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**Statement by Mr. O'Sullivan on Bulgaria  
(Preliminary)  
Executive Board Meeting 09/22  
March 4, 2009**

We would like to express our appreciation to the staff for the comprehensive report. We found it useful that the report summarised Bulgaria's reactions to previous IMF advice and that it clearly presented the views of the authorities where these diverged from the staff's assessment.

**Recent performance**

The Bulgarian authorities must be commended for excellent output and employment results attained in recent years and for their fiscal policy which has generated consistently strong outturns, both in nominal and cyclically-adjusted terms. The prudent use made of the surpluses through the accumulation of fiscal reserves and some prepayment of external debt underscores the commitment of the authorities to a stability-oriented approach. The same is true of the steps taken by the Bulgarian National Bank to prevent a crisis and to improve their ability to manage any emerging crisis. As noted in the informative Buff statement provided by Mr. Bakker and Mr. Yotsov, the combination of a solid fiscal policy track record and reserves, healthy central government sector balance sheets, and substantial foreign reserves leaves Bulgaria in a relatively strong position as it faces into the global downturn.

**The policy environment**

All agree, however, that Bulgaria is facing serious challenges. The most recent output and trade data confirm that the growth forecasts underpinning the 2009 budget are unrealisable. Even the considerable weaker assessment in the staff report carries significant downside risks and the alternative scenario which envisages a 3 percent fall in GDP in 2009 is beginning to come into sharper focus, with obvious consequences for the fiscal balance, absent policy changes. Finally, notwithstanding the steps which have been taken to bolster the stability of the financial sector, there are real risks on this score arising both from internal and external forces. These internal forces include the high probability of falling property prices and the feedback loop between the real economy and the financial sector. The external forces include the likely spillover to Bulgaria of decisions taken by its largely foreign-owned banking sector in response to developing events elsewhere. Significantly, although the findings of the FSAP are very favourable in many respects, the stress tests indicate that under not implausible

scenarios, there would be widespread undercapitalisation of the banking system and bank insolvencies.

These considerations are the background against which the authorities must frame their policies. We agree with the staff's assessment that the central question is the stability of the financial system.

### **Policy setting**

The most obvious need is for wage restraint. Whatever the view one takes of the underlying competitive position of the Bulgarian economy, more moderate wage developments in both the private and the public sector are absolutely essential not only to facilitate the desired shift of resources from the non-traded to the tradeables sector but also to address the deteriorating fiscal balance. In that respect, *could the staff say whether the very rapid growth in wages over the last two years was concentrated in the public sector and in the construction sector or whether the excessive wage growth was also a feature of the traded goods sector?*

The staff report underscores the central role of the real exchange rate in shifting the drivers of growth from the non-tradable to tradable sector. The staff estimates that while much of the current account deficit will be eliminated when capital inflows diminish, there is still a substantial underlying imbalance and the real exchange rate is overvalued by 7-20 percent. There are of course two routes by which the real exchange rate can adjust downward: a depreciation of the nominal exchange rate and/or a relative decline in domestic prices and/or costs. Given that IMF staff and the Bulgarian authorities support the maintenance of the currency peg at its current level, this adjustment can only come through prices and costs. While it will be very difficult to generate output growth via a shift to the tradeables sector, given the weakness of the external environment, the staff's growth forecasts which are summarised in Table 6 of the report emphasise the central importance of achieving such a shift. These forecasts indicate that net exports may be the only source of growth over the two years 2009/2010.

It is less easy to discern the most appropriate fiscal policy stance. While accepting completely the case made in the staff report for keeping comfortably large fiscal surpluses and the link with the stability of the Currency Board Arrangement, we are concerned that the staff may be overoptimistic in recommending the size of the 2009 target budget surplus to be 2 percent of GDP. We thank the staff for providing an alternative scenario. This suggests that the Bulgarian economy could shrink markedly over the coming years. One wonders whether an economic contraction on the scale envisaged in the alternative scenario would call for a reappraisal of the fiscal target mentioned by the staff. *We would welcome the staff's assessment of the balance of policy risks posed by a severe economic contraction.*

It is clear that the staff believes that the stability of the financial sector is intimately linked with the maintenance of the Currency Board Arrangement. We note the conclusion from the stress tests described in the FSAP that in an extreme macro scenario, a significant devaluation of the lev would wipe out the remaining capital of the banking system and that most banks would wind up with negative equity.

### **European Union funding and administrative efficiency**

The flow of EU funding earmarked for agricultural and structural development over the funding period to 2013 at 11 billion euro is equivalent to roughly one-third of the current level of GDP. This illustrates the scale of the absorption task confronting the authorities. It also suggests that the application of the 90 percent fiscal expenditure rule could be constrained by the need to avoid reductions in programmes whose completion is required to secure the funding. It will be absolutely critical for the authorities to ensure that their administrative and financial management arrangements will be sufficiently robust to ensure the effective programming of the projects and to account for the deliverables if significant reductions in this valuable source of external funding are to be avoided.