CONCLUDING STATEMENT

Bulgaria: Staff Concluding Statement of the 2020 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC – November 10, 2020. An International Monetary Fund (IMF) mission conducted remotely the 2020 Article IV consultations with Bulgarian authorities from October 26 to November 9, 2020. These discussions supplemented the discussions held in Sofia in February 2020. At the end of discussion, the mission issued the following statement:

Facing a resurgence in coronavirus infections and highly uncertain prospects, policy makers should stay nimble and resolute. Coupled with adequate health measures, policies should continue to support firms and individuals to maintain their activities and thereby limit the long-term scarring effect of the crisis. If the pandemic worsens more than expected, policy support should promptly be scaled up, taking advantage of Bulgaria's substantial fiscal space. Once the pandemic wanes, policies should progressively shift to facilitating recovery, transformation, and inclusive growth. To that effect, it will be of great importance to make effective and efficient use of EU transfers, which are expected to become quite large.

Bulgaria has faced the pandemic-induced economic crisis with ample policy buffers and credibility. Policies have appropriately aimed at supporting the health system, individuals, and firms, while preserving financial sector stability. They have cushioned the impact of the crisis and thereby also limited its long-term scarring effect, by avoiding destruction of economic activities that will again see high demand once the pandemic is over. All the while, Bulgaria took another step forward in its integration with European Union partners, by joining ERM II and the banking union.

But the fight for people's lives and livelihoods is far from over. Amid an alarming resurgence in infections, containment measures are being tightened in Bulgaria and across Europe. We now project the Bulgarian economy to contract more than in the October 2020 WEO forecast. We expect unemployment to rise but, thanks to strong policy support, not very sharply. The fiscal deficit is projected to be somewhat smaller than budgeted, in part reflecting robust revenue performance, and the current account balance should remain in surplus.

Given the very uncertain prospects, policies should be flexible and adjust nimbly to changing circumstances. If the second wave in Bulgaria and Europe were to result in widespread lockdowns and stricter social distancing, Bulgaria should rapidly augment health spending and the support for individuals and firms, preferably using temporary and well-targeted measures. The country has the fiscal space to do so. When the pandemic abates and recovery takes hold, policy focus should shift progressively from preserving activities and jobs to facilitating strong, inclusive, and environmentally-friendly growth.

Fiscal policies to remain supportive into 2021

The draft 2021 budget extends most anti-pandemic measures and introduces new fiscal initiatives that will support activity. The fiscal deficit is budgeted to reach 4.4 and 3.9 percent of GDP in 2020 and 2021, respectively, incorporating a similar level of discretionary anti-pandemic measures (about 2.5 percent of GDP each year). We welcome the broadly steady fiscal support and sizable increases in some social spending (pension and unemployment benefit) in 2021. Permanent increases in pensions and public wages provide additional demand stimulus that would, for now, help respond to the crisis.

Once recovery is entrenched, the fiscal framework needs to be steered closer to the medium-term objective, preferably with measures to further strengthen revenue mobilization. The draft 2021 budget and Medium-Term Budget Framework (MTBF) contain several permanent spending initiatives, which will require matching revenue measures (e.g., pensions) or an expenditure review (e.g., public wage increases). These should seek to bring the fiscal balance from the MTBF's 2023 deficit of 1.8 percent of GDP to the medium-term objective of a structural deficit of 1 percent of GDP.

All the while, public spending to foster inclusive and transformative growth needs to be maintained or increased. In this regard, the large expected EU transfers, notably through the Next Generation EU (NGEU) funds, provide a unique opportunity to finance the recovery and transformation toward a greener and more digitalized economy over several years starting in 2021. Because the NGEU grants need to be used quickly and are large, it is crucial to develop an investment plan early and follow through with strong implementation.

Policies should be flexible

The implementation of support policies can be improved upon. Efforts have already been made to remove administrative bottlenecks and relax eligibility criteria that limited access by some firms or workers. The delivery can be enhanced by further relaxing some eligibility criteria or simplifying them to facilitate applications, streamline the administrative review, and improve access by small firms and those without a full-time employment contract.

Policy measures should also evolve with the phase of crisis and recovery. As the pandemic wanes and recovery takes hold, the "60/40" wage subsidy scheme can gradually become more targeted at upholding viable (rather than all eligible) jobs. Greater support to reduce inefficient bankruptcies could be provided by better covering possible liquidity and equity shortfalls of viable firms. Strong incentives will need to be put in place to encourage firms with solid pandemic-proof business plans to take advantage of policy support, while discouraging the uptake by firms that are on a structural path to failure or those that could manage on their own.

Supervisory balancing act should continue

Financial sector policies should continue shoring up financial stability, while supporting banks' capacity to extend credit. Since the onset of the crisis, supervisors have supported continued credit growth by cancelling the planned increase in capital buffers and helped strengthen banks' balance sheets by requiring the capitalization of profits and a reduction of risk exposures. Banks have so far maintained strong balance sheets and credit growth has continued albeit at a declining pace. Bank supervisors should continue requiring banks to retain profits and should maintain a flexible approach, including by allowing banks room to manage the possible deterioration of loan quality without unduly constraining credit flows. In the event of a more severe downturn than expected leading to pressure on banks' capital position, supervisors could reduce the existing counter-cyclical capital buffer and/or allow banks to temporarily operate below the required capital buffers.

Supervisors should ensure that banks are equipped to address the expected deterioration of asset quality, especially after the pandemic. As Bulgaria joined the banking union, bank supervision is now aligned with the ECB. Non-performing loans (NPLs), which remained higher than the EU average before the crisis, are expected to rise further as loan moratoria started expiring and the economic downturn becomes more prolonged. Supervisors should ensure banks' timely recognition of problem assets and will later need to renew efforts to address NPLs. Effective implementation of the new corporate insolvency framework as part of the post-ERM II commitment could help with the management of NPLs.

Structural priorities

Policies should help meet structural challenges that pre-date or newly arose with the pandemic. Greater emphasis needs to be placed on addressing Bulgaria's income inequality and poverty, which were already high before the crisis. Although higher social spending planned for 2021 could provide a welcome reprieve, a review of the social protection system is needed. There is scope to broaden the social risks covered by the system, improve the targeting of social allowances, and improve the redistributive role of the state. Reforming the social protection system would strengthen the resilience of the economy and society.

Strengthening active labor market policies and access to quality education will promote faster and more inclusive income convergence to Bulgaria's richer EU partners. To that effect, spending on active labor market policies could be increased and directed more toward training programs that address several long-standing challenges, such as skill mismatch, digital skill gaps, and long-term unemployment. The labor market can also be improved with better public employment services. Furthermore, there is room to increase the public spending on education, which remains low among EU countries.

Progress in governance areas should continue. Strong implementation should follow the recent SOE governance reforms, including for ownership policy, financial oversight and board qualification. The judiciary and the fight against corruption should continue to be strengthened, including via the recently established EU's rule of law framework. Transparency of emergency spending would be enhanced by undertaking and publishing an ex-post assessment of anti-crisis policies and their expenditure.

The mission would like to thank the authorities and other counterparts for the frank and constructive dialogue.