Bulgaria—2010 Article IV Consultation, Concluding Statement

Sofia, March 1, 2010

Background

1. In the years that preceded the global economic and financial crisis, large capital inflows into Bulgaria generated a domestic demand boom. This brought strong GDP and employment growth, but also widened the current account deficit to very high levels, and led to an overheating of the economy, with high wage growth and double-digit inflation.

2. The boom came to an end in the fourth quarter of 2008, amid the global crisis that followed the default of Lehman Brothers. A sharp adjustment in capital inflows led to a contraction of domestic demand, while the recession in Bulgaria's trading partners caused a drop in exports. As a result, GDP contracted by 5.1 percent in 2009—the first decline since the crisis of 1996/97.

Economic Outlook

3. The mission expects that the economy will start to recover this year as the recovery in global GDP growth will spur exports, and projects real GDP in Bulgaria to increase by 0.2 percent in 2010. However, domestic demand is expected to decline further. On the back of an unwinding investment boom, tightened credit, and weak economic activity, investment will likely drop further. At the same time, private consumption is forecast to suffer from the decline in employment. As a result, the current account deficit will continue to narrow, from 8½ percent in 2009 to 5½ percent of GDP in 2010. Inflation is projected to remain moderate, at about 2.2 percent, almost half of which is the effect of higher excise duties; and unemployment is expected to increase from an estimated 7.8 percent in 2009 to 9.2 percent in 2010.

Adjusting to Lower Capital Inflows

4. While capital inflows will, over time, recover somewhat from the low levels during the crisis, they will remain well below the high levels experienced before 2009. Thus, both the private sector and public policies will need to adjust to the new environment.

- The private sector will need to shift resources from the non-tradable to the tradable sector. During the boom years, the expansion of the economy was driven primarily by the non-tradable sector—including construction, real estate and banking. Going forward, the contribution of these sectors to GDP growth is likely to be low, and GDP growth can only regain its previous strength if the tradable sector takes over. For the shift to the tradable sector to be successful, wage growth will need to slow considerably in 2010 and remain moderate over the medium term. Wage growth has come down significantly from its peak of 25 percent y/y in the second quarter of 2008, to 10.6 percent y/y in the fourth quarter of 2009, and given temporary statistical effects that inflate current wage growth is likely to decline further.
- Public policies will need to adjust to the end of the domestic demand-driven revenue boom. In 2007 and 2008, expenditure grew by 18 percent annually, as the surge in revenues was used to increase expenditure rather than increase fiscal surpluses further. A continuation of past spending trends would have turned the fiscal surplus into a large deficit, eroding the public sector buffers that have protected the currency board so well.

5. Adjusting public policies is important because private sector vulnerabilities remain considerable. Private sector external debt is 102 percent of GDP, while foreign currency debt of the non-financial private sector amounts to 80 percent of GDP. The external environment is more benign than it was a year ago, but considerable risks to the outlook remain—including those coming from developments in other euro area countries.

6. Adjusting public policies would also help prepare the country for eventual euro area membership. The currency board has been a pillar of stability and eventual euro adoption continues to be the only viable exit strategy. Maintaining fiscal discipline and deepening structural policies will strengthen economic fundamentals and the viability of the Bulgarian economy. It will also help make a compelling case that Bulgaria can rapidly adjust its economy within the confines of the currency board, meet all the Maastricht criteria, and prevent the re-emergence of external and internal imbalances.

Fiscal Policy

7. A timely and welcome correction of fiscal policy in the second half of 2009 prevented the emergence of a large fiscal deficit. When revenue declined sharply in 2009, expenditure initially continued to increase rapidly, growing by 24.5 percent y/y in the first seven months. Sharp spending cuts in the second half of the year, together with reforms of the tax administration and customs, helped contain the cash deficit to 0.8 percent of GDP, although the build-up of arrears toward the end of the year widened the deficit to around 1.9 percent in ESA-95 (accrual) terms.

8. Fiscal policy in 2010 will be challenging—notably meeting the government's cash deficit target of 0.7 percent of GDP. On the revenue side, projections seem optimistic, in particular given the shortfalls in the second half of 2009. Recent increases in excise duties and a number of reforms to improve tax compliance are important contributions in preventing a further erosion of tax revenues. However, in the short term they may not be sufficient to offset the deterioration in receipts resulting from the macroeconomic situation and the cut in the social security contribution rate by 2 percentage points. On the expenditure side, the budget foresees a tight envelope, including welcome freezes in public wages and general pensions, streamlining of the public administration, and stricter controls on health care spending. The repayment of arrears built up in 2009 will further add to pressures on the cash deficit (although they do not matter for the ESA-95 deficit) but should be swiftly pursued to prevent cascading of arrears in the private sector. The mission currently projects a cash deficit of 1.8 percent of GDP for 2010. Given the large uncertainties on the revenue side, it will be key that the budgeted spending limits are closely adhered to avoid risking an even larger deficit, as fiscal discipline has been an important pillar supporting the currency board arrangement, and large budget deficits could ultimately endanger macroeconomic stability.

9. For 2011 and beyond, giving fiscal policy a larger role in stabilizing the economy can best be achieved by focusing, within a medium-term budgetary framework, on the overall spending envelope rather than on headline balances. Targeting real spending growth in line with cautious estimates of potential GDP growth would make public spending more predictable, help prioritize spending and contain the large intra-year adjustments that have characterized the past few years. Revenue windfalls should be used to build up fiscal buffers that can be used in times when revenues fall short.

10. Within this medium-term framework, tax rate reductions would need to be compensated by further expenditure reductions. While lower social security contributions rates could in principle help reduce the cost of labor and support competitiveness, such a policy would further widen the financing gap of the social security system and require larger government transfers. This would put at risk the government's medium-term balanced budget targets and the sustainability, in particular of the pension system. The mission also advises against a cut in VAT rates at the current juncture, as the budget relies heavily on this source of income and with the end of the demand boom shortfalls are expected to be significant for years to come. Moreover, the impact on competitiveness from lower rates would be weak as exports are exempt from VAT.

11. As the Bulgarian economy emerges from the crisis and shifts toward more export-led growth, fiscal policies can lend support to the adjustment process needs in a number of ways. This includes not only containing the overall spending envelope, but also creating room for growth-enhancing expenditure shifts, including accommodating needs for higher infrastructure outlays. Priority should be given to the following areas:

• By rationalizing the public administration and making it more efficient and effective, including in absorbing EU funds, fiscal space for expenditure in other areas could be created. This is particularly needed to complete the delayed agenda for upgrading Bulgaria's public infrastructure and avoid it becoming a bottleneck to economic growth as well as through other productivity-raising measures, including in education and training.

• Containing public wage growth, through the announced public wage freeze in 2010 and increases in line with productivity over the medium term would not only serve the budget constraint but also help limit economy-wide wage growth and help competitiveness.

• Ensuring the sustainability of the social pension systems require urgent reforms. The combination of large pension increases and reductions in social security contribution rates in the past has widened the gap between pension contributions and pension expenditures, and the increases in minimum insurable incomes were insufficient to make up for the revenue losses. This gap can be reduced by a combination of the envisaged slowing of pension increases over the next years, after the freeze in 2010, an adjustment of the pension system parameters, including an increase in the retirement age or the minimum years of contribution, addressing the underreporting of insurable income, as well as a revision of those parameters that have created inefficiencies in the system.

• At the same time, in the health care system distorted incentives have led to a proliferation of hospitals and rising financing pressures, while satisfaction with the quality of health services remains low. A comprehensive health care reform, with a view to improve the efficiency and quality of the health care system is needed. The government's on-going reform efforts aim at mitigating the weaknesses in the health care system, including by rationalizing the in-patient care. Swift completion of a broad-based health care reform will be crucial.

• A renewed push for privatization would not only enlarge the role of the private sector, but also yield resources that could be used to replenish the fiscal reserve account.

Other Structural Reforms

12. A sustainable longer-term adjustment of the economy would be further helped by a number of supportive structural reforms. The business climate can be strengthened by further cutting red tape and reducing the regulatory costs for doing business, which are still considered burdensome and costly by the private sector, and by decisively tackling the high share of the informal economy and corruption. As the health of the corporate sector has deteriorated during the downturn, it is important to have strong legal and institutional frameworks in place that support corporate workouts, restructuring and bankruptcy procedures. The mission welcomes the authorities' plan to assess the effectiveness of the corporate insolvency framework and to amend it with a view to making it more supportive of fast resolutions and of trust between creditor and debtor.

Financial System

13. Continued stability of the financial system is key to safeguarding the economic recovery. The global liquidity pressures that emerged in the aftermath of Lehman Brothers have abated, and the stabilization of the banking system in Western Europe has reduced external funding risks. Domestic interest rates have started to come down and credit growth, after the sharp slowdown in the first half of 2009, is showing signs of stabilization.

14. The main challenge for the banking system will be to absorb the increase in non-performing loans that Bulgaria, like other countries, is currently experiencing. Thanks to prudent regulation, the banking system has built up substantial buffers during the boom years. The reported aggregate capital adequacy ratio at end-2009 was 17 percent well above the regulatory minimum of 12 percent and the EU minimum of 8 percent; the coverage ratio of non-performing loans by provisions exceeded 80 percent; and banks continued to report profits in 2009. Nevertheless, supervisors' enforcement of a cautious dividend policy remains appropriate. Contingency planning remains of the essence in Bulgaria as elsewhere, and in that respect the mission welcomes the recent creation of a financial stability unit at the BNB.

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We wish to thank the authorities for their hospitality, and for the friendly and fruitful discussions we have had in the past two weeks.

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