March 2009
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Bulgaria: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Bulgaria

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with Bulgaria, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 15, 2008, 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 February 13, 2009. 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 statement of March 4, 2009, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 4, 2009, discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Bulgaria.

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

Financial System Stability Assessment

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

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BULGARIA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representative for the 2008 Consultation with Bulgaria

Approved by Anne-Marie Gulde and Lorenzo Giorgianni

February 13, 2009

This report is based on discussions held in Sofia during December 5-14, 2008. The mission team comprised Mr. Bas B. Bakker (head), Mr.Tonny Lybek, Ms. Jianping Zhou (EUR), Mr. Paolo Dudine (SPR), and Mr. Gabriel Goddard (World Bank). The mission was assisted by the Senior Resident Representative, Mr. Juan-José Fernández-Ansola. Mr. Viktor Yotzov (OED) also joined the discussions. The mission met with Prime Minister Stanishev, Minister of Finance Oresharski, Central Bank Governor Iskrov, other senior officials, as well as representatives of Parliament, financial and business sectors, unions, and the media.

Political Background: The current government is a coalition of Bulgarian Socialist Party, the National Movement for Stability and Progress (the former king Simeon Saxe-Coburg's party), and the Movement for Rights and Freedom. Parliamentary elections will take place in June-August 2009. The ruling parties' popularity has been weakened by recent scandals related to the use of EU funds. The major opposition party, the centre-right Citizens for European Development of Bulgaria (CEDB) led by the mayor of Sofia, Mr. Borisov, currently leads the opinion polls, promising to crack down much harder on organized crime and corruption. Frictions among political parties could pose risks to needed economic actions.

Exchange Rate Regime: Since July 1, 1997, the Bulgarian National Bank has operated a currency board arrangement, pegged to the euro at the rate of lev 1.95583 per € 1. Bulgaria has accepted the obligations of Article VIII, Sections 2–4, and maintains and exchange system free of restriction on the making of payments and transfers for current international transfers.

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I. Staff Appraisal and Executive Summary

1. **In 2008, Bulgaria's economy continued to perform well, helped by strong policies**. GDP growth is likely to have reached 6 percent—one of the highest growth rates in Europe. Fiscal policy continued to be prudent, with another surplus of 3 percent of GDP. Banking sector supervision and regulation remained strong, reacting pro-actively to the global financial turmoil.

2. **At the same time, external and internal imbalances widened further—at least until recently.** Fueled by large private capital inflows, the current account deficit widened to 25 percent of GDP. The labor market overheated, with wage growth exceeding 20 percent, and annual inflation reached 12 percent—although it has come down in recent months.

3. **The global financial turmoil has begun to affect Bulgaria, and near-term prospects for Bulgaria could be more difficult than they have been in a long time.** Capital inflows are likely to slow, and exports are likely to be hurt by the global slowdown. The current staff's forecast is that GDP growth will slow to 1 percent in 2009, but there are significant risks that the slowdown could be even sharper.

4. **With a high current account deficit, high external private sector debt, and large foreign currency exposures, a key task for policies is to maintain confidence in the currency board and in the financial system.** The two are linked: a strong and resilient financial system is needed to sustain the currency board; while the stability of the increasingly Euroized banking system hinges critically on maintaining the CBA. Fortunately, Bulgaria's cautious policies of recent years have helped generate substantial buffers in the public sector: international reserves are high, public debt is low, and the government has built up considerable reserves in the fiscal reserve account.

5. **Fiscal policy should aim at maintaining comfortable surpluses**. This is not only because surpluses have been a support pillar for the currency board, but also to preserve balances in the fiscal reserve account—an important shield if problems were to emerge, including in the financial system.

6. **In this context, the government's de facto fiscal target of a 2 percent fiscal surplus in 2009 is appropriate.** While the government officially still targets a fiscal surplus of 3 percent of GDP, in practice it realizes that the 4.7 percent GDP growth on which the budget was based is no longer realistic, and has decided to offset part of the revenue shortfall by keeping expenditure 10 percent below the budgeted amount (the "10 percent rule"). If, as the government expects, GDP expands by around 2 percent, this would result in a surplus of 2 percent of GDP.

7. **With GDP growth likely to fall short of 2 percent, additional expenditure cuts will be necessary to achieve the 2 percent surplus.** If, as staff currently expects, GDP growth slows to 1 percent, the shortfall would amount to around 0.6 percent of GDP. Such expenditure cuts should be feasible, as even with the 10 percent rule the 2009 budget is by no means tight.

8. **A significant slowing of expenditure growth will also be necessary in later years.** In previous years, domestic demand has grown much faster than GDP, resulting in a surge of indirect tax revenues, but going forward, with the adjustment in the current account, domestic demand and tax revenues will grow by less than GDP. With less room for expenditure increases, spending will need to be prioritized. While the 10 percent rule was a pragmatic solution to reduce expenditure, across-the-board cuts are not a desirable tool in the longer run.

9. **The financial system is well capitalized and has so far been very profitable, but now faces a more difficult time.** Profitability is likely to decline, as foreign funding has become scarce, strong competition for domestic deposits has raised funding costs, and lending growth is expected to slow. At the same time, the reliance of banks on foreign funding for new lending makes them vulnerable to the current disruption in international financial markets. Nevertheless, banks are well-positioned for a slowdown, and have strong capital and liquidity buffers.

10. **The BNB's framework for financial sector supervision and regulation has been effective in containing risks in the banking system, but with a slowdown of the economy the operation of these arrangements is likely to be tested.** The BNB has reviewed its procedures and is—in line with other EU supervisors—preparing for any contingency. It is collaborating closely with pertinent home country supervisors and it is further enhancing its capacity to conduct stress tests, in line with recommendations of the recent IMF-World Bank FSAP Update. These preparations are welcome, especially in light of the current challenging economic and financial environment.

11. **The high growth rate of wages threatens external competitiveness**. While wages are low compared to Western Europe and can be expected to catch up over time, this will need to be accompanied by similar productivity increases. The current pace of wage growth is far too rapid for Bulgaria's relatively small productivity growth differential with Western Europe, and needs to slow down. It is a difficult question whether the current *level* of competitiveness is a cause for concern, but the *change* in competitiveness certainly is.

12. **Moderation in unit labor cost increases is essential given that resources will need to be shifted to the tradable sector.** As growth in the non-tradable sector slows, GDP growth can only be kept strong if the tradable sector takes over the slack. Without such a shift, future growth could remain very low, which eventually could put strains on the

currency board arrangement. Therefore, both export-oriented and import-competing branches need to remain sufficiently competitive.

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

II. Introduction

14. **In recent years, a surge in capital inflows has led to increasing external and internal imbalances.** The capital inflows, which were driven by expectations of rapid convergence with the EU, led to a boom in domestic demand. This resulted in a high current account deficit, an overheating labor market, deteriorating competitiveness and large balance sheet vulnerabilities (Section III).

15. **The interaction of these imbalances with the global financial turmoil was at the core of the 2008 Article IV discussions**. With global deleveraging and increased risk aversion, the large capital inflows to Bulgaria are likely to abate. The global financial market turmoil has already started to affect Bulgaria and GDP growth is likely to slow considerably (Section IV). The policy discussions focused on how to react to this slowdown. How can the risks of financial instability be reduced? What is the appropriate fiscal response to the turmoil? How can the real economy adjust to the external environment in a way that is consistent with maintaining the currency board (Section V)?

Box 1. Bulgaria's Reactions to Past IMF Advice

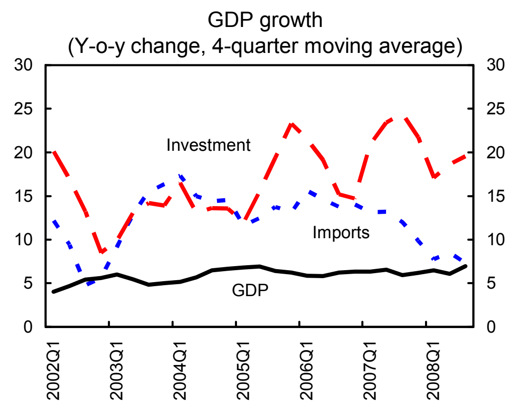
Bulgaria and the IMF have had an excellent working relationship. Policies have been generally consistent with IMF recommendations, as reflected in the successful completion of a series of Stand-By Arrangements. In recent years, the government has maintained prudent fiscal policy and built up large fiscal reserves, thus providing strong support to the currency board and a much needed policy advantage against the current global financial turbulences. However, public sector wage policies were lenient in last two years, and structural reforms hardly progressed, reflecting a lack of political consensus.

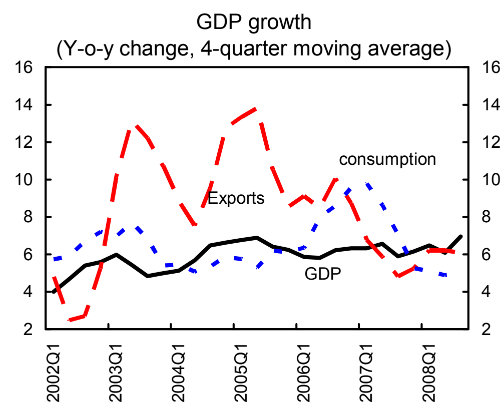
At the time of the 2007 Article IV Consultations, Executive Directors praised Bulgaria for its strong economic performance and strong policies, but expressed concern about rising imbalances. Directors emphasized that the current account deficit was unsustainable and would need to be reduced significantly over the medium term in order to contain external vulnerabilities. They also noted that, although competitiveness appeared not to have been affected, domestic price pressures were rising, in large part because of region-wide increases in food and energy prices, but also because of accelerating wage increases as the labor market tightened.

III. Macroeconomic Challenges

A. Large Capital Inflows Have Created Internal and External Imbalances

16. **Since 2004, when agreement was reached on EU accession, Bulgaria has experienced a surge in capital inflows and a credit boom** (Figures 1 and 2). Inflows were driven by expectations of rapid convergence with the EU, and were further boosted by the confidence-enhancing effect of the currency board and strong fiscal policy. By 2008, net inflows had increased to about 27 percent of GDP—one of the highest among EMCs (Figure 3). Boosted by capital inflows, credit to the private sector rose rapidly, and the credit-to-GDP ratio climbed from 36 percent in 2004 to 63 percent in 2007.

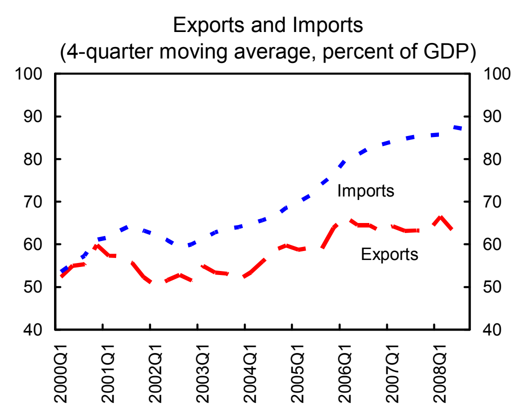




17. **The surge in inflows generated strong GDP growth, but also a sharp widening of external and internal imbalances.**

- GDP grew by more than 6 percent annually, leading to a significant narrowing of the income gap with Western Europe. Growth remained strong in 2008—at an estimated 6 percent, Bulgaria was one of the fastest growing countries in Europe.

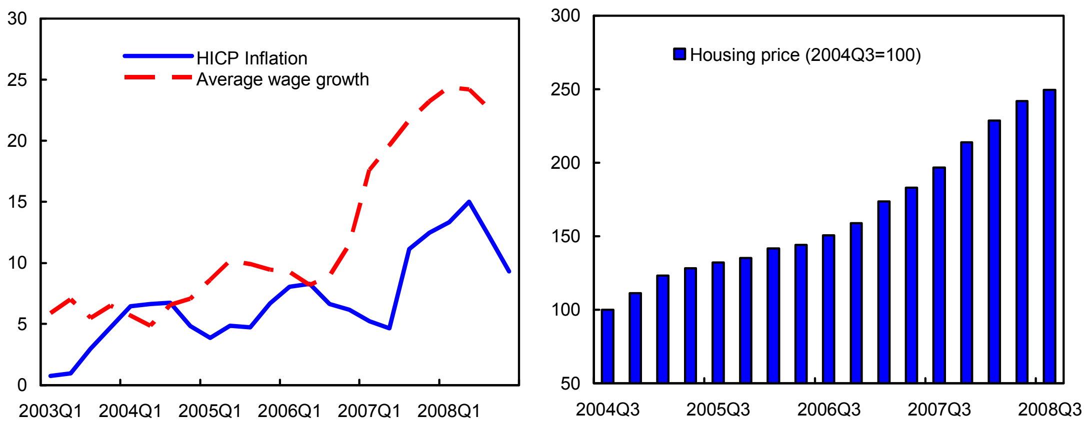
- As the growth of domestic demand outpaced GDP growth, the current account deficit widened from 5 percent of GDP in 2003 to an estimated 25 percent of GDP in 2008.



Source: Haver.

- As unemployment dropped and the labor market tightened, wage growth accelerated to a peak of 25 percent in June 2008. The overheating of the economy, together with rising food and oil prices, resulted in a surge of inflation, which peaked at 14.7 percent in June 2008. More recently, as oil prices collapsed, food price increases slowed, and the global economy weakened, inflation declined, to 7.2 percent in December.

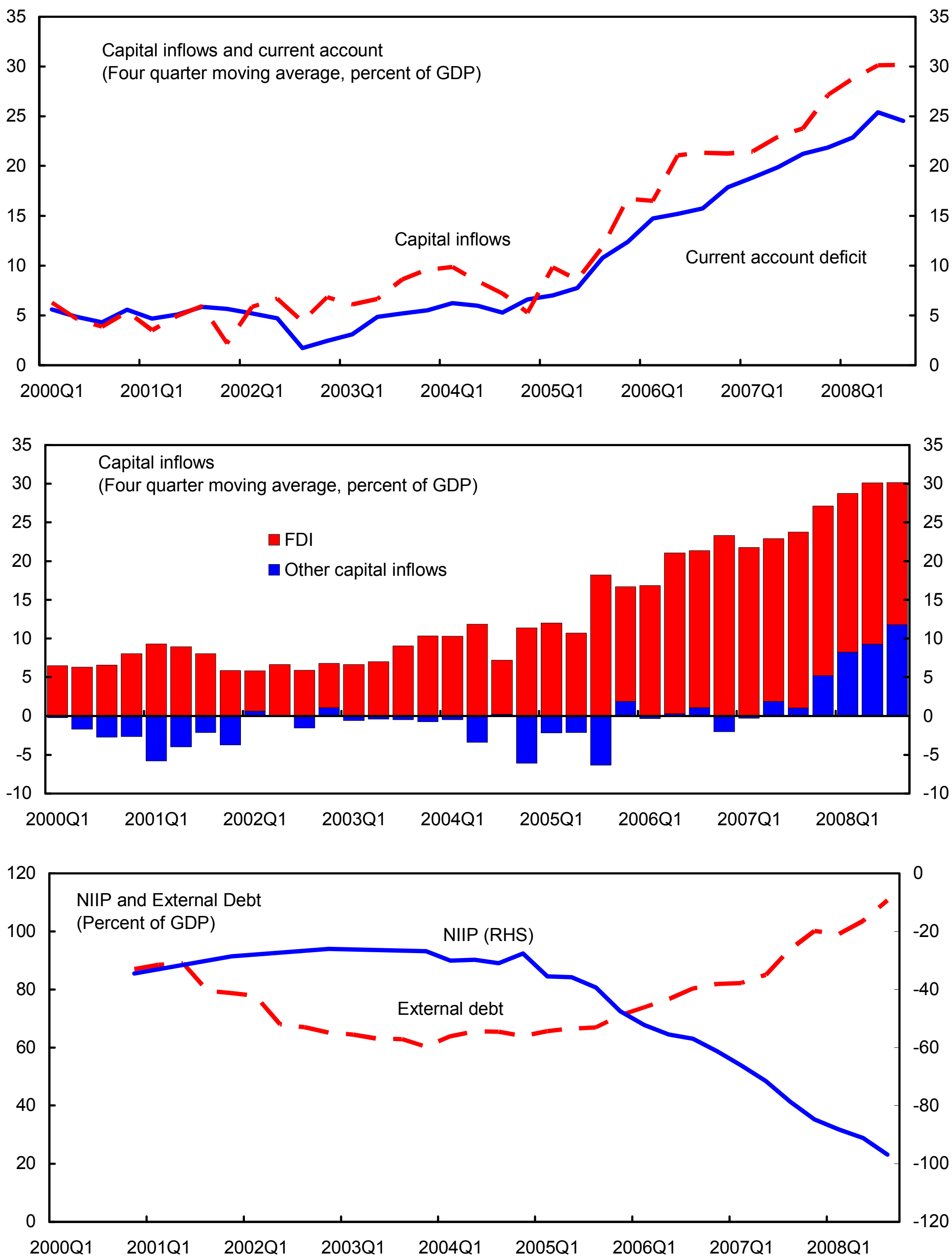
Bulgaria: Inflation, Wages, and Housing Prices



Source: BNB and IMF Staff calculations.

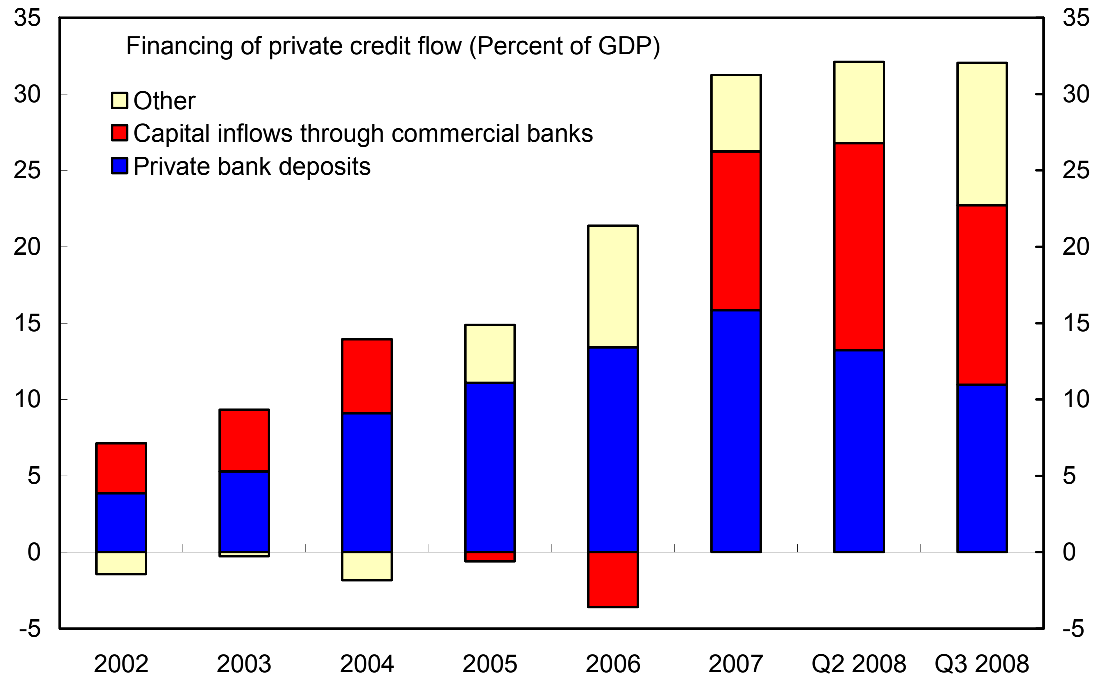
18. **Policies to address these imbalances had only limited success.** Fiscal policy targeted large and increasing fiscal surpluses, but these surpluses were offset by declining private net savings. Administrative measures to restrain credit growth moderated credit growth in the short-term, but were soon circumvented by firms' direct borrowing from abroad and had undesirable effects on financial intermediation.

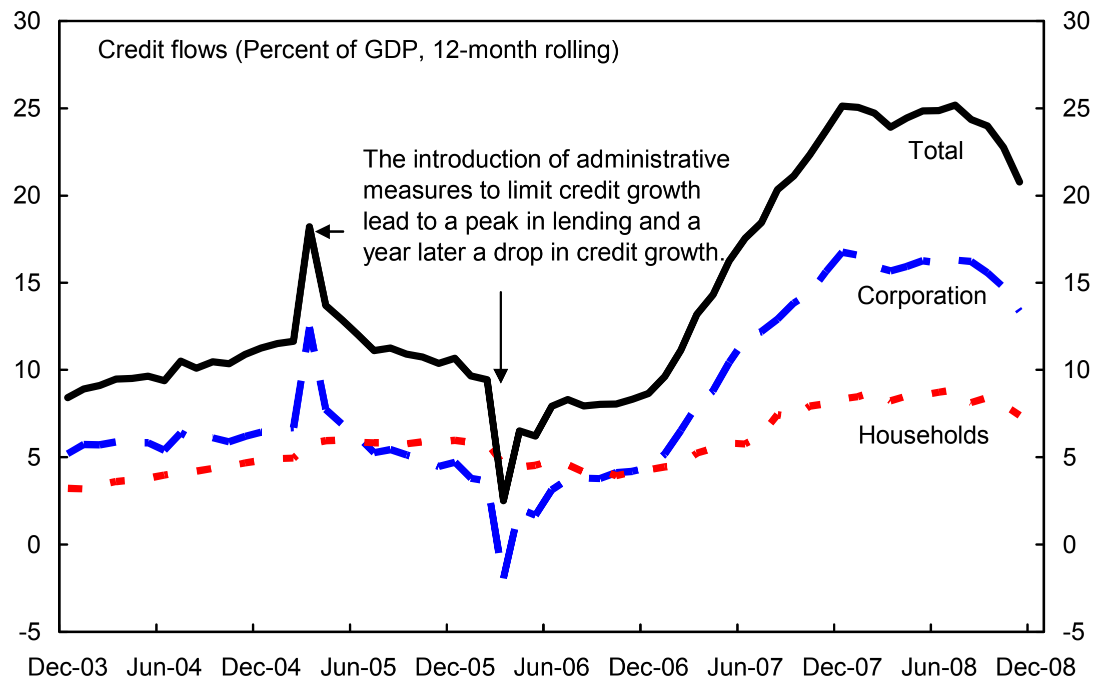
Figure 1. Bulgaria: Capital Inflows



Source: Haver Analytics.

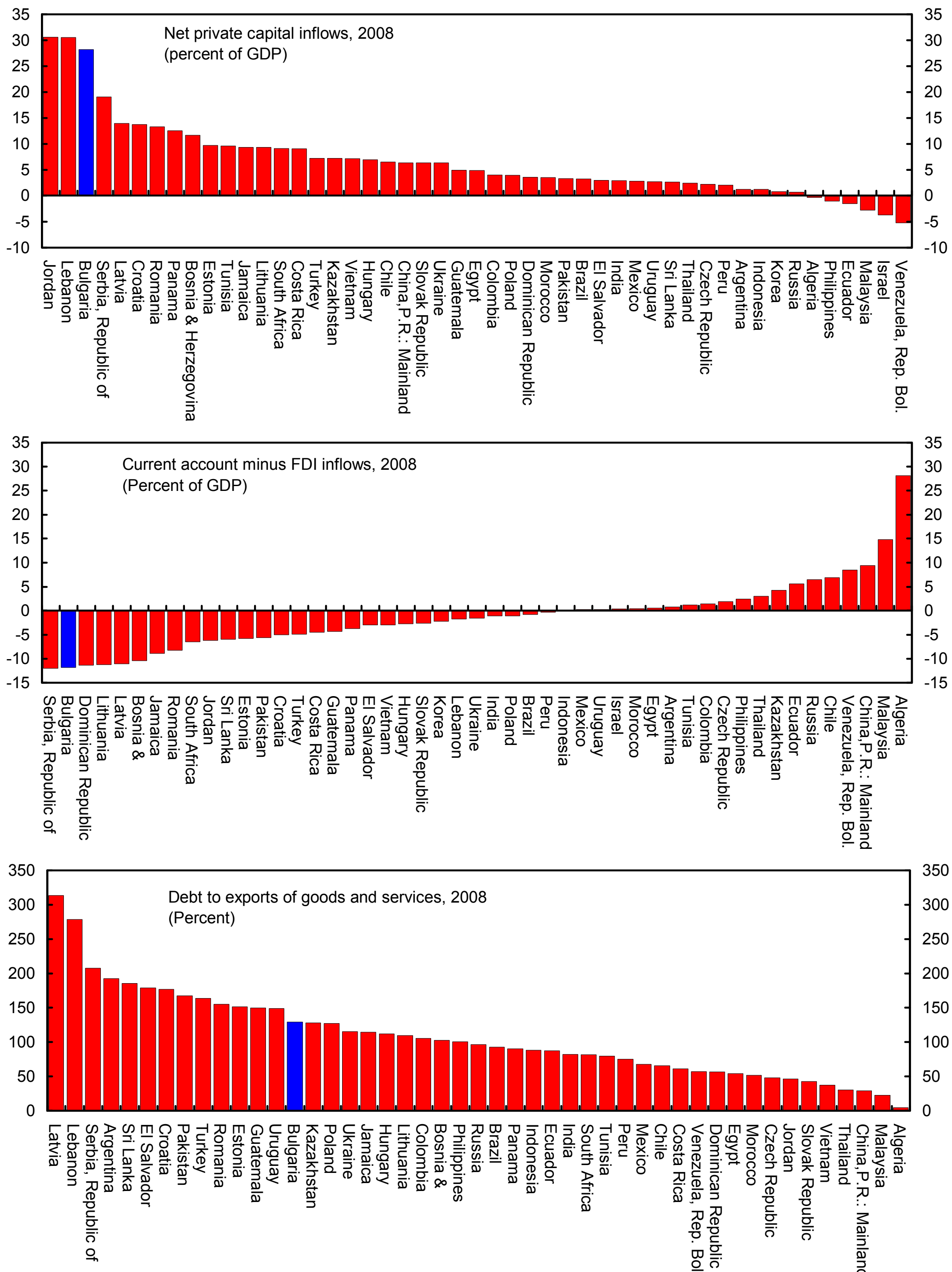
Figure 2. Bulgaria: Capital Inflows and Credit Boom





Source: Bulgarian National Bank and Haver.

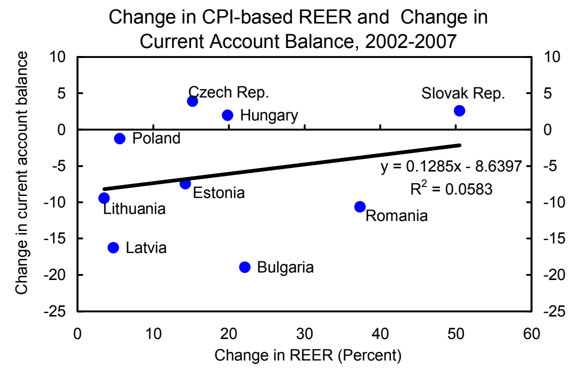
Figure 3. External Vulnerability Indicators



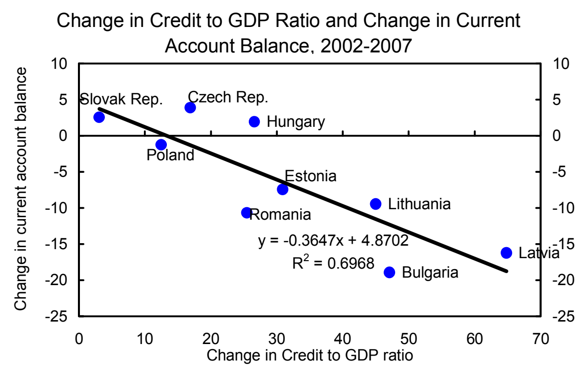
Source: WEO September 2008

B. Competitiveness is Deteriorating and Growth has been Driven by the Nontradable Sector

19. **Initially, when there was sufficient slack in the labor market, the large deterioration of the current account was not accompanied by an appreciation of the real exchange rate, suggesting that the widening of the current account deficit was primarily the result of the large capital inflows[1] and the associated credit boom.** Between 2003 and 2006, the current account deficit increased by 12 percentage points, but the real exchange rate remained relatively stable.

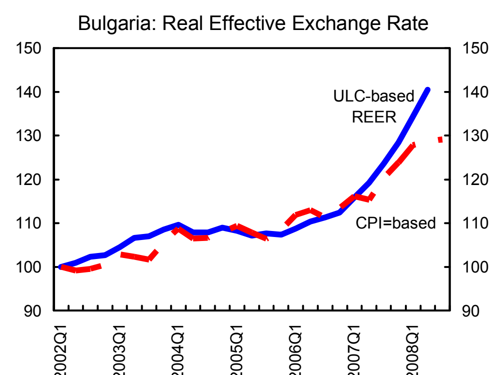


20. **Since the middle of 2006, the overheating of the labor market has resulted in a sharp real exchange rate appreciation.** Between the third quarter of 2006 and the third quarter of 2008, the ULC-based REER appreciated 26 percent, while the CPI-based REER appreciated about 16 percent.



Source: WEO.

21. **At the same time, export performance has deteriorated.** Between 2000 and 2006, the export to GDP ratio increased faster than in EMCs on average, but between 2006 and 2008, performance was worse than in most other EMCs, as the export ratio declined somewhat.



Source: Haver.

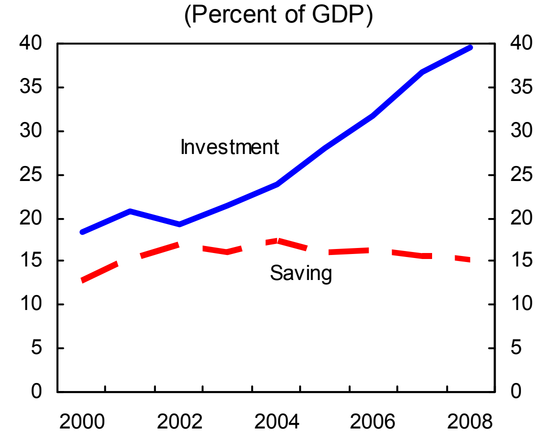
[1] Capital inflows have been much larger than the current account deficit—suggesting that they have driven the current account deficit rather than the other way around.

Exports of Goods and Services of Selected Emerging Market Countries, 2000-2008
(Percent of GDP)

	2000	2006	2000-2006		2006	2008	2006-2008
Vietnam	55	74	19	Hungary	78	85	7
China,P.R.: Mainlan	23	40	17	Vietnam	74	81	7
Slovak Republic	69	84	15	Czech Republic	77	84	7
Egypt	16	31	15	South Africa	30	36	6
Lithuania	45	59	14	Uruguay	30	32	3
Czech Republic	63	77	13	Egypt	31	34	3
Poland	27	40	13	Slovak Republic	84	86	2
Uruguay	18	30	11	Indonesia	32	33	1
India	13	22	9	Mexico	28	29	1
Bulgaria	56	64	8	India	22	23	1
Hungary	72	78	5	Turkey	22	23	0
Brazil	10	15	5	Romania	32	31	-1
Turkey	19	22	4	Brazil	15	14	-1
Latvia	41	44	3	China,P.R.: Mainlan	40	39	-1
South Africa	28	30	2	Latvia	44	43	-1
Mexico	29	28	-1	Lithuania	59	58	-2
Romania	33	32	-1	Bulgaria	64	62	-2
Estonia	85	80	-5	Poland	40	38	-3
Philippines	54	45	-9	Estonia	80	74	-6
Indonesia	43	32	-11	Philippines	45	37	-8
Advanced countries	23	28	4	Advanced countries	28	31	4
EMCs	36	43	7	EMCs	43	44	0

Source: WEO Oct. 2008 published version.

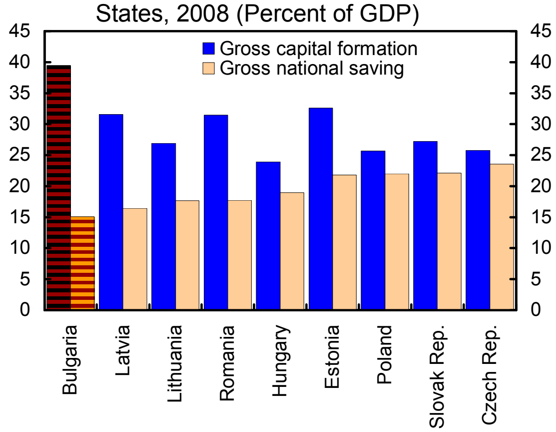
Bulgaria: Saving and Investment
(Percent of GDP)



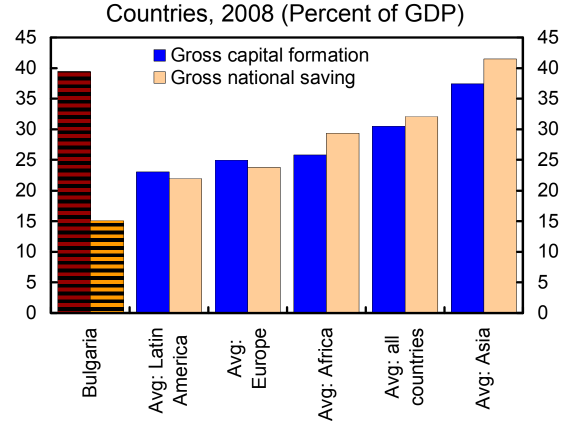
22. **From a saving-investment perspective, the *widening* of the current account deficit is primarily the reflection of the investment boom.** As the investment to GDP ratio increased sharply, the saving to GDP ratio remained flat. The high *level* of the current account deficit not only reflects high investment but also low saving—not only compared to emerging market countries outside the region, but also compared to other new member states.[2]

[2] According to the National Accounts, the low level of private saving is the result of highly negative household saving (-16.9 percent of GDP in 2006), while corporate saving is more healthy (21.3 percent of GDP). However, it is likely that the distribution between households and corporates is affected by an underreporting of wages (according to the National Accounts, the share of wages is only 35 percent of GDP) which would result in an underestimation of household saving and an overestimation of corporate saving.

Saving and capital formation in New Member States, 2008 (Percent of GDP)



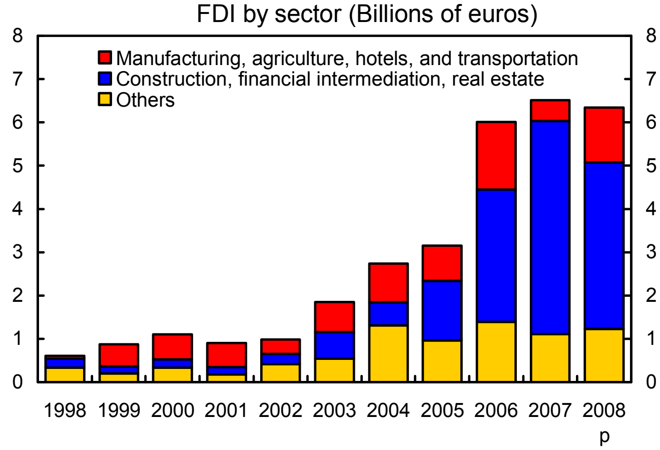
Saving and Investment in Emerging Market Countries, 2008 (Percent of GDP)



Source: WEO.

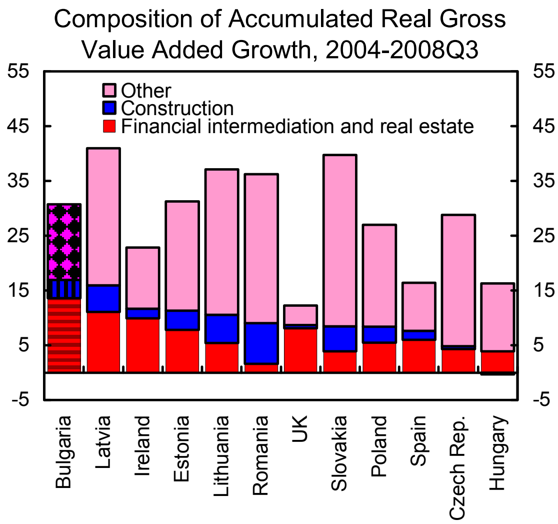
23. **GDP growth has to a large extent been driven by the non-tradable sectors**—in particular financial services, real estate and construction.[3] Capital inflows have in large part gone to the non-tradable sector, which may have been further stimulated by the widening profitability gap between the non-tradable and the tradable sector. Between late 2006 and Q3 2008, the gross operating surplus of manufacturing has declined from 50 to 38 percent, while the gross operating surplus in the non-tradable sectors has shown little change.

FDI by sector (Billions of euros)

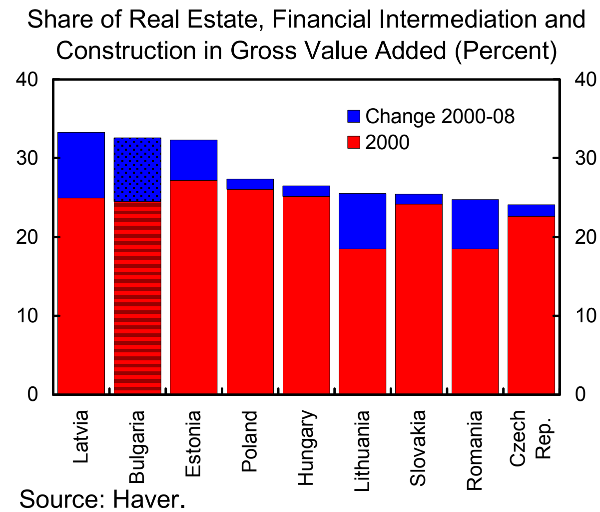


Source: NSI.

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



Source: Haver.



Source: Haver.

Gross Operating Surplus and Gross Mixed Income as a share of Gross Value Added
(Percent, 4-quarter moving average)

	2005Q1	2006Q1	2007Q1	2007Q2	2007Q3	2007Q4	2008Q1	2008Q2	2008Q3
Manufacturing	52	50	49	47	45	44	41	40	38
Agriculture, forestry, hunting and fishing	96	95	91	94	99	101	102	101	98
Mining and quarrying	42	54	71	71	70	67	66	65	65
Electricity, gas and water supply	60	54	55	57	60	63	61	59	59
Construction	63	63	67	67	67	68	67	66	65
Services	57	57	57	57	57	56	56	56	56
Wholesale and retail trade	52	55	57	57	56	58	56	55	54
Transport & Communication	67	67	67	65	64	65	65	65	65
Financial intermediation	65	69	68	67	69	67	70	71	71
Other services	52	52	52	52	52	51	50	50	50
Total	60	60	59	59	59	59	58	58	57

Source: BNB Staff Calculations.

24. **If capital inflows drop and the credit and investment boom ends, it is likely that the current account deficit will decline—but there will also be a sharp drop in growth.** With lower capital inflows and an end to the credit boom, the contribution to growth of construction, financial intermediation, real estate and businesses services will likely drop sharply. Experience in other countries suggests that it may well become negative.

C. Balance Sheet and Financing Vulnerabilities are Large

25. **Balance sheet vulnerabilities have become large.**

- External debt has increased to 111 percent of GDP. Debt is mostly owed by the private sector; public sector debt has declined rapidly to only 13 percent of GDP (Table 1).[4]
- The net international investment position has deteriorated to minus 97 percent of GDP (Table 2). While the central bank and commercial banks have large foreign assets (56 percent of GDP), there are also large non-debt liabilities (equity capital and reinvested FDI earnings)
- Foreign currency mismatches are very large. The corporate sector has high *direct* foreign currency exposure; the banking sector has large *indirect* foreign currency exposure because of high foreign currency lending. The large foreign currency mismatches have in large part been the result of the belief that euro-denominated loans carry no currency risk, as the currency board would be eventually be replaced by the euro.

26. **The non-financial corporate sector is particularly exposed.** It has high debt, high foreign currency exposure, and large short-term debt (Tables 1 and 4).

Debt of Non-Financial Corporates
(Percent of GDP)

Total debt	97.5
Domestic	60.7
External	36.8
Memorandum items:	
Foreign currency debt	70.1
Short-term debt	39.7

Source: BNB.

27. **The household sector is relatively less exposed.** Household debt is 37 percent of GDP, a third of which is for mortgages (Table 4). Foreign currency loans from banks are only 8 percent of GDP.

28. **These vulnerabilities could come to the fore if capital inflows dropped sharply.** The gap between private investment and private saving in 2008 was 27 percent of GDP. If capital flows drop sharply, the private sector will be forced to adjust saving and investment accordingly, and with new financing drying up, defaults of debtors may increase sharply, while corporate sector defaults would in turn affect the banks. Indeed, the recent FSAP update suggest that in a scenario with significant macro-economic stress, NPLs could increase sharply, and the banking sector could be become undercapitalized.[5]

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[4] Most of the intercompany loans in Table 1 are to banks.

[5] The FSAP update discusses a scenario with a sudden stop in capital inflows and a 30 percent drop in real estate prices. In this scenario, the NPL ratio would increase by about 12 percentage points, and the Capital Adequacy Ratio would decline from 14½ to 2½ percent.

Table 1. Bulgaria: Gross External Debt
(Percent of GDP)

	2002	2003	2004	2005	2006	2007	2008 Nov.
General Government	44.9	37.4	30.1	20.4	14.7	10.7	8.3
Short-term	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term	44.9	37.4	30.1	20.4	14.7	10.7	8.3
Bonds and Notes	28.3	22.2	16.6	9.9	8.2	5.9	5.6
Bonds and Notes held by residents	-1.9	-2.0	-1.5	-2.0	-1.8	-1.6	-2.2
Loans	18.6	17.2	15.0	12.5	8.3	6.4	4.8
Monetary Authorities	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Banks	2.5	4.5	8.2	12.2	14.1	20.0	29.3
Short-term	1.9	3.4	5.7	8.8	10.4	15.1	23.3
Loans	0.1	0.1	0.4	1.9	2.5	1.1	3.3
Currency and deposits	1.8	2.8	5.0	6.4	7.5	13.6	19.5
Other debt liabilities	0.0	0.5	0.3	0.5	0.5	0.4	0.5
Long-term	0.6	1.1	2.4	3.5	3.6	4.9	6.0
Bonds and Notes	0.0	0.0	0.0	0.5	0.6	0.5	0.1
Loans	0.6	1.1	2.4	3.0	3.1	4.5	5.8
Other Sectors	13.3	10.6	15.2	19.4	28.9	34.0	36.6
Short-term	7.3	5.2	6.6	9.2	14.4	18.6	19.7
Loans	0.9	1.5	2.5	4.3	8.0	13.2	14.7
Trade credits	6.4	3.7	4.0	4.9	5.7	5.4	5.1
Long-term	6.1	5.4	8.6	10.2	14.5	15.4	16.9
Bonds and Notes	0.0	0.0	0.0	0.2	1.2	1.1	0.9
Loans	5.8	5.3	8.6	10.0	13.3	14.4	16.0
Direct investment: Intercompany Lending	4.1	7.6	10.3	18.9	24.1	35.1	38.0
Total	65.0	60.1	63.8	70.9	81.7	99.8	112.2
Memorandum items:							
Long-term external debt	55.9	51.5	51.5	52.9	56.9	66.2	69.1
Short-term external debt	9.1	8.6	12.3	18.0	24.8	33.7	43.0
Public and publicly guaranteed external debt	48.1	39.8	33.2	23.8	18.0	14.2	12.4
Private non-guaranteed external debt	17.0	20.3	30.6	47.1	63.7	85.7	99.8

Source: Haver.

Table 2. Bulgaria: International Investment Position
(Percent of GDP)

	2002	2003	2004	2005	2006	2007	2008 Sep
International Investment Position, net	-26.0	-26.8	-27.6	-46.9	-60.8	-84.5	-96.9
Assets	58.3	53.7	61.2	60.7	68.5	71.1	68.1
Direct investment abroad	0.7	0.5	-0.6	0.5	0.9	1.4	2.6
Portfolio investment	3.9	3.6	3.3	3.1	3.8	3.5	3.6
Financial derivatives	0.0	0.0	0.4	0.1	0.8	0.4	0.4
Other investment	26.1	19.2	23.6	23.3	27.7	24.5	16.8
Trade credits	0.0	1.1	1.7	2.0	2.2	2.2	2.6
Loans	0.2	0.3	0.5	0.7	1.1	1.6	1.9
Currency and deposits	11.5	8.1	10.2	11.8	18.0	15.4	11.3
Other assets	14.4	9.7	11.2	8.8	6.3	5.3	1.1
Monetary authorities	0.0	0.0	0.1	0.1	0.0	0.0	0.0
General government	14.3	9.6	11.0	8.5	6.2	5.0	0.9
Banks	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Other sectors	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reserve assets	27.6	30.5	34.5	33.7	35.4	41.3	44.7
Liabilities	84.4	80.5	88.8	107.5	129.3	155.7	165.0
Direct investment in Bulgaria	21.3	27.9	37.4	53.7	69.4	87.9	91.4
Equity capital and reinvested earnings	16.6	20.7	29.3	36.2	46.8	54.8	56.7
Other capital	4.7	7.2	8.1	17.5	22.7	33.1	34.6
Portfolio investment	27.1	20.4	12.2	10.3	10.9	8.8	6.7
Equity securities	0.4	0.1	1.1	1.7	2.0	2.9	2.0
Debt securities	26.7	20.3	11.2	8.5	8.9	5.8	4.6
Financial derivatives	0.0	0.0	0.8	0.1	0.3	0.1	0.1
Other investment	35.9	32.2	38.4	43.4	48.8	58.9	66.9
Trade credits	6.7	3.7	4.0	4.9	5.7	5.4	5.1
Loans	26.0	25.2	29.0	31.7	35.1	39.5	43.3
Monetary authorities	6.1	5.2	4.4	2.6	1.0	0.0	0.0
General government	12.8	11.9	10.6	9.9	7.3	6.4	4.7
Banks	0.5	1.1	2.9	4.9	5.5	5.5	8.5
Other sectors	6.6	6.9	11.1	14.3	21.2	27.6	30.1
Currency and deposits	1.8	2.8	5.0	6.4	7.5	13.6	18.1
Other liabilities	1.4	0.5	0.3	0.5	0.5	0.4	0.4

Source: Haver.

Table 3. Domestic Liabilities of Non-Financial Private Sector, November 2008
(Percent of GDP)

Non-financial corporations	59.7
Domestic banks, on balance sheet	47.6
In levs	9.9
Short-term	6.8
Medium and long-term	3.1
In euros	33.9
Short-term	10.9
Medium and long-term	22.9
In other currencies	3.8
Other loans	10.9
Corporate bonds	1.2
Households	35.6
Domestic banks, on balance sheet	28.0
In levs	20.0
Mortgages	6.2
Other	13.8
In euros	7.7
Mortgages	5.5
Other	2.2
In other currencies	0.3
Other loans	7.6

Source: BNB and IMF Staff estimates.

Table 4. Selected Liabilities of Commercial Banks, November 2008
(Percent of GDP)

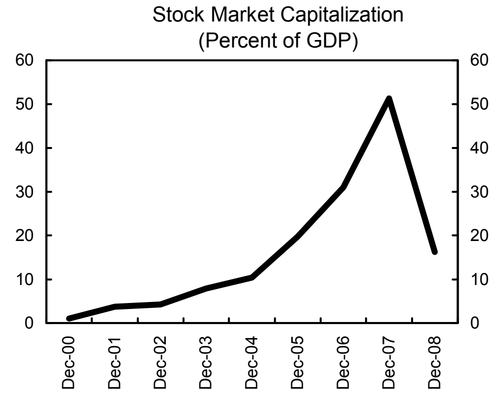
Deposits by residents	58.8
Forex	29.9
Lev	29.0
Forex deposits by non-residents (largely from parent banks)	26.4
Other foreign borrowing	4.5
Memorandum items:	
Claims on government	2.9
Commercial bank deposits with BNB	8.4
Capital and reserves	12.2

Source: BNB and IMF Staff estimates.

IV. The Impact of the Financial Market Turmoil and the Outlook

A. The Impact of the Financial Market Turmoil

29. **The global financial market turmoil has had a severe impact on financial asset prices in Bulgaria.** The stock market index has declined by 74 percent since end-August, and as of mid-February is 86 percent down from its peak in October 2007. Stock market capitalization has declined from 51 percent of GDP at end-2007 to around 16 percent at end-2008. Sovereign CDS spreads have risen to 590 basis points—from around 30 a little more than a year ago.



Source: EMED.

30. **As a result of the financial turmoil, foreign parent banks have reduced new financing to their local subsidiaries.** The Bulgarian banking system largely consists of subsidiaries of Western European banks—82 percent of bank assets are foreign owned. Western European banks, faced with capital shortages, and worried about the deteriorating economic prospects in Eastern Europe have begun to curtail new financing to their subsidiaries[6], which now need to finance loan growth from local deposits.

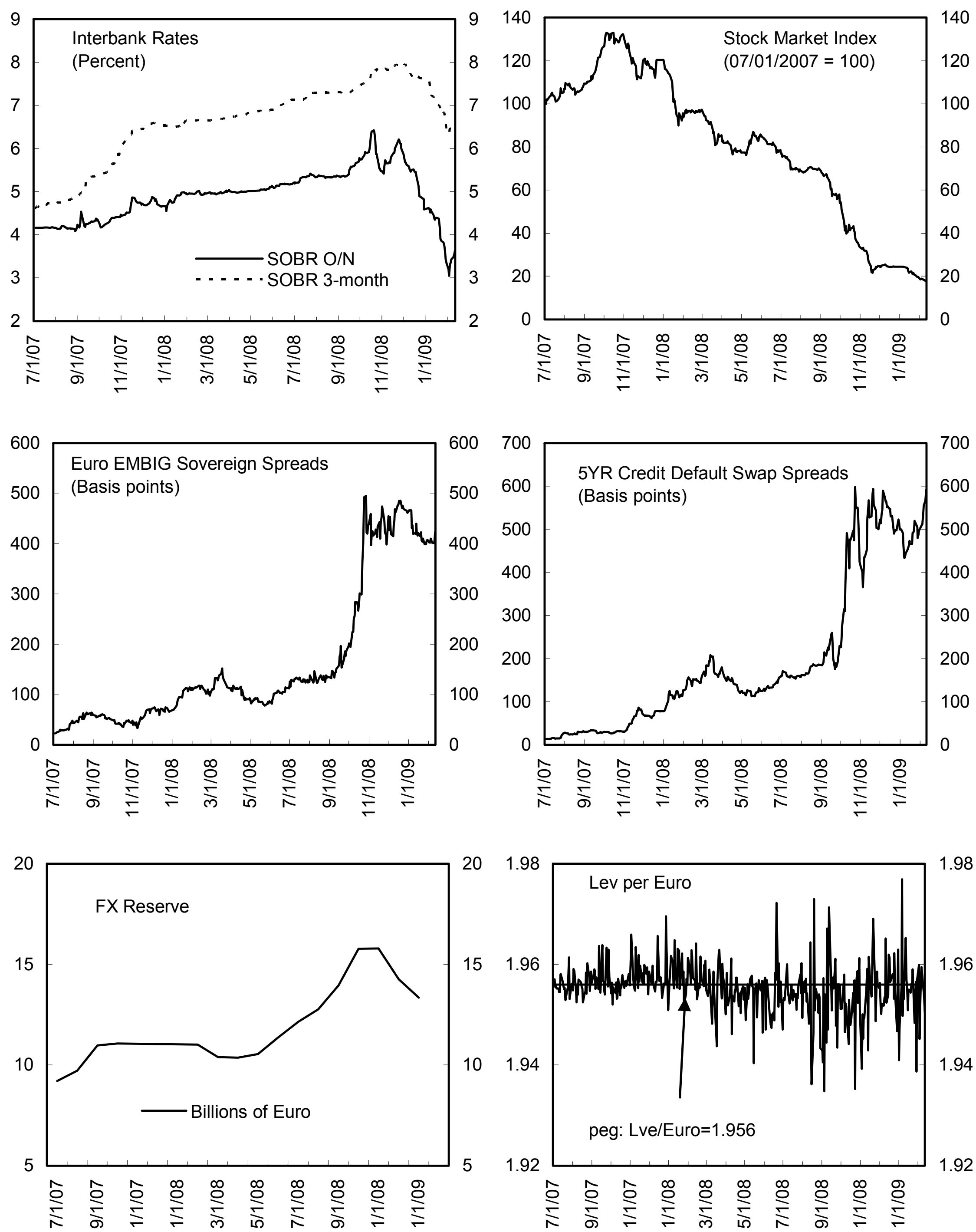
Bulgaria: Selected Banking Sector Indicators

	Assets			Loan to	
	Billions of lev	Percent of GDP	Market Share	deposit ratio	Origin
Foreign banks	49.3	74.0	82.9	111	
Foreign subsidiaries	46.3	69.4	77.8	110	
UniCredit Bulbank	8.4	12.6	14.2	96	Italy
DSK Bank (OTP)	7.7	11.6	12.9	121	Hungary
United Bulgarian Bank (NBG)	6.5	9.8	11.0	155	Greece
Raiffeisenbank Bulgaria	6.3	9.5	10.6	85	Austria
Eurobank EFG	4.8	7.2	8.1	80	Greece
Piraeus Bank Bulgaria	3.6	5.4	6.1	227	Greece
Other foreign	8.9	13.3	14.9	100	
Foreign branches	3.0	4.6	5.1	124	
Local banks	10.2	15.3	17.1	71	
First Investment Bank	4.1	6.1	6.8	99	
Other	6.1	9.2	10.3	54	
All banks	59.5	89.3	100	103	

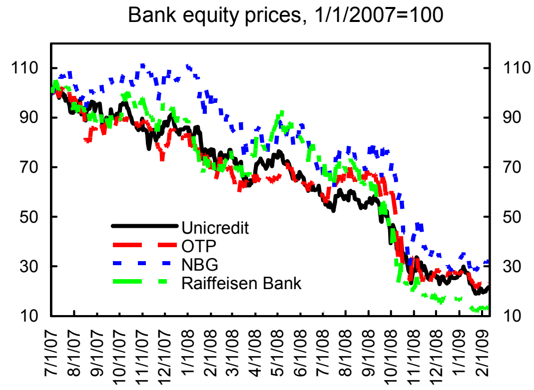
Sources: BNB and IMF staff estimates.

[6] Banks indicated that while their parent banks will not provide *new* financing, they will maintain their existing exposure.

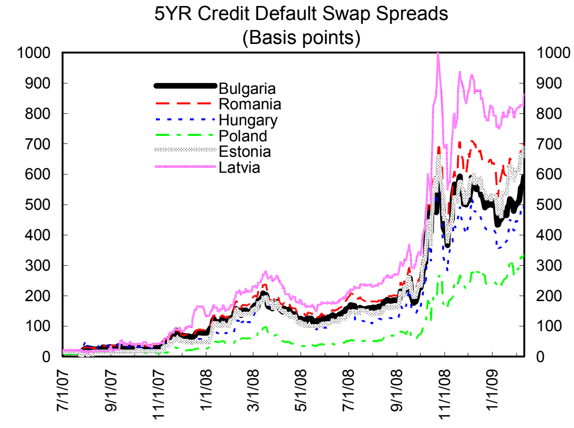
Figure 4. Bulgaria: Financial Markets



Source: Bloomberg, DataStream, IFS.

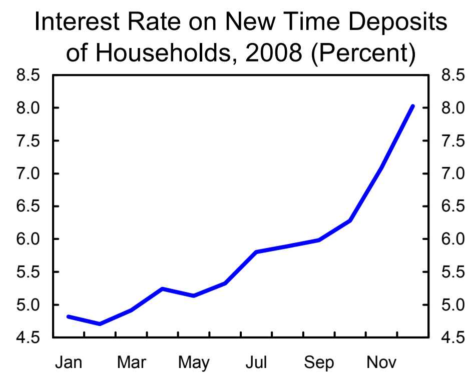


Source: Datastream.



Source: DataStream.

31. **The decline in foreign funding has resulted in strong competition for deposits and a sharp reduction in credit growth.** Interest rates on new time deposits of households rose from 5.9 percent in August to 8.0 percent in December. Banks have become much more cautious, and credit growth to the non-government sector slowed to an annualized rate of 1.2 percent in December from 66.6 percent a year ago.[7]



32. **The reduction of required reserves in November and December has eased the tightness in the money market.[8]** The overnight money market rate (SOFIBOR) has come down from a peak of 6.4 percent in October to 4.6 percent at end December. However, the reduction in required reserves has also contributed to a reduction of international reserves, which have declined from €14.2 billion at end October to €12.7 billion at end December, falling another 600 million in the first ten days of January.

[7] Many banks have reduced loan-to-value ratios to 50–65 percent and are using more conservative appraisals.

[8] On October 21, 2008, the BNB allowed 50 percent of commercial banks' cash on hand to be recognized as reserve assets and eased commercial banks' access to reserves with the BNB. Effective December 1 the minimum required reserves on all attracted funds of the banks were reduced from 12 percent to 10 percent; and effective January 1, 2009, the minimum required reserves on funds attracted by the banks from abroad were decreased from 10 percent to 5 percent, while government deposits from state and local and government will no longer be subject to reserve requirements.

33. **Reported indicators suggest that banks are generally sound.** In December, the capital adequacy ratio was 14.9 percent compared to the 12.0 percent mandatory ratio, which exceeds the 8.0 percent EU minimum requirement. The NPL ratio was around 2.4 percent.

34. **However, these indicators are backward-looking:** like other countries in the region, Bulgaria has experienced tremendous credit growth, and experience in other countries suggests that banking fragilities may emerge only after the credit boom has ended.[9] The accompanying FSSA argues that going forward, credit risk stemming from the rapid expansion of the loan portfolio in the past is by far the most important financial stability risk facing the Bulgarian banking system (Box 2).

Bank Credit to Private Sector
(In percent of GDP)

	2002	2007	Change
Africa			
South Africa	62	90	27
Asia			
Vietnam	43	70	27
India	33	48	16
Korea	93	109	16
Emerging Europe			
Latvia	37	102	65
Estonia	45	95	50
Bulgaria	20	64	45
Lithuania`	14	58	44
Ukraine	18	58	40
Hungary	35	61	26
Romania	10	35	26
Croatia	50	73	23
Russia	18	40	22
Czech Republic	31	50	19
Turkey	16	30	14
Poland	27	40	13
Latin America			
Brazil 1/	32	52	20
Costa Rica	30	45	15
Venezuela	10	23	13
Middle East /North Africa			
Kazakhastan	20	60	40
Morocco	57	80	23
Iran	22	38	16

Source: IMF and Fitch Ratings.
1/ Brazil data refer to credit of the broad finanacial system. Bank credit in Brazil grew from 25 to 36 percent of GDP between 2002 and 2007.

35. **Banks are also exposed to currency induced credit risks, especially in the non-tradable sector**. While, as discussed in the FSSA, the euroization of assets and liabilities (about half of bank assets and liabilities are denominated in euros) partly reflects the convergence process and parent bank funding, it leaves the system exposed to currency induced credit risk, and suggests that the solvency of the banking system critically hinges on maintaining the currency board.

36. **GDP growth held up well until the third quarter, but in the fourth quarter there were clear signs of slowing, and the authorities' previously held view that the impact of the global financial crisis on Bulgaria would be limited has changed.** Since October, the business climate indicator for all economic sectors has declined rapidly. Orders for non-residential construction have declined sharply, industrial production in December was 8.4 percent lower than a year ago, and exports were15 percent lower, mainly due to a slump in the exports of manufacturing good (-20.6 percent). Reflecting weakening domestic demand, imports fell by 17.4 percent year/year, while unemployment rate rose to 6.3 percent in December, reversing the declining trend during the last few years. Furthermore, the share of bad and restructured household loans has begun to increase, from 2.7 percent at end December 2007 to 3.0 percent in November 2008.

[9] However, sound provision policies have ensured early provision of NPLs.

B. Outlook for 2009 and Risks

37. **The surge in capital inflows is expected to abate in 2009**. The global financial turmoil is likely to reduce capital flows to Central and Eastern Europe, including Bulgaria. With increasing global risk aversion, FDI would decline, while local subsidiaries would no longer receive large capital transfers from their parent banks to fund credit growth.

38. **At the same time, shrinking foreign demand and declining commodity prices might lead to a drop in Bulgarian exports and a decline in tourism.** Some of this is already visible in Bulgaria, as export industries have been hit hard in recent months, including by a sharp drop in metal prices.

39. **Staff now expects GDP growth to slow to 1 percent in 2009—down from 2 percent projected at the time of the mission, and 6 percent in 2008.** The reduction in growth is in large part driven by the sharp decline in net capital inflows, from 27 percent of GDP in 2008 to 10 percent in 2009. The drop in foreign-financed bank credit and the decline in FDI would lead to a contraction in domestic demand by almost 3 percent. GDP growth will remain weak in 2010, and even in later years is likely to stay below the rates experienced during the boom years, as capital inflows are unlikely to recover to previous boom-levels. Inflation is projected to decline sharply, from 12 percent in 2008, to 4.7 percent in 2009, helped also by the sharp decline in global commodity prices.

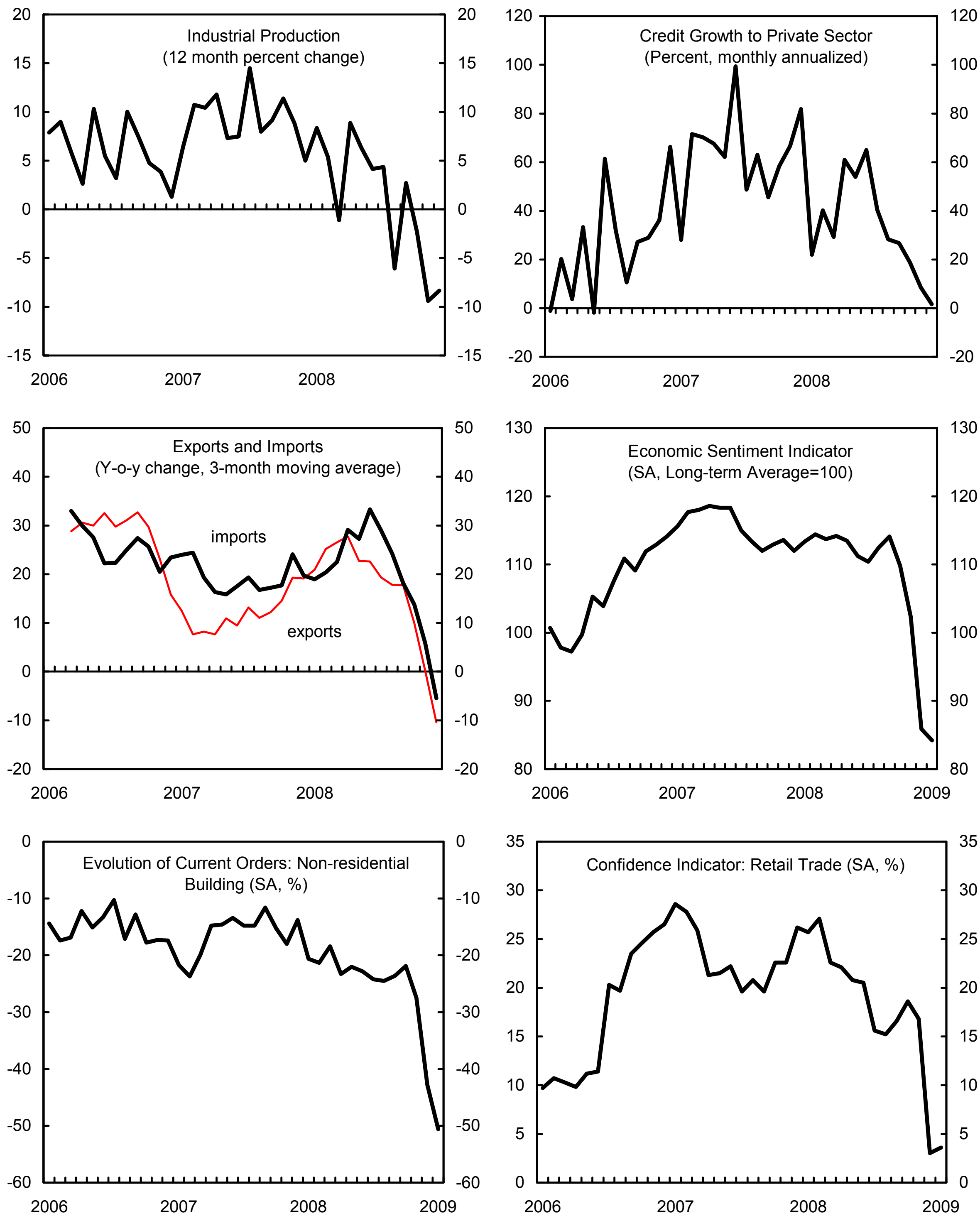
Bulgaria: Main Macroeconomic Indicators

	2007	2008	2009	2010	2011	2012	2013	2014
Capital inflows (percent of GDP)	38.0	31.8	10.9	9.4	9.1	10.0	10.4	10.3
Current account (percent of GDP)	-21.8	-24.8	-15.3	-8.4	-6.4	-7.1	-7.2	-7.2
Real GDP growth (percent)	6.2	6.0	1.0	1.5	3.0	4.5	5.0	5.5
Real domestic demand growth (percent)	9.4	7.6	-2.9	-4.7	1.3	6.3	5.7	6.0
Inflation (percent, average)	7.6	12.0	4.7	2.5	3.0	3.5	3.5	3.4
Fiscal balance (percent of GDP)	3.5	3.0	1.4	1.5	1.3	1.2	1.5	1.2

Sources: NIS and IMF staff projections.

40. **These projections are subject to an unusual degree of uncertainty and there are significant risks that growth will slow even more.** A deeper-than-expected recession in Bulgaria's trading partners and the sharp fall in regional floating currencies could lead to a faster drop in exports. Net capital inflows could drop by more than expected, and financial crises in other countries could spill over to Bulgaria. A recession in the construction sector and a fall in real estate prices could lead to a sharp increase of loan defaults and loss given default rates, which would feed back to bank weakness and a further contraction in the supply of credit. In an alternative, illustrative, scenario, in which net capital inflows slow to around 1 percent of GDP, GDP could decline by 3 percent (Box 3).

Figure 5. Bulgaria: Recent Economic Activity, 2006M1-08M12 1/



Source: National Statistical Institute; BNB; IMF Staff Estimates; Haver Analytics.
1/ Data on the last three charts are up to Jan. 2009.

41. **During the discussions in mid-December, official forecasters were more optimistic about capital inflows and GDP growth.** They argued that the large capital inflows had been the result of Bulgaria being an attractive investment destination, and this attractiveness had not been diminished by the global turmoil. With investment holding up, GDP growth would slow less than projected by the staff. Thus, the BNB's mid December baseline forecast projected GDP growth of 4.4 percent in 2009—only slightly lower than the mid-September baseline projection of the Agency for Economic Analysis and Forecasting (AEA) of 4.7 percent.

42. **Policy makers, however, were more cautious, and recognizing that there were significant risks that growth would be less than expected, were increasingly basing their policies on more pessimistic scenarios.** The AEA had developed a worse case scenario, in which GDP grew by 2.1 percent only, and this scenario rather the baseline was used to set fiscal policy (see section VC). [10]

Box 2. Alternative Scenario

In a scenario in which net capital inflows dropped to near zero in 2009, and stayed weaker thereafter, the economic downturn would be much deeper. Domestic demand, and in particular investment would shrink sharply, and while the impact on growth would partly be offset by an improvement of the current account, overall the economy could shrink by 3 percent in 2009 and another 1 percent in 2010.

Such a scenario would be challenging for policy makers, and would require strong corrective measures. The decline in reserves would be more pronounced, while—in the absence of corrective measures—the fiscal surplus would turn into a deficit of around 2½ percent of GDP in 2009, rising further thereafter.

Bulgaria: Main Macroeconomic Indicators (Alternative Scenario)

	2007	2008	2009	2010	2011	2012	2013	2014
Capital inflows, net (percent of GDP)	38.0	26.9	0.3	1.2	3.9	5.1	6.5	7.5
Current account (percent of GDP)	-21.8	-24.8	-6.2	-3.9	-3.5	-4.7	-6.2	-7.3
Gross International reserves (billions of Euro)	11.9	12.7	10.8	9.9	10.0	10.3	10.5	10.8
Real GDP growth (percent)	6.2	6.0	-3.0	-1.0	1.0	4.0	5.0	5.5
Real domestic demand growth (percent)	9.4	7.6	-17.7	-2.1	4.2	6.8	7.0	7.2
Inflation (percent, average)	7.6	12.0	3.5	0.8	1.5	2.7	3.5	3.5
Fiscal balance (percent of GDP) 1/	3.5	3.0	-2.4	-3.1	-4.5	-5.0	-4.4	-4.0
Real GDP (Level, 2008=100)		100	101.0	102.5	105.6	110.3	115.9	122.2
Idem, baseline		100	97.0	96.0	97.0	100.9	105.9	111.7

Sources: NIS and IMF staff projections.
1/ Assuming the full play of the automatic stabilizers.

[10] The BNB's worse case scenario of mid-December showed 1.2 percent growth in 2009.

V. Policy Discussions

The end of the capital-inflow driven boom poses considerable policy challenges. The most immediate challenge is ensuring that a sharp drop in capital inflows does not trigger a confidence crisis, which would expose the considerable private sector balance sheet vulnerabilities. The next challenge is ensuring that the economy is flexible enough to adjust to the drop in growth in the non-tradable sector by shifting resources to the tradable sector. Without such a shift, future growth could remain very low, which eventually could put strains on the currency board arrangement.

43. **In many ways, Bulgaria starts the current slowdown from a strong position.** The public finances are in good shape, with one of the highest fiscal surpluses in Europe. In addition, the balance sheets of the central bank and the government are strong, with large foreign reserves and substantial buffers accumulated in the fiscal reserve account.

44. **The mission and the authorities agreed that given the large private sector vulnerabilities, a key task for policies is to maintain confidence in the currency board and in the financial system**. The two are intrinsically linked: a strong and resilient financial system is needed to sustain the currency board; while the stability of the increasingly Euroized banking system hinges critically on maintaining the CBA.

Bulgaria: Potential Liquidity Drains and Liquidity Buffers, December 2008

	In percent of GDP	Billions of euros
Potential Liquidity Drains (A+B+C+D+E)	122.9	41.7
A. Cash, excluding cash in vault.	12.1	4.1
B. Deposits by residents	59.3	20.1
B.1. Domestic currency	30.4	10.3
B.2. Foreign currency	28.9	9.8
C. Commercial banks' short-term foreign liabilities	27.9	9.5
C.1. Currency and Deposits	18.9	6.4
C.2. Other liabilities	5.2	1.8
D. Nonbank short-term external debt 1/	19.2	6.5
D.1. General government	0.0	0.0
D.2. Monetary authorities	0.0	0.0
D.3 Others	19.2	6.5
E. Amortization of medium and long-term external debt (2009)	4.4	1.5
Potential Liquidity Buffers (F+G)	49.0	16.6
F. Central bank and central government liquid external assets	37.5	12.7
E.1. Reserve assets	37.5	12.7
E.2 Other liquid foreign currency assets	0.0	0.0
G. Commercial banks' liquid foreign currency assets	11.5	3.9
Potential Liquidity Shortfall	73.8	25.0
Potential buffers' coverage of potential drains [(F+G)/(A+B+C+D+E)] 2/:	39.9	

Sources: BNB and Fund staff calculations, estimates and projections.

1/ Debt by original maturity as of November 2008.
2/ Parent banks deposits dominate banks' short-term liabilities to nonresidents.

45. **Policy discussions focused on how to maintain confidence and how to shift to a new pattern of growth.** Aside from maintaining financial sector stability (section A), a key instrument is keeping comfortably large fiscal surpluses (Section B). This is not only because surpluses have been a support pillar for the currency board, but also because balances in the fiscal reserve account will be an important shield if problems were to emerge, including in the financial system.[11] It will also be important that the economy adjusts well to a decline in capital inflows, and that the tradable sector will take over as the growth engine (section C).

[11] An amendment in the budget law, that has widened the pool of eligible collateral, has facilitated using the fiscal reserve for lender of last resort operations.

A. Financial Sector Stability

46. **The BNB has taken several steps to *prevent* a crisis by improving depositors' confidence, easing liquidity pressures, and increasing capital cushions.**

- **Deposit insurance coverage has been increased, in line with EU commitments.** In mid-November coverage was increased[12] from €20,000 to €50,000; and in 2009, it will be increased further to €100,000 per depositor per bank. In contrast to some other EU countries, the authorities did not see a need to adopt blanket guarantees. The authorities will also adopt other envisaged amendments to the EU directive to ensure prompt payment of insured deposits.[13]

- **Reserve requirements have been lowered.** While there is room for further easing (reserve requirements are far above the euro area requirement of 2 percent), the authorities are well aware that an easing of reserve requirements also tends to reduce international reserves.

- **The BNB has taken further steps to increase banks' capital and liquidity cushions.** It has persuaded most bank owners not to pay dividends, but instead add 2008 profits to capital. It has also received comfort letters from parent banks to ensure that they provide adequate liquidity and capital.

- **Reporting by leasing companies owned by non-bank and financial companies to the credit register has been improved**, which facilitates banks' credit risk analysis.

47. **The authorities have taken steps to improve their ability to *manage* a potential crisis:**

- The BNB has intensified its monitoring, with special focus on liquidity and credit risks, and taken steps to further strengthen its stress testing capabilities, in line with recommendations of the recent FSAP Update.

- The BNB has reviewed its current crisis management framework. Both the BNB and the Financial Supervision Commission (FSC) have conducted targeted inspections to ensure that supervised entities have contingency plans in place.

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[12] Before the increase, 99.1 percent of depositors were covered, but only 39.9 percent of deposits.

[13] The mission voiced concern that it was not well known that "preferential deposits" (deposits with particularly high interest rates) were not covered by the deposit insurance fund. If after a bank failure depositors found out that their deposits had not been covered by the deposit insurance fund, this could trigger a loss of confidence in the system.

- The Domestic Standing Group for Financial Stability, which was established in January 2008 as a sub committee for the Financial Stability Advisory Council, has been working on contingency plans.[14]

48. **The mission discussed Lender of Last Resort facilities.**[15] The BNB has reviewed its processes to ensure fast action, but its scope to function as lender of last resort is constrained by the CBA—as of mid-January, the excess coverage of the CBA amounted to about €1.6 billion (5 percent of GDP). The government could use its fiscal reserves of around 18 percent of GDP to function as the de facto lender of last resort. The legal framework and procedures have been amended to allow prompt action. The authorities acknowledged that in the current environment, even the failure of a small bank could quickly lead to contagion, but they also noted that different approaches would be considered, including closing a bank while giving due consideration to all depositors.

49. **The authorities generally felt comfortable with the bank resolution framework**.[16] The 1997 banking crisis, when several banks were closed, triggered major changes in the bank resolution framework. Furthermore, several current decision makers had crisis management experience from this period. The authorities agreed that in the event government capital injections were necessary, it would be important to ensure that existing shareholders would carry the losses.

B. Fiscal Policy

50. **In recent years, Bulgaria has run large fiscal surpluses.** Between 2005 and 2008, the fiscal surplus averaged 3 percent of GDP. Bulgaria targeted large surpluses to bolster confidence in the currency board, and to contain the current account deficit in the context of a large private saving-investment gap. As a result of these surpluses, the *gross* public debt to GDP ratio fell from 77 percent in 2000 to 17 percent in 2008; and fiscal reserves increased to about 12½ percent of GDP in 2008.

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[14] As in other EU countries, it has been decided to delay further testing these contingency plans and instead use the scarce resources on closely monitoring with a view to acting promptly.

[15] Box 3 in the FSSA discusses emergency liquidity assistance.

[16] Discussed in the FSSA and an accompanying technical note.

51. **Yet fiscal policy was not as tight as suggested by these headline numbers.** Nominal expenditure grew by 15 percent annually, and tax rates on corporate and personal income were cut. This was, however, more than offset by a surge in indirect tax revenues, the result of a domestic demand boom, which increased the absorption gap from 3¾ percent of GDP in 2005 to 13¾ percent in 2007. Indeed, the augmented structural balance, which takes into account the effects of both the output and the absorption gap, declined from 1.5 to 0.2 percent of GDP during this period.

Bulgaria: General Government Operations, 2005-09
(In percent of GDP)

	2005	2006	2007	2008		2009 (Proj.)			
				Budget	Actual Prel.	Approved budget GDP growth: 4.7	Budget GDP growth: 2.1 without 10% rule	Budget GDP growth: 2.1 with 10% rule	IMF GDP growth: 1.0 with 10% rule
Revenue	39.8	38.8	40.7	42.5	39.7	42.8	41.3	41.3	41.3
Expenditure	37.5	35.3	37.2	39.5	36.7	39.8	41.6	39.3	39.9
Fiscal balance	2.3	3.5	3.5	3.0	3.0	3.0	-0.3	2.0	1.4
Structural balance 1/	1.5	1.6	0.2		-1.1		-1.9	0.5	-0.2
Revenue growth (percent)	14.2	12.4	20.1	14.0	14.7	19.3	10.1	10.1	8.3
Expenditure growth (percent)	13.4	9.1	21.6	16.0	15.9	20.1	20.1	13.3	13.3
HIPC inflation (percent)	6.0	7.4	7.6		12.0				4.7
Output gap	0.0	1.2	2.3		3.2		-0.1	-0.1	-0.1
Absorption gap	3.7	8.2	13.8		17.5		7.8	7.8	7.8
Nominal GDP (Lev mln)	42,797	49,361	56,520	61,711	66,354	73,485			69,096

Source: Ministry of Finance; and Fund staff estimates.

1/ Actual fiscal balance adjusted for the automatic effects of both output gap and absorption gap on fiscal position. see IMF Country Report No. 07/390, Chapter III for details.

52. **Cautious fiscal policy continued in 2008, with another large headline surplus of 3 percent of GDP.** As in previous years, aggregate spending remained very tight in the first three quarters; by September, the surplus had reached 7 percent of annual GDP. In October, the government stepped up investment spending, increased budget allocations for social spending,[17] and overall government spending in November and December reached 10.8 percent of annual GDP. While the headline fiscal surplus remained one of the largest among EMCs, the augmented structural balance deteriorated by 1.4 percent of GDP, reflecting the further widening of the output and the absorption gap

53. **The 2009 budget, which was prepared before the financial turmoil of September, and based on real GDP growth of 4.7 percent, officially aims at a surplus of 3 percent of GDP**. Based on optimistic tax revenue projections (an increase of 16 percent—higher than the 15 percent increase in 2008), the budget aimed to increase current expenditure by 16.8 percent compared to the 2008 outcome (19.2 percent compared to the 2008 *budget*), almost sixty percent of which would go to an increase of social benefits (in particular

[17] The government also raised the 2008 surplus target to 3½ percent of GDP. Partly as a result of disappointing revenues in the last few months, the overperformance did not materialize.

pensions[18]) and public sector wages. Capital expenditure would increase by 23 percent, to partly make up for the expected slowdown in investment, but this increase would largely be financed by an increase in EU transfers.[19]

54. **In practice, the government expected a surplus of around 2 percent of GDP, with spending buffers partially compensating for expected revenue shortfalls.** Recognizing that GDP growth was likely to be well below 4.7 percent, the government has decided to restrict spending to 90 percent of the budgeted amount. The remaining 10 percent would be released depending on macroeconomic and budget developments. The authorities felt that this approach of reducing spending was politically more feasible than revising the budget, as there was insufficient support for reducing budgeted spending (some members of the coalition had proposed additional spending measures, particularly to support the real economy). With GDP growth around 2 percent and expenditure in line with the 90 percent rule, the budget surplus would likely be around 2 percent of GDP.

55. **The staff warned that even with the spending buffers, the 2009 budget was by no means tight, and that a sharper slowdown could turn the surplus into a deficit**. If the 90 percent is rule is applied, spending will increase by 13 percent—8½ percent higher than currently projected inflation. While the fiscal surplus was currently high, experience in other countries suggested that if the absorption boom came to an end, the fiscal balance was likely to deteriorate significantly.[20] Staff's medium-term fiscal projections suggest that between 2008 and 2012, the tax revenue to GDP ratio could fall by 1½ percentage points, which would require a commensurate decline in the expenditure to GDP ratio.

56. **Since the mission, it has become increasingly likely that GDP growth will fall short of 2 percent, and that additional expenditure cuts may be necessary to achieve the 2 percent surplus.** If, as staff currently expects, GDP growth slows to 1 percent, the shortfall would amount to around 0.6 percentage points.

57. **The authorities agreed on the importance of maintaining sizeable fiscal surpluses.** They explained that, as in previous years, expenditure was backloaded, leaving

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[18] In April 2009, pensions will be increased by 10 percent. The increase will be implemented by counting each service year as 1.1 years, which will increase the replacement ratio from 43 percent to 48-49 percent. In addition, the minimum guaranteed pension is set to increase by 10 percent to 120 BGN. In July, pensions will be increased by another 9.7 percent.

[19] The 2009 budget includes EU grants of 3 billion leva (4.4 percent of GDP), 1.1 billion higher than the 2008 budget, and 1.9 billion more than the amount actually absorbed in 2008. The authorities explained that shortfalls in EU transfers would result in lower capital spending, and thus would not affect the fiscal balance.

[20] The augmented structural fiscal balance showed a small deficit, suggesting that if the output and absorption gap closed, and automatic stabilizers were allowed to work fully, the current surplus could turn into a small deficit.

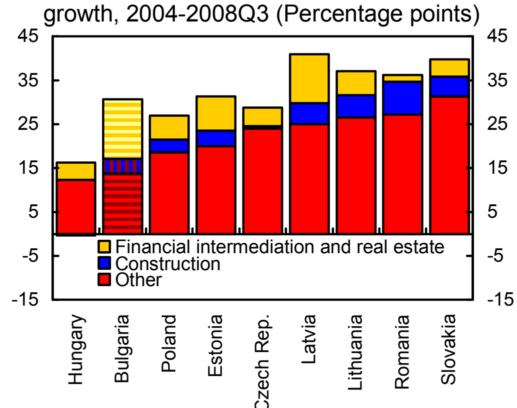
room for further expenditure cuts if the surplus came in below expectations. They were not only skeptical on the usefulness of *discretionary* fiscal stimulus, but even on the usefulness of letting automatic stabilizers work, as the impact on growth in a small and open economy such as Bulgaria was very small; and the negative impact on confidence might well offset the positive impact on demand.

58. **The mission argued that fiscal and structural reforms needed to be accelerated, notwithstanding the election cycle.** The problems regarding the disbursement of EU funds underscore the need to further upgrade control systems.[21] There have been several changes to social security contributions and social policy (¶52), and it will be essential to cost these changes realistically and ensure fiscal neutrality, paying special attention to the impact on long-term sustainability of the public finances.

C. Flexibility of the Economy and Competitiveness

59. **As the capital flow-driven boom in the non-tradable sector ends, will the tradable sector be able to take over?** The answer to this question depends in large part on whether the real exchange rate has become overvalued, and, if so, how quickly the misalignment will correct.

Composition of Real Gross Value Added growth, 2004-2008Q3 (Percentage points)

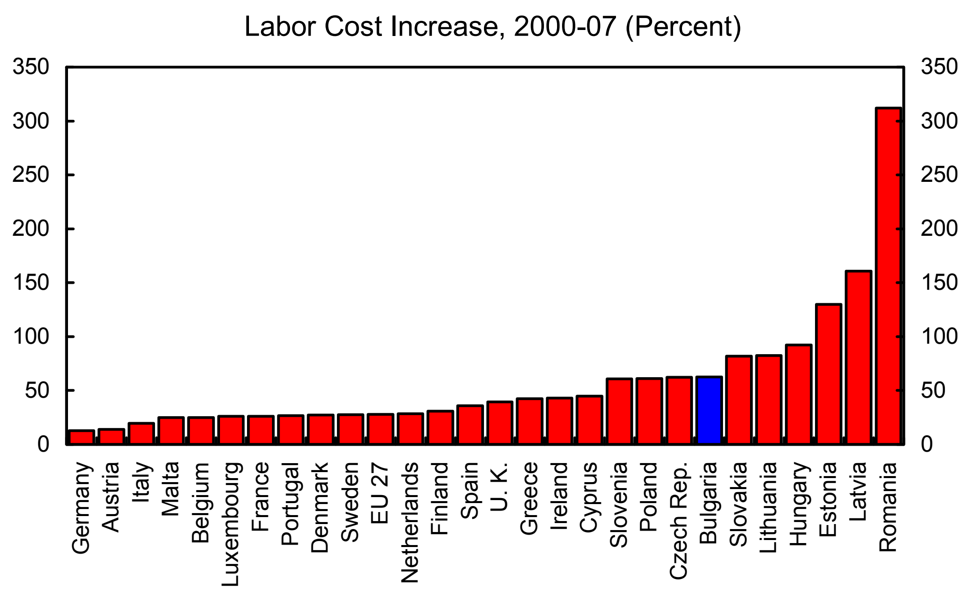


Source: Haver.

[21] In July the European Commission Brussels suspended funding under the EU pre-accession programs after a strongly critical progress report on corruption and mismanagement of pre-accession funding, which amount to 5.8 million euro. In November, the Commission canceled the funds after Bulgaria had made no progress in tackling corruption. With respect to SAPARD the European Commission has not reimbursed declared expenditure, corresponding to the European co-financing part, amounting to 7.7 million euro and European co-financing of 14.7 million euro. Under ISPA due to suspension the total amount of the funds delayed to be reimbursed is 11.9 million euro. The sanctions so far do not include the €11 billion of EU funding for agriculture and regional development that Sofia is set to receive until 2013.

60. **CGER-type calculations based on the difference between the underlying current account and the current account norm suggest that the real exchange rate is now overvalued by 7-20 percent** (Box 4).[22] These calculations have a large degree of uncertainty, which is due to the difficulty of predicting by how much the large capital inflows will come down over the medium-term. The sharper the decline, the more domestic demand will fall, and the more the current account deficit will adjust even without real exchange rate changes.

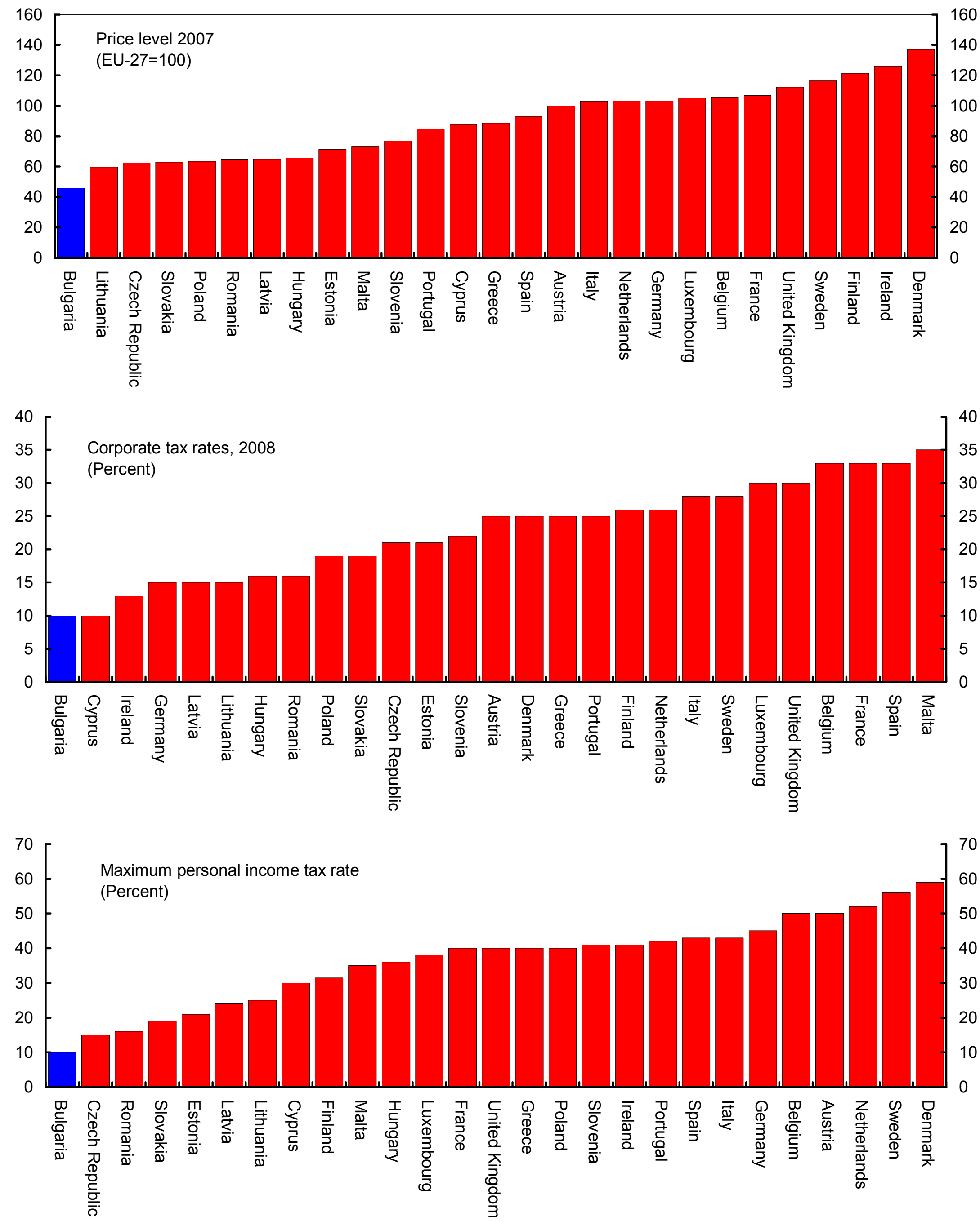
61. **The authorities did not share the mission's concern that competitiveness may have become a problem.** They pointed out that Bulgaria's market share within the EU had continued to increase. They argued that much of the rapid wage increase had been a convergence phenomenon, and noted that even after the rapid wage increases in recent years, the level of price and wages was still the lowest in the European Union (Figure 6). Competitiveness had been further boosted by the lowering of corporate and income tax rates, which were now the lowest in Europe.



Source: Eurostat.

[22] Last year's staff report argued that the real exchange rate was in line with fundamentals. Between 2007Q2 and 2008Q3, the REER has appreciated by 12 percent—close to the mid-point of the current overvaluation estimate.

Figure 6. Bulgaria: Competitiveness Indicators

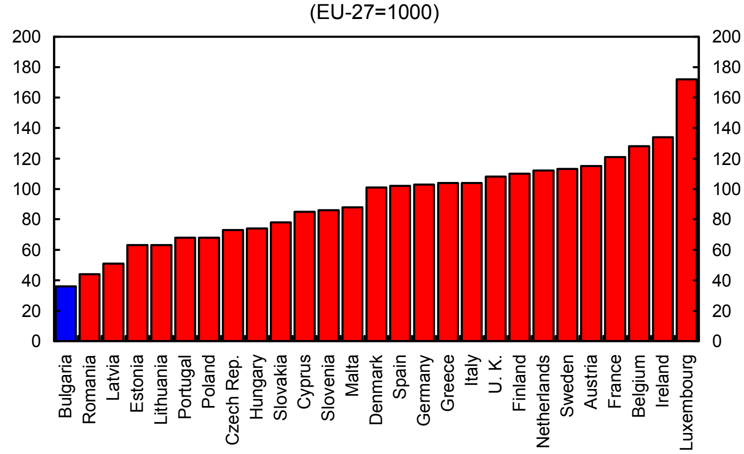


Source: Eurostat.

62. **Staff noted that even if the real exchange rate *level* was not yet a problem, the recent changes had been very rapid, and warned that wage growth needed to slow.** While the wage level was indeed low by European standards, so was labor productivity, and rapid wage increases were only sustainable if accompanied by commensurate productivity increases. The authorities reacted that the labor market was very flexible, and that wage growth would slow rapidly, when the economy slows.

63. **Staff and the authorities agreed that structural reforms that raise labor productivity and labor participation are needed to speed up convergence of per capita income with the European Union.** Recognizing the importance of further increases in employment and labor productivity, Bulgaria has recently introduced significant education and labor reforms (Box 5). Bulgaria has also made considerable progress in reducing the burden of regulation in recent years, ranking among the top 10 reformers in the World Bank's Doing Business report in 2006/07, mostly on account of improved tax system and administration.

GDP in Purchasing Power Standards per Person Employed
(EU-27=1000)



Source: Eurostat.

64. **The authorities thought there were no impediments to investment in the tradable sector.** They argued that an important reason that FDI had gone to the non-tradable sector was that when FDI to Bulgaria started to pick up, foreign investment in the manufacturing sector in Central Europe had already reached saturation levels. The car industry, for example, had already built new car plants in other transition countries. They also argued that the attractiveness of the non-tradable sector came from large capital gains, and these slowed, the tradable sector would become more attractive.

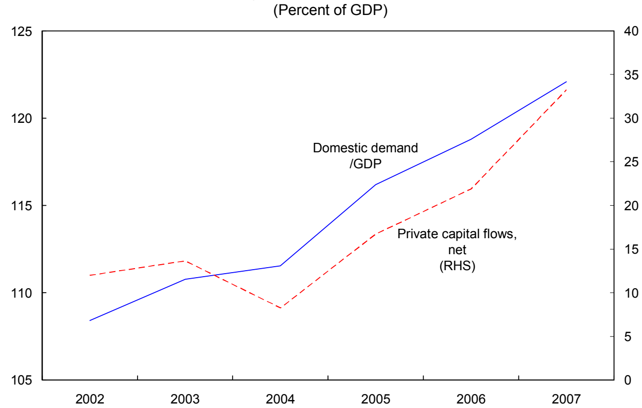
Box 3. Bulgaria: Exchange Rate Assessment

In staff's view, much of the increase in the current account deficit since 2002 is temporary, boosted by a private capital inflows-driven domestic demand boom. Between 2002 and 2007, net private capital inflows increased from 12 to 33 percent of GDP, raising domestic demand from 108 percent of GDP to 122 percent. If this temporary surge in capital inflows abates, the current account deficit is likely to decline sharply.

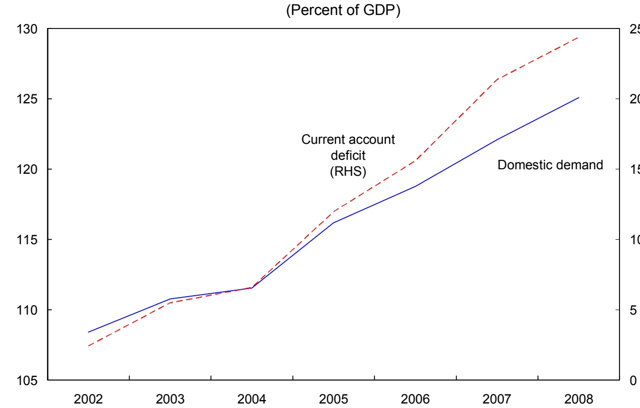
Staff's estimate of the underlying current account deficit is therefore well below the headline current account deficit. Correcting for the "absorption gap"—the temporary surge in domestic demand driven by the capital inflow surge/credit boom, as well as past changes in competitiveness that have not worked through, yields an underlying current account deficit of 12.8 percent of GDP—about half of the headline deficit.

The real exchange rate is likely to be overvalued by 7-20 percent. The underlying saving-investment deficit is about 2.9 percentage points higher than the equilibrium saving-investment balance, suggesting that the real exchange rate is overvalued by 7.5 percent. According to the external sustainability approach, which calculates by how much the saving-investment balance needs come down to stabilize the IIP, the real exchange rate is overvalued by 16 percent. If we compare the current REER level with the average of the past 5 years, the overvaluation is about 20 percent.

Private Capital Flows and Domestic Demand
(Percent of GDP)



Domestic demand and Current Account
(Percent of GDP)



Bulgaria: Underling Saving-Investment Balance and Norm
(Percent of GDP)

Headline current account balance, 2008 staff projection	-24.8
Adjustment for Temporary Factors	
Closing of absorption gap / end of credit boom 1/	14.0
Lagged effects of past changes in competitiveness	-2.0
Underlying current account balance	-12.8
Capital transfers	2.1
Underlying Saving-Investment Balance	-10.7
Equilibrium Saving-Investment Balance 2/	-7.8
Deviation from Equilibrium	-2.9

1/ Assumes that domestic demand to GDP ratio reverts back to pre-boom level.
2/ Based on Rahman (2008)

Real Exchange Rate Overvaluation, June 2008

Approach	Assessment
Macro balance	7.4
External sustainabiltiy	16.1
REER 1/	19.7
Average	14.4

1/ Deviation of REER from five-year average. (Mean of CPI and ULC-based REER).

Box 4: Bulgaria FSAP Update

A joint IMF-World Bank mission visited Sofia from June 23 to July 4, 2008, to update the findings of the 2002 Financial Sector Assessment Program (FSAP).

The financial sector has changed with the entry of foreign (mainly Eurozone) banks, which now dominate the financial system. Various efforts to contain rapid credit growth resulted in higher intermediation costs and regulatory arbitrage. Banks increasingly offered financial services through unregulated or less strictly regulated financial companies (leasing companies, consumer credit companies, etc.). Some banks were booking loans abroad and selling loans to their parents to be re-packaged. Returns—among the highest in the region—triggered strong competition for market share. Residents were also increasingly borrowing directly from foreign banks, making Bulgaria more susceptible to spill-overs from abroad.

Reported indicators suggest that banks are generally sound, but rapid credit growth and increased dependence on foreign funding have increased the vulnerabilities of the banking sector especially from the upheaval in global financial markets. The BNB adopted conservative prudential policies: 12 percent capital adequacy ratio; Basel Core Principles for Effective Banking System are observed to a large degree; high (12 percent) unremunerated reserve requirements; etc. Capital adequacy ratios range between 14-30 percent, liquidity ratios 22-39 percent, return on equity 18-29 percent, and nonperforming loans 0.2-2.4 percent. About half of banks' balance sheets are euro denominated, but positions are largely matched. However, indirect credit risk from unhedged borrowers is a risk factor. While the system relies on domestic deposits for funding, parent bank funding has been increasing (loan to deposit ratios range between 50-130 percent). The risks of regional contagion and spillovers are beginning to crystallize. Banks' exposure to real estate and construction, through lending as wells as collateral increased, which could suffer from a drop in real estate prices.

The core banking system remains resilient under most stress test scenarios, but could under come pressure under a more adverse scenario. Under an adverse macro scenario with a sudden stop in capital inflows and a 30 percent drop in real estate prices, the NPL ratio would increase by about 12 percentage points, and the Capital Adequacy Ratio would decline from 14½ to 2½ percent

The robustness of the banking critically depends on maintaining the currency board arrangement, given large currency imbalances of corporations and households (71 percent of corporate loans and 25 percent of household loans are in euro).

The securities markets, insurance industry, and private pension funds remain relatively small and underdeveloped despite rapid growth. The legal and regulatory framework is consistent with pertinent EU Directives, but enforcement could be further strengthened.

Despite significant progress, further reforms on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) are needed on several fronts including implementation of preventive measures, supported by additional supervisory resources.[1]

Key Recommendations

The BNB should: (i) enhance its capacity to stress test, particularly credit and liquidity risks; (ii) draft amendments to include non-bank borrowers in the credit registry, (iii) enhance and update its assessment tools and methodologies; (iii) develop contingency plans, but delay the introduction of risk-based premiums by the Deposit Insurance Fund; (iv) strengthen regional collaboration; and (v) participate in pertinent crisis management exercises (vi) create buffers in the fiscal space for potential solvency support, in case of systemic problems.

The Financial Supervisory Commission should: (i) strengthen its capacity to enforce securities legislation; (ii) prepare an effective oversight program of the stock exchange and settlement system; (iii) tighten the definition of related parties and develop a map of indirect ownership of pension funds; (iv) review the rules related to switching and the automatic assignation rule for undecided participants in pension funds; (v) increase disclosure of risk adjusted performance of pension funds; (vi) overhaul of the pay-out design of pension funds; and (vii) change its skill mix to better enforce insurance legislation during inspections.

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[1] An AML/CFT ROSC is being prepared based on the assessment report published in 2008 by MONEYVAL (the FATF-style regional body for Europe) and, in accordance with the agreement between the Fund and MONEYVAL, will be sent to the Board for information.

Box 5. Structural Reforms and Competitiveness of the Bulgarian Economy[1]

Structural reforms that raise labor productivity and labor participation are needed to speed up convergence of per capita income with the European Union:

- Current productivity levels are well below the EU average and that of other new Member States, and productivity growth is just 3% per year.

- Labor market performance has improved substantially in the past decade, but labor force participation remains low. The unemployment rate, which had climbed to 20 percent at the beginning of the decade, is now at record low levels. But while the labor market has become very tight for highly skilled workers, overall labor force participation remains low, particularly among youth and older workers.

Recognizing the importance of further increases in employment and labor productivity, Bulgaria has recently introduced significant education and labor reforms.

- The government has delegated budgets to schools and now provides a fixed amount per student which has led to a more efficient utilization of funds and which lays the ground for increases in the quality of education. Bulgaria has also launched external student assessments, both national and international, to benchmark and track progress of student performance. Going forward, education reforms need to be completed and consolidated in a new Education Act foreseen for 2009, and should be expanded to include vocational education and training and higher education.

- In the labor market, reductions in the social insurance burden, and new employment policies focused on activating previously inactive workers (in particular the low-skilled, youth and older workers), should contribute to increases in labor force participation and employment.

The government has also taken measures to maintain fiscal sustainability of the health sector—improving the pharmaceutical policy, introducing an integrated information system for the National Health Insurance Fund, and raising the health contribution rate to 8 percent from 6 percent until 2008. However, further steps are needed to sustainably change the underlying structure of spending from hospitals to primary health care. A continued review of the financing mechanism in the health sector is needed to make the system financially sustainable and lay the ground for improving its quality and restructuring the health facilities network.

Bulgaria has also made considerable progress in reducing the burden of regulation in recent years, ranking among the top 10 reformers in the World Bank's *Doing Business* report in 2006/07, mostly on account of improved tax system and administration. Notwithstanding this, regulation remains a serious constraint to enterprise operations and growth. In the World Bank's 2008 *Investment Climate Assessment*, senior managers in Bulgaria reported spending 17 percent of their time dealing with requirements imposed by Government regulations such as taxes, customs, labor regulations, licensing and registration. This is very high compared to other middle-income economies. The *Better Regulation Programme* adopted by the Government for 2008-10, and the broader National Reform Programme (2008-10) charting a course of action based on EC recommendations, are key steps to maintain reform momentum.

1/ Prepared by the World Bank

Table 5. Bulgaria: Selected Economic and Social Indicators, 2006–10

	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.
Output, prices, and labor market			(Annual percentage change)		
Real GDP	6.3	6.2	6.0	1.0	1.5
Real GDP excluding agricultural sector	6.5	8.1	5.6	0.6	1.1
Real domestic demand	10.3	9.4	7.6	-2.9	-4.7
Consumer price index (HICP, average)	7.4	7.6	12.0	4.7	2.5
Consumer price index (HICP, end of period)	6.1	11.6	7.2	3.0	2.7
Employment	2.4	2.6	3.1	0.5	0.2
Nominal wages	9.5	20.6	24.3	9.1	4.9
Public sector wages	8.9	17.4	22.6	10.0	5.0
Private sector wages	10.9	23.3	26.0	9.0	5.0
General government finances			(Percent of GDP)		
Revenue	38.8	40.7	39.7	41.3	39.3
Expenditure	35.3	37.2	36.7	39.9	37.8
Fiscal balance	3.5	3.5	3.0	1.4	1.5
Privatization proceeds	1.5	0.8	-0.2	0.4	0.0
External financing	-1.9	-0.5	-1.0	1.0	1.0
Domestic financing	-3.1	-3.8	-1.8	-2.8	-2.4
Gross public debt	24.6	19.8	16.8	18.7	19.4
Financial net worth	11.7	13.7	14.7	15.5	14.5
Money and credit			(Annual percentage change)		
Broad money (M3)	26.9	31.2	8.8	2.7	2.2
Domestic credit	24.6	62.5	32.0	5.0	6.0
Interest rates			(Percent)		
Euro, six-month LIBOR	3.1	4.3	4.6	2.2	2.7
Interbank rate	3.7	4.9	6.9	…	…
Lending rate	8.9	9.9	10.4	…	…
Real lending rate (HICP adjusted)	1.4	2.2	-1.3	…	…
Balance of payments			(Percent of GDP)		
Current account balance	-17.8	-21.8	-24.8	-15.3	-8.4
Merchandise trade balance	-22.0	-25.3	-29.2	-19.6	-14.2
Capital and financial account balance	28.3	38.0	31.8	10.9	9.4
Foreign direct investment balance	23.3	21.8	12.6	7.9	4.9
International investment position	-60.8	-84.5	-100.8	-108.7	-109.3
Gross official reserves	35.4	41.3	37.4	31.4	31.1
Gross external debt	81.7	99.8	110.8	106.8	108.1
Exchange rates					
Leva per euro			Currency board peg to euro at lev 1.956 per euro		
Leva per U.S. dollar (end of period)	1.48	1.34	1.45	…	…
Real effective exchange rate					
CPI based (percentage change)	4.3	5.6	8.4	…	…
GDP deflator based (percentage change)	6.3	5.8	8.4	…	…

Social Indicators (reference year in parentheses)
Per capita GNI (Atlas method, 2007): US $4590; Poverty rate (2001): 12.8 percent;
Life expectancy at birth (2006): 72.6 years; Mortality under 5 per 1,000 (2006): 14.28; Fertility rate per woman (2006): 1.38
Income distribution (Gini index, 2003): 29.2; Primary education completion rate (2005): 98.3

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

Table 6. Bulgaria: Real GDP Components and Implicit Deflators, 2006–10

	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.
	(Real growth rate by expenditure category, percent)				
Real GDP	6.3	6.2	6.0	1.0	1.5
Domestic demand	10.3	9.4	7.6	-2.9	-4.7
Private demand	12.6	8.8	8.2	-4.7	-4.7
Public demand	0.3	12.4	4.5	6.2	-4.5
Final consumption	7.4	4.9	4.7	3.8	1.4
Private consumption	9.5	5.3	5.2	3.4	2.1
Public consumption	-1.4	3.1	2.6	5.8	-1.9
Gross fixed investment	14.7	21.7	21.0	-20.7	-14.4
Private investment	16.9	17.4	24.2	-27.3	-15.9
Public investment	5.7	41.4	8.9	7.1	-10.0
Inventories 1/	1.8	1.2	-1.1	0.0	-1.6
Net exports 1/	-5.4	-4.9	-3.2	4.7	5.7
Exports of goods and services	8.8	5.2	5.1	-10.3	4.7
Imports of goods and services	14.0	9.9	7.5	-12.5	-5.5
	(Contribution to real GDP growth, percentage point)				
Domestic demand	11.8	11.1	9.2	-3.7	-4.2
Private demand	11.8	8.6	8.2	-5.0	-3.2
Public demand	0.0	2.5	1.0	1.4	-1.0
Final consumption	6.4	4.2	4.0	3.3	1.2
Private consumption	6.7	3.7	3.6	2.3	1.5
Public consumption	-0.2	0.5	0.4	0.9	-0.3
Gross fixed investment	3.6	5.6	6.2	-6.9	-3.8
Private investment	3.3	3.7	5.7	-7.4	-3.1
Public investment	0.3	2.0	0.6	0.5	-0.7
Inventories	1.8	1.2	-1.1	0.0	-1.6
Net exports	-5.4	-4.9	-3.2	4.7	5.7
Exports of goods and services	5.3	3.3	3.2	-6.4	2.2
Imports of goods and services	10.7	8.2	6.4	-11.1	-3.5
	(Percentage change in implicit deflators)				
GDP deflator	8.5	7.9	10.8	3.1	2.8
Domestic demand	6.9	7.5	12.7	-0.7	3.6
Final consumption	6.0	7.0	12.0	4.7	2.5
Private consumption	5.7	6.8	12.0	4.7	2.5
Public consumption	7.8	8.0	12.6	5.0	2.6
Gross fixed investment	7.9	8.0	9.0	3.5	1.9
Exports of goods and services	13.7	6.9	10.1	-14.1	5.9
Imports of goods and services	10.4	6.9	13.2	-15.3	4.7

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

1/ Contributions to GDP growth.

Table 7. Bulgaria: Balance of Payments, 2006–2014
(Millions of euros, unless otherwise indicated)

	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.
Current account balance	-4,502	-6,304	-8,399	-5,410	-3,110	-2,518	-3,026	-3,346	-3,669
Merchandise trade balance	-5,562	-7,303	-9,917	-6,917	-5,222	-4,988	-5,654	-6,141	-6,544
Exports (f.o.b.)	12,012	13,512	15,733	11,675	13,139	14,587	16,127	17,869	19,684
Imports (f.o.b.)	-17,574	-20,815	-25,649	-18,592	-18,361	-19,575	-21,780	-24,010	-26,228
Services balance	927	1,115	1,316	1,165	1,473	1,720	1,682	1,723	1,736
Exports of non-factor services	4,186	4,625	5,261	4,502	4,811	5,130	5,664	6,303	6,980
Imports of non-factor services	-3,259	-3,510	-3,945	-3,337	-3,338	-3,410	-3,983	-4,580	-5,244
Income balance	-537	-452	-562	-279	-154	-162	-165	-170	-191
Receipts	1,278	1,531	2,002	2,284	2,461	2,638	2,959	3,350	3,747
Payments	-1,815	-1,983	-2,564	-2,563	-2,615	-2,800	-3,124	-3,520	-3,938
Current transfer balance	670	336	764	621	794	912	1,111	1,242	1,330
Capital and financial account balance	7,143	10,984	10,790	3,840	3,478	3,569	4,272	4,845	5,234
Capital transfer balance	180	356	297	980	985	988	988	988	988
Foreign direct investment balance	5,869	6,309	4,261	2,778	1,791	2,074	2,251	2,774	2,892
Portfolio investment balance	204.2	-517	-560	-350	-350	-350	-300	-250	-200
Other investment balance	890	4,836	6,792	432	1,052	858	1,333	1,334	1,554
General government	-304	77	301	408	492	78	69	72	117
Domestic banks	-568	2,165	3,395	-2,381	-155	532	706	894	1,123
Other private sector	1,762	2,593	3,096	2,405	715	248	559	368	315
Errors and omissions	-855	-1,516	-1,650	0	0	0	0	0	0
Overall balance	1,786	3,164	741	-1,570	368	1,051	1,246	1,499	1,566
Financing	-1,786	-3,163	-741	1,570	-368	-1,051	-1,246	-1,499	-1,566
Gross international reserves (increase: -)	-1,506	-2,909	-741	1,570	-368	-1,051	-1,246	-1,499	-1,566
Use of Fund credit, net	-279.9	-255	0	0	0	0	0	0	0
Purchases	0.0	0	0	0	0	0	0	0	0
Repurchases	-279.9	-255	0	0	0	0	0	0	0
Memorandum items:				(Percent of GDP)					
Current account balance	-17.8	-21.8	-24.8	-15.3	-8.4	-6.4	-7.1	-7.2	-7.2
Foreign direct investment balance	23.3	21.8	12.6	7.9	4.9	5.3	5.3	6.0	5.7
Merchandise trade balance	-22.0	-25.3	-29.2	-19.6	-14.2	-12.7	-13.3	-13.2	-12.9
Exports	47.6	46.8	46.4	33.0	35.7	37.2	37.9	38.5	38.7
Imports	-69.6	-72.0	-75.6	-52.6	-49.8	-49.9	-51.2	-51.7	-51.6
Gross external financing requirement	42.2	53.3	55.3	57.0	47.6	44.6	45.9	42.9	41.2
				(Annual percentage change)					
Terms of trade (merchandise)	3.5	1.1	-8.0	-3.5	0.5	0.4	0.3	0.3	0.0
Merchandise export volume	11.3	10.2	12.5	-4.8	6.9	7.7	8.1	8.8	8.7
Merchandise import volume	15.0	17.3	9.5	-10.3	-5.7	3.8	9.2	8.6	7.7
Merchandise export prices	14.0	2.1	3.5	-22.0	5.2	3.1	2.3	1.8	1.4
Merchandise import prices	10.1	1.0	12.6	-19.2	4.7	2.7	1.9	1.5	1.4
GDP	25,238	28,898	33,927	35,328	36,852	39,237	42,554	46,401	50,824

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

Table 8. Bulgaria: External Financial Assets and Liabilities, 2006–13
(Millions of euro, unless otherwise indicated)

	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
International investment position	-15,355	-24,431	-34,182	-38,413	-40,288	-41,568	-43,306	-45,365
Financial assets	17,288	20,552	21,414	20,318	21,172	22,739	24,538	26,630
Foreign direct investment	219	418	656	905	1,164	1,440	1,739	2,066
Portfolio investment	949	1,026	1,026	1,026	1,026	1,026	1,026	1,026
Other investments	7,194	7,172	7,054	7,280	7,507	7,747	8,000	8,267
Gross international reserves	8,926	11,937	12,678	11,107	11,475	12,526	13,772	15,271
Financial liabilities	32,643	44,982	55,597	58,731	61,460	64,307	67,844	71,995
Foreign direct investment	17,527	25,397	29,897	32,723	34,523	36,623	38,873	41,673
Equity	11,802	15,830	18,980	20,958	22,218	23,688	25,263	27,223
Intercompany debt	5,725	9,567	10,917	11,764	12,304	12,934	13,609	14,449
Portfolio investment	2,749	2,531	1,971	1,621	1,271	921	621	371
Loans	8,851	11,417	18,091	18,749	20,028	21,126	22,712	24,313
BNB	259	0	0	0	0	0	0	0
General government	1,838	1,852	2,152	2,560	3,052	3,130	3,198	3,270
Banks	1,392	1,595	4,872	2,717	2,789	3,561	4,520	5,682
Other sectors	5,362	7,970	11,066	13,471	14,187	14,435	14,993	15,361
Other liabilities	3,517	5,638	5,638	5,638	5,638	5,638	5,638	5,638
Memorandum items:								
GIR (in percent of GDP)	35.4	41.3	37.4	31.4	31.1	31.9	32.4	32.9
GIR (in percent of short-term debt, at remaining maturity)	98.2	115.4	86.2	77.0	76.7	75.8	83.1	88.5
GIR (in percent of short-term debt and FX deposits of banks)	48.3	51.4	...	...	...	...	...	...
GIR (in months of next year's imports)	4.3	4.8	6.9	6.1	6.0	5.8	5.8	5.8
NIR (in percent of GDP)	34.4	41.3	37.4	31.4	31.1	31.9	32.4	32.9
Gross external debt (in percent of GDP)	81.7	99.8	110.8	106.8	108.1	105.7	100.4	97.0
Public	14.7	10.7	14.6	16.8	19.1	18.6	15.8	15.1
Private	67.1	89.1	96.2	89.9	89.0	87.1	84.6	81.8
Short-term	24.8	33.7	39.3	36.2	35.4	34.5	33.5	32.3
Long-term	42.3	55.4	56.9	53.7	53.6	52.6	51.1	49.5
Gross external debt (in percent of exports of GNFS)	127.7	159.0	179.0	233.2	222.0	210.3	196.1	186.2
Net international investment position (in percent of GDP)	-60.8	-84.5	-100.8	-108.7	-109.3	-105.9	-101.8	-97.8
GDP	25,238	28,898	33,927	35,328	36,852	39,237	42,554	46,401

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

Table 9a. Bulgaria: General Government Operations, 2006–14

(In millions of leva)

	2006	2007	2008 Budget	2008 Actual Prel	2009 Budget approved growth: 4.7	2009 (Proj.) MOF Rev proj without 10% rule growth: 2.1	2009 (Proj.) MOF Rev proj with 10% rule growth: 2.1	2009 (Proj.) IMF Rev Proj. with 10% rule growth: 1.0	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.
Revenue	19,140	22,985	26,210	26,361	31,456	29,030	29,030	28,548	28,310	29,904	32,516	35,430	38,392
Taxes	15,513	18,445	21,117	21,214	24,628	22,172	22,172	21,807	22,230	23,442	25,500	27,726	29,912
Taxes on profits	1,334	1,833	2,262	2,229	2,617	2,230	2,230	2,180	2,231	2,188	2,407	2,624	2,874
Taxes on income	1,325	1,809	2,190	1,971	2,327	2,127	2,127	2,052	2,160	2,275	2,523	2,756	2,990
Value-added taxes	5,824	6,599	8,110	7,485	9,321	7,575	7,575	7,502	7,376	7,799	8,465	9,203	10,003
Excises	2,498	3,315	3,798	4,083	4,260	4,360	4,360	4,324	4,387	4,719	5,107	5,612	6,171
Customs duties	455	193	195	221	215	215	215	216	164	140	195	215	235
Social security contributions	3,496	4,011	3,817	4,437	4,902	4,702	4,702	4,570	5,012	5,363	5,765	6,184	6,398
Other taxes	582	685	745	787	986	963	963	962	899	958	1,039	1,132	1,240
Nontax revenues	3,002	3,337	3,193	4,006	3,818	3,848	3,848	3,730	3,848	4,121	4,525	5,013	5,489
Grants	625	1,204	1,900	1,142	3,010	3,010	3,010	3,010	2,232	2,342	2,492	2,692	2,992
Expenditure	17,416	21,026	24,389	24,360	29,261	29,261	27,593	27,593	27,251	28,910	31,510	34,055	37,165
Current expenditure	14,742	17,177	19,437	19,842	23,178	23,178	22,028	22,028	22,187	23,453	25,547	27,571	30,076
Compensation of employees	2,773	3,204	3,596	3,842	4,285	4,285	3,857	3,857	3,975	4,243	4,553	4,909	5,343
Maintenance and operations	3,835	4,436	4,776	4,880	5,313	5,313	4,781	4,781	4,901	5,199	5,509	6,043	6,658
Interest	640	631	668	585	637	637	637	637	674	772	843	843	843
Subsidies	726	781	1,343	1,110	1,829	1,829	1,646	1,646	1,448	1,448	1,571	1,713	1,876
Contribution to EU budget	...	595	660	720	932	932	932	932	865	921	995	1,074	1,160
Social benefits	6,766	7,450	8,341	8,630	10,119	10,119	10,119	10,119	10,280	10,825	12,028	12,937	14,141
Pensions	4,149	4,622	5,277	5,546	6,531	6,531	6,531	6,531	6,532	6,911	7,867	8,490	9,270
Unemployment	1,153	1,192	1,578	1,572	1,842	1,842	1,842	1,842	2,018	2,072	2,164	2,269	2,485
Health care	1,185	1,343	1,486	1,512	1,746	1,746	1,746	1,746	1,730	1,842	1,997	2,178	2,386
Other	279	294	0	0	0	0	0	0	0	0	0	0	0
Other spending	2	80	53	74	64	64	57	57	45	45	48	51	55
Capital expenditure	2,325	3,551	4,258	4,214	5,193	5,193	4,673	4,673	4,287	4,609	5,026	5,453	5,958
Contingency	293	298	694	305	891	891	891	891	777	848	938	1,032	1,131
Fiscal balance	1,724	1,960	1,821	2,001	2,194	-232	1,437	955	1,059	994	1,006	1,376	1,227
Financing	-1,724	-1,960	-1,821	-2,001	-2,194			-955	-1,059	-994	-1,006	-1,376	-1,227
Privatization proceeds	738	450	400	-110	250			250	0	0	0	0	0
External	-933	-278	588	-694	721			721	707	687	322	322	322
Domestic	-1,530	-2,131	-2,809	-1,198	-3,166			-1,926	-1,765	-1,681	-1,328	-1,698	-1,549

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

Table 9b. Bulgaria: General Government Operations and Balance Sheet, 2006–14
(In percent of GDP)

	2006	2007	2008		2009	2009 (Proj.)			2010	2011	2012	2013	2014
			Budget	Actual Prel	Budget approved growth: 4.7	MOF Rev proj without 10% rule growth: 2.1	MOF Rev proj with 10% rule growth: 2.1	IMF Proj. with 10% rule growth: 1.0	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue	38.8	40.7	42.5	39.7	42.8	41.3	41.3	41.3	39.3	39.0	39.1	39.0	38.6
Taxes	31.4	32.6	34.2	32.0	33.5	31.5	31.5	31.6	30.8	30.5	30.6	30.6	30.1
Taxes on profits	2.7	3.2	3.7	3.4	3.6	3.2	3.2	3.2	3.1	2.9	2.9	2.9	2.9
Taxes on income	2.7	3.2	3.5	3.0	3.2	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Value-added taxes	11.8	11.7	13.1	11.3	12.7	10.8	10.8	10.9	10.2	10.2	10.2	10.1	10.1
Excises	5.1	5.9	6.2	6.2	5.8	6.2	6.2	6.3	6.1	6.1	6.1	6.2	6.2
Customs duties	0.9	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Social security contributions	7.1	7.1	6.2	6.7	6.7	6.7	6.7	6.6	7.0	7.0	6.9	6.8	6.4
Other taxes	1.2	1.2	1.2	1.2	1.3	1.4	1.4	1.4	1.2	1.2	1.2	1.2	1.2
Nontax revenues	6.1	5.9	5.2	6.0	5.2	5.5	5.5	5.4	5.3	5.4	5.4	5.5	5.5
Grants	1.3	2.1	3.1	1.7	4.1	4.3	4.3	4.4	3.1	3.1	3.0	3.0	3.0
Expenditure	35.3	37.2	39.5	36.7	39.8	41.6	39.3	39.9	37.8	37.7	37.9	37.5	37.4
Current expenditure	29.9	30.4	31.5	29.9	31.5	33.0	31.3	31.9	30.8	30.6	30.7	30.4	30.3
Compensation of employees	5.6	5.7	5.8	5.8	5.8	6.1	5.5	5.6	5.5	5.5	5.5	5.4	5.4
Maintenance and operations	7.8	7.8	7.7	7.4	7.2	7.6	6.8	6.9	6.8	6.8	6.6	6.7	6.7
Interest	1.3	1.1	1.1	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0	0.9	0.8
Subsidies	1.5	1.4	2.2	1.7	2.5	2.6	2.3	2.4	2.0	1.9	1.9	1.9	1.9
Contribution to EU budget	..	1.1	1.1	1.1	1.3	1.3	1.3	1.3	1.2	1.2	1.2	1.2	1.2
Social benefits	13.7	13.2	13.5	13.0	13.8	14.4	14.4	14.6	14.3	14.1	14.5	14.3	14.2
Pension	8.4	8.2	8.6	8.4	8.9	9.3	9.3	9.5	9.1	9.0	9.5	9.4	9.3
Unemployment	2.3	2.1	2.6	2.4	2.5	2.6	2.6	2.7	2.8	2.7	2.6	2.5	2.5
Health care	2.4	2.4	2.4	2.3	2.4	2.5	2.5	2.5	2.4	2.4	2.4	2.4	2.4
Other	0.6	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other spending	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure	4.7	6.3	6.9	6.4	7.1	7.4	6.6	6.8	5.9	6.0	6.0	6.0	6.0
Contingency	0.6	0.5	1.1	0.5	1.2	1.3	1.3	1.3	1.1	1.1	1.1	1.1	1.1
Fiscal balance	3.5	3.5	3.0	3.0	3.0	-0.3	2.0	1.4	1.5	1.3	1.2	1.5	1.2
Financing	-3.5	-3.5	-3.0	-3.0	-3.0	0.3	-2.0	-1.4	-1.5	-1.3	-1.2	-1.5	-1.2
Privatization proceeds	1.5	0.8	0.6	-0.2				0.4	0.0	0.0	0.0	0.0	0.0
External	-1.9	-0.5	1.0	-1.0				1.0	1.0	0.9	0.4	0.4	0.3
Domestic	-3.1	-3.8	-4.6	-1.8				-2.8	-2.4	-2.2	-1.6	-1.9	-1.6
Financial assets	39.4	36.1		33.8				36.4	35.9	36.6	34.2	32.8	31.2
Fiscal reserve	11.0	13.7		12.4				12.4	12.4	12.4	12.4	12.4	12.4
Currency and deposits	13.2	13.2		12.9				12.9	12.9	12.9	12.9	12.9	12.9
Shares and other equity	12.5	8.8		3.8				3.8	3.8	3.8	3.8	3.8	3.8
Other assets	17.4	0.4		4.8				7.4	6.9	7.6	5.1	3.8	2.2
Financial liabilities	27.6	22.4		19.1				20.9	21.4	21.7	19.2	17.6	16.1
Gross public debt	24.6	19.8		16.8				18.7	19.4	19.7	17.4	15.9	14.6
Foreign	18.6	14.1		12.0				12.8	13.2	13.3	12.7	11.6	10.6
Domestic	6.0	5.7		4.8				5.9	6.1	6.4	4.7	4.3	3.9
Other liabilities	3.1	2.7		2.3				2.2	2.1	2.0	1.8	1.7	1.5
Net financial worth	11.7	13.7		14.7				15.5	14.5	14.9	15.0	15.2	15.1
Memorandum items:													
Structural fiscal balance 1/	1.6	0.2		-1.1				-0.2	1.5	1.7	1.4	1.7	1.3
Structural fiscal balance (EU method)	3.0	2.5		1.7				1.4	1.9	1.5	1.4	1.7	1.2
Output gap 2/	1.2	2.3		3.2				-0.1	-1.1	-0.6	-0.4	-0.4	0.0
Absorption gap 3/	8.2	13.8		17.5				7.8	0.9	-1.2	-0.5	-0.4	-0.3
Nominal GDP (in millions of leva)	49,361	56,520	61,711	66,354	73,485	70,299	70,299	69,096	72,076	76,740	83,228	90,752	99,404

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

1/ Actual fiscal balance adjusted for the automatic effects of internal imbalance (output gap) and external imbalance (absorption gap) on fiscal position; see Selected Issues Chapter III (Country Report 07/390).

2/ Percentage deviation of actual from potential GDP.

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

Table 10. Bulgaria: Monetary Accounts, 2006–09
(Billions of leva, unless otherwise stated)

	2006 Dec.	2007 Dec.	2008 Dec. Proj.	2009 Dec. Proj.
Monetary Survey				
Net foreign assets	18.6	19.1	13.9	14.9
Net foreign reserves (billions of euro)	9.5	9.8	7.1	7.6
Net domestic assets	13.4	22.9	31.8	32.1
Domestic credit	21.1	33.5	44.5	46.1
General government	-2.2	-4.3	-5.2	-6.1
Non-government	23.3	37.8	49.7	52.2
Broad money (M3)	32.1	42.1	45.8	47.0
Currency outside banks	6.2	7.4	8.0	9.1
Deposits	25.8	34.6	37.7	37.9
Accounts of the Bulgarian National Bank				
Net foreign assets	17.0	23.3	24.8	21.1
Net foreign reserves (billions of euro)	8.7	11.9	12.7	10.8
Net domestic assets	-6.5	-9.1	-10.6	-7.5
Net claims on government	-4.0	-5.9	-6.7	-4.0
Base money	10.5	14.2	14.2	13.6
Currency in circulation	6.2	7.4	8.0	9.1
Banks reserves	4.3	6.8	6.2	4.5
Deposit money banks				
Net foreign assets	1.7	-4.2	-10.9	-6.2
Gross foreign assets	8.3	7.9	7.6	8.1
Gross foreign liabilities	6.6	12.1	18.5	14.3
Net domestic assets	24.7	39.5	49.4	45.6
Domestic credit	25.0	39.4	51.2	50.0
Memorandum items:	Annual percentage change			
Base money	25.5	35.4	-0.1	-4.2
Broad money	26.9	31.2	8.8	2.7
Domestic non-government credit	24.6	62.5	32.0	5.0
Domestic deposits	30.0	34.1	9.0	0.4
Domestic currency	27.2	29.6	7.3	...
Foreign currency	33.6	39.5	10.9	...
	Ratio			
Money multiplier	3.1	3.0	3.2	3.5
Velocity (M3)	1.5	1.3	1.4	1.5
GDP (millions of leva)	49,361	56,520	66,354	69,096

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

Table 11. Bulgaria: Financial Soundness Indicators, 2004–08
(In percent)

	2004	2005	2006	2007	2008 March	2008 June	2008 Sept.	2008 Dec.
Core indicators								
Capital adequacy								
Capital to risk-weighted assets	16.6	15.3	14.5	13.9	14.5	14.6	14.4	14.9
Tier 1 capital to risk-weighted assets	14.4	12.5	11.8	10.8	10.9	11.1	11.0	11.2
Asset quality								
Nonperforming loans to total gross loans	2.0	2.2	2.2	2.1	2.1	1.9	2.0	2.4
Nonperforming loans net of provisions to capital	1.8	2.9	2.5	2.4	2.4	2.3	2.5	3.6
Large exposures to capital	129.8	90.8	87.3	88.9	71.7	70.1	73.3	70.3
Earnings and profitability								
Return on assets	2.1	2.0	2.2	2.4	2.5	2.4	2.3	2.1
Return on equity	19.6	21.4	25.0	24.8	28.6	25.9	24.5	23.1
Net interest income to gross income	68.1	68.5	69.4	70.3	76.1	75.4	75.4	75.1
Noninterest expense to gross income	58.3	55.3	56.0	47.8	47.6	48.1	48.3	49.9
Personnel expense to total income	21.4	19.5	18.8	17.5	18.6	18.6	18.6	19.0
Trading and fee income to total income	30.1	29.8	27.3	24.5	20.5	22.1	24.6	23.9
Liquidity								
Liquid assets to total assets	30.1	28.7	31.0	24.7	21.1	21.3	19.7	19.1
Liquid assets to short-term liabilities	34.7	33.1	35.7	28.9	24.8	24.8	23.1	22.6
Encouraged indicators								
Deposit-taking institutions								
Capital to assets	10.2	7.4	7.3	7.7	8.2	8.3	8.4	8.5
Trading income to total income	8.4	8.0	2.7	2.7	-0.3	0.9	3.3	2.8
Personnel expenses to noninterest expenses	36.7	35.3	33.7	36.6	39.1	38.7	38.5	38.2
Customer deposits to total (non-interbank) loans	121.2	111.3	121.1	104.2	96.7	90.7	87.4	84.8
Foreign currency denominated loans to total loans	48.2	47.8	45.6	50.4	51.6	54.0	55.5	56.9
Foreign currency denominated liabilities to total liabilities	56.0	55.0	54.5	58.6	59.2	62.3	60.9	60.0
Net open foreign-exchange position	-5.9	-5.6	…	…	…	…	…	…

Source: Bulgarian National Bank.

Table 12: Bulgaria: Macroeconomic Framework, 2006–2014

	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.
GDP and prices (annual percent change)									
Real GDP	6.3	6.2	6.0	1.0	1.5	3.0	4.5	5.0	5.5
Real domestic demand	10.3	9.4	7.6	-2.9	-4.7	1.3	6.3	5.7	6.0
GDP deflator	8.5	7.9	10.8	3.1	2.8	3.4	3.8	3.8	3.8
Domestic demand deflator	6.9	7.5	12.7	-0.7	3.6	3.3	3.0	3.3	3.3
Consumer price index (HICP, average)	7.4	7.6	12.0	4.7	2.5	3.0	3.5	3.5	3.4
Consumer price index (HICP, end of period)	6.1	11.6	7.2	3.0	2.7	2.8	3.5	3.5	3.4
Nominal wages	9.5	20.6	24.3	9.1	5.0	6.0	6.5	7.0	7.9
Public sector wages	8.9	17.4	22.6	10.0	5.0	6.0	6.5	7.0	8.0
Private sector wages	10.9	23.3	26.0	9.0	5.0	6.0	6.5	7.0	8.0
Real effective exchange rate, CPI based	4.3	5.6	8.4	...	...	...	...	...	...
Monetary aggregates (e.o.p. percent change)									
Broad money	26.9	31.2	8.8	2.7	2.2	3.0	8.5	11.2	11.0
Domestic credit	24.6	62.5	32.0	5.0	6.0	6.5	10.0	12.5	12.5
Saving and investment (in percent of GDP)									
Foreign saving	17.8	21.8	24.8	15.3	8.4	6.4	7.1	7.2	7.2
Gross national saving	13.9	15.0	16.1	12.4	13.5	15.6	16.4	16.9	17.4
Government	8.2	9.7	9.4	8.1	7.4	7.3	7.2	7.5	7.2
Private	5.7	5.2	6.7	4.3	6.1	8.3	9.2	9.4	10.2
Gross domestic investment	31.7	36.8	40.9	27.8	21.9	22.0	23.5	24.1	24.6
Government	4.7	6.3	6.4	6.8	5.9	6.0	6.0	6.0	6.0
Private	27.0	30.5	34.5	21.0	16.0	16.0	17.5	18.1	18.7
General government (in percent of GDP)									
Revenue	38.8	40.7	39.7	41.3	39.3	39.0	39.1	39.0	38.6
Tax revenue	31.4	32.6	32.0	31.6	30.8	30.5	30.6	30.6	30.1
Non-Tax revenue	6.1	5.9	6.0	5.4	5.3	5.4	5.4	5.5	5.5
Grants	1.3	2.1	1.7	4.4	3.1	3.1	3.0	3.0	3.0
Expenditure	35.3	37.2	36.7	39.9	37.8	37.7	37.9	37.5	37.4
Fiscal balance	3.5	3.5	3.0	1.4	1.5	1.3	1.2	1.5	1.2
Gross public debt	24.6	19.8	16.8	18.7	19.4	19.7	17.4	15.9	14.6
Net financial worth	11.7	13.7	14.7	15.5	14.5	14.9	15.0	15.2	15.1
Balance of payments (in percent of GDP)									
Current account	-17.8	-21.8	-24.8	-15.3	-8.4	-6.4	-7.1	-7.2	-7.2
Trade balance	-22.0	-25.3	-29.2	-19.6	-14.2	-12.7	-13.3	-13.2	-12.9
Services balance	3.7	3.9	3.9	3.3	4.0	4.4	4.0	3.7	3.4
Income balance	-2.1	-1.6	-1.7	-0.8	-0.4	-0.4	-0.4	-0.4	-0.4
Transfers balance	2.7	1.2	2.3	1.8	2.2	2.3	2.6	2.7	2.6
Capital and financial account	28.3	38.0	31.8	10.9	9.4	9.1	10.0	10.4	10.3
Foreign direct investment	23.3	21.8	12.6	7.9	4.9	5.3	5.3	6.0	5.7
Memorandum items:									
Gross international reserves (in millions of euros)	8,926	11,937	12,678	11,107	11,475	12,526	13,772	15,271	16,837
Gross international reserves (in months of next year's imports)	4.3	4.8	6.9	6.1	6.0	5.8	5.8	5.8	...
International investment position (in percent of GDP)	-60.8	-84.5	-100.8	-108.7	-109.3	-105.9	-101.8	-97.8	-93.9
External debt (in percent of GDP) 1/	81.7	99.8	110.8	106.8	108.1	105.7	100.4	97.0	93.6
Short-term external debt (in percent of GDP)	24.1	32.2	39.3	36.2	35.4	34.5	33.5	32.3	31.3
Export volume (percent change)	11.3	10.2	12.5	-4.8	6.9	7.7	8.1	8.8	8.7
Import volume (percent change)	15.0	17.3	9.5	-10.3	-5.7	3.8	9.2	8.6	7.7
Terms of trade (percent change)	3.5	1.1	-8.0	-3.5	0.5	0.4	0.3	0.3	0.0
Nominal GDP (in millions of leva)	49,361	56,520	66,354	69,096	72,076	76,740	83,228	90,752	99,404
Nominal GDP (in millions of euros)	25,238	28,898	33,927	35,328	36,852	39,237	42,554	46,401	50,824

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

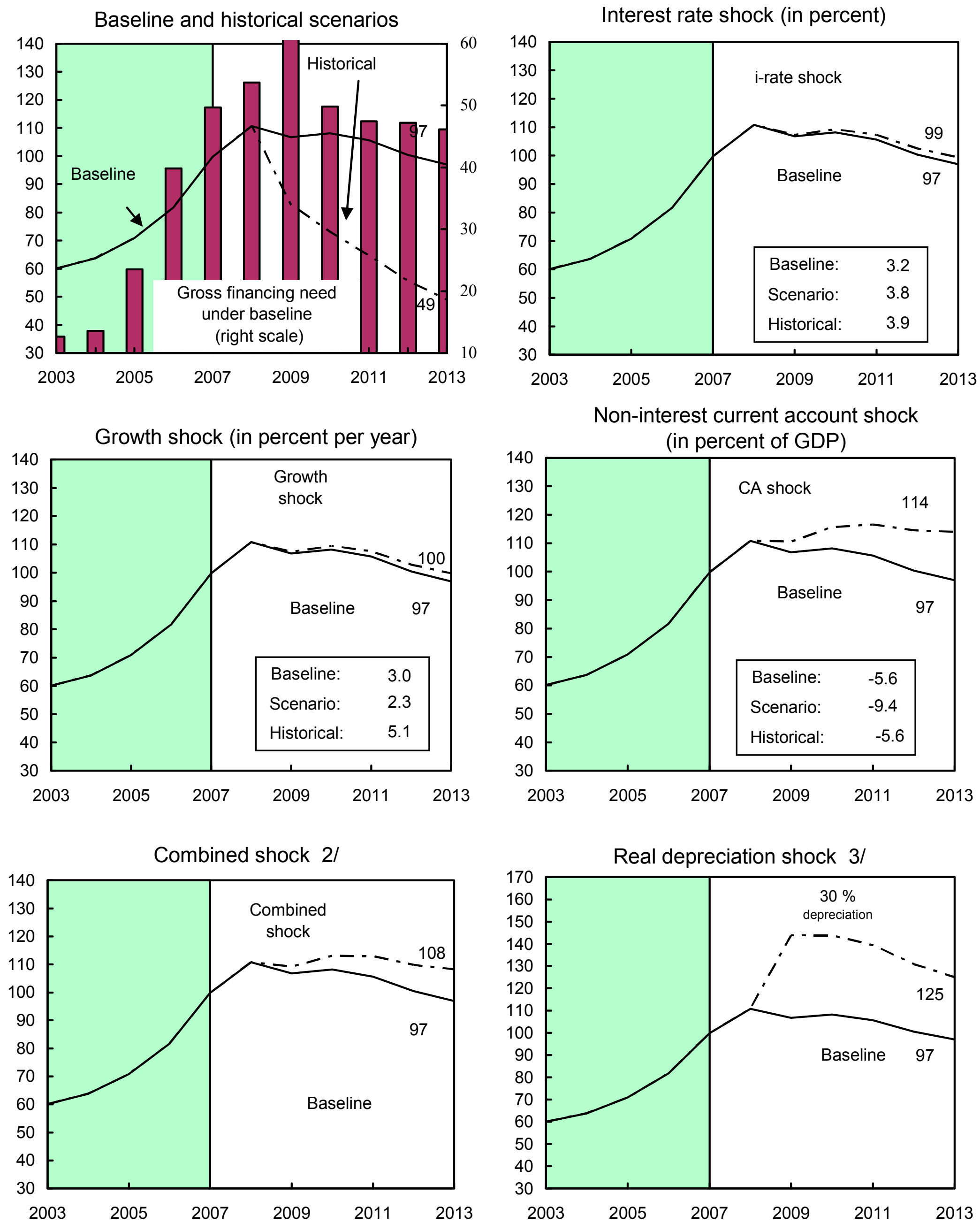
1/ At original maturity. Short-term debt at remaining maturity is estimated at about 85 percent of GDP at end-2008.

Table 13. Bulgaria: External Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	60.1	63.8	70.9	81.7	99.8	**110.8**	**106.8**	**108.1**	**105.7**	**100.4**	**97.0**	**-9.6**
Change in external debt	-4.9	3.7	7.1	10.9	18.1	11.0	-4.0	1.4	-2.5	-5.2	-3.5	
Identified external debt-creating flows (4+8+9)	-15.9	-14.8	-16.3	-2.2	-7.3	10.7	8.6	3.5	-0.4	-1.0	-1.6	
Current account deficit, excluding interest payments	3.4	4.8	10.5	14.7	20.8	22.8	12.1	5.0	3.2	4.0	4.0	
Deficit in balance of goods and services	10.6	11.6	16.4	18.4	21.4	25.4	16.3	10.2	8.3	9.3	9.5	
Exports	53.1	56.7	59.5	64.2	62.8	61.9	45.8	48.7	50.3	51.2	52.1	
Imports	63.7	68.2	76.0	82.5	84.2	87.2	62.1	58.9	58.6	60.5	61.6	
Net non-debt creating capital inflows (negative)	-7.2	-10.0	-22.6	-10.2	-12.8	-9.3	-5.6	-3.4	-3.7	-3.7	-4.2	
Automatic debt dynamics 1/	-12.1	-9.6	-4.2	-6.8	-15.3	-2.8	2.1	1.9	0.2	-1.3	-1.4	
Contribution from nominal interest rate	2.1	1.8	1.8	3.1	1.0	2.0	3.2	3.5	3.2	3.1	3.2	
Contribution from real GDP growth	-2.5	-3.2	-3.6	-3.9	-4.0	-4.8	-1.1	-1.5	-3.0	-4.4	-4.6	
Contribution from price and exchange rate changes 2/	-11.7	-8.1	-2.4	-6.1	-12.3	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	11.0	18.5	23.4	13.1	25.4	0.3	-12.6	-2.1	-2.1	-4.3	-1.9	
External debt-to-exports ratio (in percent)	113.2	112.6	119.0	127.4	159.0	179.0	233.2	222.0	210.3	196.1	186.2	
Gross external financing need (in billions of US dollars) 4/	2.5	3.4	6.4	12.6	19.7	26.8	29.7	25.3	25.8	28.0	30.0	
in percent of GDP	12.6	13.6	23.5	39.8	49.7	53.7	61.2	49.9	47.5	47.2	46.1	
Scenario with key variables at their historical averages 5/						**110.8**	**82.8**	**73.1**	**64.7**	**55.6**	**48.9**	**-13.2**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.0	6.6	6.2	6.3	6.2	6.0	1.0	1.5	3.0	4.5	5.0	
GDP deflator in US dollars (change in percent)	21.9	15.6	4.0	9.3	17.7	18.8	-3.9	3.4	4.0	4.3	4.3	
Nominal external interest rate (in percent)	4.0	3.6	3.2	5.1	1.6	2.5	2.8	3.4	3.2	3.2	3.5	
Growth of exports (US dollar terms, in percent)	32.1	31.6	16.1	25.3	22.2	24.2	-28.2	11.7	10.5	11.1	11.5	
Growth of imports (US dollar terms, in percent)	36.4	32.1	23.0	26.3	27.5	30.5	-31.0	-0.4	6.5	12.7	11.5	
Current account balance, excluding interest payments	-3.4	-4.8	-10.5	-14.7	-20.8	-22.8	-12.1	-5.0	-3.2	-4.0	-4.0	
Net non-debt creating capital inflows	7.2	10.0	22.6	10.2	12.8	9.3	5.6	3.4	3.7	3.7	4.2	

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 US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency),
and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock.
ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 7. Bulgaria: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



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

INTERNATIONAL MONETARY FUND

BULGARIA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the European Department

February 13, 2009

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Appendix I. Bulgaria—Financial Position in the Fund
(as of January 31, 2009)

I. Membership Status: Joined September 25, 1990

II.	General Resources Account:	SDR Million	%Quota
	Quota	640.20	100.00
	Fund holdings of currency	606.69	94.77
	Reserve Position	33.53	5.24
	Holdings Exchange Rate		

III.	SDR Department:	SDR Million	% Allocation
	Holdings	4.20	N/A

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

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

VI. Projected Payments to Fund: None

VII. Implementation of HIPC Initiative: Not Applicable

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

IX. Resident Representative

Mr. Fernandez-Ansola is the Senior Regional Resident Representative, based in Bucharest. He took up the position on September 4, 2006.

APPENDIX II. BULGARIA: IMF-WORLD BANK RELATIONS

A. Partnership in Bulgaria's Development Strategy

1. The World Bank has been leading the policy dialogue in structural and institutional reforms aimed at Bulgaria's successful EU integration and convergence. On June 13, 2006 the Board of Directors discussed the Country Partnership Strategy (CPS) of the Bank which outlined the roadmap for the Bank's country support for the period FY07-09. The strategic priorities of the CPS focus on: (i) productivity and employment; (ii) fiscal sustainability and absorption of EU funds; and (iii) social inclusion. In addition to the Bank's ongoing lending operations in areas such as revenue administration, social investment and employment promotion, district heating, and environment, the CPS includes a three-year program of three development policy loans (DPLs) of up to US$150 million each that supports institutional reforms in the social sectors. In addition, the CPS program includes investment lending in road, trade and transport facilitation for South East Europe, social inclusion, and municipal infrastructure, most of which is already effective. The Bank continues to undertake diagnostics providing a solid base for policy dialogue and design and implementation of its lending operations in Bulgaria.

B. IMF-World Bank Collaboration in Specific Areas

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

B.1. Areas of shared responsibility

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

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

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

5. **Public Expenditure Management.** The Bank has taken the lead in the dialogue on the efficiency and effectiveness of public expenditures and has outlined policy directions in the context of the Public Expenditure and Institutional Review[1] of 2002, and the Public Finance Policy Review[2] of 2006.

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

6. **Education.** The Bank has supported the government program in education. The first and the second DPLs, which were approved by the Bank's Board respectively in March 2007 and November 2008, support the deepening of education reforms, in particular strengthening of the institutional capacity of the Ministry of Education and Science to assess the quality of education, and improve school governance and financing system. In addition, a second Public Finance Policy Review[3], that was finalized in 2007, outlined options for reforms aimed at improving quality of education at all levels with special focus on vocational education and training as well as the quality of and access to tertiary education.

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

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

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

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

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

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

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

C. The World Bank Group Strategy and Lending Operations

9. **The Country Partnership Strategy (CPS) for Bulgaria[4],** discussed by the Bank's Board on June 13, 2006, focused on three main themes: (i) productivity and employment, (ii) fiscal sustainability and absorption of EU funds, and (iii) social inclusion.

10. **The World Bank's assistance program in Bulgaria to date comprises 43 IBRD operations with a total original commitment of US$2,655 million equivalent**, consisting of 14 adjustment loans (US$1,525.8 million), 22 investment projects (US$1004.4 million), one debt reduction loan (US$125.0 million), four Bank-managed Global Environmental Fund (GEF) grants, and two Bank-managed Prototype Carbon Fund (PCF) operations. Of these 43 operations, 31 have been completed, of which eleven have been partially cancelled during implementation, and 11 operations are currently under implementation (Table 1).

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

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

	Operation	US$ million	Board Date
1.	Registration and Cadastre	24.2	2001
2.	Wetlands Restoration and Pollution Reduction (GEF Grant)	7.5	2002
3.	Social Investment and Employment Promotion	69.3	2002
4.	Revenue Administration Reform Project	34.2	2003
5.	District Heating Project (PCF)	5.0	2003
6.	Wood Residue to Energy (PCF)	1.6	2003
7.	Energy Efficiency (GEF Grant)	10.0	2005
8.	Second Trade and Transport Facilitation in Southeast Europe (TTFSE 2)	52.8	2007
9.	Road Infrastructure Rehabilitation Project	122.5	2007
10.	Second Social Sectors Institutional Reform Development Policy Loan (SIR DPL 2)	150.0	2008
11.	Social Inclusion Project	59.0	2008

11. **Economic and Sector Work.** The country diagnostic work recently completed by the Bank includes a Public Finance Policy Review focused on reforms in labor and product markets, education and R&D aimed to boost productivity and employment and thus accelerate convergence to EU income levels. Various pieces of country diagnostic work have been finalized. These include a Judiciary Public Expenditure and Institutional Review focusing on developing a judiciary-wide modernization program to improve judiciary's performance and accountability; an investment climate assessment benchmarking study on product market regulation in Bulgaria compared with OECD countries; and a regulatory impact assessment study. In addition the following studies are currently being finalized: programmatic poverty monitoring and an investment climate assessment.

12. **IFC, as of November 2008, has 17 projects in its portfolio with total commitments of US$505 million for its own account and an additional US$234 syndicated from partner banks.** In the financial sector, IFC has supported two specialized SME banks, established Bulgaria's first micro lending bank, and has invested in a venture capital fund that also targets the SME sector. IFC has been involved in an oil and gas project in the country and is investing in a renewable energy plant in the North of the country, which will considerably add to the renewable energy capabilities of Bulgaria and contribute to the government's sustainable development goals. IFC has also supported a company investing in agricultural land and promoting land consolidation. Also, IFC has invested in a number of key manufacturing projects to support a cement plant modernization, the expansion and modernization of an electronic assembly facility, the rehabilitation and capacity increase of a wood panel production facility, revamping of a copper processing facility, and a project in retail sector to establish discount stores, hypermarkets and distribution centers in the country.

As a good example of South-South investments, IFC has committed about US$90 million to support post-privatization restructuring of a steel mill and two glass processing plants.

Questions may be referred to Ms. Stella Ilieva (3592-9697-251).

APPENDIX III. BULGARIA: STATISTICAL ISSUES

1. Data provision is generally adequate for surveillance purposes. Bulgaria has participated in the SDDS since 2003.

Real sector

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

3. The NSI has compiled estimates of quarterly GDP by the production and expenditure approaches in current and constant prices since 1994. The preliminary data are now disseminated 70 days (from the previously 80 days) after the end of the reference quarter with final figures disseminated after approximately 5 quarters. The annual data are disseminated about 5 quarters after the end of the reference year. The estimates at constant prices, which follow international standards, use chain-linked indices. Problems remain in the coverage of private sector activities as well as regarding constant price estimates of capital formation and external trade, although progress has been made in the development of export and import deflators.

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

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

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

7. The NSI also compiles and publishes wage data for various economic sectors. The main shortcomings include: (i) under-reporting of private sector wages; and (ii) reporting of average gross earnings only, not wages for time worked and wages by occupation. However, the National Social Security Institute (NSSI) administrative data are used to estimate wages by occupation and age (as well as the number of self-employed and employment in small firms). The household budget survey could provide an alternative source of data for private sector wages.

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

Government finance

9. In recent years, following the recommendations of a combined STA/FAD mission and within the framework of fiscal reporting requirements for EU accession, the authorities have made significant progress on implementing accrual accounting for government, budgetary and statistical systems. Consolidated data on central government operations are routinely reported for publication in the *GFS Yearbook* and in *IFS.* For the *GFS Yearbook 2006*, 2005 data for the general government sector and its subsectors were reported on a cash basis. Since September 2008, the Ministry of Finance (MOF) prepares and submits the SDDS indicators for the central government finances in the IMF's GFSM 2001 format. The same indicators are published on the MOF's website on a monthly and quarterly basis.

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

Money and banking statistics

11. In 2002, the BNB began to harmonize progressively its data collection and compilation methods in line with the ECB's framework for monetary statistics. The revised data for June 1995 and onward resulting from these efforts are published in IFS. Recent work in mid-2006 aimed at fully meeting the remaining ECB requirements beginning in February 2007, in accordance with 1995 ESA, the institutional coverage of monetary financial institutions includes money market funds. Consistency in the coverage of the BNB's claims on banks (which included claims on liquidated banks) and the banks' liabilities to the BNB improved in January 2003 after the BNB wrote off most of the claims on the liquidated banks.

Balance of payments

12. Bulgaria reports monthly balance of payments and external debt data on a regular and timely basis, but data on reinvested earnings by foreign-owned companies are subject to large revisions due to incomplete responses on surveys used for preliminary estimates. The data on reinvested earnings and equity are revised with the annual survey of the NSI on foreign direct investment in non-financial enterprises. In early 2006, the authorities revised the methodology for estimating trade-related transportation receipts and payments to align it more closely with actual costs. Since joining the EU in January 2007, the trade data with EU countries are being collected following the INTRASTAT system.

Table 1. Bulgaria: Common Indicators Required for Surveillance

As of February 10, 2009

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	Feb 2009	02/10/2009	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec 2008	01/23/2009	M	W	D		
Reserve/Base Money	Dec 2008	01/23/2009	W/M	M	D and M	O, O, LO, LO	O, O, O, O, O
Broad Money	Dec 2008	01/23/2009	W/M	M	W/M		
Central Bank Balance Sheet	Dec 2008	01/23/2009	W/M	W/M	W and M		
Consolidated Balance Sheet of the Banking System	Dec 2008	01/23/2009	M	M	M		
Interest Rates[2]	Feb 2009	02/10/2009	D/W/M	D/W/M	D/W/M		
Consumer Price Index	Dec 2008	01/13/2009	M	M	M	O, LO, O, O	LO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2007	1/31/2008	A	A	A	O, LO, O, LO	LO, O, O, O, NO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec 2008	01/29/2009	M	M	M		
Stocks of General Government and General Government-Guaranteed Debt[5]	Nov 2008	01/23/2009	M	M	M		
External Current Account Balance	Nov 2008	01/23/2009	M	M	M	LNO, LO, O, LO	LNO, LNO, LNO, LO, LO
Exports and Imports of Goods and Services	Nov 2008	01/23/2009	M	M	M		
GDP	2008 Q3 (Quarterly); 2007 (Annual)	12/15/2008	Q/A	Q/A	Q	O, LO, O, LO	O, O, O, O, O
Gross External Debt	Nov 2008	01/23/2009	M	M	M		

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

Statement by the IMF Staff Representative on Bulgaria
March 4, 2009

1. **According to preliminary flash estimates, GDP growth slowed to 3.7 percent year/year, down from 6.8 percent in Q3 2008.** From a demand side perspective, the slowdown was driven by a slowdown in gross fixed capital formation (from 22.2 to 9.7 percent) and exports (from 3.8 to -6.8 percent). The flash estimate was close to staff's projections (4.0 percent), and does not lead to changes in staff's GDP projections.

2. **BOP data confirm that capital inflows slowed sharply in the fourth quarter.** Net capital inflows amounted to €701 million, down from €3,416 million in the third quarter. The decline was driven in part by a reduction in foreign borrowing (by €785 million), in inbound FDI (by €753 million), and in non-resident deposits (by €589 million). The counterpart of the decline in private capital inflows was a decline in official reserve assets by €2 billion euro.

3. **The foreign reserve loss has stopped in February.** Following a reserve loss of 0.6 billion euros in January, reserves increased by €0.1 billion in the first three weeks of February.

4. **Private sector credit growth remained very low in January**. The annualized month/month growth rates was 5 percent, slightly up from 1.6 percent in December. The year/year growth rate slowed to 30.0 percent, down from 31.1 percent in December, and 61.8 percent in January 2008.

5. **Wage growth has remained high, further exacerbating staff's concerns about competitiveness.** Nominal wage growth slowed to 18 percent year/year in December, down from 25 percent in June. The decline was in line with the slowdown in inflation (from 14.7 to 7.2 percent), and real wage growth remained very high. The unemployment rate picked up from its record low of 6.0 percent in November to 6.1 percent in December.

6. **In line with other countries in the region, financial markets continue to be under pressure.** Since the staff report was issued, the Bulgarian stock market index (SOFIX) has lost another 4 percent, while sovereign CDS spreads have reached 634 basis points.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/34
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with Bulgaria

On March 4, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bulgaria.[1]

Background

Bulgaria has been hit by the global financial crisis, with clear signs that the country's capital-inflows driven boom has come to an end and that the real economy is slowing down.

Since agreement was reached on EU accession in 2004, Bulgaria experienced a surge in capital inflows and a credit boom. Inflows were driven by expectations of rapid convergence with the EU, and were further boosted by the confidence-enhancing effect of the currency board and a strong fiscal policy. By 2008, net inflows had increased to about 27 percent of GDP. Boosted by capital inflows, credit to the private sector rose rapidly, and the credit-to-GDP ratio climbed from 36 percent in 2004 to 67 percent in 2007. The surge in inflows generated strong GDP growth, but also a sharp widening of external and internal imbalances. GDP grew by more than 6 percent annually, leading to a significant narrowing of the income

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

gap with Western Europe. Growth remained strong in 2008—at 6 percent, Bulgaria was one of the fastest growing countries in Europe.

As the growth of domestic demand outpaced GDP growth, the current account deficit widened from 5 percent of GDP in 2003 to an estimated 25 percent of GDP in 2008. As unemployment dropped and the labor market tightened, wage growth accelerated to 25 percent in June 2008. The overheating of the economy, together with rising food and oil prices, resulted in a surge of inflation, which peaked at 14.7 percent in June 2008. Competitiveness deteriorated, and the unit labor cost -based real effective exchange rate appreciated 27 percent in the two years ending in mid-2008.

The global financial market turmoil has had a severe impact on financial asset prices in Bulgaria. Foreign parent banks have reduced new financing to their local subsidiaries and credit growth to the non-government sector has slowed sharply.

Executive Board Assessment

Executive Directors commended the Bulgarian authorities for their prudent policies that have built strong balance sheets in the public sector including large foreign reserves, low public debt, and a substantial Fiscal Reserve Account. They noted that there are substantial buffers in the banking system. At the same time, large capital inflows contributed to an investment and consumption boom, creating a large current account deficit and increasing private sector debt, while heavy reliance on foreign capital is a source of vulnerability. Looking forward, Directors considered that economic growth would slow sharply with the downturn in partner countries and only modest net capital inflows. Moreover, as risks are predominantly on the downside, the authorities were advised to monitor developments closely and adapt policies, as warranted.

Directors considered that the currency board arrangement has served Bulgaria well as an anchor for macroeconomic stability. They took note of the staff assessment that the real effective exchange rate is somewhat overvalued, but that determining its extent is a difficult question. The authorities were encouraged to avoid any further erosion in international competitiveness as a result of real wage increases exceeding productivity gains.

Directors considered that the most immediate policy challenge will be to maintain confidence in the currency board arrangement and in the banking system. While the banking sector remains well capitalized, liquid, and highly profitable, a severe recession could cause nonperforming loans to increase and bank capital to erode. Directors welcomed steps to improve depositors' confidence, increase capital cushions by curtailing most banks' dividend payout, and to secure commitments from parent banks to provide adequate liquidity and capital to their subsidiaries. They observed that the substantial Fiscal Reserve Account allowed a major lender-of-last-resort capacity. They supported the authorities' efforts to improve Bulgaria's crisis management capacity by intensifying the monitoring of liquidity and credit risks, further strengthening the stress testing capacity, and cooperating more closely with foreign supervisors.

Executive Directors welcomed the authorities' commitment to maintaining prudent fiscal policies, which will provide crucial support for the currency board arrangement. They concurred with the authorities' intention to maintain a fiscal surplus of 2 percent of GDP in 2009, in part by containing public spending. They cautioned, however, that were growth to slow more than expected, additional expenditure cuts will be necessary to achieve the targeted surplus. They viewed the rule to restrict spending to 90 percent of the amount budgeted as an effective short-term tool, but emphasized that prioritization and further spending restraint will be needed to sustain appropriate fiscal surpluses over the medium term.

Directors noted that further structural reforms will be key to a smooth and speedy economic recovery and achievement of convergence with the European Union. They welcomed the recent education and labor market reforms to raise productivity and labor market participation rates, and the progress made in reducing administrative burdens for businesses.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with Bulgaria is also available.

Bulgaria: Selected Economic Indicators, 2003-08

	2003	2004	2005	2006	2007	2008 1/
Output, prices, and labor market						
Real GDP	5.0	6.6	6.2	6.3	6.2	6.0
Consumer price index (average)	3.0	4.0	6.0	7.4	7.6	12.0
Consumer price index (end of period)	5.6	4.0	7.4	6.1	11.6	7.2
Employment	3.0	2.6	2.7	2.4	2.6	3.1
Public Finance						
General government overall balance	-0.2	1.7	2.3	3.5	3.5	3.0
Gross public debt	48.1	40.1	31.3	24.6	19.8	16.8
Financial net worth		8.8	9.3	11.7	13.7	14.7
Money and credit						
Broad money (M3)	19.6	23.1	23.9	26.9	31.2	8.8
Credit claims on non-government sector	48.3	48.6	32.4	24.6	62.5	32.0
Balance of payments						
Merchandise trade balance	-13.7	-14.9	-20.2	-22.0	-25.3	-29.2
Current account balance	-5.5	-6.6	-12.4	-17.8	-21.8	-24.8
Gross international reserves	30.5	34.5	33.7	35.4	41.3	37.4
Exchange rates						
Exchange rate regime			Currency board arrangement			
Leva per euro			Lev 1.956 per Euro			

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

Statement by Age Bakker, Executive Director for Bulgaria and Victor Ivanov Yotzov, Advisor to the Executive Director March 4, 2009

The Bulgarian authorities appreciate the continued constructive dialogue with the Fund. They broadly share staff analysis and recommendations as presented in the Article IV paper. The authorities attach high value to the findings and recommendations of the recent FSAP update.

Recent Developments

By and large, 2008 was yet another successful year. The confidence inspired by the good economic performance in the last years and the recent accession to the EU has continued to attract substantial amounts of capital inflows, mostly in the form of FDI. As a result, for a fifth consecutive year real GDP growth is expected to exceed 6 percent, led primarily by private investment and (to a much lesser extent) by private consumption. Over the last couple of years, the private investment-to-GDP ratio has surged, while the private consumption-to-GDP ratio remained stable, suggesting that consumption has not been the main driver of recent high growth rates.

On the back of rising energy and food prices, inflation accelerated in the first half of 2008 but, as oil and food prices reversed, disinflation is currently in place. On the other hand, robust growth, liberalized market conditions, and overall positive expectations were the main driving forces behind the sharp drop in unemployment, which, in turn, resulted in a tighter labor market and accelerated wage growth. This tendency, which can be observed in many other countries in the region, is also affected by the strive to lower the huge wage differentials (Bulgaria has the lowest income level within the EU countries) as well as by pressures arising from the still present outward migration.

Solid economic growth, steady capital inflows, and a prudent fiscal policy with sizable surpluses over the last five years resulted in a significant increase of the Fiscal Reserve Account. Accumulated reserves were used to buy back and retire all outstanding Brady bonds, to make early repurchases to all outstanding loans to the Fund, as well as to prepay a the external public debt ratio, which is now expected to fall below 15 percent of GDP. Gross external debt, however, has been on the rise since 2003 as the private sector debt has begun to grow rapidly, in line with the investment boom that the country has been experiencing.

Fiscal Policy

A well known fact is that under a currency board arrangement fiscal policy remains key to maintaining macroeconomic stability and reducing vulnerabilities. Accordingly, the authorities continue sticking to a prudent fiscal stance. At the same time, given the relatively low starting position, the main policy objective in the last years has been maximization of the capital flows' utilization as that provides the country with the unique opportunity to speed-up real convergence, deepen economic integration, and substantially increase living standards in a relatively short period of time. The growth model over the last years, however, has been associated with a strong absorption boom where domestic demand grows much faster than GDP, resulting in widening external imbalances. In this regard, the authorities have long acknowledged the need to offset sustained private sector saving-investment imbalances by running fiscal surpluses. As the latter objective has become more important over the last years, the fiscal stance has strengthened remarkably. Last year was no exception and the fiscal surplus is estimated at about 3 percent of GDP – one of the largest among all emerging market countries.

The macro-framework of the 2009 budget was prepared before the financial turmoil and envisaged a more favorable external environment associated with somewhat slower but still strong domestic growth of 4.7 percent and a fiscal surplus of 3 percent. As external circumstances have rapidly deteriorated over the last months, the authorities have no illusions that what was budgeted is hardly achievable anymore. Recognizing that the stronger than initially expected deterioration in economic activity would require additional expenditure cuts in order to achieve a surplus, the authorities decided to restrict spending to 90 percent of the budgeted amount – a practice that has been successfully used in the past and proven effective. By applying this policy, the authorities reaffirm their strong commitment to sound macroeconomic policies, acknowledging the paramount importance of a prudent fiscal stance in the context of the currency board arrangement.

External Sector

Despite the continued increase in public savings, the private sector's saving-investment imbalance has translated into a sizable current account deficit. Exacerbated by high oil and other key commodity prices, in 2008 the external current account deficit has approached 25 percent of GDP. The size of the deficit itself is high enough to raise concerns about external stability. While the authorities share the legitimacy of these concerns, it has become apparent that the recent trend of a widening deficit will sharply reverse as FDI associated imports drop substantially. The authorities are aware that the financial turmoil in mature markets has highlighted the speed and scope at which financial markets can re-assess risk premia. In the case of Bulgaria, the challenge is even larger given the monetary framework which provides only limited tools to tackle the problem. With a high current account deficit, high external private sector debt, and large foreign currency exposures, staff advice is that a key task for policies is to maintain confidence in the currency board and in the financial system. While agreeing with the general notion of the advice, the authorities would appreciate a more concrete and detailed advice on how to deal with the consequences of a possible sharp decline in capital inflows in the context of an ongoing global financial crisis.

With regard to the exchange rate assessment staff suggests that, according to different methodologies used, the real exchange rate is likely overvalued by a wide range from 7 to 20 percent. While all the approaches have well known caveats and a high degree of uncertainty, the important thing is that the widening current-account deficit has hardly been accompanied by loss of external competitiveness. Real exchange rate appreciation over the last years is rather moderate when benchmarked against conventional relationships between the exchange rate and the current account deficit. The appreciation in the real exchange rate is much more likely to reflect movements in the equilibrium rate. Purchasing power parity and dollar-wage comparisons across countries, too, suggest that Bulgaria's prices and production costs remain broadly competitive–a suggestion also supported by regression-based estimates of the real equilibrium exchange rate. Moreover, export volume growths are in double digits over the last couple of years. In 2008 for example, export volume growth is estimated at 12.5 percent – up from 10.2 percent in 2007, while import volume growth slowed to 9.5 percent from 17.3 percent a year ago. It may well be the case that a one-off private investment boom is the main driver of the large current account deficit. Accordingly, once this boom dissipates (which is already happening), it is expected that the current account deficit will approach its equilibrium level rather soon.

Financial sector

Until just months ago, bank credit expanded rapidly. In many respects this was a welcome development as it symbolized growing financial intermediation. The pace of the bank credit growth, however, remained too high for too long, and was associated with an increase in macroeconomic vulnerabilities. The rapid bank credit growth was hardly surprising given the extremely low initial base, declining nominal interest rates, rising income expectations, and a stable, well capitalized, and highly profitable banking system. All this suggests that the rapid credit growth, which was experienced until recently, was a healthy one, reflecting the overall strong economic performance – a suggestion broadly supported by the recent FSAP update. Following the global financial turmoil that started in 2007 and significantly intensified after September 2008, foreign funding has declined, resulting in strong competition for deposits and a sharp reduction in credit growth. While interest rates on deposits rose by about 2 pp, banks have become much more cautious and domestic credit growth in 2008 slowed to 32 percent, compared to 62 percent in 2007. The interbank market was affected as well, but after some targeted steps taken by the central bank it calmed down, volumes have mostly resumed and interest rates have moderated.

The steps taken by the government and the central bank were focused on preventing a depositors' confidence crisis, easing liquidity pressures, and increasing capital cushions. In this regard, the deposit insurance coverage was increased, in line with EU commitments, from €20,000 to €50,000 and will be increased further to €100,000 per depositor per bank in 2009. Reserve requirements in local currency were lowered from 12 to 10 percent and to 5 percent in foreign currency. The BNB has also taken further steps to increase banks' capital and liquidity cushions by persuading most bank owners not to pay dividends, but instead add 2008 profits to capital. It has also received comfort letters from parent banks to ensure that they provide adequate liquidity and capital. In addition, the BNB has intensified its monitoring, with special focus on liquidity and credit risks, and taken steps to further strengthen its stress testing capabilities, in line with recommendations of the recent FSAP Update.

The challenges ahead

Notwithstanding past achievements, the authorities now recognize that the end of the capital-inflow driven boom creates significant policy challenges. Recent developments in the country, as well as in the region as a whole, suggest the need of a swift change in policy priorities. Until just a short time ago, these were speeding up convergence and raising living standards, whereas now the priority is focused primarily on preserving macroeconomic stability. The authorities and staff share the view that the most important challenge is ensuring that the likely drop in capital inflows does not result in a confidence crisis. In this regard, maintaining confidence in the currency board arrangement and the financial system is crucial. With a view to the fulfillment of this objective, keeping public finances in check is regarded as key instrument. As rightly underscored by staff, in many ways Bulgaria starts the current slowdown from a strong position. The public finances are in good shape, the balance sheets of the central bank and the government are strong, with large foreign reserves and substantial buffers accumulated in the fiscal reserve account. The financial system is stable and well capitalized. All this are important prerequisites needed by each and every economy to weather the current global downturn.

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