

## **Supplementary Memorandum of Economic Policies of the Government of Bulgaria and the Bulgarian National Bank**

### **A. Introduction**

- 1. Bulgaria continues on its path toward a fully functioning and stable market economy that can reap the benefits of globalization and lead to EU accession as planned.** So far in 2002, we have maintained macroeconomic stability in the face of a difficult external environment, primarily by implementing cautious fiscal and incomes policies. At the same time, we have accelerated our program of structural reforms, in close consultation with the World Bank, with the aim of generating high and sustained growth and reducing unemployment and poverty. Recognizing, however, that some individuals are suffering from temporary adverse effects of economic transition, we have strengthened significantly the social safety net.
- 2. We will continue to implement strong policies to maintain the viability of the currency board arrangement (CBA) over the medium term.** The CBA has provided a stable monetary environment and an anchor for our economic policies more generally, while engendering confidence in our economy both domestically and abroad. To support the CBA, we will continue to implement a prudent and flexible fiscal policy, aiming in the medium term at a balanced budget and a reduction of public debt to below 60 percent of GDP. At the same time, we will continue to reduce gradually the tax burden to spur economic activity, while increasing spending in high priority areas, in particular public investment—including for EU accession requirements—and the social safety net. To help create room for these tax cuts and focused spending increases, as well as to foster the competitiveness and flexibility of the economy, we intend to continue implementing wide-ranging structural reforms and to maintain stringent income policies for the remaining public enterprises.
- 3. Despite a few delays, our economic program—supported by a stand-by arrangement approved by the IMF’s Executive Board in February 2002—is essentially on track.** All quantitative performance criteria for the first quarter of 2002 were met (Table 1). One structural benchmark and one performance criterion due by end-March and end-April 2002, respectively, were not observed. The structural benchmark on parliamentary adoption of the bank bankruptcy law is now scheduled to be implemented by end-July and the performance criterion on household electricity price increases is now a prior action before consideration of the first review of our program by the IMF Board (Table 2). We stand ready as well to take all additional steps as may prove necessary during the course of the program to meet our economic objectives.

### **B. Recent Economic Developments**

- 4. While adverse external and domestic developments have delayed attainment of some of our macroeconomic objectives, we expect overall macroeconomic performance by the end of the year to be consistent with our program.** GDP growth declined to 4 percent in 2001 as imports by the EU and Turkey slowed and prices of key exports fell. As a result, the external current account has remained under pressure, with the twelve-month

deficit growing to about 6½ percent of GDP, foreign direct investment has slackened, and gross international reserves of the BNB have declined modestly, although remaining at a healthy 4½ months of prospective imports. As the recovery in the EU solidifies in the second half of 2002, Bulgaria's growth is expected to pick up, reaching 4 percent this year. Consumer price inflation rose sharply in the first three months of 2002, and stands at 7 percent for the twelve months ending May 2002, significantly overshooting projections. As this increase largely reflects the one-time impact of adjustments in administered prices and indirect taxes and a spike in food prices, and underlying inflation remains subdued, we expect the twelve-month inflation rate to decline during the coming months, reaching some 7 percent by end-year.

5. **Our economy continues to be externally competitive, although scope remains for continued large improvements.** In spite of an appreciation of the CPI-based real effective exchange rate, resulting from the recent pickup in consumer price inflation, there are no indications that the exchange rate is overvalued. Productivity growth remains strong and real wages and unit labor costs lower than in most of our competitors. Exports of non-traditional consumer goods have continued to grow robustly even during the economic downturn. Nevertheless, to ensure that competitiveness continues to improve, we will need to act forcefully to improve the business climate and enhance the flexibility of the economy.

6. **We are successfully implementing a cautious fiscal program.** Our revised fiscal target for 2001 of 0.9 percent of GDP was met as a result of a sizable fiscal adjustment in the fourth quarter of the year. The execution of the 2002 budget is on track as well, with end-March performance criteria on the general government deficit and the fiscal reserve account (FRA) observed with comfortable margins. Revenue in the first four months of 2002 was approximately in line with the program while control over spending remained tight. We have intensified our efforts to ensure that subsidies are brought under control. A school redeployment plan designed to restructure the school network, optimize teacher employment, and increase efficiency was approved by the Council of Ministers (CoM) and a system for making child allowance more effective and better targeted was approved by parliament. Progress was made in restructuring the health care sector including by advancing the hospital accreditation process and reducing hospital overcapacity, although targets have not been fully met. In the tax administration area, we are taking steps to implement the unified revenue agency (URA) and to address weaknesses in VAT administration and the system of VAT refunds.

7. **We have implemented reforms in the financial sector to strengthen the supervision of financial institutions and increase financial intermediation.** Amendments providing the BNB legal authority to investigate the identity and suitability of direct and indirect shareholders of banks were tabled in parliament. A consultative council on financial supervision was established and the independence and resources of the Financial Investigation Bureau were strengthened to enhance anti-money laundering actions. To stimulate the interbank market we have helped introduce the Sofibor, which tracks the interest rate charged on overnight interbank lending. We adopted a strategy for the privatization of DSK Bank and issued tenders for the sale of Biochim and DZI (State Insurance Institute). The adoption by parliament of the bank bankruptcy law (structural

benchmark for end-March 2002) was delayed, but the law has passed the first reading in parliament and we have redoubled our efforts to ensure passage during this parliamentary session, which ends in July 2002. We have begun implementing the recent recommendations of the Fund's Safeguards Assessment of the BNB with regard to the auditing, staff training, and accuracy of reporting.

8. **We have made progress with the restructuring of our economy to increase its efficiency and ensure that Bulgaria becomes an increasingly attractive place to do business.** Our privatization program gained momentum with the passage of the new privatization law. Tenders were issued for the privatization of the telecommunication company (BTC) and the tobacco holding (Bulgartabac). Our medium-term energy strategy was adopted by the CoM and tabled in parliament. Preparations were made for the privatization of the electricity distribution companies and the creation of gas distribution companies. We announced the schedule for a gradual increase in household electricity prices consistent with World Bank recommendations (prior action for first review) and aimed at full cost recovery by end-2004. At the same time, we announced an increase in the upper limit of heating prices for those district heating companies that are subsidized, in line with our energy strategy. To mitigate the impact of the increase in household electricity prices, we introduced on a temporary basis two-block tariff systems, which will keep prices unchanged for a minimum level of electricity and heating. We have continued to promote trade liberalization with the announcement in June 2002 of a multi-year plan for halving the average most favored nation tariff rate.

9. **We have conducted a successful Brady bond exchange, which has furthered our debt management objectives.** In March, we swapped US\$1,328 million Brady bonds (28 percent of the outstanding Brady debt) for new U.S. dollar and Euro-denominated bonds. The exchange resulted in net present value savings of US\$94 million and a reduction of the face value of the external debt. In line with our objectives, the duration of the bonded debt has increased from 5.5 to 5.9 years, the share of the Euro-denominated instruments has risen from around 5 percent to over 20 percent, bringing the currency composition of this debt more in line with that of trade, and the share of fixed interest rate debt has approximately doubled, to about 25 percent.

### C. Policies for the Remainder of 2002 and 2003

10. **We will continue to adhere firmly to our policy framework, which emphasizes macroeconomic stability anchored by the CBA and the expeditious implementation of structural reforms.** We see this approach as the most effective avenue to achieve high sustainable growth and address social ills while preserving external viability. We are thus prepared to take all necessary adjustment measures to safeguard the CBA, while pressing ahead with our structural reform program.

11. **The macroeconomic framework underlying the program remains valid, although we have revised the inflation projection upward.** We continue to aim for a growth rate of 4 percent in 2002 and 5-6 percent over the medium term. End-year consumer price inflation is now projected at 7¼ percent, significantly outstripping the programmed

3½ percent. However, we see inflation continuing at moderate levels of 4-4½ percent over the medium term, differing from euro area inflation only insofar as productivity growth is higher in Bulgaria and additional administrative price increases are implemented and indirect tax rises remain necessary. While the external current account deficit of 6 percent of GDP underlying the program may still be attainable, developments to date and risks owing to potential delays in recovery in the EU or higher oil prices suggest that the deficit could be larger. Over the medium-term we continue to see a steady decline in the current account deficit, as private savings increasingly finance investment, with the deficit largely financed by FDI.

### **Fiscal policy and fiscal sector reforms**

**12. To guard against further negative external developments, we will continue to implement fiscal policy cautiously and flexibly, taking adjustment measures as needed.**

At this stage, we consider the budgeted fiscal deficit for 2002 of 0.8 percent of GDP as a limit rather than a target. We seek to maximize the scope for flexibility in our fiscal management and to ensure that we can deal quickly and decisively with any increased risk. Therefore, we will take the following steps in the first three quarters of the year. First, we will continue to curb discretionary spending under the 90 percent rule. Second, unless and until it is clear that our external position is in line with initial expectations underlying our program, we will:

- Refrain from using the structural reform contingency, except for spending already allocated for NATO-related reforms in the third quarter.
- Save any revenue overperformance that may emerge.
- Save all of the 20 million leva accrued interest for 2002 realized from the release of collateral as a result of the March debt swap, and at least 50 million leva out of the 140 million leva interest savings associated with this debt swap and lower international interest rates (a total saving of 70 million leva, or ¼ percent of GDP). The remaining 90 million leva interest savings are planned to be used for a one-time clearance of arrears of public sector institutions. This operation would be carried out as part of a broader plan to restructure the remaining stock of arrears and eliminate the emergence of future arrears.

Third, we will refrain from implementing any tax cuts during the remainder of 2002.

We intend to use the above-mentioned savings and revenue overperformance for additional non-interest expenditures if and when it is clear that the external position is in line with the program. In no event will this additional spending be made before the fourth quarter of 2002.

**13. Should the potential risks materialize, we stand ready to consult with IMF staff on the need for adjustment measures, their nature and timing.** In particular, IMF staff will request consultation procedures if the current account deficit worsens or reserves decline significantly compared to program projections. In any case, we would consult with IMF staff

on fourth quarter spending plans in the context of the planned September staff visit. We have already identified the following contingency measures which provide for more than  $\frac{3}{4}$  percent of GDP in potential savings: (i) continuing the 90 percent rule for some categories of discretionary expenditure through the end of the year (a cushion of 0.2 percent of GDP); (ii) limiting the share of the interest savings that is used for arrears clearance by imposing additional reform measures; (iii) fully saving the accrued interest revenue and remainder of the interest saving (0.2 percent of GDP); (iv) not spending part of the structural reform contingency (0.1 percent of GDP); and (v) postponing a number of investment projects planned for this year (0.2 percent of GDP).

14. **To ensure that our medium-term fiscal program can be successfully carried out, we will continue to modernize our tax administration.** We remain fully committed to the URA project and are taking all necessary steps to ensure it can begin operations next year. In addition, consistent with the recommendations of the recent IMF Fiscal Affairs Department's tax administration mission, we intend to strengthen the large taxpayers unit, by increasing its coverage and developing a risk-based audit strategy. The VAT refund system is being improved—including through the introduction of VAT accounts and the implementation of IMF technical assistance recommendations—with the aim of ensuring that legitimate taxpayers receive their refunds promptly (within 45 days) while focusing our audits on high-risk taxpayers. We will implement the recommendation of the Crown Agents report in the area of customs reform, aimed at achieving harmonization with the EU, increasing revenue collection, reducing corruption, and facilitating legitimate trade.

15. **We are enhancing our expenditure management to ensure our spending is increasingly efficient and focused on high priority areas.** Beginning with the 2003 budget, we have established a more adequate time frame for the budget process and are enhancing the transparency of budget documents. To make the budget more result-oriented, we are preparing a pilot program budget in one ministry in 2003, and will extend this to at least three ministries the following year.

16. **We will continue efforts to ensure that subsidies are limited and targeted to socially important activities, including by:**

- Pursuing a restructuring of the energy sector, and ensuring that prices increasingly cover economic costs; and implementing our plan to create an efficient state railway, operating on a commercial basis, with limited and transparent subsidies (see below).
- Implementing, beginning in September 2002 the recently completed school redeployment plan, including by rationalizing the school network and reducing redundant employment in the upcoming academic year.
- Increasingly focusing the proportion of National Health Fund (NHF) spending devoted to hospital care on high quality hospital service, including through completion of the accreditation process and expansion of the number of the clinical paths financed by the NHF.

- Implementing the plan adopted by the CoM in June to reform the system of inter-governmental finances, including by: clarifying expenditure responsibilities and ensuring revenues consistent with these responsibilities; developing a simple and transparent basis for intergovernmental transfers; and providing incentives for efficient provision of services at the local level.

17. **Our budget for 2003 will aim to further reduce the deficit as a percent of GDP.** This will help us to achieve our objective of eliminating the deficit by 2005. The expected return of growth to potential in 2003 will help buoy revenue, and ongoing structural reforms will limit unproductive spending. The three-year tax policy plan announced at the end of April will contribute to a simple transparent tax system and broaden the tax base, and will lead to a decline in corporate and personal income tax burdens. The budget will be based on conservative assumptions with regard to the macroeconomic environment and the supply side response to tax cuts, and would continue to be implemented flexibly.

### **Labor market and competitiveness**

18. **We will foster stronger employment creation to reduce poverty on a permanent basis.** This would require increasing the efficiency of the labor market, while ensuring that workers have the training and resources to successfully participate in the economy. We are endeavoring, in close cooperation with social partners, to bring the labor code in line with EU requirements. The continued implementation of a prudent incomes policy will help ensure that our economy remains competitive and reduce the scope for a wage-inflation spiral to take hold in the broader economy.

### **Financial sector policies**

19. **Although our banking system is generally sound and well supervised, we will strengthen further our regulatory and supervisory framework in preparation for the expected increase in intermediation and EU accession.** We are taking steps to improve the risk assessment capabilities of the BNB including by training BNB inspectors in the use of the recently completed manual on risk assessment. We will ensure that, by January 2003, all banks have complied with international accounting standards. In light of the expansion of credit to the private sector, we will monitor loan quality closely and continue efforts to strengthen the financial condition of smaller domestic banks. In addition, we will press for the adoption by parliament of a workable bank bankruptcy law by the end of its current session, no later than end-July 2002, (structural benchmark). Also, we have completed the drafting of amendments to the anti-money laundering law, which together with the recently drafted anti-terrorist finance law were endorsed by the CoM in June and are expected to be passed in parliament by end-July 2002.

20. **We are implementing measures to increase financial intermediation and to improve the efficiency and security of banking operations.** By end-September 2002, we intend to settle the sale of Biochim Bank (structural benchmark) and finalize the sale procedures of the State Insurance Institute. We will expedite the DSK Bank privatization process. Also steps are being taken to amend the commercial code to facilitate the realization

of collateral and improve foreclosure procedures. We will complete the Real Time Gross Settlements (RTGS) project—which will enhance the security and speed of payments transactions, while improving banks' liquidity management—by November 2002, and expedite the use of electronic signature in the banking system. The necessary legislative changes to allow these improvements to go forward have already been made. We will implement the recommendations of the Report on the Observance of Standards and Codes (ROSC) module on the transparency of the monetary and financial policies.

### **Other structural reform policies**

21. **We are strongly committed to completing the privatization of our state-owned enterprises expeditiously and transparently.** Following the passage of the new privatization law, we aim to complete the privatization of the Bulgartabac holding by end-July and the State Telecommunication Company by end-August. At the same time, in compliance with the privatization law, the line ministries will submit to the Privatization Agency all documents necessary so that tenders and auctions for more than 400 majority state-owned companies can be issued by year end. We will finalize the divestiture of residual state-owned shares in a large number of companies through flotation on the stock exchange.

22. **We will continue reforming the energy and railways sectors.** We will seek the early adoption by parliament of our medium-term energy strategy. We have advanced the process of privatizing seven electricity distribution companies and intend to sell them by mid-2003. We aim to bring the restructuring of the district heating sector back on track by fully implementing the plan adopted in mid-2000. In addition, we have taken initial steps to open the domestic electricity and gas markets for large industrial customers by allowing them to purchase energy directly from producers. Approval by the CoM of the Energy Act that was due by June is now expected by end-September. We will continue the restructuring of the railways company, including by clearly determining those activities that would be operated on a commercial basis and those that would continue to receive government subsidies.

23. **While these efforts will go a long way to ensuring that state enterprises operate efficiently and with financial discipline, special efforts will be required to ensure that arrears are kept under control.** In particular, Bulgargaz and NEK will reschedule arrears payments owed to them and ensure that they do not face any arrears on current due and rescheduled payments from commercial activities irrespective of ownership (performance criterion, see Annex VII). In this context, Bulgargaz and NEK will take all necessary measures envisaged in the law regarding any commercial customer with payments overdue by more than one month over the normal payment period. We will make financial assistance above the budgeted level to the Sofia district heating company conditional on the concrete and full implementation of its restructuring plan.

### **External sector policies**

24. **Our external sector policies will continue to focus on reducing vulnerability.** Our tight fiscal policy, which has resulted in the decline of public sector external indebtedness, goes a long way in lowering external vulnerability. We will continue to make sure that the

FRA balance is in excess of 1.9 billion leva—more than 100 percent of projected 2002 external debt service payments (performance criterion under the program). The FRA assets in excess of this floor will be managed prudently with a view to achieving a proper risk/return tradeoff, taking into account the FRA's role as a fiscal safeguard mechanism. We will seek to ensure that the new public debt law is approved by parliament, and will publish our medium-term external debt management strategy.