Bulgaria

Highlights

- **Economic growth is decelerating and inflation has risen sharply amid spillovers from the war on Ukraine.** Although growth was robust in the first half of 2022, inflation reached almost 19 per cent in September because of high food and energy prices, and a slowdown in gross domestic product (GDP) growth took hold in the third quarter.
- **The implementation of the Recovery and Resilience Plan (RRP) has commenced.** Following approval in April 2022, the government formally requested the first disbursement in early September 2022, contingent on the completion of 22 targets and milestones in digital transformation, innovation and education, green transition and justice.
- **The government has focused on social support in its policy response to the current crisis.** The key measure in response to elevated inflation has been an increase in wages and pensions, as pensioners are among the most vulnerable to price increases. State subsidies for company electricity and gas bills is the primary support measure to mitigate the effects of the energy crisis.

Key priorities for 2023

- **RRP implementation should be prioritised.** The country's political crisis meant that European Commission approval of a revised RRP worth €5.7 billion in grants occurred only in April 2022, and Bulgaria missed the pre-financing step. The ongoing crisis risks further delays, but political forces should commit to its implementation, as demonstrated so far.
- **Meeting the euro adoption criteria is important for investor confidence.** Bulgaria failed to meet the convergence criteria on the inflation measure in the summer 2022 assessment, and the earliest date for euro adoption is now 2024. Progress in this area would help counteract perceptions of political instability and would boost confidence in the economy.
- **Anti-corruption and judicial reforms should be stepped up.** In its latest *Rule of Law Report*, the European Commission flags, among other issues, Bulgaria's slow progress on tackling high-level cases of corruption, while the National Strategy for Prevention and Countering Corruption continues to be implemented.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	2.7	4.0	-4.0	7.6	3.0
Inflation (average)	2.6	2.5	1.2	2.8	12.4
Government balance/GDP	1.7	2.1	-3.8	-3.9	-3.3
Current account balance/GDP	0.9	1.9	0.0	-0.5	-0.9
Net FDI/GDP [neg. sign = inflows]	-1.3	-2.0	-4.5	-1.4	-1.0
External debt/GDP	66.1	61.3	63.8	58.4	n.a.
Gross reserves/GDP	44.6	40.4	50.1	48.7	n.a.
Credit to private sector/GDP	49.8	48.9	51.0	47.9	n.a.

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Macroeconomic developments and policy response

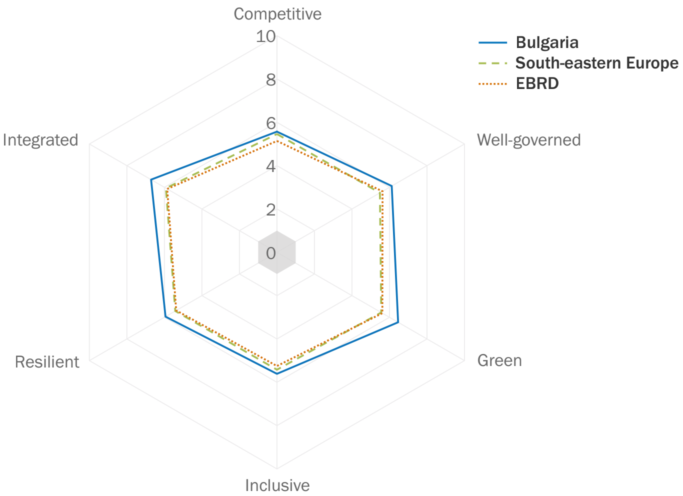
The robust growth seen in the first half of 2022 is slowing. GDP expanded 7.6 per cent in 2021, driven by strong private consumption. This, in turn, was underpinned by fiscal support and wage growth, though investment declined by 8.3 per cent. In the first half of 2022 GDP grew by 4.1 per cent year on year on the back of slowing private consumption, but increased public spending and accumulating inventories. However, preliminary figures show a further decline in investment of 9.6 per cent year on year in the first half of 2022. Although Bulgaria has stronger supply-chain links with Ukraine and Russia than most regional peers, the industrial sector has remained quite resilient so far, growing 18.6 per cent on the year in the first half of 2022. Despite decelerating amid high inflation, household spending is being supported by public spending and growing retail credit, which has accelerated in recent months amid deep negative real rates.

Russia's invasion of Ukraine has exacerbated already strong inflationary pressures. Consumer prices rose 18.7 per cent in September 2022, with food prices up 24.9 per cent on the year. Core harmonised inflation, as measured by Eurostat, reached 9.4 per cent the same month, implying relatively strong demand pressures. Higher utilities and food prices, as well as strong demand, are also feeding into services, as prices in restaurants and hotels increased 20.7 per cent year on year in the latest reading. Nominal private-sector wage growth reached 14 per cent in the first half of the year, outstripping the six-month average inflation rate of 13.1 per cent. This raises the risk of prolonged high inflation to some extent, although, in the public sector, average wages increased only 4.9 per cent in the first half of 2022.

Fiscal policy is being used to alleviate the impact of inflation. In June, the forecast fiscal deficit for 2022 was revised to 4.1 per cent of GDP, the same as in 2021. By July, however, the budget had recorded a cumulative surplus of about 1 per cent of GDP. The budget revision includes a package of measures to compensate for inflation, among them a 10 per cent hike in pensions, tax relief for families with children, full compensation of corporate electricity bills at prices above €125/MWh and value added tax (VAT) cuts to 0 per cent for bread and flour and 9 per cent for gas and heating. The government also raised the VAT registration threshold for firms from BGN 50,000 (€26,000) to BGN 100,000 (€51,200). Policy support did not include households, as the retail electricity market in Bulgaria is still regulated.

Inflation pressures, energy security risks and political uncertainty are all weighing on the short-term growth outlook. Although the economy has performed relatively well so far in 2022, the downside risks to growth are rising. A new political crisis could increase uncertainty and delay reforms, while inflation has the potential to rise even further given likely upward adjustments in electricity, heating and gas retail tariffs. Our 2022 GDP growth forecast is 3.0 per cent, while in 2023, we see a growth rate of 1.5 per cent as the overall slowdown in the eurozone affects Bulgarian exports and energy security risks weigh on confidence and economic activity.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

Energy security remains uncertain amid the halting of gas imports from Russia. In April 2022 Gazprom announced that it was shutting down exports to Bulgaria and Poland due to the countries' refusal to pay in Russian roubles. The announcement initially did not affect Bulgaria in a significant way, as gas accounts for the lowest share of gross energy consumption in the region, even though it imported almost entirely from Russia before the war. Moreover, immediately after the announcement, Bulgaria started to import Azerbaijani gas on a long-term contract, as well as liquefied natural gas (LNG), through Greece. Both the short- and long-term tenders for LNG and gas deliveries were launched in September 2022, as the caretaker government was considering all options, including relaunching Russian gas deliveries. The long-term LNG contract covers a 10-year period from 2024, booked through the Alexandroupolis terminal, while the important gas interconnector with Greece started operations from October 2022.

RRP implementation has started after significant delays. Despite the delay in the final approval of the RRP, which was given in April 2022, the authorities are trying to make up for lost time by fast-tracking the next steps. The government has swiftly set up a management and control system for the plan and has been actively meeting targets for the first disbursement request, initially planned for the second quarter of 2022, despite first needing to sign all of the technical agreements with the European Commission. In early August 2022 the Ministry of Finance signed the operational agreements with the Commission. To improve the management of RRP investments, the government reached an agreement on technical support with the European Bank for Reconstruction and Development (EBRD), while it signed agreements with the European Investment Bank and the World Bank for technical support in absorbing 2021-27 programming period funds totalling €11 billion. Parliament needs to adopt important milestones, including those related to judicial reform, by the end of 2022. However, the political uncertainty poses significant implementation risks.

E-governance reforms have progressed, alongside a new ministry focused on digital transformation. Some of the main measures adopted or in the works are: i) the development of an electronic identification tool and regulatory amendments to use the system; ii) the facilitation of online access to documents; iii) the digitalisation of cadastre, procurement and public information; iv) the strengthening of public institutions' cybersecurity; and v) support for ministries on various aspects of digitalisation, including justice, road administration, healthcare, tourism and education.

As part of the RRP, the government launched state-aid schemes for the modernisation of firms. The tender for the €130 million support scheme for technological modernisation was launched in July 2022 and received more than 2,500 proposals for about BGN 634 million (€323 million). The scheme targets small and medium-sized enterprise (SME) investment in new information and communication technologies, with the aim of increasing the overall productivity of Bulgarian SMEs, and has a target of 1,492 completed projects by the end of 2024. A second fund will be focused on equity investments in venture capital, technology transfer and social impact funds. The instrument will be managed by the European Investment Fund. These funds will be complemented by two similar programmes worth €3.57 billion financed by European Union structural funds, which will start in 2023.

The government has adopted a 2030 strategic plan to develop transport infrastructure. The plan includes measures to stimulate sustainable transport and intermodal infrastructure. These include intermodal links in Sofia and Northern Bulgaria and a feasibility study for a terminal in Vidin, as well as railway modernisation to link with ports. In July 2022 the transport ministry signed the decision that, for cost-cutting reasons, the state-owned Bulgarian Railways Holding would merge back into a single entity with its passenger and freight subsidiaries. This goes against the decision in late 2019 to fully separate the passenger and freight companies, but the announced plans include a potential listing of the company in 2024.

The Employment Promotion Act was amended. Parliament adopted the Employment Promotion Act in May 2022, aimed at strengthening the labour-market inclusion of inactive persons, young people not in training or education (NEETs) and those with informal training, who will get their skills validated in vocational training centres. This was a reform milestone for the second disbursement of the Recovery and Resilience Facility, planned for the end of 2022. The Employment Agency will now be tasked with actively interacting with and collecting information on inactive persons. An amendment to the bill ensures that Ukrainian refugees are included in the renewed effort.