

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

A. Introduction

- 1. The past six months have seen Bulgaria continue to make strong progress toward achieving rapid and sustainable economic growth and significant improvements in the well-being of our citizens.** This progress has been achieved through the implementation of our economic strategy, which rests on three main pillars. First, our fiscal policy has continued to be aimed at strengthening macroeconomic stability and the currency board arrangement and promoting private sector growth. Second, our ongoing program of structural reforms focuses on eliminating the remaining barriers to growth and improving the quality of public services. Finally, we have strengthened our social safety net and labor market policies to further reduce the poverty rate and increase employment opportunities.
- 2. Our economic program—supported by a stand-by arrangement from the Fund—remains on track.** All quantitative performance criteria (PCs) for end-June and end-September were observed. Ten of thirteen structural benchmarks through end-September have been observed as well, although some were achieved with a delay (Table 2). We aim to meet remaining benchmarks in the coming months, and stand ready to take all additional steps as may prove necessary during the course of the program to meet our economic goals.

B. Recent Economic Developments

- 3. The macroeconomic situation has improved markedly in recent months, despite the continued slow growth among Bulgaria's main trade partners.**
 - Real GDP growth picked up to 4½ percent year-on-year in the first three quarters of 2002, led by a rise in investment. Growth in Bulgaria has been one of the highest among EU accession candidates, and should reach at least 4 percent for the year as a whole. The registered unemployment rate remains high, but has declined significantly, by 1.7 percentage points during 2002 through October.
 - Consumer inflation remains subdued, with a twelve-month rate of 3.2 percent at end-November.
 - Export performance improved significantly in the second half of 2002, helping to limit the twelve-month external current account deficit to just over 3 percent of GDP by end-September, and contributing to a rise in international reserves to US\$4.5 billion, or more than five months of prospective imports, at end-November. Export growth has been driven in part by non-traditional sectors, such as textiles and light manufacturing, underlining Bulgaria's competitiveness on international markets.

- Financial intermediation continues to rise robustly. Over the twelve months through November, real credit to the private sector grew by 38 percent, as competition in the banking sector increased and lending opportunities improved. Banks remain sound, as by September the average ratio of nonperforming loans declined slightly from last year to 5½ percent and the capital adequacy ratio remained above 20 percent.

4. **These positive developments have been underpinned by a cautious approach to fiscal policy.** Preliminary data indicate that the general government fiscal deficit for 2002 was contained to below 0.8 percent of GDP, slightly better than budgeted. Nominal revenues were broadly on track, as higher nontax revenue offset a shortfall in income taxes, VAT, and social security contributions. Lower interest payments were largely dedicated to meeting priority spending needs, including clearance of hospital and, in preparation for our reform of intergovernmental finances, municipal arrears (paragraph 17).

5. **A second Brady bond swap in September furthered the government's objective to reduce the public debt-to-GDP ratio and improve the debt structure.** The exchange allowed net present value saving of about US\$30 million to be realized, while locking in historically low interest rates. The operation also allowed the release of collateral worth US\$130 million and increased the duration of the bonded debt. The swap, combined with our tight fiscal stance, helped reduce the public debt-to-GDP ratio to below 60 percent by the end of 2002 and to increase the Fiscal Reserve Account (FRA) to 3.3 billion leva, well over two years of expected debt service payments. Additionally, we have adopted a debt law, which will ensure that general government debt remains below 60 percent of GDP, impose more stringent conditions for extending state guarantees, and provide for a tighter monitoring of municipal debt.

6. **We have moved ahead with our privatization program, plans to improve the business climate, and reforms in key sectors.** Preliminary work required for the sale of minority packages has been completed and several auctions have been announced. A financial intermediary was chosen to conduct the offerings at the Stock Exchange, expected for May 2003. Winning bidders for the state telecommunication company (BTC) and the state tobacco holding company (Bulgartabak) have been identified, but finalization of the sales has been delayed by court challenges. We are, in addition, taking steps to enhance market entry and exit including by simplifying business licensing and registration, accelerating bankruptcy and foreclosure procedures and enhancing the protection of creditors. Reform of health care, the district heating companies and the railway have proved challenging, but we continue to progress on these fronts as well.

7. **We have continued to implement reforms in the financial sector aimed at strengthening supervision and enhancing financial intermediation.** Two key financial sector privatizations (Biochim Bank and the State Insurance Institute) were successfully completed. The Bank Bankruptcy law was passed in September 2002 and became effective at end-December. Amendments to the bank law allowing the Bulgarian National Bank to fully vet the identity and suitability of banks' shareholders were passed. In line with recommendations from the Fund's safeguard assessment, we have taken steps to strengthen

the internal audit function of the BNB by introducing risk-based audit methods, improving control procedures, and training staff on new methodologies and international accounting standards. We have also clarified the responsibilities of the Chief Auditor and the Internal Audit Department.

8. **Bulgaria's strong economic performance has been reflected in enhanced confidence on the part of the international community.** In October, the European Union (EU) conferred on Bulgaria the status of a "functioning market economy," and the December Copenhagen summit endorsed our timetable for accession by 2007. Standard & Poor's and Fitch have raised Bulgaria's credit rating in recent months and the spread on Bulgarian sovereign bonds has continued to decline.

C. Economic Policies for 2003

9. **We aim to maintain our broad economic strategy, anchored by the currency board arrangement and focused on prudent fiscal policy and an acceleration of structural reforms.** The improvement in the external position, even in a still-difficult world economic environment, points to the continued viability of the currency board. Further, with the EU's support of Bulgaria's accession timetable, our medium-term strategy to retain the currency board until accession has been clarified and strengthened. Nevertheless, we recognize that important external risks—including the possibility of much higher oil prices and continued slow growth in the EU—require the maintenance of prudent and flexible macroeconomic policies. Moreover, Bulgaria still has a long way to go to fully realize its economic potential and increase standards of living toward levels reached by the more advanced accession countries. Achieving this will require steadfast efforts to complete our economic transformation while ensuring that the gains from this transition are more widely shared.

Macroeconomic Framework

10. **Bulgaria's medium-term outlook is favorable.** We believe that Bulgaria has the potential to grow at 5 to 6 percent per year over the medium term, as investment rises, restructuring is completed, and employment increases. Next year, with an expected modest improvement in economic conditions in the EU, we anticipate that we will move close to that potential, registering growth of 5 percent. Gradually rising savings would allow the external current account deficit to decline to 4½ percent over the medium term, after rising modestly to about 5 percent of GDP in 2003. The current account deficit would be largely covered by foreign direct investment, allowing the public and external debt-to-GDP ratios to continue to decline. Inflation is expected to average 4 percent over the medium term, as administrative prices are raised to cost-recovery levels.

Fiscal policy and reforms

11. **The 2003 budget aims to further our objectives of balancing the budget over the next three years, reducing the tax burden, and focusing spending on high priority areas.** The budget targets a small decline in the deficit, to 0.7 percent of GDP. The revenue-to-GDP

ratio is expected to decline modestly as measures to reduce direct taxation are partially offset by increases in excise taxes and improvements in tax and customs administration. On the spending side, we continue to implement policies to reign in subsidies and allow increased expenditures on the social safety net, active labor market policies, and support for agriculture.

12. **We recognize that the implementation of the 2003 budget will not be without challenges, and are committed to taking those measures necessary to ensure that our deficit target can be achieved.** First, to address potential risks arising from external shocks or revenue shortfalls relative to budget targets, we intend to limit discretionary spending to 88 percent of budgeted levels in the first three quarters of 2003—a further element of caution compared with the previous “90 percent rule.” Second, we have set monthly targets on central government revenues and social security contributions. Significant deviations from these targets will trigger consultations with IMF staff on offsetting measures, including reductions in spending commitments. Finally, we are taking steps to limit spending overruns or arrears accumulation in municipalities and hospitals. In this regard, we have already cleared most municipal and hospital arrears from previous years, putting these institutions on more secure financial footing to start 2003, and are moving ahead with structural reforms to help address these problems in future years (see paragraphs 17 and 22).

13. **Our three-year tax policy strategy focuses on reducing corporate and personal income tax burdens to enhance incentives to work, save and invest in Bulgaria.** On the corporate side, we have introduced more rapid depreciation for a number of asset types and have announced a schedule for further gradual reductions in corporate tax rates from 2004, from the current 23½ percent to 15 percent by 2005. We have also lowered personal income tax rates in 2003 for low- and middle-income taxpayers. To help compensate for foregone revenue, and to ensure a gradual harmonization with EU tax regimes, we have introduced increases in excise taxes on tobacco, alcoholic beverages and petroleum products. We continue to view Bulgaria’s broad tax base—with few exemptions or limited other special tax treatment—as a strength. Thus, while the introduction of a zero corporate income tax rate for enterprises locating in high unemployment regions is a key element of our economic development strategy, we have designed this measure with a view to ensuring that tax benefits are well-targeted and revenue losses are minimal. In particular, all eligible assets and 80 percent of the workers must reside in a region with an unemployment rate exceeding the national average by 50 percent. Further, we intend to evaluate our experience with this provision after one year, with a view to determining its cost effectiveness. We do not intend to introduce any new tax exemptions during the remainder of the Fund-supported program.

14. **The success of our fiscal strategy rests in part on efforts to improve taxpayer compliance.** These efforts focus on accelerating the implementation of the National Revenue Agency (NRA), enhancing the effectiveness of the large taxpayer office (LTO) and improving auditing and arrears collections. The NRA is a legal entity as of January 1, 2003, and will become operational by the start of next year. In the meantime, we have already begun joint audits between the National Social Security Institute (NSSI) and the General Tax Directorate (GTD) and will expand these audits next year, with a focus on large taxpayers. In

that context, we will expand the operations of the LTO to have it cover, by end-June 2003, taxpayers contributing at least 60 percent of total revenue (structural benchmark). We are developing selective audit programs using risk-analysis methods and, to enhance the effectiveness of auditing, we will implement the Bulstat number as the single key identification for all tax operations by end-June 2003 (structural benchmark). The Council of Ministers has approved a program for improvement of tax collection and tax authorities will establish specialized teams of tax inspectors for different economic sectors. To support improved arrears collection, we will enhance the monitoring and analysis of arrears, increase the efficiency of our efforts by focusing on those arrears most likely to be collectible, and make use of arrears rescheduling and repayment plans based on individual restructuring programs where appropriate. We anticipate to reduce net arrears from all enterprises to the GTD by 200 million leva in the course of 2003 (quarterly floors on the reduction of NSSI and GTD arrears from the largest debtors are performance criteria under the program). With respect to customs, we are continuing our reform with Crown Agents, which has already begun to show good results. We expect as well that our revenue collection will be positively affected by the occupational- and sector-specific minimum insurable income levels—which will limit the extent of underreporting of income—as well as by the rigorous implementation of new requirements that all labor contracts be registered.

15. Equally important to our fiscal strategy are our efforts to reduce unproductive expenditure and create room for increases in spending on priority areas, including active labor market programs. In order to target subsidies to the most socially important activities, we are continuing to restructure district heating and railways (see paragraphs 19 and 20). A major priority in the 2003 budget and for the medium-term are measures to reduce unemployment and, in that regard, we are expanding our active labor market programs for the long-term unemployed (paragraph 17). We are also increasing our support to the agriculture sector, which will be focused on improving sector productivity and preparing for EU accession.

16. We are taking steps to ensure that the budget process and expenditure management enhance public sector effectiveness. A program budget was prepared on a pilot basis for one ministry for the 2003 budget, and this will be expanded to 2 additional ministries next year. We will also take steps to improve the efficiency of public investment, including through streamlining the process for utilizing EU resources. We are committed to have the Financial Management Information System fully operational in the Ministry of Finance by end-2003 (structural benchmark) and to prepare for its implementation in the line ministries. We believe that fiscal transparency is key to good governance and, accordingly, no later than March 2003, will publish on the Ministry of Finance website monthly data on consolidated government budget implementation on a cash basis and on the FRA (structural benchmark). We will also ensure that no new extrabudgetary funds or state enterprises are set up during 2003 (structural benchmark). We will limit the use of the FRA for the acquisition of policy-related assets to no more than 150 million leva ($\frac{1}{2}$ percent of GDP) in 2002 (performance criterion). Finally, we will, by end-September 2003, include all non-participating leva-denominated extrabudgetary funds and autonomous budget units in the Treasury Single Account (structural benchmark).

17. **A broad reform of intergovernmental relations has begun, aimed at providing local governments with increased autonomy and responsibility while limiting the scope for arrears accumulation.** The reform's main objectives are: (i) a more clear delineation of the expenditure responsibilities of the state and the municipalities; (ii) adequate funding of state expenditure responsibilities mandated to municipalities; (iii) providing an element of revenue autonomy for local governments; and (iv) improving the legal framework for municipal budget preparation and execution. It is expected also that this reform will help arrest the accumulation of municipal arrears while providing local governments with the proper incentives for improving revenue collection and the efficiency of public service provision. In the 2003 budget we have taken important steps toward meeting these goals, but have not yet been able to fund fully all mandated expenditures. To advance the fiscal decentralization reform, we will put it on a sound legal footing by, in the first half of the year, submitting to Parliament amendments to the municipal budget act and to the state and municipal property acts. We also will, in cooperation with the Association of Municipalities, prepare minimum standards for the provision of municipal services.

Labor Market Policies and Competitiveness

18. **Continued strict income policies for remaining state-owned enterprises and further steps to increase labor market flexibility are crucial for maintaining our competitiveness and reducing unemployment.** The Council of Ministers will pass a regulation on wage bill allocation in companies with more than 50 percent of state or municipal ownership that is fully consistent with these objectives. In line with this ordinance, we will limit wage bill growth in the 60 closely-monitored public-owned companies to no more than 2 percent in 2003 relative to the third quarter of 2002 (performance criterion under the program). We will continue efforts to amend the labor code in order to deregulate labor relations. In particular, revisions would aim to decentralize collective labor negotiations to the enterprise level and increase the role and responsibility of involved parties, including through adequate representation of employers and employees in the tripartite councils. We will initiate public discussions to push forward amendments to reduce procedural costs of dismissing workers, and facilitate more flexible forms of employment, organization of work, as well as wage agreements. Finally, we envisage providing up to 100,000 community services jobs for long-term unemployed through our expanded active labor market policies. A work test has been introduced for the first time and refusal to take public works jobs will result in losing eligibility for social assistance for one year. We will closely monitor and evaluate the program to avoid abuse, limit pressures on the state budget, and prevent crowding out of jobs which could be otherwise provided by the market.

19. **A key to stimulating job creation will be to continue to improve the business climate in Bulgaria.** In order to ease the entry of dynamic new private sector firms we have identified 200 regulatory regimes to be eliminated or simplified, and these changes will be implemented by end-June 2003. In order to arrest the multiplication of such regimes in the future and ensure that they are based on sound economic analysis, we also intend to enact a law on limiting administrative regulations by end-June 2003. We have moved forward with the implementation of the "one-stop-shop" program. The government has adopted a

conceptual framework for improving the provision of administrative services in the context of this program as well as a base model for their provision. We have made the program already operational in five pilot projects. It is also critical that we facilitate the exit of non-viable enterprises and, toward this end, have submitted amendments to the Commercial Code to simplify and speed bankruptcy procedures and provide more rights to creditors, and we anticipate enactment of these changes by end-June 2003.

Other structural reforms

20. **Energy sector reforms will be expedited, with a view to ensure that medium-term fiscal objectives can be reached and obstacles to growth removed.** The State Energy Regulatory Commission (SERC) has committed to raise prices for electricity to cost-recovery levels in three years. In this context, the SERC will announce increases in average household electricity prices of 15 percent by June 30, 2003 (structural benchmark), to take effect on July 1, 2003. Additionally, increases in average district heating prices of 10 percent will be announced by June 30, 2003 (structural benchmark), in line with the government's energy strategy. At the same time, targeted assistance to poor households will be strengthened. We are, in conjunction with the World Bank and the EBRD, accelerating the restructuring of the Sofia district heating company and plan to undertake a major upgrade of its infrastructure beginning in the spring. Steps are also being taken to introduce private management of the company, and complete installation of individual heat allocators and meters. It is anticipated that the need for government subsidies to this company will be eliminated by 2005. Our state-owned electricity and gas companies (NEK and Bulgargas) will take all necessary measures, in coordination with other public sector creditors, to limit arrears owed to them (ceilings on arrears to NEK and Bulgargas are indicative targets under the program.) More generally, we are moving ahead with the implementation of our energy sector strategy, based on privatization, the opening of energy markets to competition, and strengthened regulation. In this context, a draft of the new Energy Law has been developed, the public discussion of which is currently being held. After its approval by the Council of Ministers, we expect parliament to adopt it by end-March 2003. We anticipate the sale of seven electricity distribution companies and of a number of companies in the district heating, coal mining and water power plants sectors during 2003. Also, the procedures for selecting consultants for the privatization of electricity generation companies will start in mid-2003. We plan by mid-2003 to open 15 percent of the high voltage electricity market and begin the sale of licenses for low pressure gas markets.

21. **We will press ahead with reform of the railways, aimed at creating an efficient commercial operation with adequate infrastructure and limited and transparent government subsidies.** Toward this end, we have undertaken a 2 year action plan in consultation with the World Bank. We aim to increase cost-recovery on intercity passenger services to at least 70 percent by mid-2003 and 90 percent by mid-2004, while eliminating a number of loss-making services and reducing employment by 20 percent by mid-2004 with respect to 2001. We also plan, by mid-2003, to restructure the operating company into separate units for freight and passenger service, with separate accounting for each unit. Finally, we intend to have, by end-2003, a preliminary agreement between the Government

and the railway company BDZ: (i) specifying all non-commercial passenger services that will receive Government subsidies via public service obligation contracts, to enter fully in force as of January 1, 2005, and (ii) providing a plan for termination or other disposition of all other non-commercial passenger services, the implementation of which will start in 2004.

22. Efforts to advance reforms in health care, in coordination with the World Bank, will aim at enhancing service quality and expenditure efficiency. Within this broader reform, we plan to accelerate the rationalization of the hospital system along two tracks. First, we will implement a series of policies to help ensure that public spending on hospital care is increasingly focused on high quality institutions, and that the financing mechanism will provide incentives to provide services more efficiently. To achieve this we will: (i) increase the share of hospital care expenditures financed by the NHIF to at least 25 percent of total spending in the first quarter and 30 percent in the second quarter of 2003; (ii) strengthen the hospital accreditation process, with a focus on the capacity of hospitals to carry out medical activities based on explicit standards, and with hospitals not meeting accreditation requirements ineligible for NHIF financing; (iii) make expanded use of clinical pathways; and (iv) have the Ministries of Health and Finance jointly sign detailed performance contracts with individual hospitals under the Ministry of Health. Second, a national hospital restructuring plan approved in November by the Council of Ministers aims, over the medium-term, to improve the quality of, and access to, health care by investing in large regional hospitals and eliminating less productive spending in the sector.

23. We are taking all necessary steps to further enhance our oversight of the financial sector and complete bank privatization. The recent acceleration in credit to the private sector is welcome, but requires increased vigilance to ensure that credit quality remains high. We will maintain our policy of conducting unscheduled on-site inspections of banks determined to be problematic by our new and more comprehensive early warning system. In addition, we will continue to require full and expeditious implementation of the measures mandated to banks that are in violation of prudential regulations. We are building expertise in assessing and supervising banks' risk, especially through training provided to commercial banks and BNB staff. We will, by end-March 2003, set up a unified supervision of non-bank financial institutions. We continue preparations for the introduction of a real time gross settlements system (RGTS) by March 2003. In this context, banks and the BNB have set up a small credit reserve fund of Lev10 million at the BNB financed by banks' contributions, to provide room for settling temporary daily shortage of liquidity in the banking system. With the adoption by parliament of amendments to the anti-money laundering law, we have enhanced our ability to monitor suspicious foreign currency transactions and financial activities suspected to be related to terrorism, and strengthened the independence of the Bureau for Financial Investigation. Finally, all necessary steps have been taken to allow the remaining major state-owned bank, DSK Bank, to be sold by end-June 2003 (structural benchmark).

24. Further development of capital markets remains a priority of this government. We are focusing our effort on eliminating remaining obstacles to development, including through the improvement of corporate governance and shareholders protection. In particular,

we have prepared amendments to the Commercial Code to promote independence of companies' management boards, while establishing obligations regarding information disclosure and restricting conflicts of interest of board members. Additionally, we have included provisions for the enforcement of best practices in corporate governance. In order to aid in the development of the Bulgarian Stock Exchange, we plan to list the government's minority shares in 80 enterprises during 2003. The draft amendments to the Law on Public Offerings of Securities are intended to promote stock sales from minority shareholders. The development of the second and third pillars of the pension system will also serve to deepen our financial markets. We also intend to create an investment fund to increase the opportunity for equity financing for private enterprises. To guarantee that all decisions of this fund are made on a market basis and that fiscal risks are minimized, we will ensure that the government is a minority shareholder and its participation limited to 100 million leva, the fund is under private management with appropriate firewalls, and that government divestment or liquidation of the fund will take place within five years.

Debt and Asset Management

25. We will continue to manage our foreign debts and assets with a view to reducing external vulnerability and ensuring ample liquidity. We have made significant progress during the past year in reducing our public external debt as a share of GDP from 63.8 percent to 49.5 percent, reducing the share of U.S. dollar denominated debt, lengthening maturity, and raising the proportion of fixed-rate instruments. In the aftermath of the second Brady bond swap, our focus will be on reducing our overall debt burden, further developing our domestic debt market and managing risks arising from repayment peaks in future years. These issues merit public debate in the context of the government's debt strategy, which we intend to publish. In addition, we are developing a more comprehensive debt management strategy, with Fund technical assistance. We are committed to ensuring that our Fiscal Reserve Account (FRA) balance remains large enough to cover one year of external debt service payments, even under severe external shocks (a floor on the level of the FRA is performance criterion under the program). While we target a significantly larger balance than would be implied by this rule, we would also seek to make use of the FRA to prepay external debt owed to official creditors as circumstances allow. In any case, we will limit our use of FRA resources for acquiring equity in state or private enterprises during 2003, to 150 million leva (performance criterion under the program).