MISSION CONCLUDING STATEMENT

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Bulgaria: Staff Concluding Statement of the 2022 Article IV Mission

April 15, 2022

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

An International Monetary Fund (IMF) mission led by Jean-François Dauphin visited Sofia April 5-15, 2022, to conduct the 2022 Article IV consultation with Bulgaria. At the end of discussion, the mission issued the following statement:

In an uncertain environment, economic policies need to deal with significant challenges. While the recovery from the pandemic-induced crisis was getting hold, the war in Ukraine is expected to have a significant economic impact, including by slowing growth and increasing inflation. Fiscal policy needs to continue providing adequate health and economic support, respond to demands arising from the war, and plan for the unknown, while avoiding adding to inflationary pressures. The banking sector is well capitalized but, in a challenging environment, financial sector policies need to remain vigilant. At the same time, policies need to tackle long-standing structural challenges, especially raising living standards, reducing inequalities, and supporting the green transition. With the euro area accession in sight, policies that help foster income convergence with EU partners are even more important. The resilience and recovery plan, supported by EU funds, has a crucial role to play in these areas. The authorities' focus on improving governance and fighting corruption is

welcome.

1. **The Bulgarian economy has shown resilience through a succession of shocks.** Owing to policy support, the economy rebounded in 2021 despite the lingering pandemic and protracted political uncertainty that weighed on investment. GDP surpassed its pre-crisis level by mid last year, and growth reached 4.2 percent in 2021, thanks to strong consumption supported by significant fiscal support and buoyant wage growth, on the back of a strong labor market recovery. However, as in many other countries, inflation accelerated significantly, pushed by global supply-chains disruptions, rising commodity prices, increasing labor costs, and strong domestic demand. It reached 8.4 percent in February 2022 and was broad-based.

2. **As the recovery was gaining momentum, the war in Ukraine suddenly clouded the outlook and considerably increased uncertainty** . The economic effects of the war will materialize primarily through higher commodity prices, lower trading partners' demand, and the impact of uncertainty on investment, while refugees need to be cared for. High energy dependance from Russia is a significant vulnerability. On the other hand, the financial sector has very little direct exposure to Russia or Ukraine. With events unfolding rapidly, the scale of the impact of the war is difficult to predict. Growth is tentatively projected near 3 percent this year, while inflation will likely reach double digits. Risks could worsen the outlook through stronger spillovers from the war in Ukraine, resurgence of COVID infections, protracted supply-chain disruptions, and faster-than-anticipated tightening of global financing conditions.

Proving fiscal support without adding to inflationary pressures

3. **Fiscal policy needs to be flexible given the large uncertainty, but some changes are already advisable in the mid-year budget revision** . Based on our macroeconomic assumptions, the 2022 budget adopted in February would translate into a fiscal deficit of about 3 percent of GDP on a cash basis, roughly equivalent to last year's deficit. This policy stance strikes a reasonable balance between supporting the recovery in face of headwinds from the war in Ukraine and not fueling inflation pressures further. The planned mid-year budget revision will need to be approached flexibly, as new needs and priorities may emerge, and risks may materialize. These may warrant reprioritization and, possibly, a looser fiscal stance than currently planned, which the low public debt level would provide the space for. Overall, we already see scope to review the composition of spending in the following ways.

· The reorientation of the current budget toward more public investment is welcome, but the magnitude of the planned increase from last year may run against absorption capacity. New projects may need to be phased in more gradually.

· Conversely, the nominal freeze in wages that is embedded in the current budget may no longer be desirable with inflation running high. More broadly, wage policy should be informed by a comprehensive review of public wages and employment.

· The budget revision should account for new needs emerging from the war in Ukraine, for instance regarding food security and providing crucial support to refugees. Moreover, to plan for unforeseen spending, the revised budget will also need to increase its contingency reserve.

· Electricity subsidies to companies and temporary retail energy price caps have helped cushion the impact of high prices. However, the support could be adjusted by gradually shifting these existing mechanisms to direct support to households who need it. While this would preserve energy affordability, it would be fairer, help reduce fiscal costs, and encourage energy efficiency.

· At this stage of the recovery, and with labor shortages reappearing in some sectors, we support phasing out the "60/40" job retention scheme, which played a key role during the covid crisis but appears no longer needed.

· Pension increases and ad-hoc supplementary pension payments have helped support the income of pensioners during the pandemic, but their cost is further weighing on a pension system already structurally in deficit. A holistic review of the pension system would help design reforms that target both its sustainability and an adequate level of pensions.

Expanding fiscal space to foster higher and more inclusive growth

4. **Planning medium-term fiscal consolidation is warranted and should be accompanied by revenue and expenditure-management reforms** . Fiscal prudence is advisable in view of an ageing and shrinking population, the currency board arrangement, and the need for preserving buffers in light of the uncertain external environment. Room to address long-

term social and investment needs could be significantly increased by:

- *Reviewing the tax system to increase revenue and redistribution* . A reform of the low flat personal income tax rate could help create fiscal space and reduce inequalities. Also, the temporary reduction in VAT rates on selected items introduced as COVID-support measure should be discontinued as it is untargeted and regressive.
- *Increasing the efficiency of public spending to enhance human capital and foster more inclusive growth.* Improving public investment management and governance would free resources to finance maintenance, develop infrastructure, help increase the absorption of external funds, and reduce vulnerabilities to corruption. Reviewing the level, targeting and composition of social spending could help reduce income inequality and move toward more equality of opportunity. Increasing the efficiency of education spending would help harness its potential to reduce inequalities, while reforms to improve public health services delivery are also needed.

Maintaining vigilance for financial sector risks

5. **Financial sector supervision should watch for a possible increase in credit risk and other spillovers from the war in Ukraine** . During the pandemic, adjustments to financial sector policies helped support credit flows and borrowers' liquidity. The banking sector has remained well capitalized, liquid, and profitable. Credit to households is now growing at a rapid pace, led by housing mortgage lending, while credit to corporates remains subdued. The BNB has appropriately lifted COVID-related macroprudential measures and announced gradual increases in the countercyclical capital buffers. Supervisors should continue to ensure that banks closely monitor asset quality for possible deterioration and proactively resolve NPLs, as credit risks may rise because of the impact of surging commodity prices on corporates, rising interest rates, the lagged impact of withdrawing COVID-related support, or emerging imbalances in the housing markets.

Accelerating structural reforms

6. **The government's focus on improving governance and addressing corruption is essential and welcome.** Indeed, improving the effectiveness of the judiciary and judicial independence and accountability, together with strengthening the anticorruption legal framework, can play an important role in raising ethical standards, strengthening the rule of law, and promoting a more inclusive growth. Reforms in this area should be accompanied by measures to improve public investment management and spending efficiency. Continued efforts to strengthen the anti-money laundering and combating the financing of terrorism framework will also help reduce corruption and financial integrity risks. Furthermore, reforms to continue aligning governance and oversight of state-owned enterprises with OECD guidelines, in line with the law on public enterprises adopted in 2019, are welcome. To ensure transparency and accountability, ex-post audits of pandemic-related spending should be carried out and related beneficial ownership information published.

7. **Efforts to harness digital technologies and foster innovation can help raise economic potential** . Bridging digital skill gaps, investing in digital infrastructure, and promoting an ecosystem of digital start-ups are key priorities to improve the integration of digital technologies in firms' business models and raise productivity. Ongoing reforms in these areas, as well as plans to foster a more innovative economy, including through closer links between academia and enterprises, are welcome.

8. **Energy policy needs to balance near- and medium-term needs** . Climate mitigation is an important policy agenda for Bulgaria as its greenhouse gas emissions are higher than in other EU countries when compared to the size of the economy, despite recent progress. Since the war in Ukraine, ensuring energy security through alternative supplies to minimize economic disruption has become an immediate priority. Bulgaria's decarbonization strategy aims to gradually reduce the role of coal, increase the use of renewable energy sources, and improve energy efficiency of buildings and the transport sector. Investment plans in renewables and energy efficiency are welcome and should be accelerated to the extent possible, as these will help simultaneously improve energy security and reduce greenhouse gas emissions. Once energy prices recede, maintaining incentives for energy saving, investment in renewables, and reduction in the role of coal through price-based mechanism and fiscal tools will be important to support the green transition.

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