Bulgaria—September 2010 Staff Visit, Concluding Statement

Sofia, October 5, 2010

Gradual recovery

The Bulgarian economy is poised to stage a gradual recovery. Aided by a strong rebound in exports, the pace of contraction in real GDP eased substantially in the second quarter of 2010. However, depressed confidence contributed to the continued decline in domestic demand. Real GDP growth is expected to turn positive in the second half, reflecting strong export momentum, a good summer tourism season, and improving retail sales. This should help real GDP growth average between 0—0.4 percent in 2010 (updating the October WEO that reflects a July 2010 forecast).[1] In the absence of new capital inflows and strong import demand, the current account deficit is expected to continue its rapid decline, reaching just below 3 percent of GDP by end-2010. With considerable slack in the economy, inflation will remain moderate.

In 2011, the recovery should gain greater traction. Growth is forecast to rise to 2-2½ percent as the recovery broadens to domestic demand. Although the slow and steady pick-up in investment and consumption is expected to maintain the current account deficit to just above 3 percent of GDP, but it is more than covered by anticipated foreign direct investment. On a net basis, modest capital inflows should facilitate moderate growth in credit and an increase in international reserves. Employment conditions may improve as growth recovers.

Risks to the outlook are broadly balanced. With external demand the key driver of the recovery, a sharper than expected slowdown in key trading partners would reduce exports and growth. While domestic demand continues to be constrained by high unemployment, weak credit growth and uncertainty, rising household deposit levels suggests some potential for consumption to recover more quickly than projected should confidence improve.

Policy challenges

Bulgaria's prudent macroeconomic framework, anchored on the currency board, was crucial in preserving macroeconomic stability through the global crisis. The sizeable fiscal and financial buffers accumulated in the boom provided important cushions to support the economy through the downturn. Swift implementation of adjustment measures since mid-2009 contained the deterioration in the fiscal deficit, helping to sustain market confidence. As the economy recovers, the long-standing policy objective of ERM II membership and eventual euro adoption will require:

1. A credible medium-term fiscal consolidation, underpinned by bold structural reforms, to facilitate the exit from the EC's Excessive Deficit Procedure (EDP), more efficient utilization of government resources, and gradual rebuilding of the fiscal buffer.

2. Maintaining a strong, well capitalized, banking system to preserve financial stability and support the recovery by creating the conditions for new lending.

3. Improvements in the business and regulatory environment, accompanied by reforms aimed at raising labor productivity and human capital will foster the shift towards more sustainable, tradable-led, growth.

[1] The October World Economic Outlook forecast preceded the findings of this mission and GDP revisions.

Reducing the fiscal deficit

Strong policy efforts have kept implementation of the 2010 budget on–track despite weak revenue. Through August, tax revenue fell 10 percent from a year earlier reflecting declining consumption and the impact of one-off factors (e.g. clearance of a backlog of VAT refunds and tobacco excise compensation). Pressures on social spending remained high and pushed the social security funds' deficit to Leva 3.4 billion (before transfers). The steps to bolster tax administration, postpone the special pension increase, streamline public employment, and strictly limit other outlays contained the cash deficit to 2¼ percent of GDP at end-August. Still, given the extent of revenue underperformance, shortfalls on the full-year revenue targets cannot be ruled out even though revenues have shown greater promise in recent months. Continued strict control of spending is required to secure the 2010 deficit target but efforts should focus on scaling-back new obligations and not come at the expense of timely payment of existing obligations.

The medium-term fiscal program envisages an ambitious reduction in the deficit to return fiscal policy to a sustainable path. To exit the EDP, the authorities target to reduce the overall fiscal deficit to 2½ percent of GDP (cash basis) in 2011, and to lower it to 1 percent of GDP by end-2013. Achieving the 2011 deficit target and diversifying its sources of financing will help anchor expectations and re-build the fiscal reserve. Given the need for adjustment, increased absorption of EU funds would provide an important boost to the recovery and medium-term growth prospects. After 2011, increases in co-financing that are commensurate with the effective absorption of EU funds could be accommodated by a more gradual adjustment pace towards the stated medium-term goal of structural budget surplus. Such a target is essential to ensure fiscal policy is supportive of the Currency Board Arrangement and that fiscal reserve buffers are sufficient to counter future shocks.

The 2011 budget rightly envisages the continued adjustment of spending to the lower revenues that prevail in the post-boom era. Despite the recovery, higher fuel excises, and new administrative measures to combat undeclared activities and non-payment of social security contributions, budgeted tax revenues in 2011 are some 4½ percentage points of GDP below their 2008 peak. It is therefore appropriate that the budget continue the process of expenditure adjustment. The reduction in the government's workforce by 9,000 in 2010, stable pension levels, and the lengthening of qualification periods for certain social security benefits underpin the freeze in the budgeted wage and pension bills. In cash terms, the budget also benefits from a lower contingency reserve, due in part, to the anticipated clearance of all 2009 arrears by end-2010.

With considerable uncertainty surrounding the strength of the recovery, the authorities should stand ready to implement contingency measures, if needed. If as suggested by staff's forecasts, revenue collections in 2010 end the year below target, a 1 percent of GDP shortfall in revenue could arise in 2011. Announcing a set of contingency measures to address such risks would have a high payoff in enhancing budget credibility and policy predictability. Potential contingency options that could be considered on the expenditure side include additional short-term reforms in the social security system based on the advice of the forthcoming IMF technical assistance mission and identifying efficiencies in health, education, wage, and subsidy spending. On the revenue side, there is some scope to broaden the tax base. Increases in VAT or social security contribution rates could also help finance social security system entitlements.

Sustaining the adjustment momentum and improving efficiency will require bolder and more permanent reforms, crucially in the area of pensions and health. The freeze in the pension bill, while helpful in the near-term, leaves unaddressed the growing gap between entitlements and contributions. Reflecting the legacy of successive reductions in social security contribution rates and ad hoc pension increases, the deficit in the social

security system requires about 6 of GDP in transfers from the central government in 2011, more than double that required just two years ago. Pressures from aging will add to this. The proposed increase in the service requirement is a critical first step that addresses this gap. The authorities estimate it will generate up to 0.6 percent of GDP in savings in the medium-term. However, re-establishing balance in the pension system will require a more comprehensive reform that examines revenue, funding, pension formula parameters, and non-pension entitlements. Countering the risks posed by rapidly rising health care costs, particularly in hospitals and pharmaceuticals, also requires reforms to improve cost control and accountability.

Various institutional reforms would buttress the adjustment process. The budget proposals to impose ceilings on the liabilities incurred by ministries are welcome. These ceilings should be complemented by a centralized financial management system that provides the Ministry of Finance timely and higher frequency accrual data to allow for better control of spending commitments. Such data will be necessary in any case under the new European Semester monitoring framework. A robust medium-term expenditure framework based on detailed policy plans for the main spending categories would lend predictability to the adjustment process. It could be complemented by a numerical rule that targets the steady re-building of the fiscal reserve while allowing for counter-cyclical fiscal policy. Enhancing project planning and administrative capacity, especially in the larger EU programs, will also have a high payoff.

Safeguarding financial sector strength

Bulgarian banks have weathered the financial crisis well. Overall they report robust capital and provisions, and are supported by a strong supervisory framework. The reported system-wide capital adequacy ratio at end-June 2010 was 18 percent, well above the regulatory minimum of 12 percent and the EU minimum of 8 percent. As can be expected, impaired assets have risen with the downturn. NPLs stood at 9½ percent at end-June 2010 and are expected to peak in late 2010 or early 2011 before declining slowly. Aggregate profits have been more than sufficient to absorb losses. The relatively comfortable position of the banking system is the fruit of prudent regulatory policies that during the boom required banks to build substantial financial buffers through reserve requirements, provisions, and risk weights that exceeded EU and Basel minimums. In the downturn, requirements were eased somewhat to allow banks to utilize part of their cushion and banks' prudently boosted capital by retaining their earnings.

Given the backdrop of fragility in global financial markets, continued vigilance is warranted. Bulgaria, with its current prudential regulation, is well placed with respect to Basel III. Prudential requirements exceed these new requirements while system-wide buffers appear adequate. Owing to the uncertainty surrounding asset values, collateral should continue to be subject to close scrutiny to ensure adequate provisioning even if it comes at the expense of reduced profitability. As part of efforts in the EU, the contingency planning framework has been strengthened and the authorities are actively participating in discussions on the design of a new European-level bank resolution framework.

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We wish to thank the authorities for their hospitability, and for the friendly and fruitful discussions.