Bulgaria: Selected Economic Indicators

	2000	2001	2002	2003	2004Q1
Output, prices, and employment	(Annual percent change, unless otherwise stated)				
Real GDP	5.4	4.1	4.9	4.3	5.3
Real industrial sales	...	2.8	1.3	17.4	18.1
Consumer price index (average)	10.4	7.5	5.8	2.3	6.4
(End of period)	11.4	4.8	3.8	5.6	6.2
Unemployment rate (in percent)					
Registered unemployment	18.1	17.5	17.4	14.3	14.1
Labor force survey	16.9	19.8	17.8	13.7	...
Real public sector wages	2.4	6.3	2.5	3.9	...
Real private sector wages	7.8	4.1	-4.1	5.7	...
General government	(In percent of GDP)				
Revenue	38.7	37.6	36.5	37.9	9.0
Noninterest expenditure	35.7	34.7	34.9	36.2	7.5
Primary balance	3.0	2.8	1.6	1.7	1.5
Interest payments	4.0	3.7	2.2	2.1	0.9
Overall balance	-1.0	-0.9	-0.6	-0.4	0.6
Privatization receipts	1.3	2.9	0.9	1.1	0.3
External financing	1.5	-0.3	1.5	0.0	-0.3
Domestic financing	1.2	-1.7	-1.7	-0.7	-0.5
Public debt (end of period)[1]	77.0	69.9	56.2	48.3	45.1
Domestic public debt (end of period)[1]	6.6	6.2	6.5	6.5	6.4
Money and credit[2]	(Annual percent change, unless otherwise stated)				
Broad money (end of period, millions of leva)	9,857	12,401	13,857	16,566	16,806
Broad money (M3)	30.8	25.8	11.7	19.6	23.0
Claims on nongovernment	17.0	32.1	44.0	48.3	52.3
Foreign exchange deposits (euro million)[3]	2,068	2,516	2,678	3,150	4,020
Foreign exchange deposits (percent of M3)[3]	41.0	39.7	37.8	37.2	38.6
Broad money to foreign exchange reserves ratio	1.3	1.6	1.5	1.6	1.6
Interest rates (annualized)	(In percent)				
BNB basic rate[4]	4.6	4.7	3.4	2.7	2.4
Time deposits (leva)	3.3	3.4	3.2	3.2	3.1
Balance of payments	(In millions of euro, unless otherwise stated)				
Current account balance	-761	-1,102	-924	-1,498	-518
(In percent of GDP)	-5.6	-7.3	-5.6	-8.5	-12.6
Trade balance	-1,280	-1,779	-1,692	-2,196	-509
Exports, f.o.b.	5,253	5,714	6,063	6,663	1,718
Imports, f.o.b.	-6,533	-7,493	-7,755	-8,859	-2,227
Gross official reserves (end of period)	3,719	4,063	4,575	5,309	5,366
(in months of prospective imports of GNFS)	4.7	5.0	4.9	4.8	4.7
External debt (end of period)[5]	12,038	12,049	10,769	10,330	10,950
(In percent of GDP)	88.2	79.4	65.1	58.7	56.3
Exchange rates					
Leva per euro	Currency Board, peg to euro at lev 1.95583 per euro				
Leva per U.S. dollar (end of period)	2,102	2,219	1,885	1,611	1,615
(year-on-year percent change, + means depreciation)	8.0	5.6	-15.1	-14.5	-10.0
REER (end of period; CPI based)					
(year-on-year percent change, + means appreciation)	2.6	3.7	5.6	8.6	5.7

Sources: Bulgarian authorities; and IMF Staff estimates.
[1]Domestic debt as reported by Ministry of Finance and external debt as reported by BNB.
[2]Starting in 2002, a new format was adopted for monetary data resulting in revisions to historical series.
[3]Includes foreign currency deposits in broad money and other longer-term liabilities (not included in broad money)
[4]Average annual yield achieved at the primary market for three-month government securities.
[5]Includes trade credits.

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Statement by Jeroen Kremers, Executive Director for Bulgaria
and Victor Ivanov Yotzov, Advisor to Executive Director
Executive Board Meeting
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The Bulgarian authorities wish to thank the Fund for the continued support that helped the country to stabilize and reform its economy and to make progress in the run up to EU accession. They appreciated the recent ex-post assessment (EPA) and Article IV Consultation, which scrutinized past developments, but also gave a view of the policy challenges ahead. The authorities were encouraged by the main message from the EPA report, that most of the possible drawbacks identified in the case of longer-term program engagement - weaker incentives to take decisive action, loss of credibility of the Fund in supporting weak programs, poor ownership, and weakening of the surveillance function of the Fund - do not apply to Bulgaria.

The last SBA ended in March 2004 and upon its expiration the Bulgarian authorities expressed their interest in a successor arrangement. By seeking a new program, the authorities want to address the remaining macroeconomic and structural problems. To achieve its objectives, the program focuses on fiscal adjustment, measures to reduce liquidity in the banking system and further progress in structural reforms. The program will continue to rely on structural conditionality following the EPA's conclusion that this type of conditionality played an important positive role in the success of previous Fund-supported programs. In accordance with the main findings and suggestions from the last Article IV Consultation and EPA report, the successor SBA has been designed as a low access, precautionary arrangement, that will also serve as an explicit exit from Fund program engagement. The Bulgarian authorities consider such a precautionary program as an adequate exit vehicle, offering a framework that is familiar both internally and externally.

Policy framework and recent developments

Macroeconomic and political stability has been underpinned by the currency board arrangement (CBA) and related strong fiscal discipline. The authorities are firmly committed to continuing this policy approach, which proved to suit well the country's needs. There is broad agreement among all the political parties in the Parliament on the main direction of economic development – i.e. keeping the CBA until joining the European Monetary Union.

A number of positive developments occurred since the last Board meeting on Bulgaria took place less than two months ago. On June 15, 2004 Bulgaria closed all the negotiating chapters of the *acquis communautaire,* thus formally ending the negotiating process for its EU accession. The expectations are that later this year, the European Commission will deliver a positive monitoring report, which will allow the country to sign the treaty next spring and to join the union in 2007, as planned.

On the economic front, just weeks after the sale of the telecommunication company, the Privatization Agency announced the results of the bids for seven local power distribution companies. On July 1, the government officially launched the privatization procedure for the tobacco company BULGARTABAC. The latest privatization deals prove

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growing investor interest in the country and indicate that FDI in 2004 and 2005 could exceed the projected external current account deficits. These series of favorable economic developments could be extended by the early retirement of discounted Brady bonds that took place on July 28, lowering further the external public debt. As business sentiments have improved, S&P recently raised its long-term credit rating moving the country into the investment-grade. It is widely expected that other major credit-rating agencies will undertake similar steps soon.

Economic activity

Preliminary data for the first quarter of 2004 show an impressive performance. Real GDP grew by 5.3 percent compared to the same period of the previous year, which was more than expected. Overall consumption spending contributed the most, as anticipated, while fixed capital formation, which rose by over 20 percent, performed unexpectedly strongly. Exports also rose fairly well, but imports increased even faster, reflecting robust demand for both consumption and investment goods. According to the recent statistics on industrial production and sales, the growth momentum has continued in the second quarter of the year. Despite higher oil prices and a smaller than expected decline in food prices, a targeted end year inflation of 3.6 percent is likely to be observed as the accumulated inflation until end June is just 0.2 percent.

The economic expansion has led to some issues that need to be addressed. During the last mission the authorities and staff had candid discussions on the risk of overheating and how it should be reflected in the program. Continued rapid credit growth, the size of the current account deficit and the overall excess domestic demand are considered evidence for possible overheating. Although there are no threats to financial stability, owing to the existing strong supervisory practices, a common understanding was reached that the current situation should not be left unchecked. The authorities are fully cognizant of the challenges of possible overheating and are prepared to take necessary steps to solidify economic performance and prevent the external imbalance from exacerbation.

External sector

Generally favorable macroeconomic developments in the last couple of years have been accompanied by external imbalances that threaten to increase the country’s vulnerability, if not properly and timely addressed. Exacerbated by higher oil and other key commodity prices, the external current account deficit is currently estimated at about 9 percent of GDP. The strong rise in imports (both consumption and investment) is related to growing domestic demand and rapid credit growth of the private sector. To a smaller extent, though far from negligible, FDI inflows also contribute to high import growth. Competitiveness, however, does not appear to have been a significant factor in recent foreign trade developments. The appreciation of the Euro is likely to have only a moderate direct impact on external competitiveness (as most of the exports go to EU markets) and a mixed effect on the economy as a whole.

Financing the current account deficit does not seem to pose problems. Net inflows of FDI reached a record high level while the overall balance of payments has been in surplus every year since 1999. Over the program period and beyond, FDI is expected to cover about 90 percent of the current account deficit, owing to privatization receipts and

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rapidly increasing greenfield investment. This would help keep the official foreign reserves at an appropriate level, which is crucial for the economy given the specifics of the CBA.

Experiencing significant trade deficits during transition and structural reforms is not unusual. Broadly similar developments have been observed in a number of other transition countries. This, however, does not comfort the authorities and they stand ready to take appropriate measures, including further fiscal tightening, should the external conditions require it.

Fiscal policy

At the time of the last Board discussion, many Directors expressed their preference for a more ambitious fiscal adjustment, especially in 2004, to dampen domestic demand. The authorities have taken the advice. Amid strong domestic demand, increased bank lending and a widening trade deficit they have decided to tighten fiscal policy substantially. The initial fiscal stance for the 2004 budget envisaged a deficit of 1.2 percent of GDP – a fiscal expansion with respect to the 2003 outcome of a 0.4 percent deficit. However, in view of the external position and the weakening private sector saving performance, the authorities have come to the conclusion that expansionary fiscal policy in 2004 is no longer appropriate, and at least an overall general government balance will be pursued. This was a difficult political decision given the upcoming parliamentary elections to be held in mid 2005. By undertaking such a step, the authorities demonstrate their strong commitment to prudent macroeconomic policy.

Reflecting improved tax compliance and stronger economic conditions, revenue collection overperformed significantly in the first half of 2004, while expenditure was in line with the budget. This resulted in a cash surplus of about 2 percent of annual GDP. In the interest of greater transparency, all revenue categories were revised upward to mirror macroeconomic assumptions more realistically. Subsequently, and consistently with the goal to achieve fiscal balance, budget expenditure was also raised to make room for some unbudgeted priority expenditure for healthcare and road maintenance.

As the strong domestic demand requires continued fiscal prudence, the 2005 budget too will reflect a neutral fiscal stance. In accordance with its policy program the government is examining the feasibility of further lowering corporate and personal income tax rates. This revenue shortfall is expected to be largely offset by raising excise taxes toward minimum EU levels and a further improvement in tax collection. On the expenditure side, better targeted social spending and outlays related to EU accession and infrastructure remain priorities.

Credit growth

Continued rapid credit growth has been observed over the last three years. In many respects the increased financial intermediation is a welcome development that represents an overdue catching-up and supports real convergence. The recent pace of credit growth at about 50 percent year-on-year, however, may have led to an increase of macroeconomic vulnerabilities and is seen as one of the key factors behind the widening trade deficit.

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