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BULGARIAN ECONOMY ON THE VERGE OF EURO AREA – CURRENT CHALLENGES AND MEDIUM-TERM PROJECTIONS[7]

The paper examines the current state and development of the Bulgarian economy in 2022 and the first quarter of 2023 considering domestically determined and regional factors and processes. We analyse the real sector of the Bulgarian economy by tracing the dynamics of economic activity (GDP, inflation, and unemployment) considering internal and external factors affecting inflation dynamics and labour market processes. The sustainability of the fiscal sector is viewed through the possibilities of financing the green and digital transition using EU funds and programmes, and the policies needed to preserve the fiscal stability. Prospects for foreign trade are discussed in terms of the economic situation and expectations of Bulgaria's main trading partners, considering the high connectivity with the euro area and the structural specificities of foreign trade relations. The analysis of the financial sector (banking sector and capital market) focuses on the implications of the monetary policy pursued by the European Central Bank and the regulatory actions of the Bulgarian National Bank, as well as on the risks

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for the stable functioning of the sector in a dynamic macroeconomic environment. Expectations and forecasts for the Bulgarian economy to 2025 are based on key assumptions about the global economic processes and locally determined challenges. Recommendations are made to the national economic policy aimed at preserving the purchasing power of the population's income and the need to restructure certain fiscal measures.

Keywords: economic dynamics; labour market; fiscal sustainability; foreign trade; banking sector; capital market; macroeconomic projections; economic policy recommendations

JEL: E2; E44; E47; E60

Introduction

Traditionally, the Institute of Economic Research at the Bulgarian Academy of Sciences (ERI at BAS) presents its Annual Report that analyses the economic development of Bulgaria and the economic policies implemented. The Annual Report for 2023 examines the state and development of the Bulgarian economy in 2022 and the first quarter of 2023 and presents estimates of economic development to 2025.

The real sector of the Bulgarian economy is examined both in terms of the dynamics and short-term indicators of economic activity and in relation to labour market processes and their relationship to price developments. The strong dependence of budget revenues on the dynamics of consumption and imports, and hence on inflation in Bulgaria is discussed. We view the delay in national legislation as regards the National Recovery and Resilience Plan (NRRP) as a significant risk to the implementation of the planned investment projects and the government's capital programme. Although government debt in Bulgaria is still low, fiscal prudence is advisable given the pressures on public finances and the need to maintain fiscal buffers amid high regional and global economic uncertainty.

When analysing the processes in the external sector, we focus on the dynamics of the external environment, in particular the euro area, and the country's main trading partners. The commodity structure of exports and imports and the balance of payments are examined in terms of competitiveness and the sustainability of the foreign trade position. The analysis of banking sector processes in Bulgaria in 2022 and early 2023 is based on the regulatory policy of the Bulgarian National Bank (BNB) and banks' lending activity. The structural specificities of the capital market and positive developments in recent years are also commented. The main factors and risks that are expected to determine the state of the financial sector in the country in 2023 are outlined.

Based on a structural macroeconomic model, a medium-term macroeconomic framework for the Bulgarian economy to 2025 is proposed. The forecast reflects different assumptions about both the dynamics of the external economic environment and the expected directions of economic governance that shape the state and opportunities for the Bulgarian economy in the forthcoming accession to the euro area. In conclusion, we made recommendations that aimed at preserving the purchasing power of the population's income and restructuring certain fiscal measures so smooth accession to the euro area to be ensured.

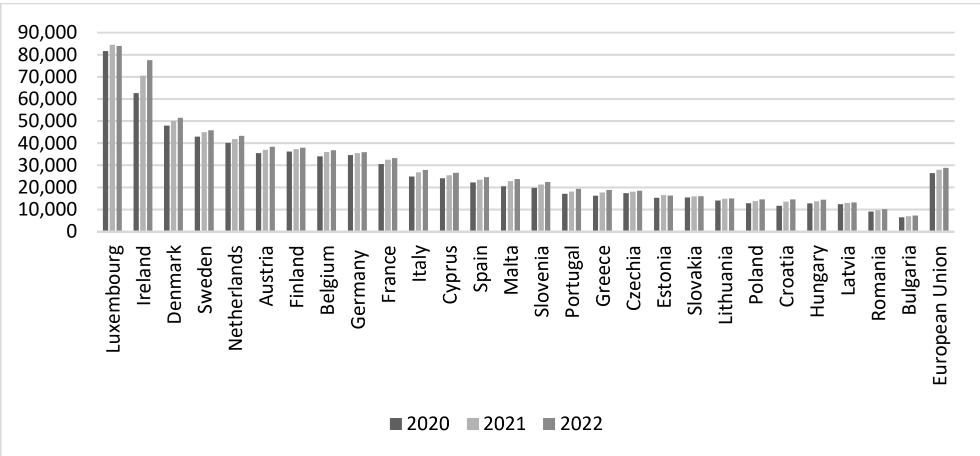
1. Real Sector and Labour Market

1.1. Economic Activity Dynamics

The economic growth for 2022 was 3.4% which represents a significant slowdown compared to the record real GDP growth of 7.6% achieved in 2021. The slowdown in economic activity in 2022 is a result of the deteriorating economic situation both regionally and globally due to the military conflict between Russia and Ukraine, the subsequent multifaceted economic sanctions against Russia, as well as the strict anti-epidemic measures taken in China to contain COVID-19, which caused difficulties and disruptions in supply chains of goods and raw materials.

The real GDP per capita in Bulgaria for 2022 amounts to 7,250 Euros. In comparison, the average real GDP per capita in the EU for 2022 is 28,810 euro indicating that Bulgaria lags in real income per capita more than 4 times compared to the EU average (Figure 1). The significant income disparity between Bulgaria and Romania is also evident, where the real GDP per capita in 2022 reaches 10,110 euros. According to Sariiski and Rangelova (2022), the different focus of initiated reforms and specific design of economic policies account for Romania's more successful transition to a market economy compared to Bulgaria. Unlike Bulgaria, Romania emphasizes more on improving its institutional framework, contributing to enhancing the competitiveness of its economy and the development of an effective market mechanism.

Figure 1. Real GDP per capita (euro)

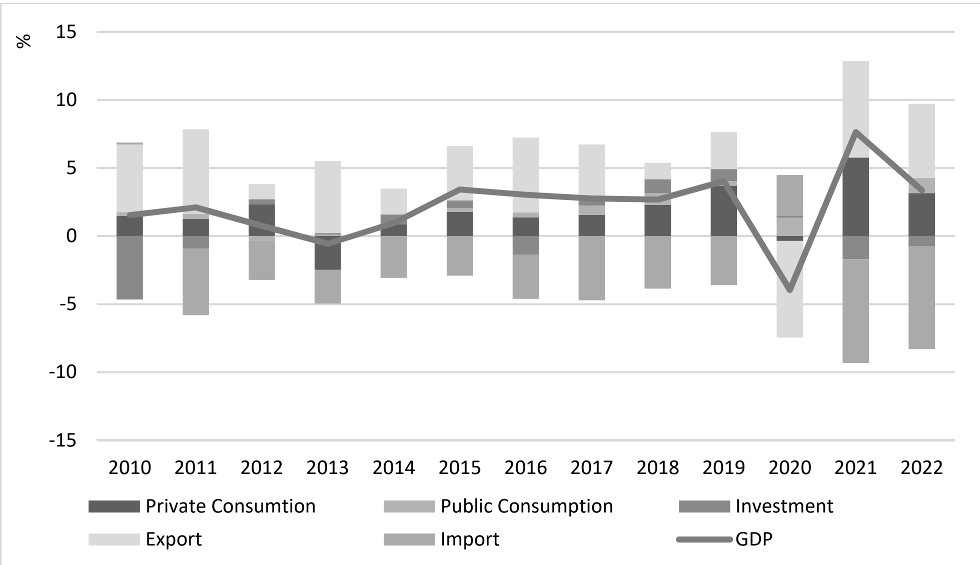


Source: Eurostat.

Another important indicator that confirms the country's lagging position among the other EU Member States (Minassian, 2021) is the Gini coefficient. According to Eurostat data for 2022, in Bulgaria, the equivalised disposable income before social transfers stands at 38.4 points, compared to the EU average of approximately 30 points and around 32.0 points for Romania. This indicates the highest income inequality in Bulgaria within the EU.

The most significant contributions to the annual growth of real GDP in 2022 are due to the increase in private and public consumption, as well as exports of goods and services (Figure 2). The higher household consumption in 2022 is driven by substantial growth in nominal labour incomes, including pension and social assistance increases, as well as wage indexation throughout the year outpacing the inflation rate. The increase in net fiscal transfers to households maintains employment and accelerates credit activity. Along with lower household savings rates due to rising inflation and low-interest rates on deposits, the increased fiscal transfers have an additional stimulating effect on household consumption. However, compared to 2021, there is a decline in the real growth of individual consumption due to higher economic uncertainty and households' expectations of deteriorating future financial conditions primarily driven by rising consumer prices in 2022. The increase in public consumption is driven by higher government intermediate consumption and wages for employed in the budgetary sector.

Figure 2. Dynamics of Real GDP by Components of Final Consumption



Source: National Statistical Institute.

Net exports also contribute to economic growth in 2022. The annual growth rate of exports is increasing, both in the export of goods and services. The growth in imports is in line with the dynamics of the components of final demand and the high import component of local production.

In 2022, gross fixed capital formation recorded a real decline of 4.3%, further deepening the unfavourable trend of contracting investment activity in Bulgaria as observed in recent years. Among the leading factors for this decline in the private sector are the high level of economic uncertainty and the underutilized production capacities in the industry, which hinder the transformation of corporate financing into investments in physical capital. The reasons for the decline in investments in the public sector are mainly due to the nearly three years of political instability which has led to delays in the implementation of various infrastructure projects. However, it is noteworthy that in 2022, the decline in investments is significantly smaller compared to 2021 and a positive change can be expected in 2023. The reasons for this are associated with payments under the NRRP.

In 2022, the gross value added (GVA) increased by 3.4% on an annual basis. The industrial sector accounts for approximately 26% of the GVA in the economy and is the only sector that experienced growth during the year under review. The growth in this sector is primarily attributed to manufacturing driven by increased exports of goods and higher domestic demand. On the other hand, the construction sector continues to experience a decline in its value-added mainly due to the slowdown in infrastructure projects. The share of the agricultural sector remains unchanged at 5% of the GVA despite a decrease in production volumes in crop and livestock farming and an increase in prices in the sector ranging between 20% and 50%[8].

Enterprises in the IT sector, which traditionally realize high value-added, account for a relatively low share of the total production in the country (7.3%). The sector, which includes scientific research, also achieves relatively low value-added (6.8%). The contribution of these two sectors to the structure of GDP should be a primary source for revitalizing innovative processes in Bulgaria. It is necessary to establish an effective mechanism for interaction between the government and these two sectors, aiming to create goods and services with high value-added and enhance the resilience of the Bulgarian economy to external shocks and cyclical fluctuations.

The data for the overall business climate indicator in Bulgaria in 2022 shows that its values remained close to the levels at the end of 2021. A significant decline in the index was observed in March and October 2022. During the remaining months, the values of the index increased but at a relatively slower pace. Among the most significant reasons causing economic uncertainty are the military conflict between Russia and Ukraine which started in late February 2022, high energy prices, shortages of materials and equipment due to difficulties in global supply chains, and a labour shortage in certain sectors of the economy crucial for the implementation of the green and digital transition (such as healthcare, education, engineering, food, and beverage industry, etc.). However, trends in the first quarter of 2023 appear favourable, with reported slight growth in the business climate indicator compared to the first quarter of 2022.

1.2. Inflation Dynamics and Wages

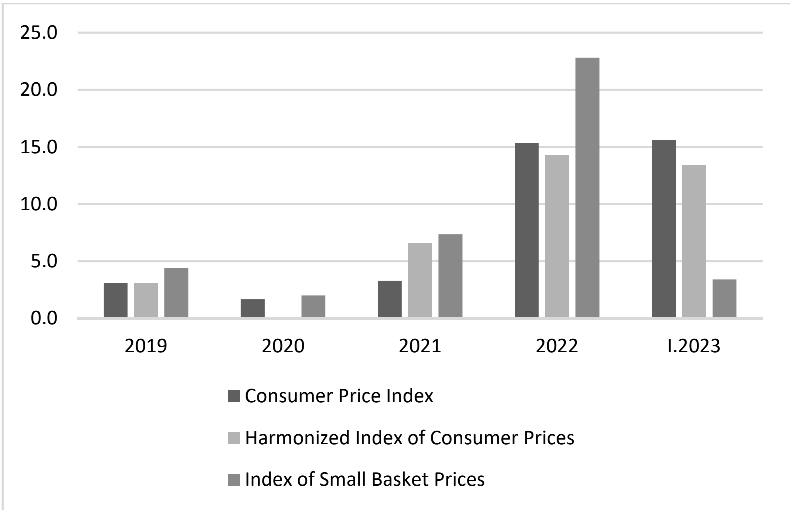
Inflation, measured by the Consumer Price Index (CPI), recorded a significant increase of 15.3% on an annual basis in 2022 (compared to 3.3% in 2021 and 1.7% in 2020). The annual inflation, measured by the Harmonized Index of Consumer Prices (HICP), also registers a substantial rise in 2022 (reaching 14.3%) with a slight deceleration observed towards the end

[8] First Estimate of Economic Accounts for Agriculture for 2022 https://www.nsi.bg/sites/default/files/files/pressreleases/AgrEAA_firstEst2022_9QO84WL.pdf.

of the year. The faster price growth in Bulgaria compared to the euro area Member States imposed the government to postpone the preparation of the Convergence Report to assess Bulgaria's readiness to join the euro area in 2022 mainly due to the failure to meet the inflation criterion.

The price dynamics are attributed to a series of external and internal shocks. Among the factors contributing to the rise in prices in 2022, the most significant are the increasing costs of primary energy sources (such as oil, natural gas, and electricity) and agricultural products on international markets, as well as high prices for international transportation. The depreciation of the euro against the US dollar is another factor driving up prices, affecting both imported basic raw materials, many of which are traded in US dollars on international markets, and imported consumer goods from third countries outside the EU and the euro area. Low-interest rates on deposits and loans set by the European Central Bank (ECB), which were maintained during the first half of 2022, combined with the continued fiscal stimulus to address the consequences of the COVID-19 pandemic, are also essential factors contributing to the acceleration of inflation. These factors amplify consumption growth during the first half of 2022.

Figure 3. Annual rate of change in consumer price indices



Source: National Statistical Institute.

The domestic pro-inflationary factors that have the most significant effect are the increased production costs due to higher electricity prices for industrial consumers and rising labour costs. The higher domestic demand resulting from increased wages, pensions, and social payments, as well as the growth of credits to households and non-financial enterprises, is also a significant driver for the acceleration of consumer prices.

During the first quarter of 2023, the slowdown in inflation observed at the end of 2022 continues, but the reported values are still relatively high. The annual inflation rate in

Bulgaria, measured by the HICP, decelerates to 8.6% in May. The pace of increase in the main components of the index such as food, services, energy products, and transport fuels, also shows moderation. Among the factors contributing to the slowing down of inflation, the most significant contribution comes from the declining dynamics of energy and other commodity prices in international markets.

In 2022, the average annual wage in Bulgaria continued the trend from the previous year, increasing both nominally and in real terms. According to preliminary data from the National Statistical Institute (NSI) the average annual wage in 2022 increased by 13%. Bulgaria ranked at the top among the EU Member States in terms of the growth in the average wage, with an increase that was over 3 times higher compared to the EU Member States of Western Europe.

Although the nominal wages have been steadily increasing over the past five years, in 2022 the growth rate was the highest which is reflected in the overall price level in Bulgaria. The reasons for this can be attributed to the indexing of a significant portion of labour remuneration due to the general rise in consumer prices and the limited labour supply in the country. The continued impact of fiscal measures to overcome the consequences of the COVID-19 pandemic also plays a role. However, in 2022, the previously established differences in the leading growth of labour incomes in the public compared to the private sector are no longer evident. The accelerated increase in wages compared to the previous few years is largely attributed to the private sector (14%). In the public sector, wage growth compared to 2021 is 9.5%. It is noteworthy that in the healthcare sector, wages decrease by 12.5% primarily due to the discontinuation of additional material incentives paid to frontline medical workers during the COVID-19 pandemic.

Despite the increase in the minimum wage in 2022 the share of the minimum wage compared to the average wage remains relatively constant (around 40%). It remains close to values observed in other EU Member States. This process has a negative impact on the disposable income of low-skilled workers, who predominantly purchase essential goods, the prices of which have increased most drastically in 2022.

The process of wage growth continues to outpace labour productivity growth. In 2019-2021 both indicators followed identical growth rates, with a difference of around 7 percentage points. However, in 2022, a difference of 11 percentage points was observed. These discrepancies in the dynamics of labour productivity and wages indicate that wages in Bulgaria are primarily influenced not so much by the workers and employees achieved economic results but rather by other mainly price-related factors. This is a contributing factor to the acceleration of inflation in the country.

1.3. Main labour market indicators in Bulgaria compared to the European Union

After a two-year decline, the labour force (comprising both employed and unemployed individuals) in Bulgaria indicates growth in 2022, despite a reported decrease in the working-age population. This increase was primarily due to the lifting of all restrictive measures related to the COVID-19 pandemic in sectors such as commerce, transportation, hospitality, and restaurants.

In 2022, the number of unemployed individuals was 140.4 thousand people, which was even lower than the registered minimum in 2019 (142.8 thousand people). Among the unemployed individuals aged 15 and above, the largest decline in unemployment was observed in the 35-44 age group. The number of long-term unemployed individuals, those without a job for over a year, also decreased in 2022. In 2022 there were 52 thousand discouraged individuals in the same age group. The number of long-term unemployed individuals also decreases as the relative share of long-term unemployed compared to the total number of unemployed for 2022 is 54%.

Following the indicators of economic activity, employment, and unemployment, Bulgaria's position is improving and converging with the overall trends of labour market indicators for EU-27 Member States after 2019 (Table 1). The employment rate of individuals between 15- and 64-years old reaches values comparable to the EU-27 average in the past few years, and in 2022, it even surpasses the EU-27 average (70.4%). The unemployment rate is decreasing in all EU Member States, with Bulgaria maintaining a lower rate compared to other EU countries (4.3%). However, the slower transition of the unemployed to employment is the main reason why the share of long-term unemployed individuals aged 15-74 in Bulgaria continues to remain higher compared to other EU Member States.

The value of the Neither in Employment nor in Education and Training (NEETs) indicator for Bulgaria is significantly higher than the other EU Member States although its values have been continuously decreasing between 2020 and 2022. Among the most important reasons for the youth being outside the labour market are the lack of education and poverty. Considering that Bulgaria is among the five countries with the highest share of NEETs in the EU, there is a need for reformulation and reorientation of existing policies addressing this issue.

Table 1. Employment rate, unemployment rate, and long-term unemployment rate in Bulgaria and EU-27 (%)

	2020	2021	2022
Employment rate (15-64)			
Bulgaria	67.6	68.1	70.4
EU-27	67.0	68.3	69.8
Unemployment rate (15-74)			
Bulgaria	6.1	5.3	4.3
EU-27	7.2	7.1	6.2
Share of long-term unemployed in total unemployed (15-74)			
Bulgaria	44.4	49.4	53.7
EU-27	33.9	39.2	38.5
Neither in Employment nor in Education and Training (NEETs)			
Bulgaria	18.2	17.6	15.1
EU-27	13.9	13.1	11.7
Economic activity rate (15-64)			
Bulgaria	72.1	72.0	73.6
EU-27	72.4	73.6	74.5

Source: Eurostat.

Increasing the economic activity of the population should be among the fundamental priorities of the economic policy in Bulgaria. The main stimulating measures aimed at increasing the economic activity of the population should be directed towards activating the potential workforce (inactive individuals, people with disabilities, those not working due to personal or family reasons, seasonal workers, etc.), supporting the work-life balance, offering flexible employment, part-time jobs, maintaining the labour force participation of individuals in retirement age, and removing barriers to active job search caused by poverty, poor health, and unfavourable living conditions. On the other hand, increasing incomes and implementing appropriate policies to encourage employment and active labour market behaviour will enhance activity and motivation for work. Another possibility is the effective management of free movement and migration processes.

2. Fiscal Sector and Challenges to Public Finances

At the beginning of June 2023, the National Assembly approved a second extended budget law, ensuring stability in the budget expenditure financing until the approval of the State Budget Law for 2023. In the updated medium-term budget forecast for 2023-2025 and the draft State Budget for 2023, a fiscal deficit of 2.5% of GDP on a cash basis and 3% of GDP on an accrual basis has been set up. Such a target for fiscal position for 2023 complies with the Maastricht fiscal deficit criteria required for joining the euro area. The fiscal deficit target of 3% of GDP in the draft budget has been achieved, implementing fiscal policies for keeping VAT reductions for some businesses, and collecting 100% dividends from the profit of state-owned enterprises for 2022. In the expenditure part of the Consolidated Fiscal Program (CFP), all social payments, as well as the update of pensions from July 1, 2023, have been preserved, while business subsidies have been substantially reduced. Capital expenditure has been increased by 1.1% compared to 2022, reaching 4.5% of GDP to support economic growth. According to ERI of BAS estimates, however, these funds will not be sufficient, considering the completion of payments on European projects for the EU Multiannual Financial Framework (MFF) 2014-2020 and the new projects started with the EU MFF for 2021-2027.

2.1. Budget revenues and tax policy

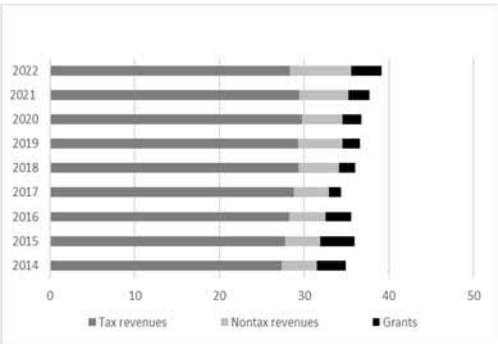
In 2022, the budget revenues increased by 1.5% of GDP on an annual basis, mainly due to higher non-tax revenues and EU grants. The relative reduction of the share of tax revenues in the structure of budget revenues shows the collection of tax revenues in the country, which, despite tax compliance measures in recent years, remains relatively unsatisfactory. The recorded annual growth in non-tax revenues and grants reflects the increased receipts of the Electricity System Security Fund, as well as EU grants, including the initial tranche from the EU Recovery and Resilience Mechanism (RRM) under Bulgaria’s NRRP.

The tax revenues recorded an increase in nominal terms on an annual basis but a decrease of about 1% as a ratio to GDP (figure 4). The growth of tax revenues in the context of rising inflation is expected, with the catch-up growth of incomes in line with the fiscal expansion driving additional inflationary processes. The taxes on profits rose because of the restored economic activity and the normalized functioning of global supply chains. As a result of the anti-crisis government measures taken to overcome the decline in employment and incomes and the gradual recovery of economic activity, personal income tax revenues increased in nominal terms, but fell as a ratio of GDP. The reduction in relative terms is a result of imposing new additional tax reliefs to support households.

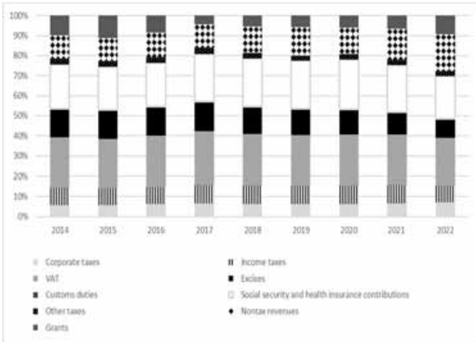
The indirect tax revenues were strongly influenced by the increased domestic consumption and imports. However, the reduction of VAT for some businesses has had a negative effect on revenues from VAT. Such measures should only be applied temporarily because they lead to a decrease in tax revenues, which limits the fiscal space for implementing priority spending policies. They represent hidden state aid and have a questionable impact on economic activity and employment. In 2022, the increased household incomes, higher social security maximum taxable income (up to BGN 3,400), and the increase in the length of service and retirement age led to an increase in social security revenues, and thus, the tax burden has been increasingly transferred to social security. The non-tax revenues grew significantly compared to the previous year, which was mainly due to the revenues of the Electricity System Security Fund. The funds were used to compensate households and business entities given the high electricity prices and to increase the share of renewable sources in the energy mix. Other policies that had an effect on the non-tax revenues during the year were related to the contributions to the state budget from deductions from profit and income from dividends of state-owned enterprises and commercial companies with state participation in the capital, the expansion of the scope and the update of the tariffs for the distance travelled within the phased introduction of the toll system, as well as the use of kindergartens and nurseries free of charge.

Figure 4. Budget revenues for the period 2014-2022

a) Main groups of budget revenues (% of GDP)



b) Structure of budget revenues (%)



Source: Ministry of Finance.

In 2022, Bulgaria received the first tranche of EUR 1.3 billion from the RRM. Despite project delays, the ending of the 2014-2020 EU program period and the advanced stage of implementation of investment projects for the new 2021-2027 period also had an impact on the growing revenues from EU grants. However, non-implementation of some European projects within the specified period by the end of 2023 becomes a fiscal risk for the next budgets as the national resources for their finalization will be needed.

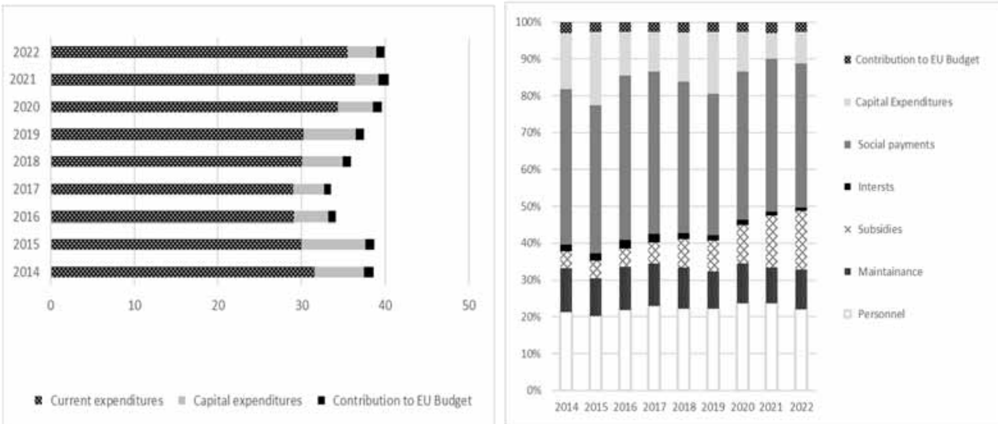
2.2. Government expenditure and spending policy

In 2022, the total budget expenditures under the CFP amounted to 40% of GDP, with a growth trend (figure 5). Although the share of budget expenditures for 2022 remained within the limits of 40% of GDP, determined by the Law on Public Finances, the implementation of investment projects with European funding in 2023 and increasing social expenditures may result in exceeding that level. The COVID-19 pandemic crisis measures have had an upward effect on current social expenditure, and they could hardly be reduced in the future without improving the efficiency of public expenditures. The one-off fiscal measures to support households and businesses to overcome the consequences of the pandemic crisis have been additionally reduced in 2022.[9]

Government subsidies continued to grow in 2022. A significant contribution to this surge was the cost of compensating business and households' customers of electricity, as well as the implementation of investment projects of state-owned enterprises and companies from the private sector, financed with EU funds. However, compensation for high energy prices represents a distortionary support mechanism by increasing the production of electricity from renewable sources.

Figure 5. Budget expenditures for the period 2014-2022

a) Main groups of budget expenditures (% of GDP) b) Structure of budget expenditures (%)



Source: Ministry of Finance.

The government programs for supporting many sectors of the economy had a positive effect on employment and predictability for business, but they also fuelled a higher inflationary environment. For households, fiscal support should be adjusted by gradually shifting existing mechanisms towards directly supporting those households who are in real need, building on existing income-based social protection programs, such as heating allowances (Peneva,

[9]According to estimates by the International Monetary Fund, one-time anti-crisis measures for businesses and households amount to 3.2% of GDP in 2020, 5% in 2021 and 1.5% in 2022. See the International Monetary Fund Article IV Report for 2022 for Bulgaria.

2022). This would preserve energy affordability, be fairness, limit price distortions and promote efficiency and energy savings as a goal of the green transition.

Although public sector compensations of employees decreasing as a proportion of GDP and as a share of total costs, they are showing sustained growth. The main factors for their rise were the higher minimum wage and minimum social security insurance thresholds, as well as the additional increase in remuneration in health and education areas of the public sector.

In the structure of budget expenditures in 2022, social security and other social benefits continued to become the biggest share. The persistent upward trend in public social spending and the ageing of the population represents a major risk to the fiscal position in the medium term, which requires structural reforms and optimization of public spending. A positive factor for restoring the balance in the pension system has been the gradual increase in the age and the period of social insurance for retirement, whose effects, however, have been assessed limited in the medium term considering the excessive expansion of pension costs.

The inefficiency of public spending and low taxation led to a limitation of fiscal space, which should be used as a priority to solve and address long-term social security and protection needs within the planned fiscal trajectory[10]. Given the small size of the national market, the open nature of the economy and its high degree of dependence on the processes in the EU and the euro area, tax and social security policy must be tailored to the promotion of the business environment and the achievement of higher sustainable economic growth. The development of economic capacity to ensure higher incomes, and, accordingly, social security budget revenues would ensure fiscal sustainability and stability of the pension system in the medium term.

Public investment projects with national and European funding are a major source for improving and protecting the environment in the context of the green transition, infrastructure and trans-European connectivity, modernization of educational and social infrastructure, and their delay had a negative impact on convergence and catch-up income growth. The mechanisms for transparent spending of public funds for investment projects are still limited only to compliance with European procedures, but the capacity to implement public-private partnerships, where the private sector shares the risk, is still not developed. In 2022, capital spending, an important fiscal stimulus for economic growth, slightly increased as a share of GDP to 3.5%, however, to a much lesser degree compared to 5.9% of GDP in 2014 and 7.7% in 2015 when the payments for the European projects for the program period 2007-2013 ended. Expectations for accelerated implementation of European investment projects for the EU program period 2014-2020 in 2022 have not been justified. The latter puts the fiscal position for 2023 at risk, because, in addition to the end of the already finished EU program period, the implementation of the new projects for the 2021-2027 EU program period, as well as the projects under the NRRP, began, and emphasis should be placed on the optimization of current costs and improving their efficiency.

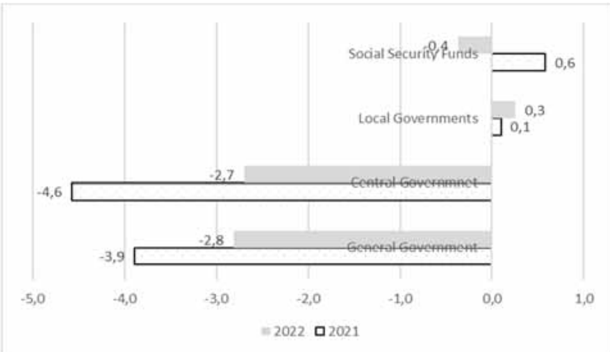
[10] This issue is discussed in detail in Tsanov, Shopov, Hristoskov (2022).

2.3. Budget balance and government debt

The deficit of the General Government for 2022 amounted to 2.8% of GDP (Figure 6), fulfilling the Maastricht criteria. The deficit of the central government decreased on an annual basis, mainly due to the low implementation of the European investment projects and the limited capital expenditure with national funding. The surplus of social security funds was a result of larger transfers from the central government.

The cash deficit of the CFP is significantly lower due to the surplus on European funds. The continued maintenance of a national budget deficit for the third year in a row is the result of the government's discretionary policy in income and social protection. The structural reforms should be undertaken in the revenue and expenditure parts of the budget, as the continuity of deficits over the following years threatens fiscal sustainability in the medium term.

Figure 6. Fiscal deficit by sub-sector of General Government for 2022 and 2021 (accrual basis, % of GDP)



Source: Fiscal Notification (April 2023).

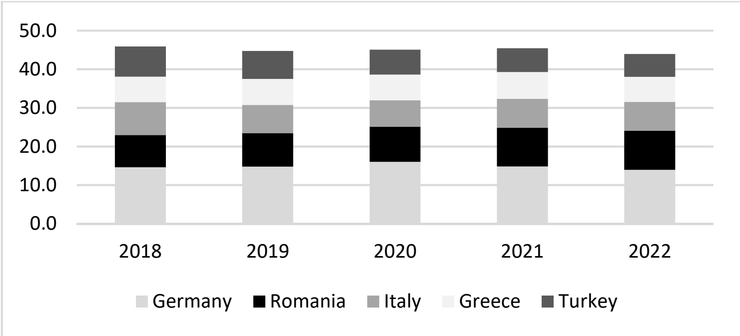
The increase in government debt to finance the fiscal deficit because of the expected lower budget revenues relative to government expenditures in the coming years and higher interest rates in international financial markets will lead to an increase in debt servicing costs and will further limit fiscal space for priority spending policies. The consolidated government debt for 2022 amounts to 22.9% of GDP, which continues to be among the lowest in the EU. The external debt represented 70% of the consolidated government debt. In March 2022 the Eurobonds of EUR 1.25 billion were repaid, but the debt issuance of Eurobonds remained with the largest relative share in the government debt structure.

3. External Sector and External Economic Environment

3.1. Main trading partners and processes in foreign trade in goods in 2022

According to BNB data on Bulgaria's trading partners, Germany, Romania, Italy, Greece, and Turkey stand out as regards merchandise exports, consistently accounting for over 45% of Bulgaria's total exports between 2018 and 2022 (Figure 7). That is why the economic situation in the abovementioned countries, as well as the prospects for their economic development, are key factors for the dynamics of Bulgarian foreign trade in goods.

Figure 7. Share of Bulgaria's total exports to major trading partners in the period 2018-2022 (%)



Source: Bulgarian National Bank.

Bulgarian exports are directed to the domestic market of the euro area, which accounts for over 45% of the country's exports. The weaker recovery of the German economy, the steady decline in the importance of the Italian and Greek markets for Bulgarian exports in recent years and the uncertain macroeconomic situation in Turkey are factors that further negatively affect the dynamics of exports of goods in 2022.

In the period 2018-2022, Germany accounts for 15% of Bulgaria's total exports of goods, making its economic development key for Bulgaria as regards foreign trade. Despite maintaining its persistently high income levels (GDP per capita in PPP is above 120 compared to the EU average), the German economy was beginning to experience a slowdown in economic growth due to the lower domestic demand growth rates, slowing export growth because of global and regional uncertainties, and the gradual imposition of new environmental standards in manufacturing and especially automotive. The severely tightened health measures to contain the COVID-19 pandemic further exacerbate the processes described. Such a development would adversely affect the opportunities of Bulgarian exporters given that the high exports of goods to Germany are primarily based on German investment attracted in the country. According to BNB data, the share of foreign direct investment from Germany in total foreign investment attracted for 2022 is 10% (EUR 235 million). The most affected by a deterioration in economic development in Germany would be exports of raw materials (copper, ores, and precious metals) as well as investment goods from the engineering, chemical, electronics and pharmaceutical sectors, which are also high value-added.

The share of Bulgarian exports to Romania is gradually increasing, amounting to 10% of total exports in 2022. The geographic proximity of the country allows for export specialisation mainly in agricultural production, but the accelerated growth rates of the Romanian economy (GDP per capita in the PPP of 55 compared to the EU average in 2011 reaches 77% in 2022) also expand the opportunities for exports of electricity, medicines, agricultural machinery, and goods from the chemical industry. The fiscal measures to increase the average income in all age groups, the improvement of the business environment and the accelerated attraction of foreign investment shape the increasing import and investment goods needs in Romania and provide new opportunities for Bulgarian exporters.

The economic difficulties after the global financial and economic crisis of 2008 in Italy led to a gradual decrease in exports of goods from Bulgaria, with their share in 2021 and 2022 stabilizing at 7.5%, while in 2008 Italy was the first among Bulgarian foreign trade partners. The traditional links between the two countries in the field of foreign trade are based on the enterprises financed by Italian investments, which in 2022 exceeded 197 million euros, as well as the high share of Bulgarian emigrants, which are more than 60 thousand people (according to Eurostat). Very similar to the economic situation in Italy is the economic situation in Greece, whose share in Bulgaria's merchandise exports is gradually shrinking and in 2022 amounted to 6.5%. The Bulgarian trade flows to Greece are mainly related to the country's tourism sector as regards hotel equipment, food products, non-durable consumer goods and textiles. Given the high cyclical vulnerability of the tourism and travel sector, export opportunities from Bulgaria to Greece are volatile. In addition to geographical proximity, traditional links through Greek-owned enterprises and a large expatriate community also contribute to trade between the two countries.

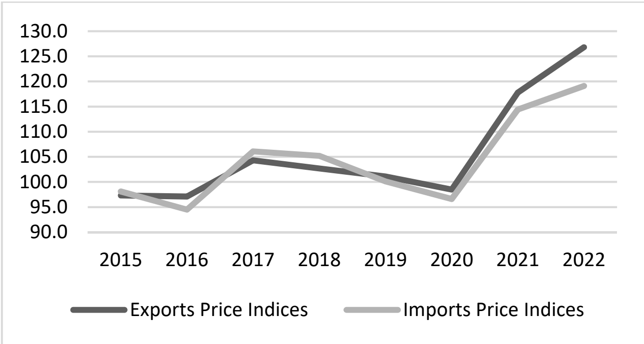
The average value of exports of Bulgarian goods to Turkey over the last 5 years is the same as that to Greece and is approximately 7% of total foreign trade. Following the depreciation of the Turkish lira and difficulties in the functioning of Asian supply chains, which Turkish exporters are partly compensating, Turkish export opportunities are favoured, which negatively affects Bulgarian exporters. Strong domestic consumption has been a key driver of Turkey's economic growth, sustaining imports, but the outlook for 2023 looks unfavourable. The slowdown in private investment in physical capital is expected to be offset by higher public investment, especially in infrastructure in the affected areas by the devastating earthquake in February 2023 and by the spending incurred in the pre-election period. Domestic demand is expected to be supported by sustained job creation and a substantial increase in the minimum wage in 2023, but it should not be overlooked that unemployment is permanently settling at 10%.

3.2. Foreign trade developments in 2022

The analysis of Bulgarian foreign trade relations in 2022 shows that the advantages arising from the increase in global prices are being realised to a relatively low degree and structural inability of the economy to adapt to higher-tech production is evident. To a large extent, the developments observed in 2022 are not significantly different from previous years. However, several specific factors stand out:

1) After 2019, the export price index for commodities is higher than the import price index in Bulgaria which is an indicator of improved terms of trade for the economy (Figure 8). The most significant price advantages in 2022 are realized in trade in agricultural products and mineral fuels and to a lesser extent in chemicals and investment goods.

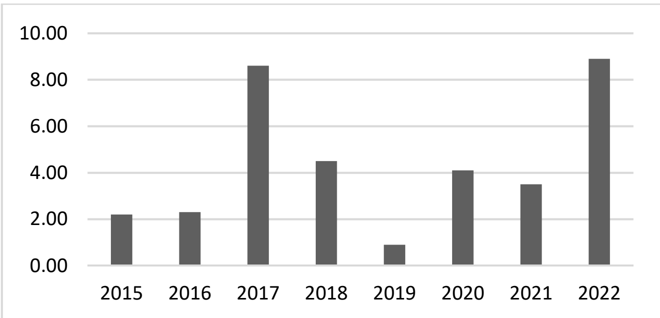
Figure 8. Bulgaria's export and import price indices in the period 2015-2022



Source: National Statistical Institute.

2) As regards labour costs, Bulgaria is one of the EU Member States with the most pronounced tendency to lose competitiveness vis-à-vis euro area trading partners (Figure 9). This indicator reflects not only changes in the exchange rate but also changes in labour costs, given the catching-up effects in the Bulgarian economy. In 2022, Bulgaria is the EU Member State with the highest labour cost growth in the whole EU, ahead of Estonia, Lithuania, and Hungary.

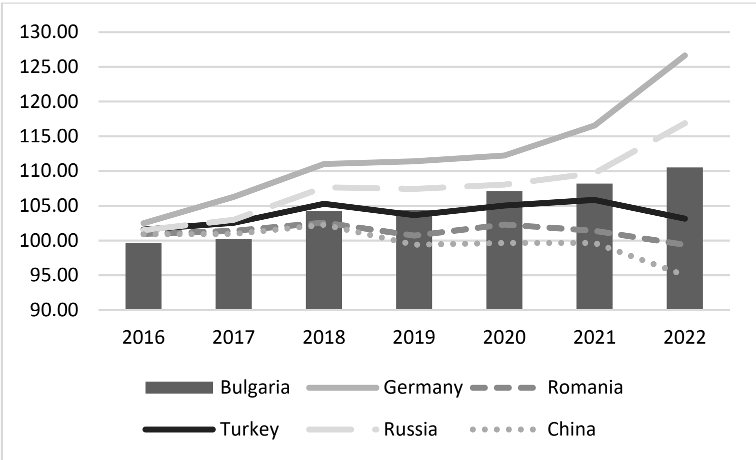
Figure 9. Annual labour cost change in Bulgaria relative to the main euro area trading partners over the period 2015-2022 (%)



Source: Eurostat.

3) Bulgaria's main import trade partners are Germany (10.6%), China (9.2%), Russia (8.7%), Turkey (7.1%) and Romania (5.3%). A comparison with the real effective exchange rate by trading partner (Figure 10) shows that the Bulgarian currency appreciates in real terms against the Turkish lira and the Romanian leu, which is unfavourable as regards the exports to these countries.

Figure 10. Real effective exchange rate deflated by the consumer price index against 42 trading partners (index 2015=100)



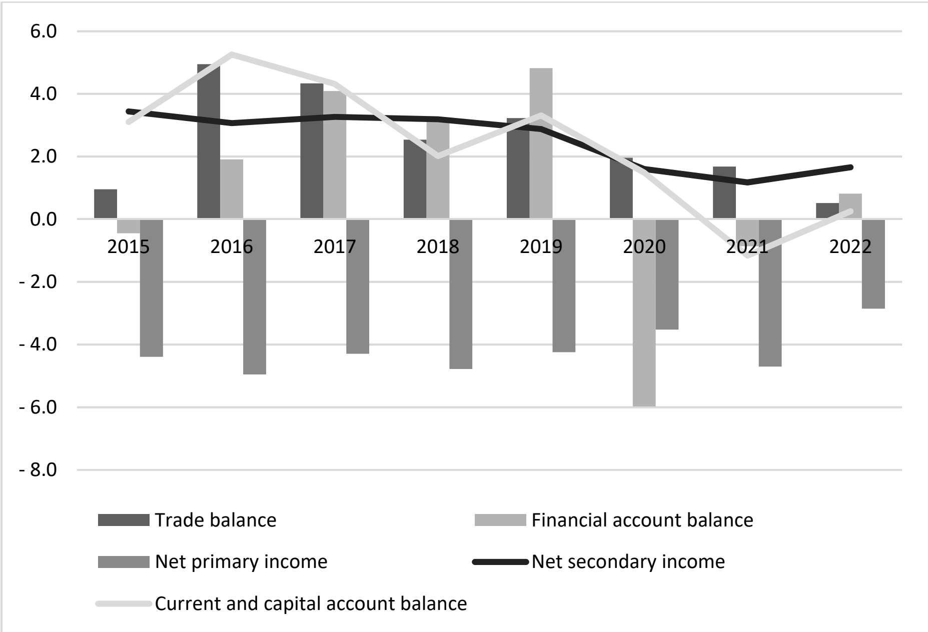
Source: Eurostat.

The higher value of the BGN against the Chinese yuan favours increased imports from China, and this is a prerequisite for a deterioration of Bulgaria's external trade balance. On the other hand, the process of appreciation of the Russian rouble in 2022 due to high energy prices and capital flow controls imposed by the Russian central bank made fuel imports from the country even more expensive. Given the high energy intensity of the Bulgarian economy, these developments further deteriorate competitiveness and have a negative effect on the terms of trade. On the positive side, the differences in the real effective exchange rate between Bulgaria and Germany favour the increase in exports to the country's main trading partner, despite signs of a contraction in domestic demand in Germany.

3.3. Balance of payments and external debt position

In 2022, the current and capital account balance improve relative to 2021 and amounts to 0.25% of GDP (Figure 11). The main contributor to this change is the over 70% year-on-year increase in general government receipts. The relative recovery of the economies of Spain, Italy and Greece has an impact on remittances received from nationals working abroad, which amount to 2% of GDP in 2022. Although shrinking in 2022, the primary income balance continues to be negative with a recorded outflow of over EUR 4 billion (4.8% of GDP) of investment income from Bulgaria. This process reflects the unfavourable investment environment in the country, where incentives to reinvest profits and business confidence of foreign investors are low. This is also demonstrated by foreign direct investment hardly exceeding 3% of GDP in recent years.

Figure 11. Key balance of payments indicators 2015-2022 (% of GDP)



Source: Bulgarian National Bank.

The country's external trade balance is also slightly positive (0.5% of GDP) with substantial growth in exports and imports of goods and services in 2022, reflecting higher prices and volumes of exported goods (especially electricity) and higher domestic demand and a high import component of exports. The relative improvement in the terms of trade (Figure 8) has had some restraining effect on the trade deficit. The trend of recent years for net trade in services to be positive has been maintained, exceeding 6.3% of GDP in 2022. The phasing out of the COVID-19 countermeasures and rising inflation, which is leading to an improvement in the terms of trade in services, allow for an annual growth of over 30% in international transport revenues and over 55% in tourism revenues in 2022. The two components of services have steadily accounted for over 60% of Bulgaria's total services exports by 2018, with their share shrinking to 45% between 2020 and 2022 because of the COVID-19 constraints.

The higher accumulation of foreign assets of residents in 2022 leads to a persistence of the positive balance on the financial account of the balance of payments (5.5% of GDP). This is mainly due to a substantial increase in foreign currency and deposits in Bulgarian banks of over EUR 3.2 billion, leading to an increase in the BNB's reserve assets, and a positive net value of the "Portfolio investments" item.

At the end of 2022, the country's gross external debt stands at 52.5% of GDP. Public sector external debt increased by 2.4% y-o-y, due to the EUR 2.25 billion sovereign Eurobond issuance on international capital markets in September 2022. Private sector external debt changed to a more significant extent (10.1% annual growth), mainly driven by the increase in the country's short-term banking sector debt. Although such a development is unfavourable, starting from the stronger pressure to repay short-term debt, the country's external debt dynamics are not unsustainable at present and the debt burden is far lower compared to other countries.

4. Banking Sector and Capital Market in Bulgaria

4.1. The banking system in 2022

In 2022, the banking sector operated in an environment mostly characterized by the military conflict in Ukraine, which resulted in the interruption of some traditional partnerships and sustainable logistics chains, as well as to blocking of a considerable portion of business activities globally because of the sanctions imposed against Russia. To rein in price trends, most central banks (including the ECB) took measures towards monetary tightening. The transmission of the effects of the monetary policy in Bulgaria resulted in simultaneous dynamics of inflation.

Against the background of the stable condition of the banking sector and the weakening of risks related to the COVID-19 pandemic as early as February 2022, BNB announced that it would discontinue the effect of the macroprudential measures imposed in March 2020 in relation to restrictions on banks' profit distribution for years 2019 and 2020. As from 1 April 2022, the effect of the measure for imposing individual and group limits on foreign counterparts aimed at limiting credit risk and the risk of concentration in the balances of commercial banks was also discontinued. The timely introduction of the above-mentioned measures had a crucial role in limiting the specific risks that arose during the period of the pandemic, but given their weakening, the lifting of measures at the beginning of last year was quite logical.

Along with that, the regulator took actions directed at the growing risk of cyclical decline, which were dictated by the prolonged high rates of credit growth and the increased economic uncertainty. As early as 2021, BNB announced two decisions to raise the level of the countercyclical capital buffer (respectively from 0.5% to 1.0%, as from 1 October 2022, and to 1.5%, as from 1 January 2023), and on 29 September 2022, a decision was made for another raising of the countercyclical capital buffer to 2.0%, as from 1 October 2023. During the annual review of the so-called other systemically important institutions, eight banks were identified for special measures. To obtain a more precise assessment of the risk resulting from the high growth rate (and the increasingly probable adjustment) of home prices at the beginning of 2022, BNB introduced an additional reporting form providing detailed information about the real estate-secured loans granted by banks to households.

The overall approach for managing the price dynamics (not only on the real estate market) continued in 2023, and by means of the amendments to Ordinance 21 of BNB adopted in April of the same year, as from 1 June 2023 the process of minimum reserve requirements on attracted funds from non-residents will be made equal to those from residents (by increasing it from 1 to 10%), and a month later (as from 1 July 2023) minimum reserve requirements on all attracted funds (from both residents and non-residents) will be raised from 10 to 12%.

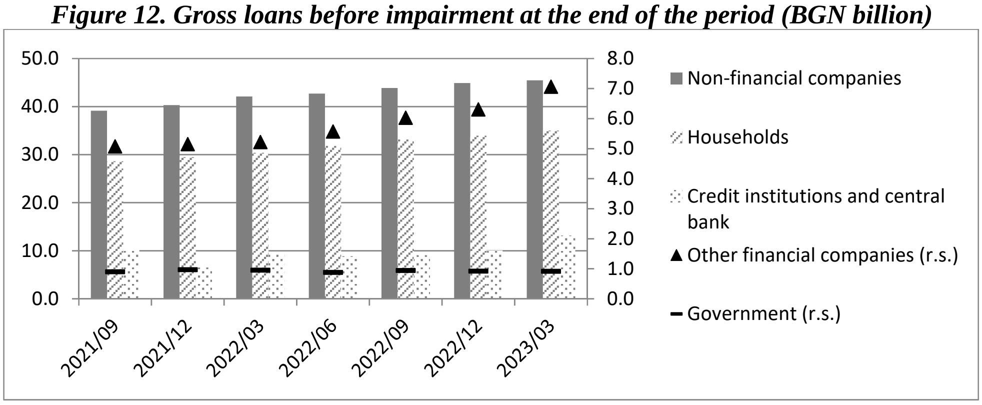
The banking system is adapting (without having to take any particularly active actions) to the changing situation, and in the conditions of automatically rising loan interest rates (as far as most loan agreements have been arranged under conditions for floating interest rate, or have a limited initial period of fixed interest rate), gross interest income increased by 19.4% on an annual basis against a much more moderate increase in gross loans (13.5%). There is a comparable rate of increase (18,5%) in gross fees and commissions income along with the increase in the net interest margin resulted in a record profit for the sector, at the amount of BGN 2,079 billion (or 46.8% more than in 2021). As a whole, 2022 was characterized by retaining intensive lending rates against the background of a still moderate increase of interest rates (which could be explained by the significant volume of liquidity buffers accumulated), faster growth in operating expenses (interest on deposits and fees) because much lower volume compared to gross revenue so far do not significantly affect net income; still continuing (though insignificant) costs for impairment and accrued provisions and most of all – the record increase in the sector's financial results.

In the conditions of serious challenges in the economic and regulatory environment, the Bulgarian banks continue to be sustainable and profitable, to retain high levels of liquidity and capital buffers. The immediate main trends in the sector are (directly and indirectly) dictated by the processes related to the military conflict in Ukraine; the restructuring of assets and liabilities so as to limit risks resulting from the rising interest rates; maintaining an adequate dynamic balance between lending conditions and standards in an unfavourable macroeconomic environment, but also from the intensive processes of digital transformation and establishing the necessary basis for managing the processes related to a transition to the green economy.

4.2. Lending activity and savings

As a result of the increased economic activity, loans to entities at the end of 2022 reached BGN 44.9 billion (Figure 12).

Figure 12. Gross loans before impairment at the end of the period (BGN billion)



Source: BNB, own calculations.

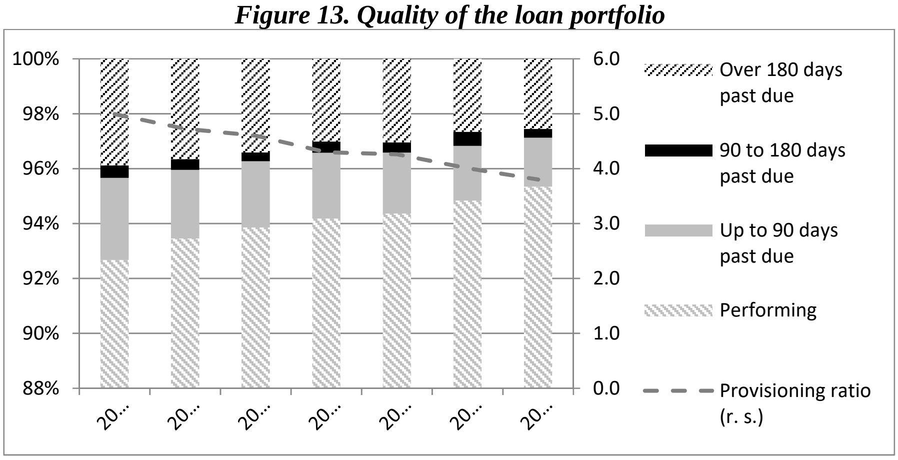
Over BGN 11.10 billion of contracted loans in the segment have an original maturity of over 5 years and thus the share of long-term loans reaches 55.5%. This is due to the different structure of lending activity because of the raising of reference rates to which the effective interest rates are linked, the lower optimism of economic agents and the greater need of loans for working capital to finance operations because of the intensively growing costs of manufacturing and principal activities.

Along with the increased interest on loans for working capital, the higher lending activity in the corporate segment can also be attributed to the retention of the lending policy of commercial banks. The summarised results from the BNB lending activity survey show that more active actions to raise the interest spread were only taken at the beginning of the second half of 2022 which incentivized economic agents to benefit from the decreasing effective interest rate on loans.

The changes in the price and interest dynamics in the third quarter of 2022 resulted in interrupting the trend of higher lending. It can be expected that given the rising risks of recession (both in Bulgaria and in its main trade partners) banks will be less prone to taking risks in corporate lending. The costs for provisions may start rising, which may provoke further tightening of both lending standards and the conditions of loans offered (in view of charging the increased risk premium as part of the price of the loan).

The nominal increase in loans to non-financial corporations (NFCs) by 4.6 billion for 2022 is significantly faster than that of new business volumes in the segment (BGN 3.8 billion). This is partially due to the continuing weakening of the pressure against the increase in the gross amount of the portfolio from a forced collection of past-due receivables and the writing-off of non-performing loans. In 2022 this trend was largely due to the rising share of performing loans (Figure 13) but also to the slower (compared to the nominal turnover rates in most sectors) increase in effective interest rates, respectively – in loan servicing costs. Such a trend was also influenced by the residual effect of the contracts concluded under the procedure for deferral of payables which results in some restriction in forced collection activities, respectively – to maintaining exposures that would have otherwise matured.

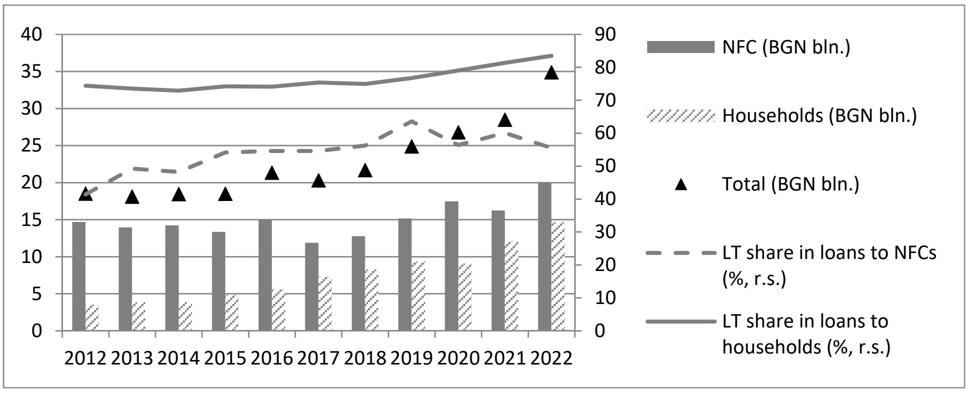
Figure 13. Quality of the loan portfolio



Source: BNB, own calculations.

There were particularly favourable trends in retail lending (Figure 14). The sector demonstrated high activity and the total new business volume continued to grow which is 44.2% higher than in 2020. The increasing share of long-term household loans was also evident. The faster growth in consumer prices and living costs compared to the nominal increase in wages motivates households to apply for a consumer loan and to structure their repayment plan so that the costs for servicing their debt take up the lowest possible share of their disposable income.

Figure 14. New business volumes



Source: BNB, own calculations.

The negative trend in the number of property transaction registrations with the Registry Agency since the end of the first half of 2022 to a large extent explains the relatively small growth in the share of mortgages. The demand and realization rates in the segment will weaken in 2023 which would result in a gradual decrease in the share of long-term loans within the overall contracted amount of loans to households.

The change in the parameters offered by individual banks on specialized websites, as well as the change in the balance of loan conditions (according to the results of the annual BNB lending activity survey) show without a doubt that the number of banks offering better conditions, especially in the past years, has decreased, and this has resulted in a lower number and gross amount of re-financing transactions in 2022. This trend may continue in the mid and long term and will initially result in an even greater shrinkage in the share of re-financing, followed by a limited new business volume for households in general.

Savings continue to grow irrespective of the slower rate of deposit interest raising and respectively the retention of negative actual profitability on all deposit products. The total amount of attracted funds from the non-financial sector grew by 15.41% on an annual basis. Households increase their deposits at a much slower rate – by less than 1/10 – mainly due to the beginning of disinflation processes at the end of the third and the beginning of the fourth quarter in 2022.

4.3. The capital market in Bulgaria

The market capitalization of the segments organized by the Bulgarian Stock Exchange (BSE) decrease by 2% in 2022 compared to the end of 2021. In the BSE trading structure, the largest share of 47% is the turnover of the Standard shares segment, followed by the share of the turnover of the segment for companies with a special investment purpose on the main market and that of the segment of shares on the alternative market. The capitalization of the Premium shares segment increased by BGN 66 million (or 4.3%). In 2022, a decline was noted in the capitalization of the Standard shares segment by nearly BGN 887 million. In the capitalization of the segments for shares of joint-stock companies with a special investment purpose (REIT) on the main market, there was a change of 9.4% and an increase in the capitalization of the same segment for shares on the alternative market by 1.25%.

2022 ended with a divergent change in the values of the BSE indices (SOFIX, BGBX40, BGTR30 and BGREIT). The movement in the values of SOFIX, BGTR30 and BGBX40 was similar, and the change in BGREIT had a different form, which is due to the type of companies that make up the index (Table 2). The value of SOFIX decreased by 5.4% and the index performed better compared to the recorded double-digit declines of other national measures during the year. The movement of the broader index BGBX40 is analogous to the behaviour of SOFIX. BGREITH managed to fully recover its value after the global financial and economic crisis of 2008 and even reached record values. At the same time, in the period 2018-2022, a well-defined cycle of rise and fall in the trading levels of securities on the Bulgarian stock market is observed, which to a significant extent reflects the trends of the world financial markets.

Table 2. Main indicators of the development and activity of the Bulgarian capital market for the period 2018-2022

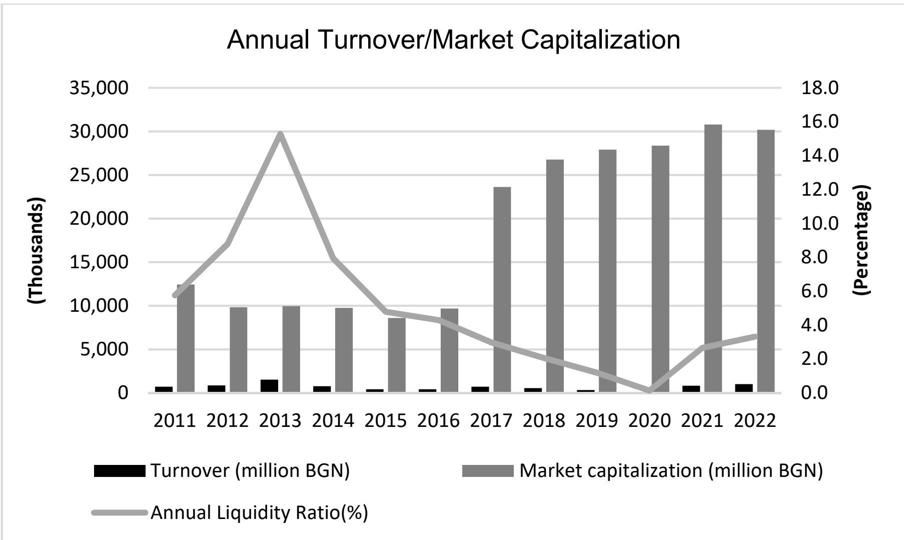
Indicator	2022	2021	2020	2019	2018
Market capitalization (million BGN)	30 176	30 781	28 355	27 905	26 765
Market Cap/GDP (%)	19.53	22.14	23.64	23.30	24.40
SOFIX	601.49	635.68	447.53	568.14	594.46
Change in SOFIX value (%)	-5.38	42.04	-21.23	-4.43	-12.25
BGBX 40	139.28	143.68	101.38	111.83	115.91
Change in BG40 value (%)	-3.06	41.72	-9.34	-3.52	-12.19
BG TR30	731.20	682.96	499.17	516.28	496.14
Change in BGTR30 value (%)	7.06	36.82	-3.31	4.06	-10.76
BG REIT	183.17	163.98	137.69	130.03	121.07
Change in value of BGREIT (%)	11.70	19.09	5.89	7.40	4.28

Source: BSE, Annual Statistics, FSC, own calculations.

The Bulgarian capital market remains small during the period 2018-2022. It continues to be characterized by low liquidity and extremely low turnover of trade, with the main share of equity capital concentrated in unlisted shares and other types of capital, and the share of loans remains high. The period since the global financial and economic crisis of 2008 has affected the results of public companies. However, in recent years they have started to report an improvement in their sales and profits. This can restore confidence in investors, and hence facilitate the financing of Bulgarian companies and the issuance of shares. The number of transactions is an important indicator of the comparability of exchange operators. It complements the turnover information by showing to what extent the turnover is realized by the high liquidity or the large number of financial instruments traded through single trades. One of the main problems with transaction prices in the conditions of low market liquidity and an underdeveloped market is that they are subject to manipulation, respectively deforming the values of trade turnover and market capitalization. This largely applies to the Bulgarian capital market.

Although for the last 20 years, the Bulgarian capital market has been permanently established with low activity on the primary market, low turnover on the secondary market and low capitalization in relation to GDP, the BSE's turnover has already reported growth for the third year in a row in 2022 due to the huge unused potential and some initiatives undertaken by the BSE (incl. the opening of the new BEAM market for growing companies). The expected annual turnover of BGN 1 billion was realized after over 100,000 transactions with more than 233 million lots. For comparison, a similar volume was registered in the distant 2013 (Figure 15). The ratio between trading volume and market capitalization, which is considered an indicator of market liquidity, shows a very sharp decline from 15.3% in 2013 to 0.1% in 2020 during the COVID-19 crisis and a recovery to only 3.3% in 2022. This is a big risk because if the turnover does not increase, ownership will change in about 50-60 years. On the other hand, the market decline is a result of the global financial and economic crisis of 2008 and the regulatory changes undertaken in its wake, driving away many investors who previously traded on the BSE when share prices rose rapidly and were unrealistically high.

Figure 15. Annual liquidity ratio of BSE in the period 2011-2022 (%)



Source: Own database calculations from the World Bank Global Financial Development Database.

The positive results in 2022 can also be represented by the 7 successful and 1 unsuccessful initial public offering (IPO), 6 of which are on the market for the growth of small and medium-sized enterprises – BEAM. On the other hand, shares and other stock instruments of

400 foreign companies are already traded on the stock exchange in Sofia. The purpose-built BSE International market, which launched on July 5, 2021, with the shares of around 200 well-known foreign companies, is in addition to all instruments traded on the BSE and enables investors to access all the world's most liquid companies. Investors can also invest in exchange-traded funds, which follow the movement of indices such as the DAX, S&P 500, FTSE All-World, NASDAQ-100 and STOXX Europe 600.

In Bulgarian conditions, however, there are several problems that do not allow the capacity of non-bank financing to be deployed. The lack of professional training and subsequent understanding of how stock markets work leads to low interest, low levels of liquidity and low efficiency. Banking is extremely popular and is valued as a highly prestigious activity in society, leading to a mass preference by both investors and citizens over the capital market. This is evident from the high levels of excess liquidity in the banks because of the accumulated savings of the population compared to the minimal trade turnover and ownership indicators of the stock market in the country. Another important issue to focus on is market manipulation and the removal of insiders from the markets. The presence of insider trading reduces efficiency, discourages, and drives bona fide investors[11] out of the market. This function should be within the prerogatives of the Financial Supervision Commission, but the problem is that: "most sanctions imposed by the Commission for market manipulation are confirmed by the court, but the disclosure and proof of these cases is complicated and slow" (Dima, Barna, Nachescu, 2018). Thus, the main challenges to the development of the capital market in Bulgaria stem from the control of insider trading, the lack of quality capital projects and the protection of minority shareholders in the case of high concentration of shareholder ownership.

5. Forecast for the Development of the Bulgarian Economy until 2025

The macroeconomic forecast is based on assumptions about economic developments in the medium term (until 2025) regarding international prices and external demand, as well as the economic policies adopted by the government and outlined in the Medium-Term Budget Forecast for the period 2023-2025. The macroeconomic forecast of the ERI at BAS is based on macroeconomic information available as of April 28, 2023.

5.1. Key Assumptions for the Period 2023-2025

The forecast is based on a structural model that includes key macroeconomic indicators. The simulations are made under the following assumptions:

- Global economic activity and trade volumes are expected to slow down, primarily affecting developed economies and to a lesser extent developing countries.

[11] Bona Fides Invest is an EU-based financial technology that globally helps individuals and organizations finance their projects through crowdfunding (Foote QC, 2021).

- Despite the easing of inflationary pressures, especially concerning energy resources, inflation will remain relatively high as central banks of G7 countries continue to pursue restrictive monetary policies in the short term.
- The military conflict in Ukraine will continue, and in the second half of 2023, further escalation is possible. Sanctions imposed against Russia and Belarus will continue to be effective and might be strengthened.
- Prices of essential energy resources will remain high compared to the average values of the previous three-year period, but with a tendency to gradually decrease.
- Most EU Member States will enter a recession in 2023, which will suppress Bulgaria's external demand, and export rates will decline, particularly during the current year. This will be counteracted by the production and export of military products and electricity, which will continue throughout 2023 and probably in the following years.
- The inflow of financial flows to the country will mainly depend on funds from EU programs and the package of programs related to the European Recovery and Resilience Fund.
- Economic activity will continue to be subdued due to both the unstable external environment and internal political specificities. Acceleration of economic development can be expected after 2023, as the effects of the absorbed funds allocated by the NRRP become evident. However, economic growth rates will remain low (especially at the beginning of the forecast period) and will not exceed the potential GDP growth.
- If there are no new shocks to energy prices, the economy will enter a period of disinflation, but the process will be rather slow. Meeting the Maastricht inflation criterion within the forecast period is highly unlikely.
- There is significant uncertainty concerning the labour market. A substantial increase in unemployment is not expected despite rising wages in recent months. This can be explained largely by the deteriorating demographic situation in Bulgaria rather than economic activity. However, such a state of the labour market is unsustainable.
- The budget deficit will be heavily dependent on the political situation. Continuing the implementation of adopted compensatory mechanisms and promises of further increases in the minimum wage and pensions will not allow the economy to achieve a balanced budget throughout the forecast period. The public debt is likely to reach levels of about 30% of GDP by the end of the period, but this is unlikely to have a significant impact on economic activity and inflation. Significant changes in the tax policy are not expected.
- The recent policy of the BNB to increase the minimum reserve requirements is not expected to have a significant effect on inflationary processes in Bulgaria but would reflect in some slowdown in the pace of lending.

5.2. Dynamics of key macroeconomic indicators during the forecast period

Given the unfavourable external and internal economic environment, real GDP growth is expected to decline to around 1.7% in 2023. High inflation in the past two years means that by 2024, the nominal GDP will exceed BGN 200 billion. By the end of the forecast period, economic growth is expected to gradually recover to pre-COVID-19 levels. The forecast for Bulgaria's economic growth in the medium term is expected to remain at around 3-3.5% annually. The growth in investments will mainly depend on the progress of the program period and the expectations for accelerated absorption of European funds in Bulgaria, especially under the NRRP.

At the beginning of the forecast period, internal demand will decrease, but it is expected to gradually recover. The dynamics of consumption will be influenced by increasing wages, moderate employment growth, and weak but positive credit activity which will be further slowed down by measures taken by the BNB to increase minimum reserve requirements. The contribution of external demand to economic growth is expected to remain negative throughout the forecast period.

Inflation is expected to remain higher than usual in recent years, largely due to external factors and some inconsistent decisions in the field of economic policy (implementation of measures not in line with the country's real financial capabilities), contributing to a higher rate of price growth compared to the EU Member States' average values. High inflation and potential fiscal consolidation will have a negative impact on households' purchasing power, which is expected to lead to relatively weaker consumption growth. Inflation leads to higher production costs, which, combined with high economic uncertainty at both domestic and international levels, is expected to result in restrained investment activity, largely determined by public capital expenditures.

During the second half of the forecast period, a recovery in internal demand is expected based on a combination of real income growth and a decrease in inflationary pressures. The external sector is not expected to make a significant contribution to economic growth in the coming years. In 2023, the current account deficit is expected to slightly decrease mainly due to price factors (improving trade conditions), but over the entire period, the trade balance is likely to remain negative.

Until 2025, employment in Bulgaria is expected to continue to be determined by the pace of economic growth, considering demographic constraints. At this stage, there is no consideration of a change in labour supply due to the refugee wave from Ukraine, as almost one-third of the refugees are of working age, and the rest do not demonstrate (at least for now) a desire for permanent settlement in Bulgaria. Unemployment is forecast to remain at the same levels, even slightly decreasing. Wage growth will remain positive in real terms but lower than in previous years.

Considering the overall macroeconomic situation, lending in the economy (both for households and firms) will slow down at the beginning of the forecast period due to the negative impact of higher interest rates, with a tendency to gradually increase in the following years. As most commercial banks in Bulgaria maintain reserves significantly above the minimum reserve requirements, the recent changes in the BNB's monetary policy are expected to have a weak effect, and the effect on the money supply strongly depends on the population's reaction to available money.

Table 3. ERI's Macroeconomic Forecast until 2025

	Preliminary	Forecast		
	2022	2023	2024	2025
Real Sector (%)				
Economic Growth – Growth Rates by Components	3.4	1.7	3.4	3.1
Private Consumption	4.8	3.6	3.6	3.5
Public Consumption	6.5	5.4	5.4	5.0
Gross Fixed Capital Formation	-4.3	5.5	4.8	5.5
Exports of Goods and Services	8.3	2.3	5.7	6.7
Imports of Goods and Services	10.5	5.4	6.1	7.3
Price dynamics (%)				
Average Annual Inflation (HICP)	13.0	9.0	4.0	2.7
GDP Deflator	15.1	11.7	4.2	3.5
Labor market				
Employment Rate (ages 15-64)	70.8	71.0	71.1	71.1
Unemployment Rate (ages 15-64)	4.3	4.0	3.9	3.9
Increase in Wages (%)	12.8	11.6	6.6	5.7
Rest of the World (% of GDP)				
Current Account	-0.7	-0.8	0.3	1.2
Trade Balance	-5.8	-3.3	-2.3	-1.3
Capital Account	0.9	0.9	1.3	1.4
Financial Account (including currency reserves)	5.5	3.3	2.5	2.5
Foreign Direct Investments	3.6	3.3	3.4	3.6
Gross External Debt	52.5	50.6	51.9	53.3
Financial Sector (annual change, %)				
Money Supply (M3)	13.2	11.2	8.7	7.8
Credit to Non-Financial Sector	12.1	5.3	6.8	6.2
Fiscal Sector (% of GDP)				
Budget Revenues	39.2	36.4	36.5	36.7
Budget Expenditures	40.0	40.2	39.5	39.7
Budget Balance (on cash basis)	-0.8	-3.8	-3.0	-3.0
Debt of the "Central Government"	22.4	23.6	25.5	27.1

5.3. External and internal constraints on economic growth and risks

The risks of a possible escalation of the military conflict between Russia and Ukraine and its potential transformation from a local to a global conflict are difficult to estimate. The consequences would be of such magnitude that any forecasts would become meaningless and thus would not be considered. Therefore, we pay attention to other limitations and risks:

- The inability to form a lasting political consensus on important issues for Bulgaria jeopardizes the implementation of already undertaken commitments, including those related to the NRRP. If this situation continues, a higher budget deficit and a greater need for external financing can be expected. In such circumstances, joining the euro area could be postponed until after 2025.

- The external environment is likely to remain unfavourable, with the risk of further deterioration if a quick resolution to the military conflict between Russia and Ukraine is not found. The slowdown in economic growth in the euro area has already been observed. Given the inflation dynamics, it is more likely that the ECB will follow its policy towards a gradual increase in interest rates.
- The domestic demand, which has been emerging as a key factor driving economic growth over the past two to three years, is unlikely to grow at the same pace as before the COVID-19 pandemic. The increase in purchasing power will be limited by the slower growth of new jobs and higher inflation.
- The Bulgarian economy has practically achieved (or is very close to) full employment. Any newly created job will come at the expense of reducing the number of unemployed and increasing the employment rate in the pension-age population group. However, there are natural limits to this process, which are nearly reached.
- The risks associated with inflation are asymmetrical and trending upwards. The unstable economic environment, as well as the accumulated excess liquidity and growing public debt from previous years, will also influence inflation expectations.
- In a more optimistic scenario, the quick resolution of the military conflict in Ukraine and the activation of European funds can further accelerate economic growth but the likelihood of such developments is rather low.

Conclusions

The study of the Bulgarian economy in 2022 as well as the forecasts for its development in the medium term until 2025, allow us to highlight some recommendations for the national economic policy.

Measures to preserve the purchasing power of people's incomes in a context of high inflation:

- The slowing down of inflation cannot be tackled by pursuing a pro-inflationary fiscal policy without corresponding measures to stimulate productive capacity and overcome the structural imbalances arising from the investment environment and the labour market challenges related to the age and education of the workforce.
- Domestic factors of higher price dynamics can be addressed by introducing a tax-free minimum on personal income to overcome the high-income inequality in Bulgaria and to support the purchasing power of the lowest income groups. Fiscal support should be strongly differentiated and based on clear criteria to compensate for the purchasing power of certain population groups to ensure sufficient budgetary buffers.
- The focus of labour market policies should be on the restructuring of productive capacities through the effective use of financial resources under the NRRP. An effective transition to a green and digital economy requires changes in labour legislation to help regulate the process of identifying, reaching, and activating people of working age who are not working, studying, in vocational training or registered with labour offices.

- The demographic factor is becoming increasingly important in Bulgaria, which acutely raises the question of the need for effective policies to regulate it. Policies are needed to facilitate immigration and labour market transitions from different regions of the country and abroad. Solutions to the problem should also be sought in attracting back to Bulgaria compatriots who work and live abroad, other EU and third-country nationals.

Fiscal policy guidelines:

- A more cautious expenditure policy should be pursued to ensure that the accumulated budgetary revenues are able to cover unforeseen expenditures, both in the context of the difficult international environment and given the need to stimulate investment activity.
- Priority needs to be given to fiscal structural reforms that will help to secure financing for public policy priorities and contribute to the long-term sustainability of public finances, including by improving the coverage, adequacy and sustainability of health and social protection systems.
- Shared responsibility between the private sector and government for jobs is a better option for spending policy than direct provision of benefits and social assistance, which in the short term maintain household purchasing power but lack the capacity to dynamize domestic demand and provide budgetary revenues.
- Sustainable revenue sources with low cyclical dependency should be ensured. The high-income growth over the last two years poses risks not only to the country's inflationary developments but also to fiscal stability and euro area accession. This cannot be done through indirect tax revenues and demand stimulation alone but requires reciprocal social measures to develop the business environment. Measures in this direction include the creation of conditions for wider lending to SMEs, the issuance of state guarantees for investment projects and state-guaranteed lending, the implementation of public-private partnerships, and the successful implementation of projects with EU funding.
- The pursuit of a tax policy aimed at differentiating tax rates with mainly sectoral effects creates disproportionate risks to fiscal stability that are not justified in terms of its multiplier effect. The reform of the tax system should be based on a systematic approach, considering the growing share of revenues from social and health insurance contributions, which in recent years have almost equalled VAT revenues. This poses fiscal risks in the medium term, given the country's declining and ageing population and the observed decline in employment.
- Ensuring a transparent use of public resources and accelerated absorption of the NRRP funds are key prerequisites for dynamizing investment in the country. The systematic underfinancing of infrastructure projects and the very limited impact of government investment on the real economy are not conducive to building productive capacity for catching-up development and convergence with EU and euro area Member States.

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