2013 Article IV Consultation with Bulgaria—Concluding Statement of IMF Mission

Sofia, November 14, 2013

Policy continuity has supported sustained macroeconomic and financial stability, despite political and social challenges and external headwinds. The authorities have rightly emphasized the need to safeguard stability while developing a new paradigm for growth and job creation that does not depend on extraordinary inflows. Adverse demographic changes, accelerated by emigration, add to the challenge. Effective targeting of public resources and increased efficiency of social services, careful implementation of reforms in the European financial sector framework, and addressing long-standing institutional and broader structural rigidities are key to promote competition, increase potential growth, and ensure a better quality of life for all Bulgarians.

Low growth amid domestic uncertainty

Growth decelerated in the first half of 2013, with domestic uncertainty manifested in lower-than-expected domestic demand. Increased exports and government spending kept growth positive, with full year growth projected at 0.5 percent. Employment rose slightly for the first time since 2009, but unemployment remained flat, as more of the population entered the workforce. Consumer prices began to decline in the second half following a cut in administered electricity prices. The current account is in surplus and government bond yields and risk premia remain in line with other strong performers in Central and Eastern Europe.

Growth is projected to pick up slowly. Recovery in trading partners and higher domestic demand, including through EU funds spending, should underpin growth of about 1.6 percent in 2014, with a modest increase in prices. In the medium-term, growth could reach 3 percent, suggesting only very gradual income convergence with other EU countries. Further emigration and population aging, as well as low projected productivity growth and investment, constitute drags on more rapid growth and job creation.

There are several risks to the outlook. On the domestic side, building support for needed reforms will remain a challenge, particularly in a still difficult political context. While Bulgaria’s hard-earned credibility as a fiscal stalwart is intact, fiscal policy under the government’s proposed budget is now operating closer to domestic fiscal rules and parallel commitments under the EU medium term objectives. In the financial sector, nonperforming loans (NPLs) have stabilized and remain well provisioned, but their gradual reduction through asset disposal will be important to reduce asset price uncertainty and support future investment. On the external side, uncertainty about the outlook for Europe carries adverse short and medium-term implications for trade and foreign direct investment. Balance of payments vulnerabilities are limited as the current account is in surplus, financial inflows consist mostly of foreign direct investment, Bulgarian banks’ net foreign asset position is in surplus, and official foreign exchange reserves are strong.

Policies for maintaining stability

Given economic risks and the demands for vigilance under the currency board, high defenses against shocks remain important. Bulgaria’s robust policy framework has insulated it from the challenges posed by the 2008 crisis, the turmoil in neighboring Greece, and more recent domestic discord. Strong policies remain important to support the currency board, which has served Bulgaria well (and is a natural bridge to eventual euro adoption).

The widening of the fiscal deficit in 2013 has been appropriately countercyclical. After several years of consolidation, the fiscal deficit is projected to increase from 0.5 percent of GDP in 2012 to 2 percent in 2013. Increases in pensions (about half the deficit increase) and social assistance were well balanced against the need to contain the deficit. The sizable increase in EU-funds related spending is welcome given positive long-term growth effects.

With subdued growth projected in 2014, the authorities' 1.8 percent of GDP deficit target is justifiable, but there are implementation risks. While the recently announced South Stream project provides possible revenue upside, revenue may underperform if domestic demand recovery is slower than projected, gains from administrative reforms are lower than budgeted, or, as projected by the mission, inflation remains subdued. Thus, expenditures may need to be restrained to achieve the deficit target. While the authorities have rightly emphasized the importance of growth-enhancing expenditures, it will be important to clarify procedures to ensure efficient and transparent allocation under the newly constituted public investment fund and to limit uncertainty in the program budgeting process. The soon-to-be-established fiscal council will have an important role in preserving fiscal credibility. As such, it will be important to ensure its independence upfront, including through adequate resources.

Fiscal consolidation is needed to rebuild buffers, and mitigation of medium-term fiscal risks remains important. While the government's intention to maintain a small structural deficit through 2016 is reasonable in the context of still tepid growth, targeting a balanced structural budget should be considered thereafter to bolster the defenses that Bulgaria needs. In this context, medium-term fiscal risks will need to be considered:

- **Sustainability of pension system.** Delay in planned increases to the retirement age and the introduction of the so-called "Swiss rule," which links annual indexation of pensions to both price inflation and social insurable income growth, will have adverse budgetary implications over the longer term without compensating reforms. This will add to already substantial budgetary pressures from an aging population.
- **Targeting of social protection spending.** While social protection spending has helped to mitigate the income effects of the global crisis in Bulgaria, better targeting is needed to enhance the effectiveness of this spending. At the same time, inefficiencies in key sectors, including health, represent a drain on scarce resources.
- **Contingencies stemming from state-owned enterprises.** The weak financial position of firms in the railroad sector and some segments of the energy sector if not adequately addressed could represent significant fiscal risks going forward.

The financial system remains stable, well capitalized, and liquid, but profitability remains low. Prudent supervisory policies have resulted in a high system-wide capital adequacy ratio of 16.9 percent, comfortably above the 12 percent regulatory minimum, and aggregate Tier 1 capital is 15.6 percent. Gross NPLs are 17.2 percent of total loans but are well provisioned, and NPLs net of IFRS provisions are 10.6 percent. Weak credit demand and strong deposit growth have boosted liquidity, allowing banks to further reduce external financing.

The central bank's intention to preserve a conservative approach to bank supervision in a changing European framework is appropriate. The adoption of European Capital Requirements Directive IV at the beginning of next year implies changes to both capital adequacy requirements and the provisioning framework in Bulgaria. The authorities' intention to use available flexibility under the European framework to maintain high capital adequacy requirements is appropriate given the domestic economic environment and the banking system situation, as well as broader uncertainties related to ongoing changes in the European financial sector framework for Bulgaria and partner countries in Europe. They also plan to address banks' idiosyncratic risks using instruments under Pillar 2 of the Basel accords.

Increased efforts by banks to address the stock of distressed assets and claim associated collateral are steps in the right direction and should be further encouraged. Effective efforts to clean banks' balance sheets by disposing of encumbered assets could act as a catalyst to reduce asset price uncertainty inhibiting investment. Past recommendations to improve the insolvency framework, including to speed up court procedures and reduce related costs, remain valid. The BNB will continue to play a supportive role to encourage a steady but gradual process of reducing distressed assets and releasing the associated collateral that avoids unduly disturbing markets.

Policies for growth and poverty reduction

Achieving income convergence with other EU countries will require difficult institutional and structural reforms. In comparative studies, Bulgaria ranks favorably on macro-policy outcomes but less so on other dimensions critical to the well-functioning of the economy. The authorities' efforts to reduce administrative barriers to business—an area where Bulgaria continues to rank less well—and improve public procurement are welcome as a first step. Broader reforms to confront rent-seeking behavior and reinforce effective institutions—including through further reform to the judiciary, independent market supervision, promotion of competition, and the anti-corruption regime—are also key.

Measures to strengthen labor market outcomes would afford a wider swath of the population benefits from economic opportunities. The authorities have recognized the importance of improved education and training, especially for social groups that tend to be excluded. The greater absorption of EU funds, with a significant infrastructure component, could also boost opportunities in sectors particularly hard hit by the downturn, including construction, with positive effects for low-skilled labor. Government actions that increase the cost of labor for lower-skilled workers need to be carefully weighed, and consideration should be given to differentiating minimum wages (as well as minimum social security thresholds) to help address regional disparities and youth unemployment.

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The mission would like to thank the authorities for the collegial and informative discussions.