



Bulgaria: Staff Concluding Statement of the 2017 Article IV Mission

December 14, 2017

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](#) 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.

A strong economic recovery has taken hold as Bulgaria is poised to take over the EU presidency. The challenge facing policymakers is to translate this recovery into durable and inclusive convergence of people's incomes toward levels prevailing in the richer EU partners. This will require continued action on many fronts, notably increasing the efficiency of public institutions at all levels; remedying weaknesses in education, healthcare, and labor markets; and further strengthening the financial stability framework. Progress on all these fronts will ultimately help deliver the better, more rules-based governance toward which many in government and society have been working tirelessly in collaboration with EU partners and institutions.

Strong economic growth

1. The economy is performing well. Real GDP growth has been on an upward trend for five consecutive years, reaching 3.9 percent in 2016 and we project broadly similar growth for 2017 and 2018. The current account is in large surplus, helped by a competitive external sector, and external debt has been brought down sharply. Fiscal policy has been conservative. And the currency board has delivered price stability. But there still is a long way to go in terms of income catch up with EU levels. And while growth could be even stronger in the short term than we project, there are many downside risks, including from global financial market volatility or geopolitical events.

Good fiscal policy

2. The government's fiscal strategy, laid out in the 2018 budget and medium-term budget framework, is broadly appropriate. The real GDP growth projections appear realistic for the near term and ambitious for the medium term. However, the revenue projections are suitably prudent throughout. By targeting a 1 percent of GDP deficit for 2018, policy may be mildly procyclical, but this adequately considers the need to catch up on public investment. If revenues exceed projections, these could usefully be saved to avoid adding excessive fiscal stimulus. The objective of returning to a balanced budget by 2020 is adequate, both on account of cyclical considerations and the need to preserve buffers consistent with the currency board arrangement (CBA). Population aging-related fiscal challenges deserve continued attention.

Improving government

3. Rules-based governance and more efficient government are key to support sustained and inclusive income convergence. This will require a better use of public expenditure, improved management of state-owned enterprises (SOEs) including the Bulgarian Development Bank, and an even stronger financial stability framework. The underlying supervisory policies and practices need to foster a market-based allocation of savings that contributes to stronger and sustained growth, while also serving as a line of defense against corrupt business practices.

4. Bulgaria's public goods need improvement. Public infrastructure is seen to be lagging in terms of quality, which calls for enhancing the impact of domestically and EU-funded spending on investment. Healthcare is expensive, given the outcomes it produces. Education appears underfunded if the objective is to raise outcomes to levels achieved in EU partners. On the revenue side, there is room to improve VAT collection, raise property taxes, and reduce undeclared work. The following measures, largely aimed at formulating accurate diagnostics, could be considered:

- Design targeted policies to reduce the VAT gap.
- Conduct a public investment management assessment.
- Expand the scope of ongoing expenditure reviews.
- Undertake a functional review of public sector employment and wages.

5. Improved access to better education and training are essential to address Bulgaria's complex structural challenges, including the deepening shortage of skilled labor. The recent measures, targeting performance-based funding for higher education as well as the launch of pilot programs to improve vocational training in partnership with the business community, are welcome. The same holds for the plans to appreciably raise teachers' low salaries to attract young, bright recruits and to better follow up on early school leavers. It would be important to link part of the pay increases to performance and to adapt their implementation

reflecting the findings of a functional review. Also, additional efforts are needed to reach vulnerable groups.

6. There is a need to address significant deficiencies in the public healthcare system. In the near term, public hospitals in a difficult financial situation need to be restructured to ensure service continuity. Significant efficiency gains could be achieved through better control of the distribution of pharmaceutical drugs and of the contracts between the National Health Insurance Fund and private providers. On a structural basis, the development of the national health map to identify medical needs should be used to alleviate the territorial imbalances in access to medical attention and the excessive reliance on hospitals as opposed to primary and preventive care. Measures will also be needed to address the lack of specialists and replace aging medical personnel.

7. Providing better public goods entails also improving the performance of SOEs. More transparency about their financial performance is a first step in this regard. Several SOEs, notably in the energy and transport sectors, have significant debt. The government's recent decision to start including SOE contingent liabilities in the budget documentation is a welcome step to increase transparency. Still, management and oversight of SOEs should be strengthened. To that effect, the policy and oversight functions could usefully be separated and the supervisory boards of SOEs be carefully staffed, while demanding greater accountability.

A sound judiciary is the most important public good

8. We welcome the broad commitment to further improve the functioning of the judiciary. Important measures have been put in place lately, including to enhance the independence and operation of the Supreme Judicial Council (SJC). It is well understood that more progress is needed and we note that efforts are underway to improve the performance of the SJC, to strengthen the effectiveness and accountability of the Prosecutor's Office, and to step up the fight against corruption. The experience of Eastern Europe suggests that the reform of the judiciary can be helped along with a more even distribution of opportunities and resources across society and with increased transparency and accountability.¹ The efforts underway and the measures we are recommending to improve the efficiency of government and strengthen the financial sector should support further progress in this critical area.

A stronger financial sector

9. Prudent supervisory policies have resulted in high system capital ratios that are comfortably above the regulatory minimums, and earnings and liquidity are also strong.

¹ [“Reforming the Judiciary: Learning from the Experience of Central, Eastern and Southeastern Europe”](#) in *Regional Economic Outlook: Europe Hitting Its Stride*, IMF, November 2017.

However, non-performing loans (NPLs) remain elevated at more than double the EU average. In line with the Financial System Assessment Program (FSAP) recommendations², several legislative initiatives have been taken, while other steps are in preparation, including implementation.

- *Governance of the Bulgarian National Bank (BNB)*. The recent amendment of the Law on Credit Institutions (LCI) has accelerated governance reforms at the BNB by vesting decision making authority at the level of the Governing Council. This welcome broadening of the accountability to the Council, from the deputy governors overseeing banking and payments supervision, should strengthen the central bank's institutional framework. The BNB needs to quickly put in place procedures for a smooth transition to the new governance model, and ensure that the new collective process does not hamper decision-making. We appreciate that this is a major task.
- *Addressing NPLs*. Renewed efforts are underway in Europe to tackle NPL problems. In this context, we welcome the BNB supervision department's draft prudential guidance on NPLs that was recently circulated for industry comments, as it incorporates relevant supervisory metrics for credit loss provisioning, NPL accounting write-offs, and collateral valuation. The draft guidance appropriately addresses the legacy NPL stock as well as loans that fall into default in the future. This approach takes account of important local characteristics that include banks' high capital and profitability, and credit conditions favorable to advance the adjustments. Importantly, NPL reduction should also require incentivizing banks and debtors to engage in restructuring discussions, further developing the NPL market, and improving the judiciary procedures for debt resolution.
- *Regulation and supervision*. In line with the FSAP's recommendations, the amendments to the LCI also strengthened the definition of related-party exposures and tightened the control over related party exposures to align with EU legislation and country-specific circumstances. It is now important to complete the regulations and supervisory processes/guidance. In addition, based on 2017 and forthcoming inspections, the BNB should enforce remedies to address concentration and related party risks.
- *Financial safety net and crisis management arrangements*. The resolution regime for credit institutions and investment firms needs to be fully operationalized. The Public Finance Act has been amended to support the safety net requirements. The legislative changes set down a credible legal foundation to enable transition from early intervention into resolution, though considerable efforts will still be required procedurally to ensure consistency with EU state aid rules and with the currency board arrangement.

10. The 2016 asset quality review (AQR) and stress test showed that the banking system overall is resilient. However, two domestically-owned banks require larger capital buffers and credible new investment should be finalized promptly. The BNB needs to adopt a

² [Bulgaria, Financial System Stability Assessment, IMF, 2017.](#)

comprehensive supervisory strategy to monitor and ensure the banks' viability over the medium term.

11. The authorities have also made welcome legislative progress with regard to the nonbank financial sector in line with FSAP recommendations. The amended Financial Supervision Commission (FSC) Act improves the independence of the FSC. The amended Social Insurance Code broadens the definition of related parties.

Integrating further into the European Union

12. EU membership has come with many benefits and has been a great catalyst of reform. Bulgaria now stands on the cusp of taking over the EU presidency. The challenges facing the EU are significant and we wish the Bulgarian government every success in helping address them during the country's presidency. We also note that Bulgaria is contemplating joining ERM II with a view to ultimately fulfilling the country's commitment to join the euro area. Membership in the euro area, including the banking union, will provide for a greater role of Bulgaria in the EU's decision-making bodies and more responsibility for the success of the currency union. The reforms we propose should support a successful participation.

An IMF mission, led by Jörg Decressin and Jaewoo Lee, visited Sofia during December 5-14 to conduct the 2017 Article IV consultation discussions. The mission would like to thank the authorities and other interlocutors for the constructive dialogue and kind hospitality.