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Minutes of Executive Board Meeting 19/19-1

10:00 a.m., March 20, 2019

1. Bulgaria—2019 Article IV Consultation

Documents: SM/19/47 SM/19/48; and Correction 1; and Supplement 1; and Supplement 2

Staff: Lee, EUR; Sun, SPR

Length: 36 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A. Abdullahi (AE), Temporary
	H. Razafindramanana (AF)
	D. Vogel (AG), Temporary
	J. Shin (AP), Temporary
	M. Coronel (BR), Temporary
	Z. Huang (CC), Temporary
	J. Montero (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
H. de Villeroché (FF)	
	K. Merk (GR)
	M. Siriwardana (IN)
	M. Psalidopoulos (IT)
	Y. Saito (JA)
	K. Badsi (MD), Temporary
	D. Fadhel (MI), Temporary
	R. Doornbosch (NE)
T. Ostros (NO)	
	A. Tolstikov (RU), Temporary
	F. Rawah (SA), Temporary
	K.Tan (ST)
	P. Trabinski (SZ)
	O. Haydon (UK), Temporary
	A. Grohovsky (US), Temporary

H. Al-Atrash, Acting Secretary
P. Cirillo, Summing Up Officer
E. Mannefred, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
European Central Bank: A. Meyler, R. Rueffer. European Department: J. Decressin, A. Hajdenberg, J. Lee, N. Suphaphiphat, Y. Wu. Fiscal Affairs Department: H. Miyamoto, V. Perry. Finance Department: J. Hallaert. Legal Department: I. Luca. Middle East and Central Asia Department: A. Sadikov. Strategy, Policy, and Review Department: Y. Sun. World Bank Group: A. Kucey.

Alternate Executive Director: P. Sun (CC). Senior Advisors to Executive Directors: M.Gilliot (FF), T. Ozaki (JA), O. Stradal (EC). Advisors to Executive Directors: M. Bernatavicius (NO), S. David (AP), P. Mooney (CO), E. Ondo Bile (AF), B. Parkanyi (NE), A. Urbanowska (SZ).

1. BULGARIA—2019 ARTICLE IV CONSULTATION

Mr. Doornbosch and Mr. Manchev submitted the following statement:

My Bulgarian authorities thank Mr. Lee and his team for the report and constructive policy discussions during the Article IV mission. They welcome the well-balanced appraisals, the elaborations in the Selected Issues Papers on the policy challenges, and strong encouragement to continue economic adjustments to the slowing external demand.

Bulgaria's immediate priority is to simultaneously join the European Exchange Rate Mechanism II (ERM II) with the existing currency board arrangement (CBA), at the current fixed rate of the Bulgarian lev against the euro, and establish a close cooperation between the Bulgarian National Bank (BNB) and the European Central Bank (ECB). These are important and timely steps for the country to enhance economic and financial convergence toward the euro adoption. In line with this, the authorities take the necessary steps to further strengthen the financial sector supervision and macroprudential policy framework and advance the cooperation with the European Structural Reform Support Service to close gaps in the insolvency framework, the governance of the state-owned enterprises (SOEs), and strengthening the Anti-Money Laundering Framework. They are committed to further boost competitiveness and growth potential by strengthening the public finance management, accelerating the EU funds utilization and efficiency of the public capital spending, and improving the business environment and oversight of the SOEs.

The authorities consent to the publication of the Staff Report and Selected Issues papers and will take the staff comments into consideration during the design and implementation of future reforms aimed at addressing the challenges to the economy. Encouraged by staff's acknowledgement of the Bulgarian solid macroeconomic policies and robust economic performance, we will focus our remarks on the following issues: (1) recent developments and outlook (2) fiscal stability and sustainability, (3) structural reforms to strengthen economic potential, and (4) the way forward to enhance financial stability.

Recent Economic Developments and Outlook

The Bulgarian economy continues to demonstrate resilience to multiple shocks. Despite growing geopolitical uncertainty and moderation of the current EU economic cycle, GDP growth remains robust and has accelerated to 3 percent y-o-y in Q4/2018, up from 2.7 percent y-o-y in the

previous quarter. Growth acceleration was mainly supported by investment and export, while final consumption eased to 3.4 percent y-o-y pressured by the base effect. In early 2019, the HICP inflation went down and stabilized (2.4 percent in February), after the slight acceleration observed last summer.

The authorities call for a cautious interpretation of the overall assessment that Bulgaria's external position is stronger than fundamentals suggest. In principle, the Bulgarian current account surplus of recent years cannot be easily explained by policy distortions or the EBA-lite model, as well demonstrated in Annex I of the Staff Report. The authorities encourage further methodological work by the IMF on the EBA-lite model to address the large residual, overestimation of the natural disasters and conflicts impact, and improve model specifications to better reflect the country specifics. From their side, the authorities work in close cooperation with the international partners to further strengthen the data quality and timelines and guarantee reliable BOP statistics in line with the IMF Special Data Dissemination Standard Plus.

Fiscal Stability and Sustainability

The authorities will continue their conservative fiscal strategy, compliant with the European Stability and Growth Pact. In 2018 the authorities progressed with the fiscal consolidation at a slightly faster pace than initially anticipated thanks to higher economic growth, further strengthening of the revenue mobilization, and under-execution of capital spending. Consistent with its principal policy strategy, the government used most of the revenue overperformance to strengthen fiscal buffers and contain the cyclicality of private demand. In line with the goal to ensure a structurally balanced budget by 2020-21, the 2019 budget has been carefully crafted to guarantee higher capital expenditures consistent with the projected increase in EU funds absorption, as well as sufficient financing needed for the ongoing reforms of the education, health and defense sectors. The tax policy remained broadly unchanged in line with the authorities' long-standing commitment to maintain a predictable and low tax environment.

Bulgaria has a sound track record of more than 20 years of maintaining fiscal stability and sustainability. It includes building up liquidity buffers in good times and containing excessive debt accumulation during downturns. As a result, budget surpluses have been recorded in almost half of the period and public debt (20.5 percent to GDP at the end of 2018) is among the lowest in the EU. Without deviating from their concept of a broadly balanced budget in the medium-term, the authorities adhere to the Fund's advice on risks in the current juncture and stand ready to set automatic stabilizers in motion. Given

the long-term challenges to the pension system, the social security contribution rate was increased by an additional percentage point at the beginning of 2018. In the near-term, the authorities do not plan additional changes to the pension reform package, which has been steadily implemented since 2015 to allow for a proper assessment of the outcomes and build consensus on future policies.

While strictly observing the hard budget constraints, the authorities make steadfast progress with the fiscal structural reforms. Last year, supported by IMF Technical Assistance (TA), they started developing a framework to improve public investment management aimed at increasing the efficiency of capital spending, thus enhancing the productivity of public investment. The IMF TA also supported the Bulgarian National Revenue Agency to improve the tax gap assessment process and tax compliance and collection. The authorities will continue this collaboration to strengthen the revenue administration. Building on the earlier TA from the Fund on management of SOEs, the authorities and OECD currently implement a project to fully align the Bulgarian legislation with the best international practices. The next steps in the public education and health care reforms have been implemented in line with the authorities' plan to preserve fiscal sustainability of the sectors, while narrowing the existing negative public wage premiums and improving the quality of services.

Structural Reforms and Growth Potential

Bulgaria has progressed with the key structural reforms. The 2018 European Commission Report[1] on progress in Bulgaria under the Cooperation and Verification Mechanism (CVM) acknowledged this progress through closing the monitoring on three out of six areas under the mechanism: judicial independence, legislative framework and organized crime. The Commission also expressed[2] its firm confidence that Bulgaria will be able to fulfil all the remaining recommendations and meet the outstanding benchmarks before the end of this Commission's mandate in November 2019, thus concluding the CVM process for Bulgaria by that date. In line with earlier Fund recommendations, the 2018 amendments to the Public Procurement Act significantly streamlined the procurement process without sacrificing transparency. The government has already established an electronic public procurement system, for which user trials are currently conducted. The new system should be available for general use by the beginning of the second half

[1] https://ec.europa.eu/info/files/progress-report-bulgaria-2018-com-2018-850_en
[2] http://europa.eu/rapid/press-release_IP-18-6364_en.htm

of 2019 at the latest. Further progress has been made to address air pollution in the big cities through expansion of environment-friendly transport.

The authorities agree with Fund staff that Bulgaria's growth potential should be strengthened. As discussed in the staff report, many policies are in operation to address unfavorable demographic prospects, emigration and to close the structural and income gaps vis-à-vis the EU average. The government has also made decisive efforts to increase public awareness in the needed structural and institutional reforms, aiming to consolidate public confidence and accelerate the reform process. Staff correctly noted "the apparent dissonance between governance reform efforts and public perception could reflect several factors" [3]. In any case it takes a long time for perceptions to change in response to ongoing reforms. They will only gradually adjust to the changing realities.

Financial Stability

The Bulgarian banking sector is resilient, and institutions continue to build capital buffers. In the low-for-long global interest rate environment, banks' profitability, liquidity and capitalization have further improved since the last Article IV Consultation. The BNB has adopted a comprehensive Supervisory Review and Evaluation Process Manual (SREB), including an explicit and detailed supervisory Pillar 2 capital requirement. Supported by the BNB, the process of market-driven changes in banks' ownership structure and consolidation has continued, and four acquisition deals have been completed since 2017. Credit growth has further strengthened, driven by the low interest rates, the high credit demand and the overall economic and employment recovery. Potential spillover risks for the Bulgarian banking system remain well contained thanks to the stable domestic deposit funding and low reliance on both domestic and international wholesale financial markets.

The BNB's prospect to enter a regime of "close cooperation" with the ECB leads to a steady adoption of the procedures and methodologies developed in the Single Supervisory Mechanism (SSM). To prepare for the application of a common decision process for most administrative acts under the SSM, the Bulgarian parliament adopted at the end of 2018 the necessary legislative amendments to pave the way for introduction of these procedures and methodologies. The BNB has started synchronising its supervisory practices with those of the ECB, including the IT systems and statistics. In

[3] Selected Issue Paper "Bulgaria's Governance Reforms", Paragraph 21, p.23.

parallel, the BNB supports the ECB's[4] asset quality review and the stress test of six Bulgarian banks, of which the results are expected to be announced in July.

The BNB has taken a similar approach to prepare for participation in the Single Resolution Mechanism (SRM) after entering a regime of "close cooperation" with the ECB. It is expected that the Bulgarian Parliament will adopt the necessary legal amendments by the end of this quarter. The BNB is currently working on the overall framework of determining the amount of funds to be contributed by banks to the Single Resolution Fund (SRF) and the amount and process of transferring funds from the Bank Resolution Fund in Bulgaria, which was set up in 2015, to the SRF. At the final stage, distribution of responsibilities and tasks between the Single Resolution Board and the BNB should be clarified to facilitate planning and conduction of the resolution activities.

Mr. de Villeroché submitted the following statement:

We thank staff for their informative papers in the context of Bulgaria's Article IV consultation and Mr. Doornbosch and Mr. Manchev for additional details in their buff statement.

Bulgaria is experiencing robust economic growth sustained by solid private consumption growth. Nevertheless, population ageing and skilled workers scarcity pose challenges. We agree with staff that the implementation of structural reforms should continue to raise potential growth, increase the quality of labor supply and mitigate the impact of unfavorable demographics. Further improvement in human capital and employment as well as in the efficiency of public spending and the quality of public institutions is also key to boost Bulgaria's income convergence. We therefore welcome the ongoing reforms of the Bulgarian authorities in the fields of education, judiciary, SOE governance, and banking and non-banking financial supervision. In this respect, preparation for ERM II and banking union will certainly contribute to maintaining the reform momentum.

Macroeconomic developments

Growth has been and is projected to be robust, with some moderation expected over the medium term. The 2018 slowdown was driven mostly by external factors such as weakening exports due to softer external demand from large trading partners. On the domestic side, wage increases continued to fuel

[4] https://www.bankingsupervision.europa.eu/press/pr/date/2018/html/ssm.pr181112.en.html

private consumption growth and the recovery in the use of EU investment funding provided a boost to investment growth. Domestic demand should lose some momentum in 2019 but will keep driving economic growth, the overall expansion remaining sustained by the recovery in goods exports and sustained wage increases both in the public and private sectors. While these are positive developments, income convergence process with other EU members has been slow, including compared to other most recent EU members. Bulgaria's per capita GDP remains to the lowest in the EU. We agree with staff that the risks are tilted to the downside, notably external risks including weaker-than-expected growth in the euro area, in the EU and in Turkey, trade tensions, uncertainty around the exit of the UK from the EU and global financial conditions tightening. Bulgaria is also facing a shortage of skilled labor, net emigration and slowing productivity growth.

Fiscal policies

The prudent budgetary policy allows shifting the focus on structural reforms that improve the quality of public services and enhance governance in the public sector. Bulgaria has over-achieved its medium-term objective (a structural deficit of 1 percent of GDP) in 2018 and is expected to continue to do so in the coming years. The debt-to-GDP ratio is low, and it is expected to further decline to below 20 percent of GDP. Against this background, we broadly share staff's recommendation to maintain prudent fiscal policy in view of growing ageing-related costs and that there is ample room to allow automatic stabilizers to work in case of negative economic shocks. Nevertheless, as staff, we see a need to better manage public expenditure, make revenue collection more efficient and improve the quality of public services, especially in social protection, health and education. Increased public investments, together with a much-improved governance in the public sector and increased absorption of EU funds would support potential growth and help to deal with an elevated emigration level.

Financial market policies

Banks' profitability and asset quality continue to improve, and the banking system overall appears to be adequately capitalized and liquid. We welcome the continued reduction in non-performing loans (NPLs) but their still high level remains a source of concern. Measures to facilitate the sale of NPLs as well as improvements in the insolvency framework would make banks less vulnerable to adverse developments in the future. The authorities should continue monitoring closely banks' governance and ownership structures. We acknowledge progress in dealing with the non-banking

financial sector, but important gaps still remain and challenges opened up in 2018 in the motor-insurance sector. We encourage the authorities to pursue their efforts in this regard, including to continue developing a risk-based supervisory process, valuation practices and group-level supervision.

We welcome the continued implementation of the 2017 FSAP recommendations that were given new impetus by preparations to join the ERM II and banking union. Following the request to establish close cooperation, the ECB is undertaking an asset quality review and a stress test of six Bulgarian banks, with results expected in July 2019. The ECB has also started discussions with the Bulgarian National Bank (BNB) about continuing to implement high supervisory standards and support supervisory convergence. While we acknowledge the progress achieved in relation to banking supervision (e.g. legislation for related-party lending, adoption of SREP methodology), it is important to maintain progress to adequately address the IMF FSAP recommendations (e.g. staffing, banking statistics) and ensure, inter alia, an adequate full implementation of the SREP methodology. Other measures to be completed include addressing valuation issues and strengthening the framework for resolving banks in an orderly way. We welcome recently establishing a legal basis for borrower-based macroprudential measures and the decision of the BNB to raise the countercyclical capital buffer from 0 to 0.5.

Structural policies

Sustained and broad-based reforms should continue to address the challenges of shrinking labor force and slowing productivity growth. Accelerating the convergence process of Bulgaria to the EU average warrants further reforms. Not only retaining but increasing the pool of skilled labor and attracting more capital by upgrading the infrastructure and improving the institutional framework are essential. We therefore share staff's recommendations on improving government efficiency, revamping the legal systems, upgrading infrastructure quality, increasing the quality of education and healthcare, and enhancing labor market policies. The sound implementation of new standards will also be critical to improving SOEs' performance and accountability, which would also help to contain fiscal risks related to contingent liabilities. Strengthening the link between businesses and research institutions and a better-integrated research and innovation system also appear key – especially in light of the findings of the Selected Issue Papers - to removing bottlenecks to productivity gains and boosting innovation capacity.

Continued efforts are needed to ensure effective implementation of the new anti-corruption framework adopted in January 2018. We take positive note of the progress achieved in the fight against corruption that was also acknowledged in the European Commission's November 2018 report under the Cooperation and Verification Mechanism and encourage the authorities to continue implementing the recommendations made under this mechanism. Efforts to improve the framework for investigating and prosecuting high-level corruption would need to continue for lasting results. The use of financial investigation and financial profiling is still limited, which prevents effective asset recovery in organized crime and corruption cases. A key challenge for the newly established unified anti-corruption agency will be to fulfill its broad mandate and building public trust.

Mr. Lopetegui and Mr. Vogel submitted the following statement:

We thank staff for the reports, and Mr. Doornbosch and Mr. Manchev for their helpful buff statement.

We welcome Bulgaria's economic performance this past year, and especially staff's forecast for 2019 which will take place amidst a substantial regional slowdown. Indeed, according to the upcoming WEO, Bulgaria is the only country in Emerging and Developing Europe that shows an increase (although very small) in projected growth in 2019 compared to the previous year. Nonetheless, the country faces significant challenges and risks. One of the main challenges is clearly presented in the staff report, that robust growth should be translated into sustainable and inclusive medium-term income convergence, given Bulgaria's low-income level and high inequality compared to EU countries. The entry to ERM II and the banking union would constitute a critical step for the country.

We are encouraged by the staff's assessment that the government's fiscal plan is broadly appropriate. We agree that considering Bulgaria's low level of debt relative to its GDP, the country would have ample space to react through automatic stabilizers in case of temporary domestic or external shocks. However, staff warns about contingent liabilities, making a sensible and timely recommendation regarding the establishment of a fiscal risk management unit to monitor SOE fiscal risks. More broadly, it appears that there is room to enhance the efficiency of government operations, including in infrastructure and public services like education and health.

Bulgaria's economic expansion has been accompanied by a substantial decrease in unemployment rates, falling from about 9 percent in 2015 to

almost half that figure in 2018. While this is a positive fact, at the same time it reflects a key concern for the country: emigration and its related labor shortage. Figures on the emigration rate by age are eloquent about the significant and increasing outflows of people between 15 and 44 years. The authorities' commitment to address this critical issue, through a multi-dimensional set of policies and reforms, is an initial step in the right direction.

Governance reforms constitute a key aspect for Bulgaria's further development. We thank staff for the comprehensive chapter on Bulgaria's governance reforms, which depicts the country's progress, for instance, in terms of fiscal transparency, but also its challenges, namely public perception of the control of corruption and judicial independence. We would support implementation of judicial reforms, and greater efforts to combat corruption. The staff report notes that "political uncertainty related to the elections could delay policy implementation". Related to this issue, we would like to have a further elaboration from staff on Bulgaria's political developments and outlook in this electoral year.

With these comments, we wish Bulgaria and its people every success in their future endeavors.

Mr. Ostros and Mr. Bernatavicius submitted the following statement:

We thank staff for their insightful reports and Mr. Doornbosch and Mr. Manchev for their informative buff statement. The preparation for the entry into ERM II and the banking union provides a good opportunity to proceed with much needed structural reforms in the areas of financial supervision, judicial independence, control of corruption, and improving the SOE governance. We urge the authorities to continue implementing policies to achieve faster income convergence, which remains a key policy challenge. We associate ourselves with Mr. de Villeroché's statement. We are in broad agreement with staff's appraisal and offer the following remarks for emphasis.

Despite robust economic growth in recent years, income gap vis-à-vis the EU average remains sizable. There is an urgent need to raise economic growth potential which requires better public goods provision in infrastructure, education, and healthcare. We welcome the recent progress made in reducing corruption and urge the authorities to ensure a continued implementation of recommendations provided under the Cooperation and Verification Mechanism.

The ERM II preparation process provides a welcome impetus for further enhancing the quality of institutions and strengthening the financial sector supervision. We welcome the progress achieved so far and call for a full implementation of all remaining commitments under the Action Plan for joining ERM-II.

Bulgaria's public debt remains among the lowest in the EU and is projected to decline further. Nevertheless, there is room for further improvement in the efficacy of public spending and better revenue administration, as the VAT gap remains large compared to peers. We also share staff's recommendation to maintain a prudent fiscal policy as long-term fiscal pressures from emigration and population aging remains substantial. Efforts to further strengthen the SOEs' governance and align the legal framework with OECD guidelines are crucial to contain fiscal risks related to contingent liabilities.

Despite record low unemployment rate and some recent moderation in the wage growth, challenges in the labor market remain substantial. The widespread labor shortages, skill mismatches, and low labor productivity growth calls for an urgent need to increase the quality of education and enhance the active labor market policies.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

The Bulgarian economy remains strong, with good growth, low unemployment, moderate inflation, and low public debt. However, structural reforms are needed to tackle medium and long-term challenges, including strengthening potential growth, narrowing the sizeable income gap with the EU, and tackling unfavorable demographics, while preparing for eventual euro membership. We generally concur with staff's analysis and recommendations and focus our comments on the following areas.

Corruption and Governance

We welcome the report's focus on corruption and governance issues, including the detailed Selected Issues paper on Bulgaria's governance reforms. We echo staff's statement that effective institutions are critical to promote economic growth and development. The authorities' efforts to improve fiscal transparency and judicial independence are commendable. However, further efforts are needed, including on reforms under the Cooperation and Verification Mechanism, tackling the shadow economy, and improving public perceptions. While the authorities believe that public

perceptions are a limited tool for judging good governance—and it takes a long time for perceptions to change in response to reforms—these perceptions often have a significant impact on economic activity. Improved communication around the reforms and strong and continued commitment to address issues should help improve perceptions and are therefore warranted.

SOEs and Contingent Liabilities

We also emphasize staff's call to improve SOE governance, in line with the OECD guidelines. This is an area of governance and corruption where considerable improvement is needed. In addition to governance, we welcome the report's highlighting of contingent liabilities from SOEs and the focus on containing fiscal risks. The authorities should follow staff's recommendation to create a fiscal risk management unit which, along with better general SOE governance, should help prevent the realization of these risks.

ERM II and Euro Membership

Finally, preparation for ERM II and euro adoption will require numerous further reforms, including in the financial sector and on structural issues to help ensure income convergence. While the authorities have made good progress on building resilience—in both the financial and fiscal sectors—flexibility and dynamism are also key to succeeding in a currency union. Could staff comment on a timeline for euro adoption, particularly if structural reforms and convergence take longer than expected, as well as what further FSAP recommendations should be prioritized?

Mr. Merk and Ms. Lucas submitted the following statement:

We thank staff for its insightful report and Mr. Doornbosch and Mr. Manchev for their helpful buff. We concur with the thrust of staff's assessment and the given policy recommendations. We associate ourselves with Mr. de Villeroché's statement and would like to add the following comments.

While we take note of Bulgaria's robust economic growth, including strong household consumption, we remain cautious in view of the downside risks to the economy. Political uncertainty related to the upcoming elections could delay important policy implementations. In addition, we take note that excessive wage growth could negatively affect export competitiveness.

Important structural impediments continue to weigh on the economy. In this context, improving the fight against corruption including reducing vulnerabilities to corruption in the financial system, judicial independence and the quality of institutions remains of the essence. We recognize that since the EU accession, Bulgaria has adopted meaningful reforms in this regard. Nonetheless, a dissonance between reform efforts and public perception persists. Overcoming the institutional obstacles would allow the more efficient use of available technologies and allocation of resources, hence contributing to productivity growth. Therefore, reforms need to be underpinned by a consistent implementation process. We thus agree with staff and call on the Bulgarian authorities to continue their on-going efforts to implement the reforms monitored by the European Commission under the Cooperation and Verification Mechanism to fight corruption and organised crime.

We echo staff's call to address weaknesses in the banking sector as identified by the AQR/stress test and the FSAP. Even though non-performing loans have declined, they are still high – well above the EU average. Non-financial corporate debt remains high as well. We also note the increased vulnerability of the Bulgarian financial sector to adverse shocks. We echo staff's call to address weaknesses in the banking sector as identified by the AQR/stress test and the FSAP. In addition, we take note that the Bulgarian authorities are concerned about the possibility of credit risk as a consequence of rising interest rates. In this context, we would appreciate staff's assessment to what extent a rise in interest rates could pose a potential source of credit risk to the Bulgarian economy and what would be advisable steps to increase financial resilience.

Regarding Bulgaria's ERM II application, we take positive note of the commitments that the authorities have made. A sustainable path towards macroeconomic convergence to the euro area member states remains of paramount importance. As outlined by staff, further steps await the results of the upcoming AQR and the stress test conducted by the ECB. We share staff's view that Bulgaria's preparation for ERM II and the banking union will facilitate reforms to strengthen the framework conditions for sustainable growth.

Finally, we take positive note of the (slight) fiscal surplus in 2018. At the same time, we would like to point out the outlook for a weakening fiscal position in 2019 and important longer-term fiscal risks. These emanate, inter alia, from liabilities from state-owned enterprises and from unfavorable demographic developments. We therefore support staff's call for improved efficiency of spending and revenue administration and welcome its

recommendation of technical assistance. In addition, we consider a reform of the pension system as necessary.

Last but not least, we encourage the authorities to consent to the publication of the staff report.

Mr. Tan and Ms. Rauqeuqe submitted the following statement:

We thank staff for the insightful set of reports and Messrs. Doornbosch and Manchev for their informative buff statement. Robust consumption and public investment have yielded strong growth and employment outcomes, despite weak productivity and remaining structural bottlenecks. In this context, the supportive macroeconomic environment, combined with ground work for entry into ERM II and the banking union, provide a valuable anchor for deepening structural reforms that are central to improving medium-term growth prospects and achieving income and institutional convergence with EU peers. As we share the thrust of staff's assessment, the following comments are made for emphasis.

A comprehensive structural reform agenda will help support public goods provision and medium-term growth prospects. We positively note the authorities' undertaking to align Bulgaria's SOE legislation to the OECD Corporate Governance guidelines, as part of ERM II commitments. This would be beneficial for effective SOE oversight and containing fiscal risks. The authorities' efforts in strengthening training in priority skills sectors and proposed tax relief for R&D activity are also welcome steps to enhance education quality and Bulgaria's attractiveness as an investment destination. Furthermore, there is scope to improve judicial independence and effectively enforce the anti-corruption framework. Together, these measures would strengthen Bulgaria's institutional and infrastructure quality. This is key to attracting FDI that would help diffuse much-needed productivity gains and stem the high emigration that has posed a drag on the country's growth potential.

The authorities' track record on fiscal discipline is commendable. Prudent public finance management has yielded one of the EU's lowest public debt levels. Increased expenditures on health and education, and strengthening public investment management are all supportive of growth. Nevertheless, improving the quality of public service and addressing the negative public wage premiums via a comprehensive functional review of public sector employment will further benefit public employment management and overall competitiveness. We see merit in deeper reforms to the pension system to

ensure its long-term sustainability, especially in light of demographic headwinds.

Durably addressing still-high NPLs will further enhance the resilience of the financial system. We acknowledge the decisive and comprehensive steps taken by the BNB to strengthen banking sector supervision, consistent with FSAP recommendations. In addition, delivering on ERM II commitments should bolster financial resilience further. With NPLs remaining above the EU average, further strengthening of the NPL market and insolvency framework is warranted, in addition to the authorities' SREB that seeks to augment capital buffers further.

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for an informative set of reports and Messrs. Doornbosch and Manchev for their insightful buff statement. The Bulgarian economy has shown excellent signs of resilience and stability over the last years. Joining the ERM II is a milestone that rewards these achievements and it well proves the authorities' commitment to a sound macroeconomic policy. Further progressing with structural reforms to buttress potential growth and strengthening governance is key going forward. We broadly agree with staff's recommendations and we associate ourselves with Mr. de Villeroché's statement, with the following additional comments.

The report rightly places particular emphasis on the structural challenges preventing a full convergence to EU living standards. We support staff's assessment that closing the gap with peers on education spending is warranted to expand access to educational opportunities and update workforce skills. Improving revenues forecasting –given the frequent episodes of overperformance- and the efficiency of tax administration may help to secure the required financing while maintaining sound public finance. In addition, public investment management needs to be strengthened at all the phases of the cycle to avoid the systematic underspending and narrowing the infrastructure gap. We would be interested in staff's opinion on the drivers of revenue overperformance and to what extent they reflect structural factors that can be incorporated in the baseline projections.

The results of the EBA analysis, although subject to considerable uncertainty, signals an external position stronger than fundamentals and desirable policies settings. While the slowing productivity growth represents a challenge to be addressed, the current upward trend in wage growth seems not having hurt so far export performance and should contribute to external

rebalancing, income convergence, and lower emigration rate. What are, in staff's views, the reasons for the large error and omissions in the BoP?

We welcome the analysis on governance reforms in the well-written SIP. The paper describes the progress achieved in strengthening legislation in several areas of concern, based on assessment by international bodies with a specific expertise. Moreover, the inherent limitations of the perception-based indicators are also duly reported. We concur with the authorities that the dissonance between the legal framework and the still very high public perception of corruption can be the result of the lags required for the reforms to make a dent in sedimented perceptions. Therefore, it is key to remain committed to an effective reform path, also with a view at fully reaping the benefits of future Euro membership through more sustained FDI inflows. In this regard, the continuous commitment to timely update the national AML/CFT framework is very welcome. However, an assessment against the 2012 FATF can provide a better understanding of the effectiveness of the AML/CFT regime in preventing financial crimes, including corruption. We would appreciate an update on the envisaged timing of the next assessment.

Mr. Benk and Mr. Stradal submitted the following statement:

We thank staff for their informative set of reports and Messrs. Doornbosch and Manchev for their helpful buff statement. Bulgaria's economic growth over the past several years has been impressive and despite downside risks, is projected to remain robust in the near term. However, income per capita is still only half of the EU average and income inequality remains high. The population ageing, outward migration, and sluggish productivity growth are formidable medium- and long-term headwinds putting a premium on structural reforms aimed at improving the quality of institutions, infrastructure, education and health care. The persistently large gap between compensation and productivity growth rates is also a major concern threatening the competitiveness in the future. We associate ourselves with Mr. de Villeroché's statement and offer the following comments.

Fiscal buffers are ample and have been further strengthened by the recent cyclical revenue outperformance. We welcome the authorities' commitment to prudent fiscal policy. We agree with staff that further pension reforms will be needed to ensure the system is sustainable in the longer term given the unfavorable demographic projections. The ongoing legislative reforms in cooperation with the OECD to align the state-owned enterprises (SOE) governance with best international practices is a welcome step in the right direction. We note that the contingent liabilities are concentrated in the

unprofitable SOEs. Restructuring and privatization of some of them should be considered.

We commend the Bulgarian National Bank for making steady progress in strengthening banking sector supervision. The recent multi-pronged initiative to upgrade the financial sector policy frameworks is welcome and will strongly benefit Bulgaria regardless of the ERM II accession. While the banks' profitability and asset quality continue to improve, the non-performing loans ratio remains well above the EU average. Its further reduction should be prioritized, including by improving the insolvency framework.

Structural reforms lie at the heart of the needed reform agenda. Despite the continued tightness in the labor market, emigration remains high and is heavily skewed towards younger cohorts of the productive age. We suspect the skew is also towards the better educated and more skilled. Is there any evidence of that? The list of the reforms is long and ranges from increasing the quality of education and healthcare to improving the business environment, as well as the public investment management. The agenda is mutually reinforcing but hinges on reforming the judiciary system, improving the public sector governance and fighting the corruption with the overarching goal of increasing the legal certainty and strengthening the rule of law. We welcome that progress is being made in the context of Cooperation and Verification Mechanism under the auspices of the European Commission.

Finally, we disagree with staff's claim in Box 1 that Bulgaria's accession to the ERM II sets a precedent for future candidates. Linking the entry into the ERM II with joining the banking union at the same time was a decision made by the Bulgarian authorities. Neither the voluntary commitments of an acceding member country nor a legally non-binding statement by a group of EU member states can expand the ERM II entry requirements set out in the EU laws.

Mr. Saito and Mr. Ozaki submitted the following statement:

We thank staff for the informative papers and Mr. Doornbosch and Mr. Manchev for their insightful statement. We welcome that the growth rate picked up since 2015, and economic performance remains robust. We note that inflation pressure has eased with both headline and core inflation moderating. Could staff share their view on the background of the moderating core inflation? We commend the low level of public debt and general government gross debt is projected to decline over the medium term, as fiscal consolidation and a favorable growth-interest rate differential will help reduce

general government debt. On the other hand, we observe that risks are tilted to downside and in particular, we carefully take note that external risks dominate the near-term outlook. As we broadly agree with the thrust of the staff's appraisal, we will limit our comments to the following points:

Entry into ERM II and the banking union

We acknowledge that the preparation for entry into ERM II and the banking union will be one of the key priorities of the government in 2019. Staff assess that the macroeconomic impact of joining ERM II could be minimal, while enhancing market confidence. Staff also indicated that the banking union membership would enhance the quality of institutions, including by strengthening financial sector supervision and the credibility of the overall policy framework. While we observe that staff assess the ERM II and banking union participation as positive, we are wondering there might be downside risks for Bulgaria when joining the euro in the future, especially during a transition period. Could staff elaborate more on the future risks when Bulgaria joins the euro area, and what kind of measures Bulgaria should take in order to mitigate the risks?

Labor market

Many policies are in operation to address skill mismatches and across-the-board labor shortages, but challenges remain. The unemployment rate has declined to a historical low of 4.7 percent, and labor shortage is widespread. However, nominal wage growth has moderated despite labor shortage. We would appreciate it if staff could elaborate more why the nominal wage growth has moderated, and how the wage of new employment affects the total picture. Focusing on public sector, the budget introduces a 10 percent increase in the wage bill. The government wage increase is to be performance-based and applies to all ministries, helping to narrow the negative public-wage premium that is likely to have widened from that estimated in 2013 (controlling for worker characteristics). In this regard, we concur with staff's recommendation about a comprehensive functional review of public sector employment and wages, which could further improve public employment management. The review also would help contain future inefficiency and avoid the legacy from putting pressure on future budget.

Fiscal Policy

We welcome that the authorities will continue their conservative fiscal strategy, compliant with the European Stability and Growth Pact, as the buff

statement mentioned. Having said that, we agree with staff's view that contingent liabilities from SOEs and unfavorable demographics pose long-term fiscal risks. As for SOEs, we have concern that several SOEs, notably in the energy and transport sectors, have significant debt. We encourage authorities to continue efforts to strengthen SOE governance. When it comes to unfavorable demographics, as the buff indicated, the social security contribution rate was increased by an additional percentage point at the beginning of 2018. However, in the near-term, the authorities do not plan additional changes to the pension reform package, which has been steadily implemented since 2015 to allow for a proper assessment of the outcomes and build consensus on future policies. Meanwhile, we also take note of staff's view that even after the 2015 reform, the social security system's annual deficit is projected to rise from 3.6 percent of GDP in 2018 to about 6 percent of GDP by 2050. Further pension-related reforms would eventually be needed to ensure long-term fiscal sustainability. We need to bear in mind that the cost of postponing adjustment can be substantial—benefiting current retirees and adversely affecting current workers and all future generations. We encourage the authorities to implement further reform swiftly once found to be necessary.

Mr. Sun and Mr. Huang submitted the following statement:

We thank staff for the set of papers and Mr. Doornbosch and Mr. Manchev for their informative buff statement. The Bulgarian economy has enjoyed a robust growth with historic low unemployment, stable inflation, and low level of public debt. Meanwhile, risks to the outlook are tilted to the downside. Going forward, the authorities are encouraged to address the remaining fiscal challenges, strengthen financial sector supervision, and maintain the momentum of the broad-based structural reforms. We broadly concur with staff's appraisal and would like to limit ourselves to the following comments.

Building on the conservative policies, more efforts are encouraged to address the long-term fiscal challenges. We commend the authorities' sound track record of more than 20 years of maintaining fiscal discipline. The low level of public debt provides adequate policy room against external shocks. We view the authorities' near-term fiscal plan broadly appropriate, as the budget deficit for 2019 reflects higher capital expenditure as well as higher education and health expenditures. Revenue mobilization is equally important and can be further improved. In this regard, we welcome the authorities' plan to combat tax fraud and evasions and to extend the Single National Strategy (SNS). Given the relatively large size of the shadow economy in Bulgaria, could staff comment on the reasons behind and the progress of the SNS in the

past years. Nevertheless, by accessing the capacity of revenue administration, a comprehensive strategy should be developed, supported by Fund technical assistance, to improve efficiency.

The authorities should continue to strengthen financial supervision, while preparing to join the European Exchange Rate Mechanism II (ERM II) and the banking union. These efforts can improve the overall policy framework and align the country's supervision and regulation with best international practices. We welcome the positive developments since the last consultation, including the formalization of the supervisory review and evaluation process, the improvement of the central bank's governance, and the setup of a risk-based supervisory system for insurance companies and pension funds. The rise of countercyclical capital buffers would further improve the resilience of the banking sector, but NPLs still warrant attention, as they are high compared to EU peers.

Sustained structural reforms are essential to raise growth potential and accelerate convergence towards the EU average. We welcome the authorities' efforts to strengthen governance. Effective institutions and good governance could help boost productivity growth, attract more investment, and discourage net emigrants. The forthcoming implementation of the OECD Guidelines on Corporate Governance of SOEs, as the ERM II application requires, will help improve SOEs' transparency and performance, mitigating fiscal risks from contingent liabilities. Improving the judicial independence and combating corruption are steps in the right direction and should continue, but caution is needed when drawing cross-country comparison for governance, as many third-party indicators are perception-based.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for the well-focused set of reports and Mr. Doornbosch and Mr. Manchev for their helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We share staff's view on the importance of continuing the implementation of broad-based structural reforms to strengthen growth potential and accelerate income convergence to EU levels. It is encouraging to

note that Bulgaria's economic performance remains robust and that the economy continues to demonstrate resilience amid challenges as noted in the buff statement. In particular, we take positive note that unemployment is at historical lows, output gap has closed, inflationary pressures have eased, and the public debt ratio is lower than the EU average and declining. However, risks are tilted to the downside, labor force is shrinking, while income gap continues to manifest, and income inequality is high compared to the EU average.

We echo staff's call for further improvement in revenue administration and spending efficiency and would like to underscore the importance of vigilance to contingent liabilities. Here, we welcome the important steps taken, underpinned by Fund TA, in improving tax compliance and collection and enhancing public investment management. We also agree that further public wage increase, on the back of negative public-wage premium, should be linked to performance. Notwithstanding the lower SOE debt to GDP ratio than the EU average, close monitoring is warranted going forward to avoid fiscal risks. On a separate note, steps taken to improve public procurement framework are also welcome.

Improving productivity growth and enhancing labor force participation are key priorities. In this context, we welcome the authorities' ongoing reforms to enhance the inclusion and modernization of the education system, address skill mismatches, in addition to improving the public health system. These efforts are indeed important as net emigration and population aging continue to pose challenges. Separately, we take positive note of the important progress made to improve judiciary independence and reduce corruption vulnerability. We also encourage the authorities to steadfastly implement the newly-adopted anti-corruption framework, with a view to ultimately improving governance and business environment.

Finally, we take positive note of steps taken to fulfill ERM II commitments and the continuous improvement in asset quality and in banking supervision. Here, the BNB's efforts to strengthen banking supervision, following the 2017 FSAP, and the steady decline in NPLs are welcome. However, NPLs remain high, compared to the EU average and therefore efforts to address this issue should be sustained.

With these remarks, we wish the authorities further success.

Mr. Gokarn and Mr. Siriwardana submitted the following statement:

We thank staff for the detailed reports and Mr. Doornbosch and Mr. Manchev for their informative buff statement.

Bulgaria's economic performance has been robust with the support of sound macroeconomic policies, while being resilient to multiple shocks. Growth remains high together with stable inflation, positive current account and fiscal balances, adequate reserves and low public debt. Unemployment also has declined gradually. We commend the authorities for their commitment to prudent macroeconomic and financial policies. However, the risks to the outlook has increased recently amid slowing external demand, while the economy faces several challenges, including low productivity, subdued investment, loss making SOEs, emigration, aging and governance issues, affecting the fiscal sustainability and long-run potential growth. Addressing these key challenges and achieving inclusive growth by reducing structural and income gaps remain as key policy challenges while taking efforts to enhance Bulgaria's economic and financial convergence toward the euro adoption. We broadly agree with the staff appraisal and wish to make the following comments for emphasis.

We concur with staff that fiscal policy remains conservative with strengthened buffers, but continued fiscal prudence is important to maintaining long-term fiscal stability and sustainability. Authorities have rightly used the over-performance on revenue to build-up buffers and the decision to maintain a balanced budget over the medium-term seems appropriate. We agree with the need for improving expenditure efficiency and provision of public goods, including health, education, social, and public investment, in ensuring long-term fiscal sustainability and enhancing growth, particularly given the unfavorable demographics. The room to improve revenue should also be used appropriately, as envisaged in the MTBF. Staff comments are welcome on the status of the income distribution and poverty in Bulgaria in the context of prioritizing fiscal policy measures. We note the progress of structural fiscal reforms and encourage the authorities to stay on course for further reforms with TA from the Fund.

The financial sector has strengthened due to strong efforts, which need continuation to improve resilience. Banks remain profitable with adequate liquidity. We commend the Bulgarian National Bank (BNB) for fully operationalizing its new governance model, taking measures to strengthen banking supervision and its support to the ECB's comprehensive assessment of the banking sector. We welcome the ongoing preparation for ERM II and

the banking union, which will improve the quality of institutions and credibility of the overall policy framework. Could staff comment on Bulgaria's commitments in terms of post ERM II policy measures and procedures? The ongoing process will be complemented with the synchronization of Bulgaria's supervisory practices with the ECB in the country's accession to the Single Supervisory Mechanism (SSM). The decline in the NPL has been continuing, but we encourage the authorities to continue their efforts to reduce NPLs further while monitoring the risks associated with loans and adopting NPL guidelines, given the gradual pick up of credit growth.

Structural reforms are imperative to address slowing productivity, increase the growth potential and achieve an inclusive growth. In this regard, we note the specific issues faced by Bulgaria, highlighted in the informative structural gap analysis in Box 2, which reveals significant structural gaps in institutions and governance, infrastructure quality, education and health, and labor market. We invite the authorities' specific attention to these areas, as they tend to hinder the productivity of the economy amidst declining working age population due to aging and emigration, and skill mismatches. We also note, with concern, the most rapidly aging teacher body in the EU and staff comments are welcome on intended additional measures to address this issue going forward.

We welcome the informative SIP on Bulgaria's Governance Reforms. The progress achieved in many aspects, including revenue outcomes and budget transparency, as well as the other broader areas (indicated in Table 1 of the SIP) are commendable. We encourage the authorities to continue the policy measures to address remaining issues, including SOE governance to mitigate fiscal risks, procurement, preventive measures under AML/CFT framework and perceived judicial independence. Related to this, we note staff's assessment that Bulgaria is perceived among the most laggard in the EU on control of corruption and judicial independence (¶20). Hence, we encourage the authorities to effectively implement the newly adopted anti-corruption framework with associated measures. We note staff's assessment that the public perception on many of these areas has changed very little. We agree with authorities that it takes a long time for perceptions to change in response to ongoing reforms, as indicated in the buff statement. Continued commitment to the intended policies is important so that in the long run, the expected objectives would be achieved.

With these remarks, we wish Bulgarian authorities every success in their future endeavors.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its set of reports and Messrs. Doornbosch and Manchev for their insightful buff statement. We broadly agree with staff's appraisal and associate ourselves with Mr. de Villeroché's statement. We would like to offer the following comments to emphasize some specific topics.

Bulgaria is experiencing a period of robust economic growth supported by strong private consumption on the back of solid job creation and wage gains, as well as prudent macroeconomic policies. Inflation remains moderate—anchored by a disciplined management of the currency board—the unemployment rate declined to historical lows, and labor shortages are becoming widespread. Moreover, the fiscal position remains healthy because of authorities stated preference for a balance or small surplus on government accounts, while the current account remained sizable over the last few years. Despite this positive landscape, characterized by a relative bias towards macroeconomic stability, Bulgaria's income level is still half of the EU average and income inequality is high among EU countries. It also shares long-term challenges related to demographics and low productivity growth with its regional peers.

Thus, as staff rightly points out, the authorities should shift their focus towards broad-based reforms to strengthen institutions and public goods provision, and to address labor market bottlenecks. In our view, the main binding constraint for sustained growth is the poor quality of certain institutions; namely, government inefficiencies, poor control of corruption and inadequate judicial independence and efficiency. In this regard, we take a positive note of the two-pronged strategy followed by the Bulgarian authorities, consisting of, on the one hand, stepping-up the preparation for entry into ERM II and the banking union, which will strengthen Bulgaria's policy framework and, thus, market confidence (as appropriately described in Box 1). On the other, they are working in parallel to thoroughly implement the reforms monitored under the Cooperation and Verification Mechanism in the areas of judicial reform and the fight against corruption and organized crime. On both counts, we acknowledge the authorities' strong commitment with the EU project.

The authorities' efforts to advance in the adoption of key legislative measures in the areas of governance and corruption are commendable. However, we call on authorities to put adequate efforts on steadfast

implementation of the newly adopted legislations, particularly in the areas of judicial reform and fight against corruption, which are crucial not only for the promotion of private sector-led growth and foreign investment, but for changing public perceptions as well.

Finally, we have reservations regarding staff's analysis on the risk from fast wage growth and believe that the appraisal in the Risk Assessment Matrix is based on a lopsided view on competitiveness. First, the level of Bulgarian wages is extremely low, at ½ of its regional peers and at 25 percent of the EU average. Thus, we see an excessive emphasis on this risk, even more so when the evolution of the HIPC-REER has been stable over the last 10 years, which means that domestic firms have been able to absorb increases in wages easily without affecting their external competitiveness—which depends not only on wage costs, but on price markups as well. This fact, along with the positive evolution of the current account and the NIIP, attests to the favorable overall competitiveness position of this economy. Could staff comment on the possibility that non-price-related competitiveness may also be behind this evolution? Second, we perceive a disconnect between staff's concern about inflationary risk from wage growth and its recommendations to stem the brain drain and bring back emigrated Bulgarians. Without attractive salaries, these efforts will be futile and a waste of resources (see next point). And thirdly, this fact also connects with the advice to improve education and the public health system. We have doubts about the return to investments aimed at enhancing the human capital content of Bulgarian workers when the benefits from these investments will probably accrue to other countries through emigration because of unattractive domestic wages. Between 1989 and 2017, the total population has relentlessly declined from 9 to 7 million people (-22 percent), mostly driven by emigration, and is projected to fall to 6.4 million by 2030. Staff's comments would be welcome, especially on an adequate sequencing of reforms to address all these difficult trade-offs.

With these comments, we wish the Bulgarian authorities all the success in their future endeavors.

Mr. Daïri and Mr. Badsi submitted the following statement:

We thank staff for the interesting papers and Mr. Doornbosch and Mr. Manchev for their informative buff statement. In a context of a large income gap with the EU and unfavorable demographics, as well as lower external demand, the authorities' efforts to preserve robust economic performance and financial stability in preparation for entry into ERM II and the banking union are commendable and should help set the stage for eventual

euro adoption. The output gap has been closing while inflation remained contained and unemployment reached a historical low. The fiscal position was close to balance in 2018 and fiscal buffers are comfortable, and the current account surplus remained sizable, albeit declining compared to 2017. The outlook is for continued robust growth, even though with a slight moderation from 2020. Downside risks to the outlook include insufficient progress in structural reforms, slower growth in European partners, a sharp tightening of global financing conditions, and rising protectionism. The resilience of the Bulgarian economy, and the authorities' strong commitment to sound policies and reform, along with the catalytic role of the process toward close cooperation with the ECB and euro adoption, as underscored by Mr. Doornbosch and Mr. Manchev, give confidence that the authorities will be able to face these risks and other challenges and achieve their ambitious objectives. We agree with the thrust of the staff appraisal.

We commend the authorities for their renewed commitment to fiscal discipline, as reflected by the better-than projected fiscal outcome in 2018, even if it results in part from lower EU funds absorption, and agree with staff that their budget plan is broadly appropriate. We see merit in improving EU funds absorption, a comprehensive review of public sector employment and wages, and monitoring SOE fiscal risks. Revenue overperformance is encouraging although further improvement can be expected from strengthening revenue administration, including by reducing VAT compliance gap. This being said, we would welcome staff elaboration on the equity of the tax system in view of its heavy reliance on indirect taxation (2/3 of the total). Following the incorporation of Electricity Power Security fund in the General Government Operations table last July, subsidies now account for 3.5 percent of GDP this year and are projected to decline only moderately going forwards. We note the absence of a discussion of subsidy reforms in the report, and welcome staff elaboration on the authorities' intentions in this area.

According to staff, the rise in headline inflation last summer, which has moderated by December, was due to the impact of the increase in wages and in tourism accommodation and commodity prices. Could staff indicate the extent to which the rise in tourism accommodation prices in itself reflected wage increases from tight labor market? We would welcome staff elaboration on the impact of international energy price changes on inflation.

On the external sector assessment, we note that the REER model under EBA-Lite indicates that the REER (CPI based) is broadly consistent with fundamentals and desired policy setting, even though competitiveness is seen as better measured by ULC-based REER. However, while the current account

model suggests an undervaluation of 13 percent, it is not more convincing in view of the large size of the residual and the significant statistical uncertainty from frequent large revisions to BOP data and the large size of errors and omissions. We join Mr. Doornbosch and Mr. Manchev's call for addressing the methodological shortcomings of the EBA light model and better reflect country specifics. We welcome staff indication of the efforts being made, including with Fund TA as necessary, to improve BOP data compilation in Bulgaria.

The banking system seems to be healthy with appropriate capital adequacy, high liquidity and rising profitability. We welcome the authorities' bold strides made in strengthening banking sector supervision, including the legislation for related-party lending and the supervisory review and evaluation process, the calibration of the bank-specific Pillar II capital add-on, and the new governance framework. We note with satisfaction the steps taken to address the identified shortcomings of ERM II commitments. NPLs are declining albeit still high compared to other EU countries. We take comfort in the forthcoming entry into force of the EBA guidelines on NPLs.

The authorities are encouraged to push ahead with structural reforms, including through bold actions to strengthen productivity and address demographic headwinds and institutional weaknesses. Addressing labor shortages and skill mismatch remain crucial for raising potential growth. In this regard, we agree on the importance of reforming labor markets and the education and public health systems. Improving infrastructure is also important, and the new guidelines on public investment management should be implemented to promote efficiency. We commend the authorities for the progress made on judicial independence and control of corruption. We look forward to the forthcoming alignment of SOE legislation with OECD guidelines which would help improve governance. This being said, we agree with Mr. Doornbosch and Mr. Manchev that despite the authorities' strong reform efforts, it may take long for public perception to change for the better.

We wish the authorities' continued success in their endeavors.

Mr. Trabinski and Ms. Urbanowska submitted the following statement:

We thank staff for the informative set of papers and Mr. Doornbosch and Mr. Manchev for their helpful buff statement. As we broadly share staff's assessment of the economic outlook and the balance of risks, we would like to offer the following comments for emphasis:

Bulgaria's economic growth remains robust, but it will moderate in the medium term.

The economy has shown resilience to shocks, with comfortable levels of fiscal buffers and international reserves as well as historically low unemployment. The economic expansion will continue to be underpinned by strong domestic demand, supported by wage growth, favorable monetary conditions, and potential acceleration of the EU-funded investment. Nevertheless, the income gap relative to the EU average remains substantial with little progress in improving governance and reducing income inequality. Moreover, Bulgaria faces long-term growth challenges due to population aging, emigration, and decelerating productivity growth.

Fiscal policy has been broadly appropriate, but long-term challenges need to be addressed. In 2018, Bulgaria has put in place a number of measures aimed at improving tax collection and tackling the shadow economy, especially undeclared work. These efforts, combined with lower capital spending, contributed to a fiscal surplus. We commend the authorities for their work to improve fiscal transparency and we encourage them to further strengthen their revenue administration efforts and improve the efficiency of government spending, in particular with respect to the health and pension system. Moreover, enhancing efficiency and governance of SOEs would help contain fiscal risks.

Further progress on the structural reform agenda remains essential. Shrinking labor force and slowing productivity growth pose important obstacles to economic growth and convergence. We share staff's view that reforms aimed at improving the quality of institutions and upgrading infrastructure should be of the highest priority. In this context, we encourage the authorities to improve public investment management to better absorb EU funds as well as attract foreign investment. Furthermore, addressing skills shortages and mismatches, by introducing training programs and deepening the collaboration between research institutions and business, could help reduce structural impediments and raise overall productivity.

We appreciate the authorities' efforts to join ERM II and banking union simultaneously. We take note of the progress made toward strengthening financial sector resilience (through inter alia enhancing supervision and the macroprudential toolkit, as well as amending the insolvency and AML frameworks). However, given the country's low convergence level, we would suggest more caution and greater flexibility in the euro adoption process. Finally, with regard to the information enclosed in

Box 1, could staff elaborate in what sense Bulgaria's ERM II application would set a precedence for prospective euro adopters?

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their report and Messrs. Doornbosch and Manchev for their informative buff statement. Economic growth in Bulgaria is robust, business confidence is high, the fiscal balance remains in surplus and unemployment is at an historical low. We recognize the sound macroeconomic policies that contributed to these outcomes but note the important risks to the outlook: tightening global financial conditions, geopolitical uncertainties and weaker than expected growth in the EU and Turkey being factors in this regard. We agree with the thrust of staff's assessment and offer the following points for emphasis.

The authorities' fiscal plan appears broadly appropriate, but we would emphasize the need to continue the improvements in the efficiency of government spending and revenue administration. We welcome the increased capital expenditure signaled in Budget 2019 and the higher spending in areas such as health and education. We agree with staff that revenue mobilization can be improved further and note the need to reduce the large VAT compliance gap, particularly given Bulgaria's heavy reliance on indirect taxes.

On the financial sector, we welcome the work undertaken to date by the authorities to enable Bulgaria to join ERM II and the banking union. This will enhance market confidence in Bulgaria's policy framework whilst strengthening the financial supervision of the relevant institutions, which has progressed since the 2017 FSAP. We note the continued improvement in banks' profitability and asset quality, in addition to the progress made in dealing with the high stock of NPLs. The ECB comprehensive assessment of banks currently underway will help identify priority actions required in order to join the banking union.

We note that Bulgaria's potential growth rate is held back by a declining labor force arising from emigration and population ageing, and agree with staff that further sustained and broad based reforms are needed to address these challenges. Increasing the quality of education and healthcare, particularly amongst low income workers, would assist in this regard. We welcome the establishment of the unified anti-corruption commission and the strengthened independence of judges and prosecutors in the Supreme Judicial Council and would urge authorities to continue the implementation of such anti-corruption measures.

The representative from the European Central Bank issued the following statement:

We would like to thank Staff for their report and Mr. Doornbosch and Mr. Manchev for their buff statement. We associate ourselves with the statement by Mr. de Villeroché.

To add momentum to the convergence process, important structural reforms need to be taken aimed at tackling weaknesses in the institutional framework and labour markets. Growth in GDP per capita has been above the EU average and is projected to remain so. However, it slowed in 2018 and Staff analysis suggest it has lagged peers since the global financial crisis. In this context and given the continued labour shortages and labour cost increases over recent years, it would be important to strengthen productivity growth to achieve sustained competitiveness gains and thus facilitate a sustainable convergence process. We agree with Staff that the risks to economic activity are tilted to the downside. On the domestic side, we share their view that the main downside risks stem from the recently observed high wage growth, particularly were it to accelerate further and erode competitiveness. On the external side, we concur with the assessment that weaker than expected growth in the EU and Turkey, rising policy and geopolitical uncertainties including Brexit and protectionism, and tightening global financial conditions could weigh on trade and growth.

With the aim of joining ERM II, Bulgarian authorities adopted an action plan in August 2018 based on a number of commitments in policy areas which are of high relevance for a smooth transition to, and participation in, ERM II. The ECB and the Commission are monitoring the effective implementation of these commitments acting within their respective areas of competence i.e., the ECB is monitoring progress made on Measures 1 (banking union) and 2 (macro-prudential supervision), while the Commission is monitoring the progress made on Measures 3 to 6 (non-banking supervision, insolvency law, anti-money laundering and state-owned enterprises). The procedural process related to the commitment to enter the banking union is proceeding relatively smoothly. The Bulgarian authorities have sent an application to establish close cooperation with the ECB in line with the existing procedures. The cooperation with BNB, both in preparing the comprehensive assessment and the supervisory collaboration for the future, is going very well. On the legal side, the Bulgarian legislative process laying the groundwork for close cooperation has been concluded. The next step in this respect should be the formal confirmation of the adoption of the law, together with the required legal opinion prepared by an independent third party. Exactly when close cooperation may start will depend, among other things, on

the outcome of the comprehensive assessment and the possible follow-up actions that will be identified. Finally, Bulgarian authorities have already completed Measure 2 on enhancement of the macroprudential toolkit. The commitment taken consisted in the adoption of legislative amendments to the Law on Credit Institutions to enable the BNB to introduce borrower-based measures when needed. Such amendments were adopted by the National Assembly in December 2018.

Fiscal policy is overall sound, and we agree with Staff that it should remain prudent, with revenue overruns directed mainly towards medium and long-term demographic challenges. Fiscal structural reforms should continue and enhance recent progress. Notwithstanding increases in public sector's wages and the rise of public investment, the European Commission projects the general government balance to remain in surplus over the next few years and the structural balance to exceed the medium-term objective (MTO). As a result, Bulgaria should be able to continue building fiscal buffers. The rise of public sector compensation is aimed at reducing the negative public-private sector pay gap, attracting high-skilled workers and, consequently, improving the quality of public sector services. Nonetheless, we agree with the Staff view that a comprehensive functional review of public sector employment and wages could contribute to further enhance public employment management. Regarding the shadow economy and tax compliance, current data indicate that the implementation of the Single National Strategy, that was aimed at a reduction of shadow economy, has brought about the expected effect. However, we agree with Staff that some additional steps can be undertaken to further improve revenue collection. Public debt is low but there are risks related to contingent liabilities from state-owned enterprises (SOEs) and adverse demographic trends.

Sustained and broad-based reforms are needed to address the challenges of emigration and slowing productivity growth. Priority reform areas (where Bulgaria has significant gaps relative to other EU countries, the narrowing of which should strengthen Bulgaria`s growth potential) include the quality of institutions, government efficiency, infrastructure, education and healthcare. We agree with Staff's recommendation to enhance governance and performance of state-owned enterprises (SOEs). In its action plan to join ERM II, Bulgaria has committed to align the SOE legislation with OECD guidelines, which would help to strengthen SOE governance. The sound implementation of new standards will be critical to improving SOEs` performance and accountability, which would also help to contain fiscal risks related to contingent liabilities.

Banks' profitability and asset quality continue to improve, and the banking system overall appears to be adequately capitalised and liquid. However, and notwithstanding the recent reduction of NPLs, the NPL ratio is still above the EU average, and remains a cause for concern. Following the request to establish close cooperation, the ECB is undertaking an asset quality review and a stress test of six Bulgarian banks, with results expected in July 2019. The ECB has also embarked on discussions with the BNB to safeguard adequate supervisory standards and support supervisory convergence in view of the envisaged close cooperation. While we acknowledge the progress achieved in relation to banking supervision (e.g., legislation for related-party lending, adoption of SREP methodology), it is important to maintain progress to adequately address the IMF FSAP recommendations (e.g., staffing, banking statistics) and ensure, inter alia, an adequate full implementation of the SREP methodology. Further improvements in the supervisory planning process, with an increased focus on a risk-based, proportionate approach would be also welcome. Regarding the macroprudential policy framework (legislative basis for borrower-based measures), we welcome recent improvements and we welcome the decision of the BNB to raise the countercyclical capital buffer from 0 to 0.5 from October 2019 onwards that aims to mitigate potential systemic risks and imbalances in the banking system against the background of buoyant consumer and mortgage credit growth. The authorities should continue to monitor closely banks' governance and ownership structures.

The Acting Chair (Mr. Furusawa) noted that Directors had welcomed Bulgaria's robust economic growth, stable inflation, and lower public debt. Given the downside risks and ongoing structural challenges facing the economy, broad-based reforms were needed to raise potential growth and support stronger income convergence with EU peers. Directors had also underlined the importance of the authorities' strong commitment to improve governance and fight corruption.

Mr. de Villeroché made the following statement:

We issued a gray statement with my European colleagues, and I will insist on a few important points.

On the outlook, we commend the authorities for the positive developments and the strong fundamentals of the economy. Despite a slight slowdown in growth in 2018, domestic demand has remained strong, and will keep driving economic growth over the coming years. The expansion should continue to be sustained by the recovering goods exports and sustained wage increases, both in the public and private sectors.

We agree with the staff that downside risks have risen, reflecting both external risks related to weaker external demand, trade tensions, the exit of the Untied Kingdom from the EU, and domestic risks linked to emigration, skilled labor shortages, and slowing productivity growth.

On the fiscal side, we broadly share the staff's recommendation to maintain prudent fiscal policy. The country is facing aging-related costs. There is room to allow automatic stabilizers to work in case of negative economic shocks. Therefore, the authorities have policy space to pursue their program policies and make further progress toward income convergence with the rest of the EU. We notably encourage further improvement of public expenditure management, revenue collection, and the quality of public services, especially in social protection, health care, and education. In this respect, preparation for the Exchange Rate Mechanism (ERM II) and the banking union will certainly contribute to maintaining the reform momentum.

On the financial system, we welcome the improvement in banks' profitability and asset quality, and we share the staff's assessment of an adequately capitalized and liquid banking system. We welcome the constant reduction in NPLs, but their still-high level remains a source of concern. Therefore, measures to facilitate the sales of NPLs, as well as improvements in the insolvency framework, would make banks less vulnerable to adverse developments.

We also welcome the continued implementation of the 2017 Financial Sector Assessment Program (FSAP) recommendations that were given new impetus by preparations to join the ERM II and banking union.

Finally, and maybe most importantly, accelerating the convergence process of Bulgaria to the EU average warrants further structural reforms. It is essential not only to retain but also increase the pool of skilled labor and attract more capital by upgrading the infrastructure and improving the institutional framework. We therefore share the staff's recommendations on improving government efficiency, revamping the legal systems, upgrading infrastructure quality, working on education and health care, and enhancing labor market policies. Sustained efforts are needed to ensure effective implementation of the new anti-corruption framework adopted last year.

Mr. Benk made the following statement:

I want to reiterate on one of our points from our gray statement concerning Bulgaria's accession to the ERM II. The Bulgarian authorities

decided that they will link their ERM II accession with rejoining the banking union. Let me stress that this is the unilateral decision of the authorities, so in this regard we do not agree with the staff when they claim that this should be set as a precedent for future candidates, because such a voluntary commitment or or legally non-binding statement by a group of few countries should not be considered and cannot be considered as an expansion of the ERM II entry requirements set out otherwise in the EU laws.

Mr. Tan made the following statement:

As noted by other chairs, due recognition is warranted for the authorities' commitment to prudent macroeconomic policies and key reforms. It is also encouraging that the groundwork for joining the ERM II and banking union will further build on the progress made and provide additional impetus to the country's reform efforts.

We would like to touch on a few points. First, we note that the country faces a multitude of challenges ahead in the form of low productivity, population aging, loss-making state-owned enterprises (SOEs) that pose potential contingent liabilities, and broader governance issues. This places a significant premium on comprehensive structural reforms that need to be targeted and that improve the labor market, the education and health care sectors, infrastructure, public finance and investment management, as well as institutional quality. While many of these reforms would be mutually reinforcing in nature, others may entail inherent tensions, and this brings into focus the need to coordinate and pursue the right policy mix to achieve the wide-ranging reform objectives. Perhaps more importantly, this accentuates the need to guard against reform fatigue, given the efforts needed on multiple fronts, a case in point being the selected issues paper, which highlights the persistent public perception of weak judicial independence and corruption despite various reform efforts on the institutional and governance front.

The staff has also cautioned in its written responses that electoral campaigning could delay reform implementation. That being said, we would add our voice to those of other chairs, such as Mr. Merk and Mr. Psalidopoulos, who emphasized that commitment to the reform path is key as it may take time for the envisaged benefits to come to bear.

Lastly, careful judgment in accounting for country-specific circumstances may be warranted in relation to the authorities' call for a cautious interpretation of the staff's assessment of Bulgaria's external position being stronger than fundamentals. This is considering the various

competitiveness measures that have yielded different and less-than-conclusive results. The fact should also not be lost that the authorities have been actively trying to improve data quality, which feeds into these assessments that are subject to substantial statistical and model uncertainty.

Mr. Montero made the following statement:

I associate myself with Mr. de Villeroché's statement and his intervention, and I would like to make a few remarks.

The first one is that we believe that the main binding constraint for sustained growth is the poor quality of certain institutions, particularly inefficiencies in public administration, poor control of corruption, and inadequate judicial independence and efficiency. We have noticed that the authorities' efforts in the adoption of the measures in these areas are commendable and that they have made good progress, but now it is time for the most difficult part, which is implementation—and implementation is crucial for strengthening the rule of law effectively and the business environment but also for changing public perceptions, which is something that the authorities are worried about.

The second comment relates to the multiple roles played by wages. Wages are helpful to improve the labor markets. They play a role in driving external competitiveness, in providing incentives for investment in human capital, preventing brain drain or even attracting expatriates who work abroad. We acknowledge the tensions among these multiple priorities, which make it difficult to elaborate a consistent set of policy recommendations. This is acknowledged by the staff. In this sense, we would like to underscore the importance of adequate sequencing of reforms and of thinking out of the box and coming up with creative proposals.

In this sense, let me finish with a question for which I do not have an answer, but it is somewhat provocative. It is an example of the creative proposals that I was referring to before. Would it be more profitable in terms of productivity growth to make the utmost efforts to bring back the more than 1 million skilled Bulgarians living abroad rather than trying to boost the skills levels for those remaining in Bulgaria?

Mr. Psalidopoulos made the following statement:

I would like to associate myself with Mr. de Villeroché's oral remarks. Bulgaria's economic performance is robust, and we commend the authorities

for their prudent fiscal policy. Stepping up structural reforms is critical to improve potential growth, raise living standards, and accelerate the income convergence with the EU. In the same vein, following up with the implementation of the new anti-corruption framework and updating the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework in a timely manner remain key and are critical to revitalizing FDI and fully reaping the benefits of the likely ERM II membership.

Our chair has asked the staff to correct the chart on page 10 of the report regarding the liabilities of non-financial loss-making SOEs in 2016. Data for 2017 show a totally different picture, with liabilities for both Bulgaria and Italy respectively at 1.9 and 0.7 of GDP rather than the 6.6 and 7.6 percent reported in the chart. While for Bulgaria the latter values correspond to those prevalent over the last years, this is not the case for Italy. Consequently, reporting just one year when a particular spike has been recorded is questionable from a methodological point of view. While the staff agreed to issue a correction, the request to update the chart with the last available data has not been accepted on the grounds that the data for 2017 were released by Eurostat only after the report had already been prepared. While this can be consistent with the current formulation of the Transparency Policy, it points to the inherent limitations that could lead to inaccurate policy messages. We look forward to the review of Transparency Policy to discuss this issue among others.

Mr. Coronel made the following statement:

We did not issue a gray statement but would like to share a few points.

The transition from a highly centralized planned economy to a market-based middle-income country has not been easy for Bulgarians, particularly during the great recession and the European debt crisis, and they experienced a series of setbacks such as low growth, reform stagnation, loss of productivity, high debt, or loss of savings.

The expectations of EU accession ushered in a new era of high economic growth and improved living standards, and in this year's report, we found plenty of positive material to conclude that the country's prospects do look much brighter than they have in a long time. Macroeconomic fundamentals have improved, so have public finances, and most importantly, unemployment is at its lowest in decades.

As indicated by Mr. Doornbosch and Mr. Manchev, the authorities are focused in fulfilling the requirements to join the ERM II in line with an eventual euro adoption. We look forward to hearing positive news on the completion of the European Central Bank's (ECB) assessment for Bulgaria's entry to the EU banking union later this year. In this regard, we are glad to hear that Bulgaria outperforms the average of the so-called new member states and the EU itself in most areas of AML/CFT, but the authorities are also cognizant that there is room for improvement in these areas, such as the anti-corruption framework, the judiciary, public procurement, and SOE governance.

These improved conditions and achievements notwithstanding, income inequality levels in Bulgaria still lag far behind the EU average. The country faces many challenges, the most pressing being raising productivity and dealing with what experts have called a severe case of depopulation. We welcome the paper on corporate productivity from the selected issues paper and adhere to its conclusion, and although we acknowledge the staff's comprehensive references to the issue of depopulation in paragraph 16 of the report, we believe the problem is far more acute than implied in the report, even by Eastern European standards, and deserves more attention. Bulgaria has the world's fastest shrinking population. About a million Bulgarians live abroad, and I echo Mr. Montero's remarks on making the effort to bring them back, as stated in the selected issues paper discussion, and as broadly commented by Directors in the context of the 2016 Article IV consultation. This adverse demographic trend has enormous long-term ramifications, both socially and economically, and perhaps it would be useful to be kept abreast in more detail of the long run developments vis-à-vis the country's labor market, pension system, productivity levels, and overall impact in the context of Bulgaria's accession to the EU in future Article IV reports. Part of this issue was addressed in the staff's responses, but the problem could prove too formidable, and a broader all-out approach might be required.

Mr. Trabinski made the following statement:

We broadly agree with the analysis, so we would like to raise three points for emphasis.

First, we commend the authorities for their sound public finances and prudent macroeconomic policies. Bulgaria has made significant progress in bringing its economy closer to the EU levels, yet more reform efforts will be needed to address the sizeable poverty rate and income disparities relative to other EU peers. In this regard, faster income convergence remains of

paramount importance. Also, the high emigration and unfavorable demographics mentioned by Mr. Montero call for immediate action. Therefore, we stress the need for further progress with structural reforms by increasing the quality of human and physical capital, as well as improving the business environment.

Second, we note the authorities' commitment to enter ERM II and the banking union concurrently and their intensified efforts to achieve this goal. Bulgaria continues to implement high supervisory standards and improve its legislative framework, including fighting corruption, which we find commendable. As the country is moving in the right direction, we echo Mr. Benk's remarks, emphasizing that the path toward the ERM II accession by Bulgaria should not be confused with an obligation for other countries to follow the same path.

Finally, joining the banking union would further strengthen financial sector supervision. While Bulgaria's linking to the banking union would transfer the supervision of the three largest banks to the single supervisory mechanism, the less significant institutions would remain under the supervision of the Bulgarian National Bank (BNB). We ask the staff to elaborate on how the strengthening of the financial sector stemming from joining the banking union would affect the rest of the Bulgarian financial sector.

With these remarks, we wish the authorities all success in future endeavors.

Mr. Haydon made the following statement:

We did not issue a gray statement but wanted to offer a few points on the subject of governance and anti-corruption. As Mr. de Villeroché noted in his gray statement, we take positive note of the progress achieved in the fight against corruption. That was also acknowledged in the European Commission's 2018 report under the cooperation and verification mechanism. At the same time, continued efforts are clearly needed to ensure effective implementation of the new anti-corruption framework adopted in January 2018, and as several other Directors have noted, improving public perceptions is particularly key in this.

More generally, we welcome the selected issues paper on governance reforms in Bulgaria. As the beginning of the paper said, effective institutions are critical to promoting economic growth and development, and we agree

with this. We felt that this selected issues paper could be a model for the Fund's work and analysis in countries with similar challenges to Bulgaria and with similar commitments to address these challenges.

The staff representative from the European Department (Mr. Lee), in response to questions and comments from Executive Directors, made the following statement:[5]

I thank Directors for their comments, support, and questions. I will start with the last question about the effect of the banking union on the rest of Bulgarian banks. Our view is that it mainly comes through providing a stronger banking supervision framework in the sense that it will be aligned with European standards, which seems to be adding clarity and helping align business practices with the rest of Europe. That is the main benefit that we see in terms of providing a stable background for the banking business.

On the importance of emigration or depopulation, we fully agree. This was one issue taken up in the 2016 Article IV consultation, and it is a project being undertaken quite seriously currently in the European Department, with the ongoing work on the implications of demographics for all Central, Eastern, and Southeastern (CESEE) countries. Clearly by the time of next Article IV consultation, we should be able to bring more information both from this ongoing project as well as derivative work that we plan to do after the CESEE-level analysis comes to a conclusion.

On the country-specific factors in assessing the external position, any cross-country model has its limitations, and thus we try our best to consider that in bringing multiple approaches together, and we try to make some balancing judgment in incorporating messages from different approaches and also factoring in the various limitations of data and models, as we explained in our annex.

On the question raised about multiple roles played by wages, as we acknowledged in our written response, we do agree with the extreme complexity of this question. As regards the proposal to bring back overseas Bulgarians, I would say that this is also a point registered with the Bulgarian authorities as well, who emphasized the importance of their efforts in this direction while we were in Sofia. Our sense is that the efforts are bearing some fruit already, but not yet at the scale of bringing back a million or so Bulgarians, which would be an extremely desirable development. However, we also noted that most of the reforms that we proposed—which the

[5] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

authorities agree with and chairs all endorse—are all in the direction of strengthening the attractiveness of Bulgaria as a place for overseas Bulgarians to return. These are all in a consistent direction.

Two chairs made a point that there is no legally binding decision on the future path for joining the ERM II, which is a point well noted by all concerned. That was the sense in which we said it is expected to set a precedent, quoting from the press release that was issued by the European Commission in July. But we fully agree that there has been no amendment of treaty or written legal requirement which sets out the exact precedent. We have no disagreement about that point.

Mr. Doornbosch made the following concluding statement:

I thank Directors for their insightful comments and their written statements in response to this meeting.

The Bulgarian authorities believe the current robust growth and the soundness of the government's finances provide a good opportunity to address the remaining structural challenges to the economy and increase growth potential and economic competitiveness. Many Directors acknowledged this in their statements, and the authorities are committed to take full advantage of this window of opportunity. The authorities also considered the preparatory actions for the simultaneous entry into the ERM II and the close cooperation with the ECB in anticipation of joining the EU banking union to be an integral part of their reform efforts.

At the same time, the authorities are aware that it takes a long time for the public perception to change in response to the ongoing reforms. Trust comes on foot but leaves on horseback, and with that in mind, I would like to make three remarks that exemplify the consistent and steadfast implementation of reforms in Bulgaria, the importance of which was highlighted by several Directors.

On fiscal sustainability, with fiscal discipline securely anchored in the budget framework, emphasis in Bulgaria has focused on or has shifted to fiscal structural reforms in line with the European Stability and Growth Pact and effectuating commitments to enter the ERM II. I will give four examples of reforms that are well underway in this respect. First, the authorities will continue cooperation with the Fund to strengthen revenue administration and tax compliance by enhancing risk-based controls. Second, several measures have been implemented to better target public spending toward the most

vulnerable groups. Third, in 2019 the government will implement enhancements to the public procurement process and strengthen its transparency and accountability through adoption of an EU procurement system. Finally, building on the earlier technical assistance from the Fund to address fiscal risks stemming from SOEs, the authorities and the OECD implemented a project to fully align the Bulgarian legislation with the best international practice by this July. This will allow a further strengthening of SOE management.

Second, Bulgaria has initiated several policies through strengthened convergence with the EU average by simultaneously addressing the shrinking labor force and thereby the demographic challenge and low productivity growth, and the focus in 2018-19 is on public education and health care reform. The authorities have increased teachers' and doctors' wages to narrow the existing public wage premiums. They have strengthened communication to deal with the dissonance in public perceptions of these professions and continue investing to improve the quality of services.

Consistent with the authorities' plan to preserve in that process fiscal sustainability, the above measures have been accompanied with targeted spending restructuring to better support training, retraining, and job search for the most vulnerable groups like youth and minorities, and to address skilled labor shortages in highly affected sector like information and communications technology and engineering. They also laid the foundation for establishing an e-healthcare system.

Third, my authorities strongly believe that the simultaneous entry into the ERM II with the existing currency board arrangement at the current fixed rate of the Bulgarian lev against the euro and the establishment of close cooperation between the BNB and the ECB will boost confidence and bring an additional impetus to implement the needed structural reforms.

In close cooperation with the European institutions, Bulgaria started implementing last July a comprehensive plan to enhance financial supervision and strengthen the macrofinancial framework. In this effort, special attention is given to closing gaps in the insolvency and anti-money laundering framework.

With that, my Bulgarian authorities look forward to continued cooperation with the Fund, and once again, they thank Mr. Lee and the excellent team for their research contribution to the domestic policy debates and their constructive engagement in the policy dialogue.

The Acting Chair (Mr. Furusawa) noted that Bulgaria is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Bulgaria's robust economic growth, historically low unemployment, and improved financial sector conditions. While prospects remain good, Directors considered that downside risks have recently risen, emanating mostly from the weakening in trading-partner growth and global trade. With sound macroeconomic policies in Bulgaria, Directors emphasized the need to implement broad-based structural reforms to boost potential growth, accelerate EU income convergence, and address unfavorable demographic dynamics. Improving the efficiency of public spending, the quality of public institutions, and the governance framework will be key to bolstering prospects.

Directors welcomed the strong fiscal outturn in 2018, and supported the authorities' fiscal policy plan to preserve buffers against downside risks. They were reassured that Bulgaria's low public debt provides ample room to allow automatic stabilizers to operate in the event of a negative shock. Directors encouraged the authorities to continue to improve revenue and spending efficiency.

Directors highlighted that sound institutions are important to support inclusive and sustainable growth over the medium term, and encouraged the authorities to maintain the reform momentum through effective implementation. They considered that stronger public investment management will have dual benefits of improving investment efficiency and strengthening public institutions. Directors welcomed recent progress on reforms to improve the judiciary and the fight against corruption, and commended the authorities' plan to strengthen the anti-money laundering framework and governance of state-owned enterprises.

Directors stressed that improving education and healthcare and addressing labor market bottlenecks would enhance human capital and mitigate labor shortages and skill mismatches. Directors emphasized that effective labor market policies and a deeper collaboration between educational institutions and business could help alleviate these challenges.

Directors commended the authorities' progress in strengthening financial supervision, including operationalizing the new governance

framework, strengthening legislation for related-party lending, and formalizing the supervisory review and evaluation process. They welcomed the recent decline in non-performing loans (NPLs), and encouraged the central bank to ensure that banks with high NPLs maintain sufficient capital buffers.

Directors noted that Bulgaria's preparations for ERM II and the banking union would help support reforms and enhance the quality of institutions, including by strengthening financial sector supervision.

It is expected that the next Article IV consultation with Bulgaria will be held on the standard 12-month cycle.

APPROVAL: April 13, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risk

1. ***The staff report notes that "political uncertainty related to the elections could delay policy implementation". Related to this issue, we would like to have a further elaboration from staff on Bulgaria's political developments and outlook in this electoral year.***

- This year, Bulgaria will hold two elections, the European Parliament election in May and the local elections in October. According to the polls, the two main parties are separated by a small margin for the EU parliament election. Internal disagreements in the minor member of the ruling coalition (itself an alliance of three small right-wing parties) imply that they will run separately. This has not affected the stability of the ruling coalition so far. However, as noted in the staff report, electoral campaigning could delay the implementation of reforms.

Fiscal Policy

2. ***We would be interested in staff's opinion on the drivers of revenue overperformance and to what extent they reflect structural factors that can be incorporated in the baseline projections.***

- The revenue overperformance in 2018 reflected the authorities' continued efforts to strengthen revenue administration (e.g., combating tax fraud and evasion, strengthening compliance enforcement) as well as conservative revenue forecasting. Although it is difficult to quantify the revenue gains from better administration, a modest improvement in collection due to further efforts has been embedded in the 2019 projections.

3. ***We would welcome staff elaboration on the equity of the tax system in view of its heavy reliance on indirect taxation (2/3 of the total).***

- Public spending is intended to play a stronger role in income redistribution compared to taxes, while the simplicity of the tax system is intended to facilitate collections and business activity. The tax system is estimated to play a limited role in reducing income inequality (EC country report 2017): the difference between income inequality indices before and after taxes and benefits is relatively small. However, the redistributive impact of the social security system is in line with other EU countries

(IMF SDN/18/01). The share of public spending on social security, assistance, and care is set to increase from 31.4 percent of total spending in 2019 to 32.1 percent in 2021.

- According to the latest Eurostat data, Bulgaria's VAT revenue was 43 percent of total tax revenue in 2017, higher than the EU average of 27 percent of total tax revenues.

4. ***Following the incorporation of Electricity Power Security fund in the General Government Operations table last July, subsidies now account for 3.5 percent of GDP this year and are projected to decline only moderately going forwards. We note the absence of a discussion of subsidy reforms in the report, and welcome staff elaboration on the authorities' intentions in this area.***

- Subsidies in 2019 are projected to increase to 3.5 percent of GDP. This is due to changes in the coverage of the general government operations. As discussed in the text table, the incorporation of the Electricity Power Security Fund (ESPF) into the Consolidated Fiscal Program (CFP) since July 2018 increases both non-tax revenues and subsidies. The ESPF has helped to offset the shortage of financing in the National Electric Company for purchase of electricity at prices fixed under long-term contracts, by collecting contribution fees from electric power producers. Reflecting the amendment to the Energy Act, the fees paid by power companies are now included in the general government budget as non-tax revenues, which are then transferred to the EPSF. In the CFP, the transfers are classified as a subsidy expenditure. As non-tax revenues and subsidy expenditures are of the same amount, the impact on the budget balance is neutral. The bulk of the remaining subsidies (amounting to 2 percent of GDP) are for SOEs, and would likely decline with the improvement of SOEs' financial performance.

5. ***Staff comments are welcome on the status of the income distribution and poverty in Bulgaria in the context of prioritizing fiscal policy measures.***

- Income inequality and the share of population at risk of poverty in Bulgaria are among the highest in the EU. In 2017, the Gini coefficient of equivalized disposable income stood at 40 percent and about 40 percent of population was at risk of poverty. The elderly and people in other vulnerable groups face an even higher risk. The authorities undertook measures to alleviate the risk of poverty for these groups, including increases in minimum pension in 2017 and social benefits and heating allowances for vulnerable groups in 2018. Inequality of opportunity remains a challenge, linked to low levels of education and skills. The authorities' effort to ensure equal access to quality education and reduce the high rate of early leavers from education and training could help address inequality of opportunity. Also, the

increase in the minimum wage envisaged in the MTBF would help increase the income of the lowest income group in the labor market.

6. ***Given the relatively large size of the shadow economy in Bulgaria, could staff comment on the reasons behind and the progress of the SNS in the past years.***

- As many factors affect the size of the shadow economy (Medina and Schneider, IMF Working Paper No. 18/17), it is not easy to identify a unique reason for the large shadow economy in Bulgaria. However, a survey conducted by the Association of Chartered Certified Accountants (2017, Emerging from the shadows) shows that the low quality of institutions is one of the main factors for Bulgaria's large shadow economy. According to Medina and Schneider (2018), the size of the shadow economy in Bulgaria declined to 20.8 percent of GDP in 2015 from 28.6 percent of GDP in 2005.

- The authorities have adopted the Single National Strategy (SNS) 2015−17 and increased labor inspections to tackle the shadow economy. By the end of 2017, more than 60 percent of the measures in the SNS were implemented. To further improve tax collection and tax compliance, the authorities extended the SNS in 2018.

ERM II and Euro Adoption

7. ***Could staff comment on a timeline for euro adoption, particularly if structural reforms and convergence take longer than expected, as well as what further FSAP recommendations should be prioritized?***

- The authorities have made a number of commitments to be completed before joining ERM II and the banking union (see Box I of the staff report). Bulgaria is expected to join ERM II and the banking union simultaneously following the completion of these commitments. Bulgaria would then need to stay in ERM II for a minimum of two years as confirmation of the sustainability of economic convergence and that Bulgaria can play a full role in the euro area economy. Eventually, the Council of the EU decides whether a country is ready to join the euro area.

- The Bulgarian National Bank (BNB) should maintain its vigilance on NPLs. In line with the FSAP recommendations, NPL resolution would benefit from a better market infrastructure, including the removal of existing impediments. The BNB should also ensure full implementation of the SREP. While staffing has been strengthened at financial oversight authorities, target levels have not been reached yet and authorities need to ensure adequate staffing and resources as recommended by the FSAP.

8. ***While we observe that staff assess the ERM II and banking union participation as positive, we are wondering there might be downside risks for Bulgaria when joining the euro in the future, especially during a transition period. Could staff elaborate more on the future risks when Bulgaria joins the euro area, and what kind of measures Bulgaria should take in order to mitigate the risks?***

- Given that Bulgaria has been under a currency board for a long time, the risks would not substantially increase. Once in the euro area, the option to exit would be virtually foregone, and Bulgaria would be exposed to greater spillover effects from other members. As under the currency board, it would need to rely on fiscal and structural measures to manage shocks. Further improving the flexibility of the economy, including by developing flexible labor markets along the lines of staff recommendations, would help mitigate future risks.

9. ***With regard to the information enclosed in Box 1, could staff elaborate in what sense Bulgaria's ERM II application would set a precedence for prospective euro adopters?***

- The precedent refers to joining ERM II and the banking union simultaneously, and making other commitments under the ERM II application, mostly to strengthen the financial sector. The Council of the EU's statement on Bulgaria's path towards ERM II participation (December 7, 2018) notes that "In the future, we expect to follow a similar approach for Member States wishing to join ERM II, in line with the principle of equal treatment."

10. ***We welcome the ongoing preparation for ERM II and the banking union, which will improve the quality of institutions and credibility of the overall policy framework. Could staff comment on Bulgaria's commitments in terms of post ERM II policy measures and procedures?***

- The authorities have indicated that they would maintain the currency board under ERM II. Successful participation in ERM II for at least two years is considered as confirmation of the sustainability of economic convergence and that a member state can play a full role in the euro area economy. Eventually, the Council of the EU decides whether a country is ready to join the euro area.

Monetary Policy and External Sector

11. ***We note that inflation pressure has eased with both headline and core inflation moderating. Could staff share their view on the background of the moderating core inflation?***

- Core inflation peaked to 3.1 percent in August and moderated thereafter to 2.1 percent in December. The surge in core inflation was mainly due to price increases in restaurants, hotels, and recreation sectors. Some of these increases were driven by temporary factors and subject to seasonality, including the EU presidency held by Bulgaria in H1 2018 and tourism.

12. ***According to staff, the rise in headline inflation last summer, which has moderated by December, was due to the impact of the increase in wages and in tourism accommodation and commodity prices. Could staff indicate the extent to which the rise in tourism accommodation prices in itself reflected wage increases from tight labor market?***

- Staff views that the increase in tourism accommodation prices was driven by high sectoral demand. Wage in the accommodation sector rose faster than the economy-wide average wage in 2018, in particular growing more than 10 percent during the tourism season (Q3) before moderating thereafter.

13. ***We would welcome staff elaboration on the impact of international energy price changes on inflation.***

- Staff expects that a decline in energy price would moderate headline inflation to an average of 2.4 percent in 2019. Based on the latest data, energy prices for the first two months of 2019—which increased by 0.4 and 1.7 percent y/y, respectively—supported staff projection.

14. ***What are, in staff's views, the reasons for the large error and omissions in the BoP? We welcome staff indication of the efforts being made, including with Fund TA as necessary, to improve BOP data compilation in Bulgaria.***

- The magnitude of errors and omissions tends to become smaller with each BOP update. The main reason for this reduction is the long lag in compiling trade and FDI-related flows. Nonetheless, even when data are finalized, errors and omissions remain substantial reflecting broader measurement issues.

- The central bank is currently working with the statistical institute and with customs to reduce the lag in compiling trade and FDI-related flows. This work is also expected to reduce errors and omissions.

15. ***The level of Bulgarian wages is extremely low, at ½ of its regional peers and at 25 percent of the EU average. Thus, we see an excessive emphasis on this risk, even more so when the evolution of the HIPC-REER has been stable over the last 10 years, which means that domestic firms have been able to absorb increases in***

wages easily without affecting their external competitiveness—which depends not only on wage costs, but on price markups as well. This fact, along with the positive evolution of the current account and the NIIP, attests to the favorable overall competitiveness position of this economy. Could staff comment on the possibility that non-price-related competitiveness may also be behind this evolution?

- Manufacturing exports have been the main source of export growth. This expansion is in large part related to foreign investment and increased integration in the global value chains. As a result, there has been an increase in the foreign value-added component of exports. Moreover, domestic value-added in manufacturing exports remains lower than in services exports. Thus, though non-price competitiveness has evolved, cost competitiveness remains essential notably given the size of labor-intensive production. Cost competitiveness has deteriorated significantly over the past decade as labor cost increased faster than productivity. The capacity of exporters to absorb cost increases and maintain their price competitiveness has limits and the authorities estimate that this will be exhausted over the medium term. Therefore, wage growth outpacing productivity growth is expected to affect export performance in the medium term including in the services sector, where the impact of cost increase for tourism is temporarily masked by the economic difficulties faced by the main competitor, Turkey.

Financial Sector

16. ***We take note that the Bulgarian authorities are concerned about the possibility of credit risk as a consequence of rising interest rates. In this context, we would appreciate staff's assessment to what extent a rise in interest rates could pose a potential source of credit risk to the Bulgarian economy and what would be advisable steps to increase financial resilience.***

- Higher interest rate would raise payment burden and possibly lead to higher NPLs. However, staff does not see this as a major financial risk. Household debt remains moderate (25 percent of GDP as of 2018Q3). Corporate debt remains high but has been declining. Reforms that improve business environment, e.g., strengthening governance and upgrading infrastructure, could also help improve corporate profitability and improve debt service capacity. The BNB's announcement of raising the countercyclical capital buffer from 0 to 0.5 percent as of October 2019 would also help ensure sufficient capital buffers for banks. It should also be noted that the ECB is expected to hike its policy rate next year.

Labor Market

17. ***Despite the continued tightness in the labor market, emigration remains high and is***

heavily skewed towards younger cohorts of the productive age. We suspect the skew is also towards the better educated and more skilled. Is there any evidence of that?

- The data from Brücker H., Capuano, S. and Marfouk, A. (2013)—which compiles total number of foreign-born individuals aged 25 years and older, living in each of the 20 considered OECD destination countries, by year, gender, country of origin and educational level—showed that about 80 percent of total emigrant stock in 2010 were skilled labor, with education at a secondary level or higher.

- Using the same database, the IMF Staff Discussion Note (SDN/16/07) "Emigration and Its Economic Impact on Eastern Europe" showed the share of Bulgarian emigrants to total population had increased over time and skewed toward skilled labor.

18. ***We would appreciate it if staff could elaborate more why the nominal wage growth has moderated, and how the wage of new employment affects the total picture.***

- Despite moderating, nominal wage in 2018 grew robustly at 7 percent. The slight wage moderation reflected a strong base effect in 2017, when the average wage grew more than 10 percent. Amid labor shortage, staff expects that wage will continue to grow in 2019 and be one of main drivers for growth.

19. ***We perceive a disconnect between staff's concern about inflationary risk from wage growth and its recommendations to stem the brain drain and bring back emigrated Bulgarians. Without attractive salaries, these efforts will be futile and a waste of resources (see next point). This fact also connects with the advice to improve education and the public health system. We have doubts about the return to investments aimed at enhancing the human capital content of Bulgarian workers when the benefits from these investments will probably accrue to other countries through emigration because of unattractive domestic wages. Between 1989 and 2017, the total population has relentlessly declined from 9 to 7 million people (-22 percent), mostly driven by emigration, and is projected to fall to 6.4 million by 2030. Staff's comments would be welcome, especially on an adequate sequencing of reforms to address all these difficult trade-offs.***

- Staff agrees with the possible tensions among multiple concerns and priorities, when reforms are delayed or otherwise fail to boost productivity growth. However, successful structural reforms that are undertaken simultaneously on multiple fronts—including education, quality infrastructure, and the quality of institution—would help boost productivity and prospects for sustainable growth. It could then achieve dual benefits of boosting productivity growth and addressing the emigration challenge. We

would also note that the IMF study (SDN/16/07) have identified the quality of institutions as a key factor affecting the immigration of high-skilled workers.

- There is indeed a risk that some of the benefits of the spending on health and education will be reaped by other countries, at least for some time. Nevertheless, investment in human capital (as well as improving physical infrastructure and institutions) is an essential pre-condition to raise productivity and, hence, salaries. By contrast, raising salaries before productivity gains are achieved would be unsustainable, leading to overheating of the economy and leading to domestic and externa imbalances. Wage growth persistently outpacing productivity growth would in any case raise concern on inflation and external competitiveness.

20. ***We note, with concern, the most rapidly aging teacher body in the EU and staff comments are welcome on intended additional measures to address this issue going forward.***

- Apart from doubling teachers' salary by 2021, the government plans to improve teachers' social status, including investing in teacher training programs. In addition, the government also provides teachers with additional subsidies covering transportation and accommodation costs.

Governance Issues

21. ***The continuous commitment to timely update the national AML/CFT framework is very welcome. However, an assessment against the 2012 FATF can provide a better understanding of the effectiveness of the AML/CFT regime in preventing financial crimes, including corruption. We would appreciate an update on the envisaged timing of the next assessment.***

- Based on the MONEYVAL and the authorities, the date for the new assessment has yet to be scheduled.