been relevant**. Conditions at the outset of the program, the external environment, and financial support were somewhat better in 1997 than before, but not decisively so. These factors are discussed in Box 2, together with the role that over-optimism in policy design may have played in the failure of the pre-1997 programs.

Box 2. Initial Conditions, External Environment, Over-Optimism, and Financing

Initial conditions: Bulgaria's starting point on the transition route was weak. By 1997, in spite of remaining major shortcomings, some structural progress had been made. Implementation capacity had also increased. Moreover, the early 1997 hyperinflation cut the burden of domestic debt dramatically, strengthening the fiscal accounts. The importance of these factors should not be exaggerated, though: in other respects, Bulgaria in 1997 was in worse shape than in the early 1990s: inflation expectations had been rooted, per capita GDP was lower, unemployment had surged, and external debt had been inflated by the depreciation.

External environment: Market sentiment towards emerging markets was weak in 1994, and, while improving, remained weak in 1996. In contrast, the 1997 program benefited from more favorable conditions. For example, the average of the EMBI spread for the six months around the program's starting date was 727 basis points for the 1996 program and 449 basis points for the 1997 program. However, external financing conditions had been propitious also in the early 1990s. Moreover, the post-1996 program was resilient to sizable external shocks: for example, the Russian crisis caused only a brief rise in Bulgaria's spread.

Over-optimism: An interesting, and separate, issue is whether the external environment had been assumed to be better than it turned out to be, and, more generally, whether over-optimism had contributed to the failure of earlier programs. Clearly, the repeated failures of pre-1997 programs resulted in sizable over-prediction of growth performance (and under-prediction of inflation). But was this the result of the failure, or of optimistic assumptions on outcomes, given the program policies? The EPA team could not explore this issue fully, due to resource constraints. However, during the EPA interviews over-optimism was not mentioned as a relevant cause of failure.

Financing: Lack of financing was not a key factor behind the failure of the pre-1997 programs. By end-1995, the Fund was Bulgaria's largest creditor accounting for 8¼ percent of external debt. Fund support to the failed 1996 program was broadly equal to that to the successful 1997 program, and was frontloaded. However, it has been noted that the 1996 program was underfunded vis-à-vis borrowing needs, and that larger access could have bought time to push reforms through. Be this as it may, the Fund in 1996 did contact donors for additional support, but their lack of enthusiasm may have reflected the authorities' poor track record.

B. Why Did The Change Not Occur Earlier?

20. **The EPA interviews highlighted the central role the 1996–97 crisis played in exposing the failure of earlier policies and in triggering the change in policies**. The view that there simply was not enough consensus for reform before 1997, within the government, parliament, and the population at large, was undisputed during the interviews. Pre-1997 governments, while including reformers, were not homogeneously reformist, reflecting an underlying lack of pro-reform consensus in the population at large and the political economy

factors discussed in paragraph 6.[10] With the crisis, output collapsed, unemployment surged, and the savings of the populations vanished as prices skyrocketed. This triggered the change that allowed addressing at the core the SOEs/banks link.

21. **Was the change also delayed by lack of understanding by the Fund about the nature of Bulgaria's problems?** This does not seem to have been the case. While data problems were significant (Box 3), at least as of 1993, the Fund had singled out the criticality of the SOEs/banks link. Indeed, the Executive Board, in the context of the 1993 Article IV consultation, highlighted the vulnerabilities created by the lagging reform effort. Program discussions were delayed in 1993 by lack of consensus on reforms.[11] Both the 1994 and the 1996 programs regarded SOE/banking reforms as critical.[12] The centrality the Fund attributed to these reforms is confirmed by internal documents and the EPA interviews. One could note, however, that neither the 1994 nor the 1996 program conditionality covered SOEs/banking reform to an extent comparable with the 1997 program. These programs did envisage reforms but these were described in relatively general terms, with conditionality operating primarily through the program review process. However, as detailed in Box 4, this more limited conditionality does not indicate lack of understanding of the importance of structural problems, nor did it have major implications for the failure of the 1994 and 1996 programs. A few participants in the EPA interviews argued that more detailed conditionality might have facilitated the implementation of reforms. Be this as it may, quantitative macro-conditionality was able, indirectly, to catch the authorities' structural slippages, which the authorities decided not to correct. However, when ownership was strong in 1997, the specification of detailed structural conditionality did help, primarily in providing the authorities with a blueprint for their reform agenda.

[10] Political instability before 1997 was obviously also an obstacle to policy implementation. But this instability was, in itself, also a reflection of lack of a pro-reform consensus.

[11] During 1995 staff argued that, without reforms, the macroeconomic stabilization achieved after the 1994 crisis was not sustainable. At the end of the 1995 Article IV consultation, Executive Directors also highlighted the need to reinvigorate reform efforts, and stated that "as regards the banking sector, rehabilitation plans need to be bold and implemented vigorously to avoid a looming banking crisis… ."

[12] For example, the 1994 LoI (paragraph 15) stated that "losses of the enterprise sector in 1993 represented a quasi-fiscal deficit that is estimated to be roughly of the same magnitude of the budget deficit in this year. We recognize that these deficits threaten Bulgaria's economic and financial stability and the time has come to address this challenge."

Box 3. Did Lack of Data Prevent Diagnosing the SOEs/Banks Problem?

As in other transition countries, program design in Bulgaria was hampered by lack of adequate data. The government's quasi-fiscal activities were notoriously hard to pin down. While by the mid-1990s all SOEs had to provide their financial data quarterly, poor accounting standards made the reported data relatively unreliable. But the existence of severe problems in SOEs and banks was well known, and was confirmed by the repeated need for the government to cover bank losses through the injection of securities, and for the central bank to provide liquidity.

Box 4. Structural Conditionality (or lack thereof) In the 1994 and 1996 Programs

The 1994 letter of intent committed the authorities to SOE reform and privatization. However, these actions were not covered by conditionality, except through the program review process. With ample evidence that the pre-program discussions had clearly focused on the SOE/banks link, this cannot be due to an underestimation of the problem. Rather, the Fund preferred to rely on an indirect, and more traditional, approach to enforce SOE/bank reform, namely through credit ceilings. Failure to deliver on the structural side would have implied breaching these ceilings, as it did.

The 1996 program did involve a series of structural prior actions, but they were not sufficiently comprehensive. One prior action was to agree with the World Bank on a program for enterprise reform, which was achieved "in principle". As to banks, the authorities were not willing to go ahead with a complete restructuring. The Fund eventually accepted a "two-step" approach on the condition that the banking strategy would be quickly revised if market confidence was not restored (this involved agreement on a side letter, whose leak may have deepened the crisis further). In addition, an early review was provided for to assess financial sector developments and progress in SOE reform.

C. Why Did the Fund Support Programs That Were Too Weak?

22. **If the main reason for the failure of the programs was the lack of a pro-reform consensus, did the Fund fail to see this**? The World Bank decided to delay the conclusion of program discussions in 1994 and held the release of its adjustment operation tranche in 1995-96 due to lack of progress in structural reforms. The Fund went ahead. Did the Fund fail to appreciate political risks?

23. **This does not seem to be the case**. The prolonged program discussions ahead of both the 1994 and the 1996 programs, the authorities' unwillingness to take adequate measures, and the repeated slippages in earlier programs were clear evidence of problems to come. Moreover, internal Fund documents did repeatedly point at the risks of the political situation.

24. **Three reasons were mentioned in the EPA interviews to explain why the Fund went ahead in spite of these political economy risks:**

- The most important one was that the decisions to support Bulgaria in 1994 and 1996 were taken under crisis situations, that is, when it is inherently more difficult to deny support, particularly for an institution that has crisis prevention at the core of its mandate. The Fund faced the difficult choice of not supporting Bulgaria, with virtual certainty of deepening the crisis, or supporting her with a modest chance of success. This dilemma is illustrated, for example, by the discussions ahead of the 1996 program. At that time, the authorities were unable to reach agreement with the World Bank on key structural reforms, particularly on enterprise reform. On that occasion, Fund management took the view that waiting for this agreement could have slowed down discussions and delay completion until September/October 1996. However, the crisis situation required putting in place a program expeditiously. One could take the "cynical view" that a deeper crisis was needed to shake up the political system, but such a position comes out as the best course of action only with the benefit of hindsight, and in the absence of a counterfactual.

- The authorities' performance was not uniformly bad. As noted, both in 1994 and 1996, the central budget position was strengthened significantly, also reflecting the fact that the Ministry of Finance was controlled by the most reformist component of the government's coalition. [13] The fact that this was the main ministry counterpart of the Fund in the discussions may have made it more difficult to deny support.

- The increased attention of the international community and the Fund to ownership issues is relatively recent. In the mid-1990s, it would have perhaps been harder for Fund staff to deny support to a program based on ownership considerations.

25. **It is difficult to assess whether better cooperation between the Fund and the World Bank would have avoided giving support to the 1994-96 programs**. The World Bank felt that Bulgaria did not deserve support at that time, while the Fund supported the two failed programs. In 1997, the Fund again took the lead, this time in supporting the successful program. Indeed, in the absence of a World Bank supported program, the Fund had to take the lead in the negotiations of both macroeconomic policies and structural reform, including in the critical banking and SOE sectors.[14] One would be tempted to find in all this an

[13] In early-1994, the central budget position was even stronger than targeted. Moreover, some structural reforms were undertaken in 1994: a VAT was introduced, the bankruptcy law required to close loss-making SOEs was approved, and an external debt reduction was successfully negotiated. And, in 1996, insolvent banks started being closed.

[14] In reviewing Bulgaria's experience in 1997, the Bank's Operations Evaluation Department noted that:

(continued)

example of the Fund's alleged bias towards giving the benefit of the doubt, or of the Bank's alleged propensity for caution. With the Fund's mandate including crisis prevention, its propensity to take risks may have been higher. Moreover, when two institutions are involved in decisions that are, by and large, judgmental, there are bound to be cases of disagreement, which may complicate approaching the authorities with a unified front.

IV. Did Bulgaria Need Seven Years of Fund Support after 1996?

26. **Fund support is usually seen as providing three benefits: financial, catalytic, and "political economic"**. The first relates to the classical role Fund resources can play in closing a financing (balance of payments) gap. The second relates to the effect of the Fund's stamp of approval on the availability of financial resources from other sources. The third relates to the role the Fund can play in mobilizing internal support for appropriate policies. Of course, if a program were fully owned by the government, the opposition, and the population at large, this latter role would be meaningless. Conversely, the discipline provided by Fund monitoring cannot be a substitute for a sufficient degree of ownership. But, in between these two extremes, there is a continuum of situations in which appealing to an external source of discipline may facilitate policy implementation.

27. **The EPA interviews highlighted that the relevance of the first two roles declined over time for Bulgaria, while the third role remained important, or even increased in importance**. This justified not only the EFF that followed the 1997 SBA, but also the most recent SBA, although in the latter case a precautionary SBA may have been as effective.

A. Financial Benefits

28. **The direct financial benefit of IMF support (in closing the financing gap) is difficult to quantify but was not trivial**. Under the extreme case in which Bulgaria had not been able to borrow additional resources at all, the adjustment would have occurred through a lower level of activity, which would have involved sizable losses.[15] At the other extreme, one could assume that Bulgaria could have borrowed from international markets additional

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"After 1997, once the new Government adopted a Currency Board and began implementing reforms, the Bank adopted a prudent stance and only gradually launched a full lending program....With growing evidence of government commitment and achievement of macroeconomic stabilization, the Bank began to support a broad reform program through a series of sectoral adjustment loans addressing, enterprise, banking, agricultural, social protection, and energy sector reforms... ."

This confirms that the Bank resumed support only after growing evidence that macroeconomic stabilization had been achieved. The latter, however, did require early structural reforms, which were initiated under the Fund's SBA.

[15] Quantifying these losses would require making a number of assumptions (on the effect on growth, the response of capital flows, and the alternative use of international reserves).

resources at the rates it was actually borrowing. Taking into account the spread between those rates and the IMF lending rate, the saving for Bulgaria from borrowing from the Fund declined over time: the 1997 SBA, the 1998 EFF, and the 2002 SBA involved annual benefits, respectively, of 0.4 percent of GDP, 0.3 percent of GDP, and less than 0.1 percent of GDP. The decline reflected the falling spread on Bulgaria's debt and, for the last program, the smaller size of support.[16]

B. Catalytic Effects?

29. **As noted, unlike later programs, the 1997 SBA contributed to a tightening of spreads, consistent with the existence of a catalytic effect**. However, quantifying the catalytic effect of Fund programs is complicated by the difficulty of separating the effect of the change in policies and the political environment from the mere effect of the Fund's stamp of approval. [17] The effect on spreads was more limited in later programs. To these effects, one should add those related to financing from other multilateral creditors (EU, World Bank, EBRD), which may have been missing without a Fund-supported program.

C. Mobilizing Internal Support

30. **The consensus view in the EPA interviews was that Fund endorsement facilitated reform implementation significantly, particularly in later years**. As discussed, until 1997, Fund endorsement was not sufficient to promote good policies. Conversely, it could be argued that the reforms may have been implemented even without Fund support in 1997, given the overwhelming popular support for reform. Be this as it may, the Fund has generally been well regarded in Bulgaria, so that its support for a certain measure has typically added to its legitimacy, making it less likely to be opposed in parliament. In this respect, the importance of Fund endorsement may have increased in later years, as parliamentary majorities became more fragmented. This appears to have been particularly important in justifying the 2002 SBA, as the government elected in 2001 did not have a strong majority, and included less reform-minded coalition partners.[18] It may also provide a rationale for a new program.

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[16] Considering the outstanding stock of Fund resources committed in earlier programs, the financial benefit for Bulgaria would be about 0.7 percent of GDP per year during 1997–2002.

[17] Recent studies that try to disentangle these effects would suggest that the fall in Bulgaria's spread was not due to catalytic effects. Mody and Saravia (2003) conclude that catalytic effects emerge only when the program country's fundamentals are initially "not too bad," as defined by middle-of-the range external debt-to-GDP ratios and/or reserves-to-imports ratios. Thus, in principle, given Bulgaria's high external debt ratio, no program with Bulgaria was likely to have had a catalytic effect.

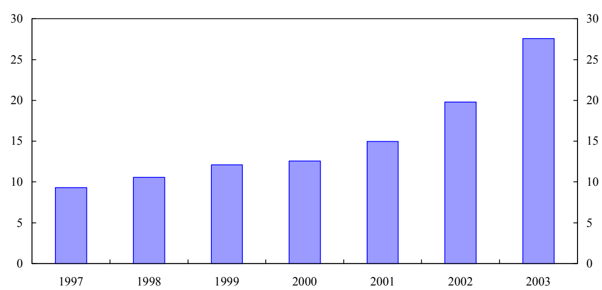
[18] For example, the fiscal tightening in 2003 (with respect to original plans) would most likely not have been implemented as promptly in the absence of a Fund-supported program.

V. A NEW FUND-SUPPORTED PROGRAM?

A. The Risks Ahead

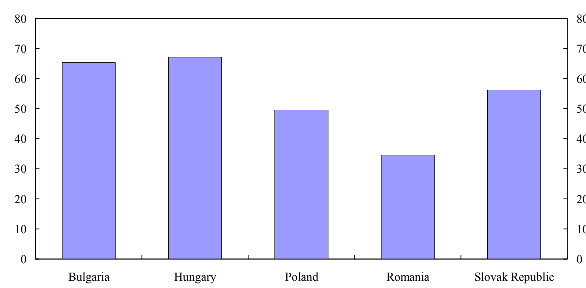
31. **Important macroeconomic risks remain**. Bank credit is booming and the current account deficit nearly doubled in 2003, possibly signaling the emergence of unsustainable imbalances (Box 5). The extent these developments pose risks is uncertain. As to credit growth, "bad" credit booms are hard to distinguish from "good" credit booms based on macro indicators,[19] and the assessment for Bulgaria is complicated by the fact that the level of bank credit is still relatively low (Figure 9).[20] Prudential indicators do not yet show signs of deterioration (although such indicators provide a lagging signal of bank asset quality). As to the widening of the external deficit, it could reflect the need to raise Bulgaria's output and export capacity, and is still largely financed by FDI. Financial markets have viewed these developments in a benign way. But, markets have been wrong before, and, with external debt still high (Figure 10), Bulgaria remains exposed to the vagaries of market sentiment.

Figure 9. Bulgaria: Claims on Non-Government Sector as a Percent of GDP 1997-2003



Sources: Bulgarian National Bank; and Fund staff estimates.

Figure 10. Bulgaria: External Debt to GDP, 2003
(U. S. Dollar based)



Source: National authorities.

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[19] As Gourinchas, Valdez, and Landerretche (2001) note "while most banking crises may be preceded by a lending boom, most lending booms are not followed by a banking crisis."

[20] A model-based approach suggests that the post-transition equilibrium level of the bank credit-to-GDP ratio for a country with Bulgaria's fundamentals is some 50 percent (Cottarelli, Dell'Ariccia, and Vladkova-Hollar, 2003). The actual 2003 level was 27½ percent.

Box 5. The Recent Widening of the Current Account Deficit and External Sustainability

The external current account deficit almost doubled in 2003, to 8½ percent of GDP, while bank credit to the private sector rose by close to 50 percent. Both consumer and investment goods' imports surged. In parallel, credit growth was driven by both households and business. If credit does not slow, the current account deficit could widen further. A compensating factor is that, while declining, FDI coverage of the current account deficit was 82 percent in 2003 (but only 63 percent excluding privatization receipts). Bulgaria's real effective appreciation also bears watching. The CPI-based REER has appreciated significantly in recent years, including vis-à-vis other CEE countries and Turkey (Figure 8). Other competitiveness indicators are more favorable: unit labor costs have fallen, and Bulgaria's export market shares have risen.

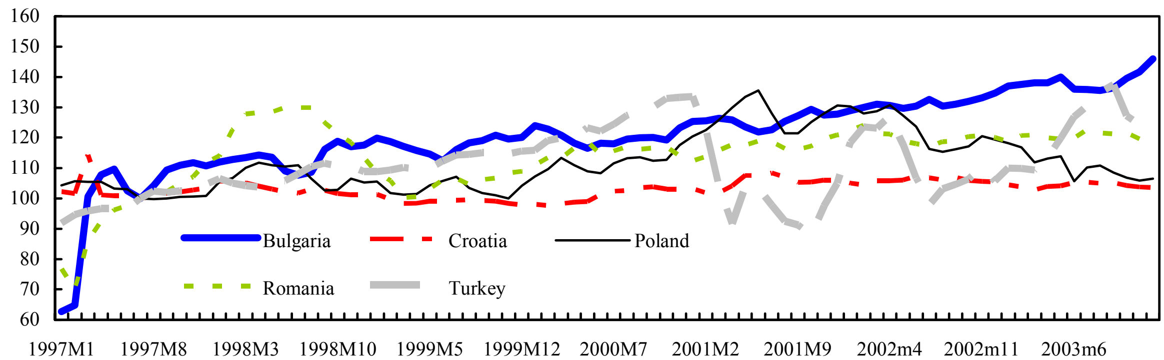
32. **There are also political and social risks**. Growth performance has been good, but not impressive. Moreover, unemployment and poverty, while better than in 1997, are still relatively high (World Bank, 2002b). Reflecting these problems, the political situation is not as solid as in the late 1990s and there may be a risk of reform fatigue. The recent local elections have shown that support for the government has weakened, and the coalition's cohesion has eroded. While there may be little appetite for early elections, opinion polls suggest that, on present trends, a new government coalition is likely to be formed after the mid-2005 elections, but its composition remains highly uncertain. This uncertainty is partly offset by the consensus to maintain the CBA and advance EU accession.

B. Nature of Future Fund Engagement and Exit Strategy

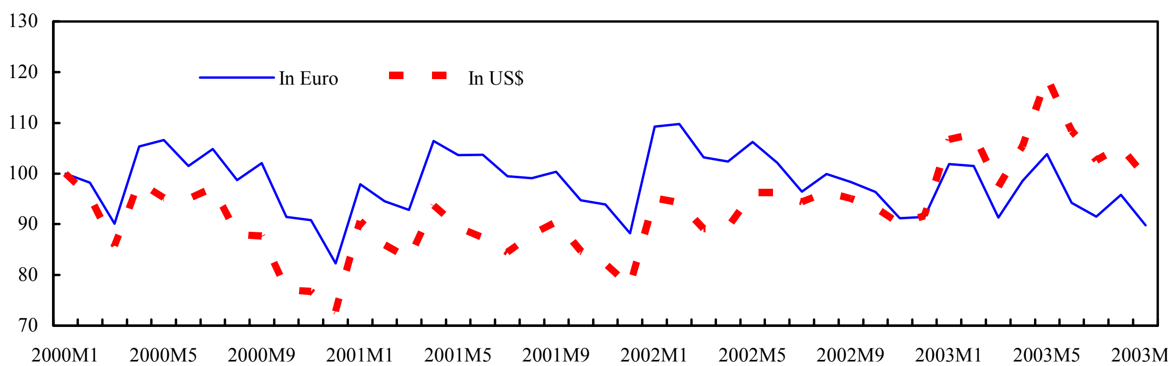
33. **The authorities are interested in a new precautionary SBA in support of a program aimed at reducing current risks while preserving the growth momentum**. This seems to require lowering the external current account deficit and, preferably, external debt. The current account deficit is now some 1½ percentage points of GDP above what staff regards as adequate to stabilize the external debt ratio without relying on one-off privatization receipts and given reasonable assumptions on greenfield investment. A larger deficit may eventually prove viable, but the still high external debt ratio, the lack of exchange rate flexibility, the need to avoid risks to the credibility of the CBA, uncertainty about the prospects for FDI, and the relatively distant date of EU entry, call for prudence. Within the context of a declining current account deficit, one-off privatization receipts—which could be high in the next two years—should be used to lower external debt. There is also a need to keep credit growth under close watch, to ensure that it does not give rise to an unsustainable financial bubble.

Figure 8. Bulgaria: Competitiveness Indicators, 1997-2003

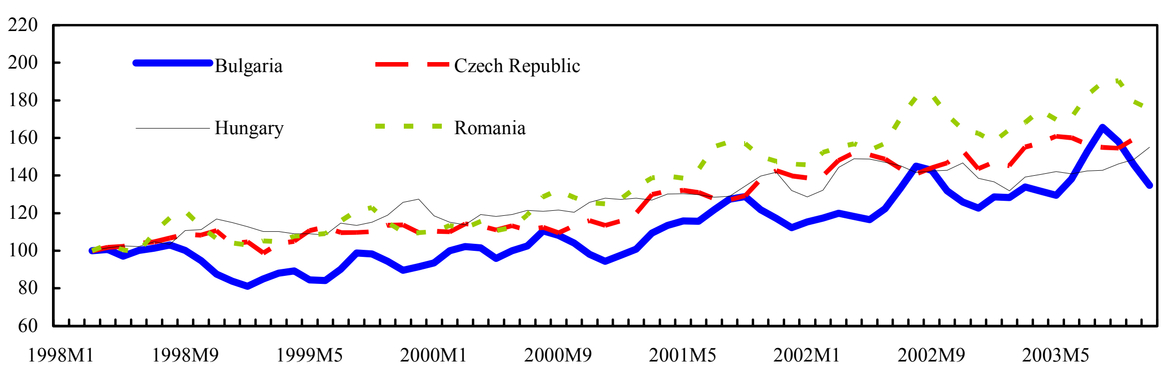
Central European REERs, 1997-2003
(INS, 1997=100)



Unit Labor Costs, 2000-03
(2000M1=100)



Share in EU Imports of Selected Countries, 1998-2003
(March 1998=100; 3-month rolling average) 1/



Source: National Statistical Institute; INS; Direction of Trade Statistics; and Fund staff estimates.

1/ Bulgaria, Czech Republic, and Hungary: Authorities' data; and Romania: Direction of Trade Statistics.

34. **Achieving these goals would require appropriate macroeconomic and structural policies.** More specifically:

- The external current account deterioration appears to be related primarily to rapid domestic demand growth (in addition to the cyclical weakness of demand in the euro area), partly driven by fast credit growth. Tight fiscal policy will have to be the main instrument to contain excessive domestic demand growth. Its specific parameters will have to be set in light of updated macroeconomic developments and their definition goes beyond the scope of this paper. But, in any case, it will be important to maintain fiscal flexibility in response to shocks.[21] At the same time, the quality of fiscal policy, which has recently been skewed towards short-term measures, should be improved. Structural fiscal measures should focus on enhancing tax administration and expenditure management. The 1999 pension reform should also be strengthened in some respects.[22]

- Containing external risks will also require strict incomes policies in the public sector and increased labor market flexibility through labor market reform, so as to reduce inflationary pressures and boost competitiveness.

- Should credit growth be excessive, the authorities must stand ready to implement further measures—including perhaps tightening reserve requirements and prudential regulations (although the effectiveness of these measures would depend on the extent of capital mobility and the degree of capitalization of banks, both or which are high). More generally, a continued strengthening of financial supervision is needed to reduce financial stability risks.

- Reforms to further improve the business environment are needed to attract foreign capital and boost potential output and exports. Earlier sections have once again confirmed the strict connection between macroeconomic performance and structural policies, and the important role that Fund conditionality has played in this area in Bulgaria. Looking ahead, the reform agenda should include completing privatization, and strengthening governance and the fight on crime (Bulgaria ranks 54th out of 133 countries in the Transparency International Corruption Perceptions Index; Transparency International, 2003).

35. **The balance of the arguments would be for recommending continued program involvement, assuming a successful completion of the program discussions**:

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[21] Public asset and liability management can also help avoid overheating. Borrowing domestically rather than externally, or shifting government deposits from commercial banks to the central bank, would tighten domestic liquidity, *ceteris paribus*.

[22] The modalities of pension indexation should be set by law. Moreover, the procedures for granting disability pensions, which have increased rapidly, should be reviewed.

- At the economic level, market sentiment towards Bulgaria is currently favorable, and there does not appear to be an imminent balance of payments need. However, as discussed, economic and political risks are nontrivial. There is little room for policy slippages, given Bulgaria's lack of monetary flexibility, and a potential balance of payments need cannot be ruled out.

- The macroeconomic nature of the risks justifies the Fund's involvement.

- The authorities have stressed that Fund support could: (i) facilitate internal consensus on appropriate policies, including in the run up to the 2005 elections; and (ii) provide confidence to foreign investors, rating agencies, and perhaps other multilateral institutions. As to the first objective, the EPA team concurs that the Fund's presence has and would likely continue to facilitate the enactment of appropriate policies. As noted in reviewing the 1997-2003 programs, the Fund's presence may be perhaps more important at a juncture when caution in macroeconomic policies may be jeopardized by the more fragmented political situation. As to the second objective, while catalytic effects vis-à-vis private capital are unlikely to be strong in the future, other multilaterals—the EBRD, the European Commission, and the World Bank—may prefer to engage with Bulgaria in the context of Fund arrangements.

- As highlighted earlier, the longer-term program engagement between Bulgaria and the IMF during 1997-2003 has not reflected a lack of receptivity of Fund advice, but rather the appreciation that the authorities have had for that advice. Thus, most of the drawbacks identified by the IMF's Independent Evaluation Office (2002) in case of longer-term program engagement—weaker incentives to take decisive action, loss of credibility for the Fund in supporting weak programs, poor ownership, and weakening of the surveillance function of the Fund—do not apply to Bulgaria.

36. **A surveillance-only relationship, while feasible, would be significantly less effective in supporting the authorities' program.** In particular, the EPA interviews highlighted that a surveillance-only relationship would be seen as signaling a more detached role for the Fund in the eyes of Bulgaria's public opinion. As such, it may not be very effective in maintaining policy discipline. Program conditionality would facilitate gathering the political support for appropriate policies.

37. **However, given the longer-term program engagement and the absence of an imminent financing need, a new SBA should be lower access and precautionary**. A precautionary SBA is in line with Executive Board decisions on signaling devices. The Board has agreed that precautionary agreements will continue to provide a framework for monitoring policies in countries that meet standards for Fund financial support, but which do not have an immediate financing need. Indeed, Management's guidance note to the staff for Assessments of Countries with a Longer-Term Program Engagement (IMF(2003)) points out that "precautionary arrangements may provide a more effective device for facilitating the transition from sustained reliance on Fund resources... ."

38. **The new arrangement is expected to be the last one, with EU accession serving as a natural exit from a program-based relationship**. A precautionary arrangement could cover a period of two to three years, thus bridging the gap before possible EU accession in early 2007. By then program policies are expected to have achieved the targeted decline in the external deficit and brought closer to completion the structural reform agenda. Moreover, the proximity of EU accession, and later the need to progress towards adoption of the euro, will provide an alternative to the discipline arising from Fund support. As intended by the authorities, euro adoption would be, in a successful scenario, the exit strategy from the CBA.

39. **Program discussions should focus on understanding better the extent of the risks**. Attention should be paid to the level of competitiveness, the determinants of the import boom (particularly to what extent it is driven by investment that would raise export capacity), the prospects for greenfield FDI, and the determinants of the credit boom, especially any sign of emerging asset price bubbles. The latter will require, in particular, further analysis of the breakdown of credit (by borrowing sector, maturity, and currency composition), of risk management practices, and of banks' funding sources. Equally important, political economy factors should be assessed to evaluate the risk of noncompliance.

VI. Conclusions

40. **The EPA team reached a number of conclusions:**

- The nature of Bulgaria's longer-term engagement with the Fund differs deeply between the pre-1997 period and the later period. In the former, that engagement occurred in the context of programs that failed to achieve their objectives; in the latter, it occurred within the context of successful programs and reflected the authorities' belief that the Fund could play a useful role in supporting the transition process even after the initial stabilization.

- The pre-1997 programs failed primarily because they were not implemented in their entirety, which in turn reflected insufficient ownership and support for reform. Policy implementation was good only in some areas (e.g., the central budget), which were perhaps under closer control of the reformists within the government, but did not extend to the critical SOEs/bank sector. The programs did recognize that macroeconomic stabilization required SOE/bank reforms. While the 1994 and 1996 programs did not include conditionality on these reforms to the extent of later programs, they did include policy commitments and quantitative macro-conditionality consistent with the reform goals. But those commitments were violated.

- The major shortcoming in the Fund's actions was its willingness to support programs that lacked sufficient ownership. This underscores the importance of an adequate assessment of political economy factors. But the fact is that the Fund has no control over those factors and that, in those circumstances, the best it can do is to deny support. This becomes more difficult when a country is in crisis, and when a program has even a modest chance of success.

- The 1996–97 crisis proved to be a watershed for the country, and triggered the change in politics and policies, boosting programs' ownership. As of 1997, Bulgaria benefited from Fund support in a number of ways that could not have been realized through a surveillance-only relationship. The most important one was the role the Fund played in providing a blueprint for reform and in mustering domestic support to implement it. In the most recent period, this role may even have become more important, given the less homogeneous composition of government forces.

- The cooperation between the Fund and the World Bank on Bulgaria went through different phases. In both 1994 and 1996, the Fund supported Bulgaria without a World Bank supported program. In 1997, the Fund again took the lead, this time in supporting the successful program. Indeed, in the absence of a World Bank supported program, the Fund took the lead also in the design of structural conditionality. In more recent years, the cooperation between the two institutions was more consonant with their respective areas of responsibility (and was mentioned as an example of effective collaboration in the recent Joint Fund-Bank Progress Report on Fund-Bank Conditionality and Collaboration). However, from the point of view of program design, Bulgaria's post-crisis experience suggests that detailed structural conditionality may have played a useful role in coordinating domestic policies particularly during 1997–2001. The use of structural conditionality to the extent of, in particular, the 1997–1999 programs would, *de facto*, have been significantly more difficult under the 2002 guidelines on streamlining conditionality.

- Looking forward, the balance of arguments is in favor of accepting the authorities' request for a new precautionary SBA, provided policies are right. Economic risks ahead are nontrivial, and a program-based engagement could help mobilize support for appropriate policies and reforms, minimizing those risks. A surveillance-based relationship would unlikely be as effective. Prospective EU accession in early 2007 is seen as a natural exit from Fund programs.

- A new program should contain measures to limit the risks related to the widening of the external current account deficit and the ongoing bank lending boom. This falls squarely within the mandate of the Fund, including in the area of financial sector stability. Alongside, the reform process should continue with the goal of further privatization, and improvement in the business climate. This is needed to stimulate a supply response, which is critical for the political sustainability of macroeconomic stability. Cooperation with the World Bank in this area is essential. While the Bank should take the lead in the structural area, Fund conditionality can play selectively an important role, in areas of more direct macroeconomic implication such as privatization (given its relevance for lowering external debt).

- During the program discussion, there is a need to evaluate not only current macroeconomic risks, but also implementation risk arising from political economy factors. The EPA for Bulgaria has confirmed that a proper evaluation of these risks should be a necessary component of any pre-program discussion.

Table 1. Bulgaria: Selected Economic Indicators, 1990-2003

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average 1990-1997	Average 1998-2003	Average 1992-2003
Output, prices, and employment	(Period average; percent change from same period of previous year)																
Real GDP	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-5.6	4.0	2.3	5.4	4.1	4.9	4.3	-5.3	4.2	-1.2
Consumer price index	23.8	338.4	91.3	72.9	96.1	62.1	121.6	1061.2	18.8	2.6	10.4	7.5	5.8	2.3	233.4	7.9	136.8
Registered unemployment rate (in percent)	1.7	11.1	15.3	16.4	12.8	11.1	11.0	14.0	12.4	13.8	18.1	17.5	17.4	14.3	11.7	15.6	13.4
Real public sector wages	...	-39.0	12.0	-7.7	-29.9	9.3	-26.7	-21.5	26.3	10.7	2.4	6.3	2.5	3.9	-14.8	8.7	-4.0
Real private sector wages	...	...	...	...	...	...	...	-16.8	22.1	9.4	7.8	4.1	-4.1	5.7	-16.8	7.5	4.0
Consolidated government 1/	(In percent of annual GDP)																
Revenue	52.9	40.4	38.4	37.2	39.9	36.1	31.9	30.7	37.9	38.5	38.7	37.6	36.5	37.9	38.4	37.8	38.2
Noninterest expenditure	56.2	37.1	37.2	38.8	32.2	27.8	22.6	25.4	32.6	35.7	35.7	34.7	34.9	36.2	34.7	35.0	34.8
Primary balance	-3.3	3.3	1.2	-1.6	7.7	8.3	9.3	5.3	5.3	2.8	3.0	2.8	1.6	1.7	3.8	2.9	3.4
Interest payments	9.5	17.9	6.4	9.3	13.5	14.6	19.7	7.8	4.3	3.8	4.0	3.7	2.2	2.1	12.3	3.3	8.5
Domestic	0.7	6.0	4.8	8.3	12.2	11.3	17.0	5.5	0.9	0.6	1.0	0.9	0.5	0.5	7.4	0.7	5.0
External	8.8	11.9	1.6	1.0	1.3	2.8	2.7	2.4	3.9	3.7	3.1	2.9	1.7	1.6	4.1	2.8	3.5
Overall balance 2/	-12.8	-14.6	-5.2	-10.9	-5.8	-6.3	-10.4	-2.4	1.0	-0.9	-1.0	-0.9	-0.6	-0.4	-8.6	-0.5	-5.1
External financing	4.0	9.9	-0.7	-1.2	-0.5	-1.3	-2.4	-1.3	-0.6	1.2	-1.5	-0.3	1.5	0.0	0.8	0.0	0.5
Domestic financing	8.8	4.7	6.0	12.1	6.3	7.0	14.9	0.5	-2.0	-2.5	1.2	-1.7	-1.9	-1.8	7.5	-1.4	3.7
Privatization receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.3	1.6	2.2	1.3	2.9	0.9	1.1	0.4	1.7	0.9
Total public debt 3/	...	...	158.3	135.9	140.2	100.9	105.8	110.4	80.0	82.8	77.0	69.9	61.4	53.4	125.3	70.8	98.0
External	...	...	133.6	109.3	97.5	63.6	83.8	84.6	69.9	74.2	70.5	63.7	54.8	46.8	95.4	63.3	79.3
Domestic public debt 4/	...	...	24.7	26.6	42.7	37.3	22.0	25.8	10.2	8.6	6.6	6.2	6.6	6.6	29.9	7.5	18.7
Money and credit	(End-of-period; percent change from same period of previous year)																
Nominal credit growth 5/	...	...	32.3	32.7	33.9	32.3	50.9	46.7	45.5	21.4	17.0	32.1	44.0	48.3	36.4	34.7	36.4
Net domestic assets of the monetary authorities	...	...	26.7	47.6	93.7	13.5	115.8	-387.2	20.0	18.3	33.3	-4.4	81.6	33.4	-15.0	30.4	7.7
Balance of payments	(In millions of US dollars)																
Gross official reserves	...	636	1,240	969	1,311	1,546	793	2,474	3,056	3,222	3,460	3,580	4,747	6,705	1,281	4,128	2,595
(In months of prospective imports of GNFS)	...	2.7	2.8	2.0	3.0	3.1	1.5	5.0	5.6	5.0	4.9	4.7	4.6	5.2	2.9	5.0	3.9
Current account balance (in percent of GDP) 6/	...	-5.3	-9.3	-12.8	-1.7	-0.6	0.2	10.1	-0.5	-4.8	-5.6	-7.3	-5.6	-8.5	-2.8	-5.4	-4.0
Exchange rates																	
Leva per U.S. dollar (IFS) 7/	0.003	0.022	0.024	0.033	0.066	0.071	0.487	1.777	1.675	1.947	2.102	2.219	1.885	1.611	0.3	1.9	1.0

Sources: Bulgarian authorities; and staff reports.
1/ Includes the republican budget, municipalities, and extrabudgetary funds. The coverage became more comprehensive from 1998 onward, resulting in a structural break.
2/ In 2003, includes below-the-line transfers. Excluding such transfers, the overall balance as a percent of GDP was zero.
3/ Domestic debt as reported by Ministry of Finance and external debt as reported by BNB, in US$.
4/ In leva and other currencies.
5/ Banking system claims on non-government sector.
6/ Data are US dollar-based ratio before 1999 and euro-based from 1999 onwards.
7/ End-of-period, in redenominated leva.

Table 2. Bulgaria: History of Lending Arrangements

(In millions of SDRs; unless otherwise indicated)

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Agreed	Amount Drawn	Percent Drawn	Notes
SBA	Feb-02	Mar-04	240	240	100	All reviews completed and purchases made.
EFF	Sep-98	Sep-01	628	628	100	All reviews completed and purchases made.
SBA & CCFF	Apr-97	Jun-98	480	480	100	All scheduled reviews were completed and purchases made.
SBA	Jul-96	Apr-97	400	80	20	No reviews and envisaged purchases were made; inspite of the program, public confidence in the lev and banking system did not return resulting in the 1996 financial crisis and a severe economic crisis. Actual economic performance deviated substantially from program targets.
SBA & STF	Apr-94	Mar-95	256	232	91	Only the first financing review in August '94 was completed. During that review, the SBA was augmented to SDR 139.5 million from 69.7 million. In September 1994, the government resigned and elections were called for December. In view of the need for decisive measures especially in structural reforms and the short tenure of the program, envisaged reviews could not be completed and further purchases under the SBA and STF were not made.
SBA	Apr-92	Apr-93	155	124	80	Except for the final one, all reviews and purchases under the SBA were completed. Heightened political tensions, which culminated in the fall of the UDF-led government in October 1992, was associated with a loosening of fiscal and income policies, and much slower progress in structural reforms. As a result, the ambitious targets for 1992 under the SBA were missed.
SBA & CCFF	Mar-91	Mar-92	357	336	94	All reviews under the SBA were completed and all purchases were made as scheduled. The SBA had attached to it a CCFF equivalent to SDR 77.5 million; a purchase of SDR 56.9 million was made in March 1992 under this mechanism. In March 1991, Bulgaria had made a CCFF purchase under Section V of the CCFF decision for SDR 60.6 million; however this was repurchased in full in March 1992.
Total			2,514	2,119	84	

Source: IMF, FIN Department.

Table 3. Bulgaria: Prime Ministers and Governing Coalitions Since 1990

Period	Prime Ministers	Governing Coalition
3 Feb 1990 - 7 Dec 1990	Andrey Karlov Lukanov	BKP/BSP
7 Dec 1990 - 8 Nov 1991	Dimitur Ilchev Popov	BSP, UDF, BZnS
8 Nov 1991 - 30 Dec 1992	Filip Dimitrov Dimitrov	UDF
30 Dec 1992 - 17 Oct 1994	Lyuben Borisov Berov	BSP, MRF
17 Oct 1994 - 25 Jan 1995	Reneta Ivanova Indzhova	Interim
25 Jan 1995 - 13 Feb 1997	Zhan Vasilev Videnov	BSP, BZnS
13 Feb 1997 - 21 May 1997	Stefan Antonov Sofianski	Interim
21 May 1997 - 24 Jul 2001	Ivan Yordanov Kostov	UDF, DP
24 Jul 2001 -	Simeon Borisov Sakskoburggotski	SNM/MRF

Notes:
BKP/BSP - Bulgarian Communist and later Socialist Party.
BZnS - Bulgarian People's Farmers Union.
DP - Democratic Party.
MRF - Movement for Rights and Freedoms.
SNM - Simeon II National Movement.
UDF - Union of Democratic Forces (center-right).

Table 4. Bulgaria: Performance under Fund Supported Programs

Arrangement	Number of Quant. Performance Criteria			
	Total	Met	Modified	Not Met
SBA (Mar-91 to Mar-92)	19	16	1	2
SBA (Apr-92 to Apr-93)	20	19	1	0
SBA and STF (Apr-94 to Mar-95)	24	18	3	3
SBA (Jul-96 to Apr-97)	22	19	0	3
SBA (Apr-97 to Jun-98)	58	53	0	5
EFF (Sep-98 to Sep-01)	77	73	1	3
SBA (Feb-02 to Feb-04)	76	71	0	5

Arrangement	Number of Structural					
	PCs	Benchmarks	Prior Action	Met on Time	Met w/delay	Not Met
SBA (Mar-91 to Mar-92)	0	0	0	...	...	...
SBA (Apr-92 to Apr-93)	0	0	0	...	...	...
SBA and STF (Apr-94 to Mar-95)	0	0	5	5	0	0
SBA (Jul-96 to Apr-97)	0	0	13	12	1	0
SBA (Apr-97 to Jun-98)	0	0	54	43	11	0
EFF (Sep-98 to Sep-01)	29	44	21	89	2	3
SBA (Feb-02 to Feb-04)	2	20	5	18	5	4

Source: MONA and Staff Reports.

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Statement by the IMF Staff Representative
June 14, 2004

This statement provides information that has become available since the issuance of the staff report for the 2004 Article IV Consultation. This information does not change the staff's appraisal in that report.

- High-frequency economic data point to robust growth. Industrial output and sales volume surged by 17¼ percent and 15½ percent year on year, respectively, in the first quarter while twelve-month inflation eased from 6.2 percent in March to 6.1 percent in April. The registered unemployment rate declined to 13.2 percent in April, while real wages increased by 0.1 percent year on year in January-March 2004.

- External developments are broadly in line with projections. As expected, the twelve-month external current account deficit widened to 8.8 percent of GDP in March, with a weaker trade deficit (13.4 percent of GDP) offset by better net income and transfers balances. However, at €280 million in the first quarter, net FDI inflows (mostly greenfield) were higher than expected, covering 58 percent of the current account deficit and contributing, together with strong capital inflows, to a small gain in international reserves.

- The growth of credit to the nongovernment sector slowed from 52¼ percent year on year in March to 50¾ percent in April, with credit to households and nonfinancial corporations rising by 80 percent and 40 percent, respectively. The authorities have begun to take measures to reduce bank liquidity by shifting government deposits in commercial banks to the central bank and imposing a reserve requirement of 4 percent (from July 1) on previously excluded instruments with maturities of two years or above, while excluding (from September 1) 50 percent of cash in vault from reserve requirement calculations.

- In the first four months of the year, the government accumulated a cash fiscal surplus of 1.4 percent of GDP, reflecting a large revenue overperformance (1.8 percent of GDP), partly offset by higher expenditure (0.4 percent of GDP). The overperformance of tax revenue was due mainly to higher-than-projected corporate profits in 2003 and imports in the first quarter of 2004. The latter led to higher VAT and customs and excise duties. Expenditures for maintenance and operations, subsidies and social programs exceeded budget allocations—in contrast to the authorities' intention, reported in paragraph 20 of SM/04/179, to limit discretionary central government spending to 93 percent of its downward revised levels through the third quarter.

- On June 7 the communications regulatory commission approved the granting of a GSM license to the BTC communications company, thereby removing the remaining obstacle to the completion of its sale. The deadline for the submission of binding bids for the privatization of seven electricity distribution companies was extended to July 9 at the bidders' request.

- On June 4, Bulgaria closed three additional EU accession chapters and negotiations on the last one (competition policy) are expected to be completed by end-June.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/65
FOR IMMEDIATE RELEASE
June 18, 2004

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

IMF Concludes 2004 Article IV Consultation with Bulgaria

On June 14, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bulgaria.[1]

Background

Bulgaria's economic performance has continued to improve since the 1996–97 crisis. A policy strategy anchored by the currency board arrangement and supported by a prudent fiscal policy, a strict incomes policy for state-owned enterprises, and structural reforms, has resulted in average real GDP growth of 4½ percent since the last Article IV consultation. The unemployment rate, although still high, has dropped considerably, and inflation has remained subdued. The Currency Board Arrangement has provided necessary stability to the economy, and the accompanying tight fiscal policy has allowed public debt to decline commensurately. In 2003, Bulgaria tightened fiscal policy, saving half the revenue overperformance and reducing the deficit to 0.4 percent of GDP. The ex post assessment of Bulgaria's long-term involvement with Fund-supported programs concluded that the relationship had been generally effective and that a program-based engagement would be the most effective way of supporting the government's economic program in the run-up to European Union accession in 2007.

Despite generally favorable macroeconomic developments, Bulgaria faces a risk of economic overheating due to a surge in credit growth and a related sharp widening of the current account

[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.

deficit. Bank claims on the nongovernment sector rose by nearly 8 percentage points of GDP in 2003, and their growth has not abated. Bank prudential indicators, however, show no signs of deterioration. The credit-induced import boom widened the current account deficit to 8½ percent of GDP in 2003. However, foreign direct investment inflows have been strong and reserves have been rising. Competitiveness remains broadly adequate, but warrants close monitoring.

Structural reforms have continued, albeit at a slower pace. Bank privatization has been completed. Measures have been taken to bring energy prices to cost-recovery levels, and the restructuring of electricity distribution companies has advanced. In the fiscal area, the large taxpayer office was expanded, and program budgeting and better budget preparation practices were initiated. However, progress has been limited in reforming the health, education, and railway sectors. Furthermore, delays in selling tobacco holding Bulgartabac remain troubling.

For 2004, given the high credit growth and the associated risks of economic overheating, the authorities have agreed to a deficit of 0.4 percent of GDP—rather than 1.2 percent of GDP as originally planned in the budget—and to further use the expected overperformance of revenue to attain balance for the year. They also intend to achieve balance in the coming years, although EU-related expenditures may necessitate a small deficit in 2007. The authorities have planned to reduce bank liquidity to the extent permitted by an open capital account by tightening reserve requirements and shifting government deposits from commercial banks to the central bank.
In order to enhance Bulgaria's supply potential to attain sustainable higher growth, the authorities plan to undertake measures to further improve governance and the business climate. Furthermore, privatization of remaining state-owned enterprises is also being planned, not only to help alleviate risks emanating from high current account deficit but also to facilitate further FDI inflows.

Executive Board Assessment

Executive Directors welcomed the solid economic performance in recent years, which—despite a weak external environment—has delivered robust economic growth, a reduction in unemployment, moderate inflation, and declining public and external debt ratios, and supported the authorities' commitment to persevere with their policy framework. However, they were concerned about the recent widening of the external current account deficit caused by a sharp expansion of credit, and emphasized the need to moderate the pace of domestic demand as well as accelerate structural reforms to boost output and export potential.

Directors noted that the credit boom has led to a surge in imports, and may point to possible economic overheating. However, they considered that it does not presently seem to represent a threat to financial stability owing to the strengthened supervisory practices of the Bulgarian National Bank (BNB) and the sound financial positions of banks. Nevertheless, Directors were concerned that, if left unchecked, the rapid credit growth and the increase in foreign borrowing might further exacerbate the external imbalance and undermine the favorable external debt dynamics and solid economic performance of recent years.

Directors encouraged the authorities to tighten macroeconomic policies more forcefully to address these challenges. They recommended a mix of policies—within the constraints of the currency board arrangement (CBA)—to moderate demand and enhance supply as well as export capacity by tightening the fiscal stance, draining liquidity from the banking system, and implementing structural reforms, including privatization, more vigorously. The timely adoption of such policies, and pursuit of the recommendations of the Financial Sector Assessment Program (FSAP) follow-up, will also support maintaining the currency board arrangement until euro introduction.

Against this background, Directors viewed the authorities' macroeconomic program for 2004–05 as adequate, although many of them would have preferred a more ambitious fiscal adjustment, especially in 2004, to dampen domestic demand, particularly as the CBA constrains monetary policy actions. They commended the authorities for reversing the expansionary stance of the 2004 budget and for envisaging budget balance in 2005. In light of the revenue overperformance so far in 2004, they urged the authorities to save the overperformance at least until budget balance is assured, and to resist pressures to increase spending in the run up to next year's election. Directors welcomed the authorities' intention to undertake further fiscal tightening should the current account or inflation performance be weaker than currently projected.

With regard to the medium term fiscal position, and in view of the need to accommodate higher infrastructure spending in the future, Directors cautioned the authorities to implement their strategy of shifting partially from direct to indirect taxation in a revenue neutral way, and urged them to accelerate reforms to strengthen tax administration and expenditure management. Measures are also needed to ensure the sustainability of the pension and health care systems. Finally, in light of the need to enter ERM2 with a solid fiscal position, Directors encouraged the authorities to take timely steps to prevent fiscal deficits upon EU accession.

Directors commended the authorities for their measures to reduce credit growth by tightening reserve requirements and shifting certain government and other deposits from commercial banks to the central bank. However, as the effectiveness of these measures remains to be seen in the context of an open capital account, fiscal flexibility needs to be maintained to respond promptly if credit expansion continues to fuel excessive growth of domestic demand and imports.

Directors strongly supported the authorities' intention to complement demand management policies with structural reforms aimed at enhancing supply. They were encouraged by the authorities' focus on measures to improve the business climate, including by reducing barriers to entrepreneurial activity and making the labor market more flexible, which will help to attract greater foreign direct investment. Directors noted that structural reforms have slowed, with the privatization of some major state monopolies still incomplete, and little progress in health, education, and railway sector reforms. As privatization is critical to meeting Bulgaria's external financing requirements in the next few years and to increasing productivity, they welcomed the long-delayed sale of the telecoms company (BTC) and the plans to complete the privatization of the tobacco holding (Bulgartabac) as well as to sell the electricity distribution companies before year end. The establishment of a new privatization pipeline for 2005-06 is also crucial.

Directors welcomed the opportunity to review Bulgaria's program engagement with the Fund since the mid 1990s. They considered that the ex post assessment (EPA) contains a balanced analysis of the country's performance under Fund arrangements and of the role played by the Fund in Bulgaria. The EPA also highlights that strong country ownership from the outset is critical for the success of Fund-supported programs. Directors noted that the 1996/97 crisis had been a watershed for the country, triggering a fundamental change in policies and boosting program ownership. They considered that the Fund had played an important role in providing a blueprint for reform and in helping to muster domestic support for its successful implementation since the crisis. As important macroeconomic risks remain, most Directors viewed continued Fund engagement under a successor Stand-By Arrangement (SBA) appropriate to support the government's economic program and help maintain policy discipline, provided that economic policies and the commitment to reform are consistent with the need to reduce macroeconomic risks. However, given the long-term program engagement and the absence of an imminent financing need, they concurred with the authorities that a new SBA should have lower access and be precautionary, and provide a clear strategy for the transition from a program-based relationship with the Fund. Most Directors were of the view that in this regard EU accession, expected for early 2007, should offer a natural exit. A few Directors, while prepared to go along with a precautionary SBA, noted that a surveillance-only relationship would be as effective in supporting the authorities' economic program, and would not imply a reduced role for the Fund.

Directors welcomed the improvements in data quality as well as the decision to subscribe to the Fund's Special Data Dissemination Standard.

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Bulgaria: Selected Economic Indicators

	2000	2001	2002	2003	2004[1]
Real economy	Percent change				
Real GDP	5.4	4.1	4.9	4.3	5.0
Consumer price index (end of period)	11.4	4.8	3.8	5.6	3.2
Registered Unemployment	18.1	17.5	17.4	14.3	...
Public finance	(In percent of GDP)				
General government balance	-1.0	-0.9	-0.6	-0.4	-0.4
Public debt (end of period)	77.0	69.9	61.4	53.4	47.3
Money and credit	(Annual percent change)				
Broad money (nominal, end of period)	30.8	25.8	11.7	19.6	18.2
Credit to nongovernment sector (nominal, end of period)	17.0	32.1	44.0	48.3	25.9
Interest rates (annualized)	(In percent annualized)				
BNB basic rate	4.6	4.7	3.4	2.7	...
Time deposit (leva)	3.3	3.4	3.2	3.2	...
Balance of payments	(In millions of euro)				
Gross official reserves (end of period)	3,719	4,063	4,575	5,309	5,775
(In months of prospective imports of GNFS)	4.7	5.0	4.9	5.1	5.1
Current account (percent of GDP)	-5.6	-7.3	-5.6	-8.5	-8.2
Trade balance (percent of GDP)	-9.4	-11.7	-10.2	-12.5	-12.8
Exchange rates					
Exchange rate regime	Currency Board since July 1997[2]				
Leva per dollar (end of period)	2.102	2.219	1.885	1.611	1.614
Nominal effective exchange rate (1995=100)[3]	6.0	6.3	6.6	7.2	...
Real effective exchange rate (1995=100)[3, 4]	125.3	131.2	137.0	144.7	...

Sources: Bulgarian authorities; and IMF Staff estimates.
[1]Projection.
[2]The Currency Board arrangement fixed the exchange rate at 1,000 leva = 1 DM through end-1998 and 1,955.83 leva = 1 euro since January 1, 1999. On July 5, 1999, the lev was redenominated by removing three zeroes.
[3]Annual average level.
[4]CPI-based.