ИНСТИТУТ ЗА ИКОНОМИЧЕСКИ ИЗСЛЕДВАНИЯ НА БЪЛГАРСКАТА АКАДЕМИЯ НА НАУКИТЕ
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BULGARIAN ECONOMY IN 2023 – STRUCTURAL CHALLENGES AND MEDIUM-RUN PERSPECTIVES[7]

The paper examines the current state and development of the Bulgarian economy in 2023, considering domestic and regional factors. We analyze the real sector by tracking GDP, inflation, and unemployment, linking these to EU processes. Emphasis is placed on labour market adjustments in the context of digitalization and transitioning to a climate-neutral economy. The sustainability of the fiscal sector is explored through financing the green and digital transition with EU funds, and the necessary policies to maintain fiscal stability. We discuss foreign trade prospects, considering the economic conditions and expectations for Bulgaria's main trading partners, the high dependence on euro area performance, and the specifics of foreign trade relations. The banking sector and the capital market analysis focus on the implications of European Central Bank monetary policy, regulatory actions of the Bulgarian National Bank, and risks to sector stability in a dynamic macroeconomic environment. Expectations and forecasts for the Bulgarian economy through 2026 are based on assumptions about global

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economic processes and local challenges. We make economic policy recommendations aimed at preserving the purchasing power of the population's income and restructuring certain fiscal measures.
Keywords: economic dynamics; labour market; digitalization and climate change; fiscal sustainability; foreign trade; banking sector; capital market; macroeconomic projections; economic policy recommendations
JEL: E2; E44; E47; E60

Introduction

The Economic Research Institute at the Bulgarian Academy of Sciences (ERI at BAS) presents its 13th report on Bulgaria's economic performance and policies. The report examines the state and development of the Bulgarian economy in 2023 and projects economic development through 2026.

The paper aims to trace the future development trajectory of Bulgaria's economy by examining macroeconomic development in 2023, outlining the challenges for 2024, forecasting economic dynamics to 2026, assessing economic policies in the context of regional and global trends, and making specific economic policy recommendations. Using a structural macroeconomic model, the report proposes medium-run projections based on external economic dynamics and expected economic governance. It concludes with recommendations to preserve the purchasing power of incomes and restructure fiscal measures to ensure smooth accession to the euro area.

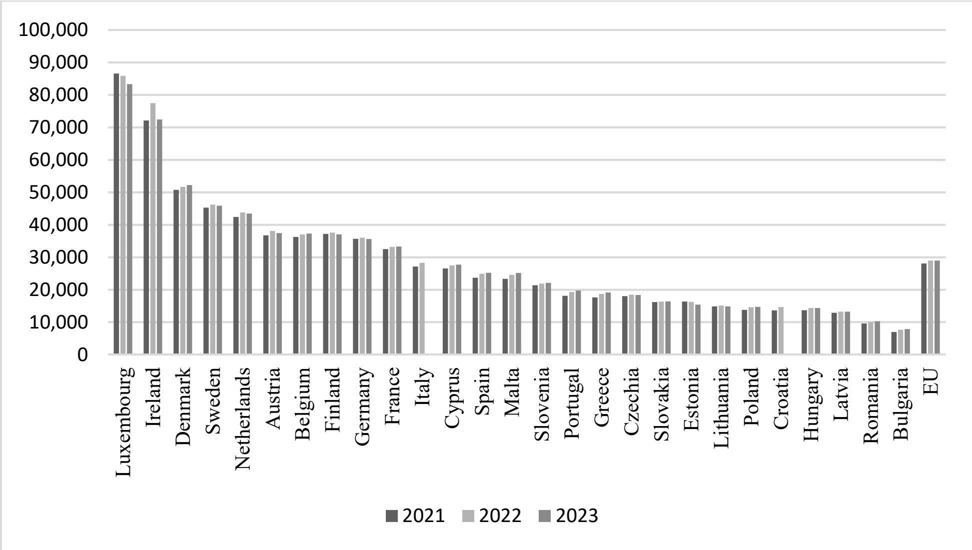
1. Real sector and labour market

1.1. Dynamics of economic activity

In 2023, the GDP at current prices stands at BGN 191.2 billion. The economy grew by 1.8% which is significantly lower than the 3.4% growth rate recorded in 2022. The deceleration of the economic activity is due to the challenging regional and global economic conditions caused by the ongoing Russia-Ukraine military conflict, the broad range of economic sanctions imposed on Russia and Belarus, and escalating geopolitical tensions in the Middle East. One of the main obstacles to Bulgaria's economic growth is the slowdown experienced by its key trading partners, such as Germany and Italy.

Based on chain-linked indices (2010=100), Bulgaria's GDP per capita in 2023 is €7,850 compared to the EU average of €28,940. Therefore, Bulgaria's real per capita income is approximately one-quarter of the EU average (Figure 1). Despite these trends, Raleva (2022) found that Bulgaria's economy has been consistently closing the gap with the average GDP per capita levels in the EU and the euro area based on the convergence in real GDP per capita in 2020-2021, using the purchasing power standard (PPS) indicator.

Figure 1. Real GDP per capita (Euro), (2010 = 100)

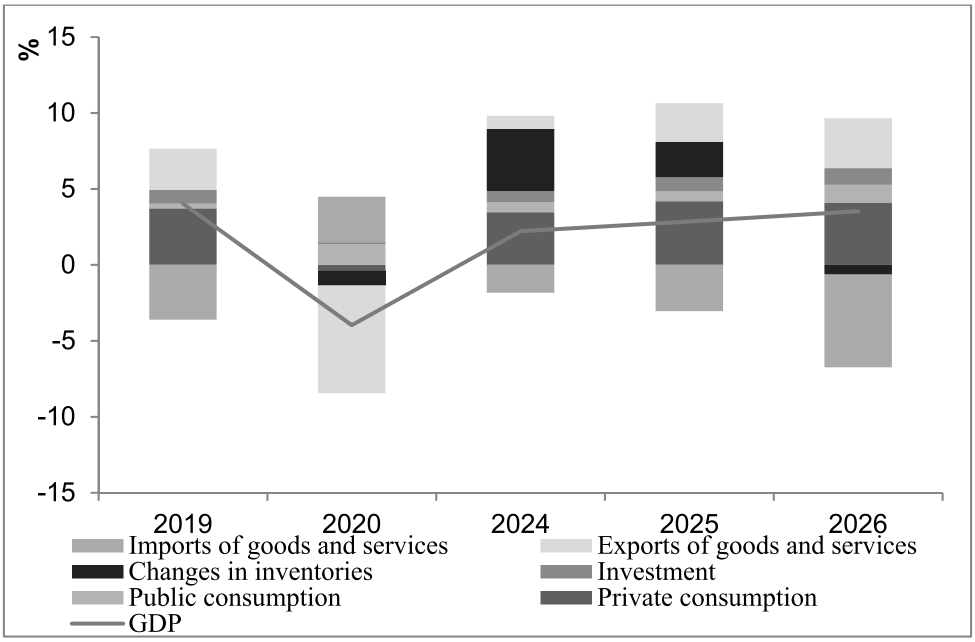


Source: Eurostat.

Among the components of GDP by final expenditure, private consumption made the most significant contribution to the annual growth of real GDP in 2023, increasing by 3% (Figure 2). This growth was primarily driven by higher labour income and various discretionary fiscal measures implemented by the government, such as increased social payments and initiatives to support household disposable income and firm liquidity. Additionally, the growth in consumer credit and the persistence of nearly zero interest rates on household deposits enhanced the propensity to consume. In comparison, public consumption exhibited considerably less growth in 2023. This was primarily due to social transfers in kind, including healthcare costs. Major constraints on public consumption included a decline in intermediate government consumption and a slowdown in public sector wage growth.

Gross fixed capital formation in both the private and public sectors contributed only 0.1% to real GDP growth in 2023. Despite the rise in consumer spending and the availability of credit resources from banks at relatively lower interest rates compared to the euro area, investment activity remained subdued. Potential obstacles to private investment growth included unfavourable external conditions, efforts to enhance productivity in specific industries such as energy, and a reported annual decline in new home sales.

Figure 2. Dynamics of real GDP by final expenditure (%)



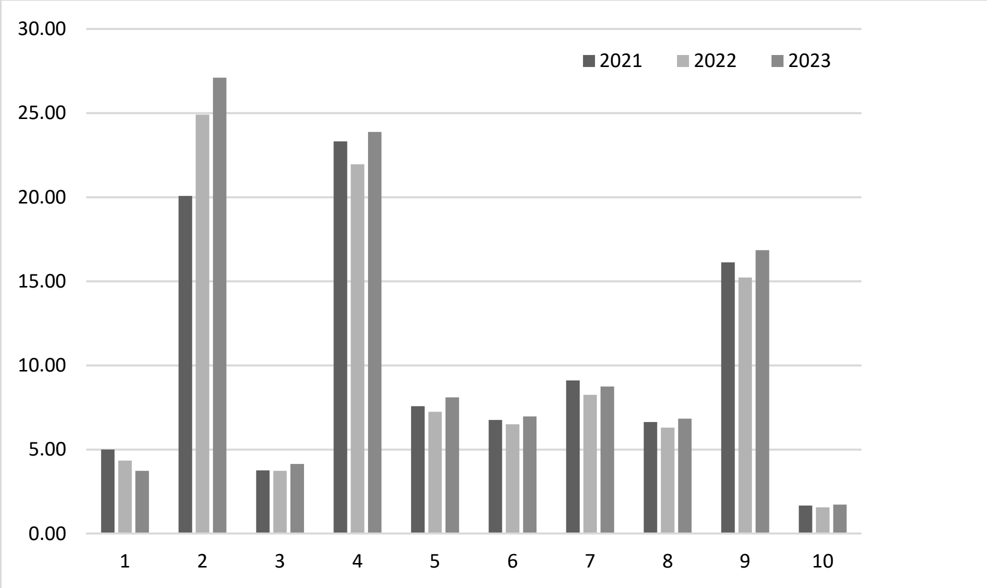
Source: National Statistical Institute.

In 2023, net exports contributed to the annual growth of real GDP by experiencing a smaller decline in the exports of goods and services compared to imports. The slowdown in imports of goods resulted from lower inventories of raw materials, supplies, and finished goods held by businesses since late 2022. This reduction was due to increased efficiency in global supply chains, decreases in the prices of key raw materials in international markets, and reduced uncertainty regarding economic development.

1.2. Economic sector performance and short-run indicators of economic activity

In 2023, the gross value added (GVA) reached BGN 161.2 billion, reflecting a real growth of 1.8%. The share of all economic activities in GDP increased except for agriculture, which experienced a slight decline. The sectors contributing most significantly to the higher GVA in 2023 include industry (excluding construction); trade, transport, hospitality, and catering; government; education; health and social work; and real estate operations (Figure 3). Industry, accounting for approximately 27% of the GVA, saw the largest increase in 2023, driven mainly by higher exports of goods and increased domestic demand. In contrast, the agricultural sector's share in the GVA continued to decline. This trend is due to various constraints on agricultural development in Bulgaria, such as fragmented land ownership, a sluggish restructuring process, and insufficient progress in absorbing EU funds and programs.

Figure 3. Share of economic activities in GVA (%)



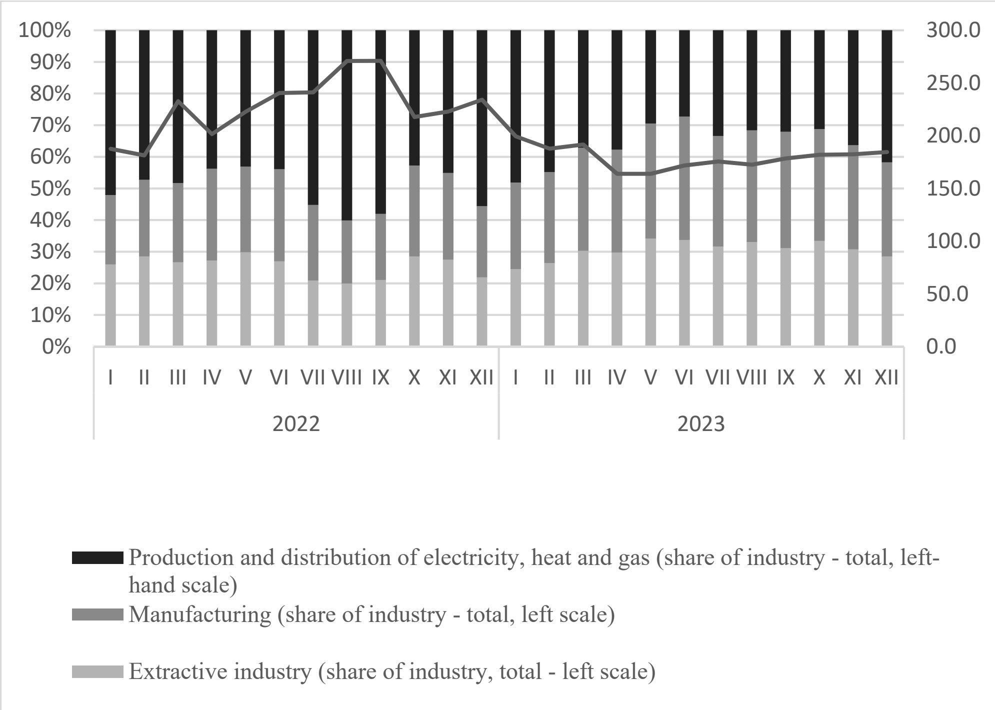
Note: 1 – Agriculture, forestry and fishing; 2 – Industry (excluding Construction); 3 – Construction; 4 – Wholesale and retail trade, transport, accommodation and food service activities; 5 – Information and communication; 6 – Financial and insurance activities; 7 – Real estate activities; 8 – Professional, scientific, technical, administration and support service activities; 9 – Public administration, defence, education, human health and social work activities; 10 – Arts, entertainment and recreation; other activities.

Source: National Statistical Institute, author's calculations.

Seasonally adjusted short-run business statistics indicate that the industrial production index declined in 2023 compared to 2022. This decline is observed across all types of activities, primarily due to the reduced volumes and prices in both international and domestic markets. However, the manufacturing industry remained the largest contributor to the industrial production index. Notably, the production of vehicles (excluding cars) significantly contributed to the growth of the manufacturing industry in 2023, followed closely by the production of computer and communication equipment, and electronic and optical products. This growth was driven by increased domestic demand and exports in various transport industry sectors, higher international transport costs, and ongoing technological advancements in the automotive sector to meet the EU's low-carbon economy requirements.

In 2023 enterprises in electricity, heat energy and gas production and distribution achieved the highest turnovers (Figure 4). This is largely due to the still high prices of energy on international markets, despite a downward trend. Contributing factors include internal processes within the EU and escalating sanctions against Russia and Belarus, which have driven up energy commodity prices worldwide.

Figure 4. Industry structure (left scale) and industrial turnover index – total (right scale)



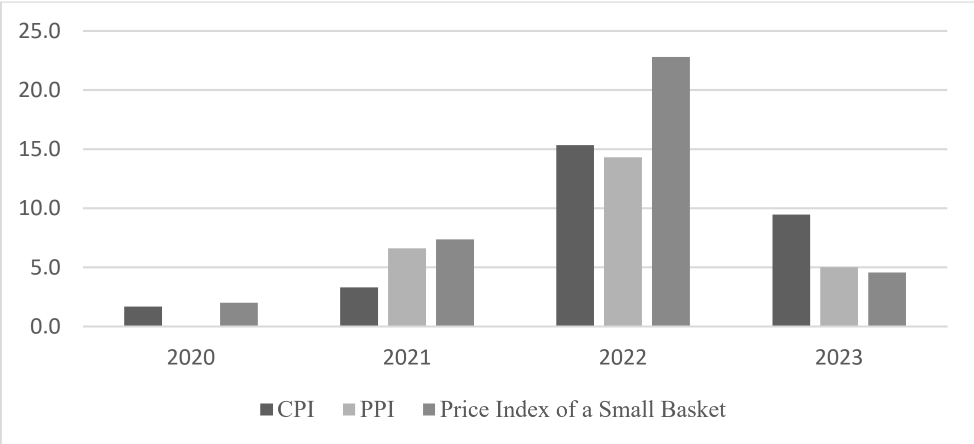
Source: National Statistical Institute.

Data on the general business climate indicator in Bulgaria for the first six months of 2023 show an improvement compared to 2022, with values exceeding their long-term average. The sectors primarily contributing to this positive trend include industry, construction, trade, and services. According to the business surveys of the National Statistical Institute (NSI), significant obstacles hindering corporate activity in 2023 include the uncertain economic environment, intense competition, and labour shortages in key sectors such as healthcare, education, engineering, and the food industry. These sectors are crucial for achieving the green and digital transition.

1.3. Price dynamics

Annual inflation measured by the consumer price index (CPI) decelerated significantly in 2023, reaching 4.7% by the end of the year, down from 16.9% in 2022. Similarly, annual inflation measured by the Harmonized Index of Consumer Prices (HICP) experienced a substantial decline, dropping to 5% at the end of 2023 from 14.3% in 2022. The price index of the small basket also experienced a notable decrease falling from 22.8% in 2022 to 4.6% at the end of 2023 (Figure 5).

Figure 5. Annual rate of change of consumer price indices



Source: National Statistical Institute, author's calculations.

Among the HICP components, passenger air transport, transport-related insurance, and pharmaceuticals were the most significant contributors to the increase in the average inflation. Air transport encounters substantial challenges in both the USA and Europe. The International Air Transport Association attributes these difficulties to disrupted supply chains for aircraft engine spare parts, labour strikes by airline employees, and heightened demand for tourist travel. The most significant price drops in 2023 were observed in prices of key energy sources, raw materials, and agricultural goods on international markets.

Despite the anti-inflationary impact of international factors, such as reductions in energy, raw materials and agricultural prices, along with the European Central Bank's restrictive monetary policy, several domestic macroeconomic factors continued to exert pro-inflationary pressure in 2023. Discretionary fiscal policy measures of lower excise duties and VAT rates on certain energy and food products and compensation to industrial end-users for high electricity prices fueled inflation. Increased social payments, wage hikes in various public sectors, and higher fiscal transfers to households contributed to growth in private consumption, hindering the transmission of downward trends in international raw material prices to final consumer prices in Bulgaria.

1.4. Labor market performance

In 2023, the labour market remains relatively calm despite negative structural changes compared to 2022. The adjustment to low economic growth dynamics is reflected in a relative contraction in employment and a slight increase in unemployment while maintaining the economic activity levels of the population. Additionally, there is an increase in the share of inactive persons who experienced difficulties transitioning to the labour market due to its contraction (Table 1).

Table 1. Labor market indicators

	2019	2020	2021	2022	2023
Employed persons aged 15-64:					
Number (thousands)	3136.3	3024.3	2986.7	2840,7	2821.7
Coefficient (%)	*70.1*	*68.5*	*68.1*	*70.6*	*70.7*
Employed persons aged 20-64:					
Number (thousands)	3121.2	3014.7	2976.8	2830.8	2812.8
Coefficient (%)	*75.0*	*73.4*	*73.2*	*75.9*	*76.3*
Unemployed persons aged 15-64:					
Number (thousands)	140.1	166.1	168.6	124.7	129.7
Coefficient (%)	*4.3*	*5.2*	*5.3*	*4.2*	*4.4*
Share of unemployed persons for 12 months and longer (%)	56.7	45.0	49.4	54.0	52.3
Long-term unemployment rate (%)	*2.4*	*2.3*	*2.6*	*2.2*	*2.3*
Labour force aged 15-64:					
Number (thousands)	3276.4	3190.4	3155.3	2965.4	2951.4
Economic activity rate (%)	*73.2*	*72.2*	*72.0*	*73.7*	*73.9*
Economically inactive persons aged 15-64 (thousands)	1197.7	1226.7	1227.4	1057.0	1041.2
Proportion of economically inactive persons aged 15-64 (%)	*10.2*	*11.3*	*14.0*	*13.1*	*11.9*

Source: National Statistical Institute, Labor Force Survey (LFS).

The number of employed people of working age is declining and continues to depend mainly on those aged 35-64. Despite the increase in the number of unemployed aged 15-64, their unemployment rate remains relatively low compared to the EU-27. The reasons for this decline below 4% include limited demographic resources and the high risk of poverty for the unemployed. Therefore, reducing long-term unemployment and the share of young people neither in employment nor in education and training (NEETs) is imperative.

The structural changes in employment in 2023 are weak. The ageing of the labour force continues, but with positive changes in its structure by educational attainment. The distribution of employees by economic activity and occupation effectively illustrates the links between the labour market and structural economic changes. In 2023, only the share of employees in the industry has increased. The presence of employees in other economic activities decreased, while their share in the service sector remained unchanged. To derive an overall estimate of changes in the distribution of employees by economic activity, an integral coefficient of their structural differences is calculated following Shopova (2018) and Gatev (2007). We find it is negligible – 0.025 – in 2023. In terms of occupation, the highest share of employees was in personal services, trade, and security, followed by professional experts. The coefficient of structural disparity for 2023 was very low at 0.016. Thus, the structural changes in employment by economic activity and occupation are minimal.

Labour demand remains subdued, although employers' needs for qualified labour in some economic activities remain consistently unmet. We expect an intensification of employer demand in the near future, particularly in relation to decarbonization and digitalization.

In 2023, labour cost dynamics remained high. The wages and salaries increased by 14.4% compared to 5.2% for the EU-27. However, Romania (16.3%), Hungary (15.5%), and Croatia (14.5%) experienced even higher growth rates. According to the NSI, the average annual wages of employees grew at an annual rate of 13.7% in 2023, compared to 13.4% in 2022 and 12.3% in 2021. The highest annual wage growth was reported in education (17.8%), followed by construction and transport (15.7% and 14.4%, respectively). Despite these increases, wages in Bulgaria remain the lowest in the EU-27. In 2023, the integral coefficient of structural change was 0.018, indicating insignificant changes in the wage structure compared to 2022.

According to Eurostat, in 2023 the ratio of minimum to average monthly wages in Bulgaria is 38.4%, the lowest among EU Member States. The share (and number) of people with wages below 60% of the national median equivalized disposable income (after social transfers) is increasing. This reduces the importance of wages as a material incentive for employment. Due to the observed disinflation, the real wage dynamics are diverging from nominal wage dynamics in 2023. This trend indicates a lack of effective labour income protection policy, combined with declining labour productivity.

1.5. Adaptation of the labour market in the transition to a climate-neutral economy and digitalization

The restructuring of the Bulgarian economy in line with the requirements of digitalization and efforts to limit climate change and decarbonize production (the so-called greening of the economy) will impact the quantity, quality, and structure of employment. Direct effects will be evident through changes in the number of employees in the environmental goods and services sector (EGSS) and information and communications technology (ICT) sector. We also expect indirect impacts, such as redundancies or job creation in ICT-related and greening activities. Although some academic research (Beleva, 2023; Loukanova & Houbenova, 2024) exists, it remains challenging to determine the cumulative employment effects of greening and digitalization.

In the near term, we anticipate an expansion of employment in the environmental sector, with energy resource management continuing to play a leading role, as well as stabilizing the decline in employment in waste management and limiting the reduction in employment in forest conservation. Additionally, new job creation is expected in activities aimed at improving the energy efficiency of buildings and in renewable energy generation. However, job losses are foreseen due to the restructuring of the Maritsa East power complex.

We also expect the higher share of ICT services employment in Bulgaria to be maintained. A restructuring within the ICT sector is anticipated, with an increase in the share of self-employed professionals working remotely for both Bulgarian and foreign companies. Additionally, changes in the professional composition of ICT workers are expected due to advancements in artificial intelligence.

1.6. Short-run outlook for the real sector and labour market

We foresee the economic activity in Bulgaria to experience an acceleration but remain below its potential due to foreign uncertainties and internal political instability. Economic growth is forecasted to reach pre-pandemic levels on average. Domestic demand will continue to be a significant driver of growth, influenced by increasing wages, modest employment growth, and still limited credit expansion. Investment activity will primarily be fueled by EU funds and programs, including the Next Generation EU initiative.

Considering current trends, international commodity price dynamics, and Bulgaria's labour market conditions, annual inflation for 2024 is expected to gradually decrease. Factors contributing to this trend include persistently higher unit labour costs and private consumption. Additionally, the government's income policy also contributes to a higher inflation rate compared to the EU average. Meeting the Maastricht criterion for inflation has emerged as the primary challenge for entry into the euro area.

A crucial factor in overcoming the negative changes in the labour market in 2023 is the acceleration of new investments in the real economy, particularly in creating new quality jobs in competitive, high-value-added industries in the field of environmental technologies. This requires extensive greening and digital training of the labour force.

2. Fiscal policy challenges

2.1. The fiscal sustainability in the European context

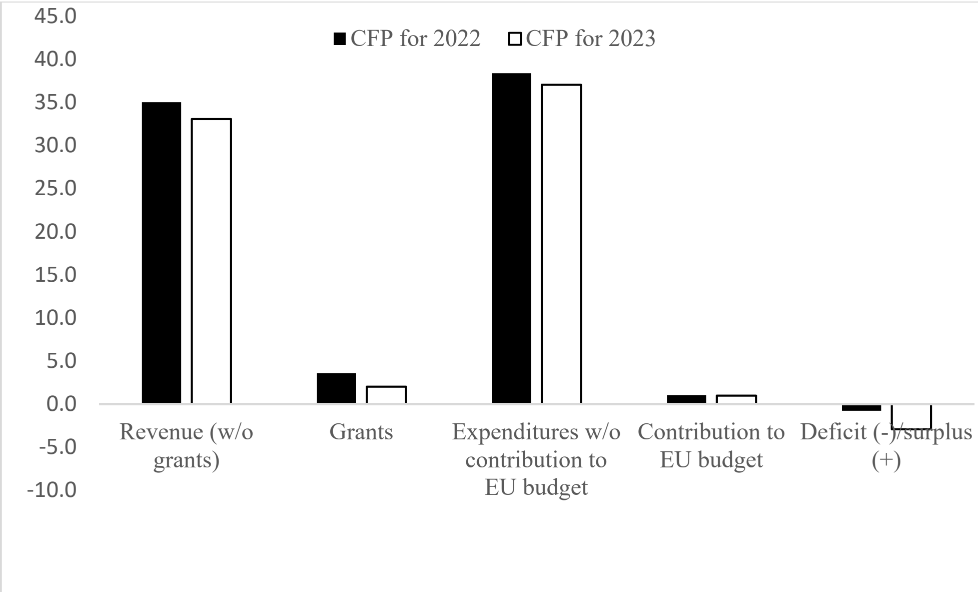
Despite the expansionary fiscal policy and inflationary processes, Bulgaria is not listed by the European Commission among the EU Member States at risk of macroeconomic imbalances. However, it should be highlighted that following the COVID-19 pandemic and given the military conflict between Russia and Ukraine, fiscal consolidation in Bulgaria and other Central and Eastern European (CEE) countries, is occurring at a slower pace than after the 2008 global financial and economic crisis. During the period 2021-2023, Bulgaria together with Croatia, Latvia, and Estonia reported a budget deficit within the reference value of 3% of GDP, while the rest of the CEE countries are still in the excessive deficit procedure.

With a budget deficit of 1.9% of GDP on an accrual basis for 2023, Bulgaria (Figure 6) formally complies with the Maastricht criteria for the fiscal deficit and debt. However, achieving the Maastricht inflation criteria in 2024 appears challenging. The increase in the cash budget deficit compared to 2022 is mainly due to substantial resources allocated for municipal investment projects, reported as expenditure on a cash basis for 2023, which will impact the deficit on an accrual basis for 2024.

In 2023, Bulgaria and Estonia continue to be the EU Member States with the lowest government debt-to-GDP ratio, at 22.4% and 19.2% of GDP respectively (Figure 7). This provides them with fiscal space to counter economic shocks and issue state guarantees related to strategic energy projects and the green transition of state-owned enterprises. As of December 2023, the nominal amount of the central government debt of Bulgaria amounts to 21.6% of the GDP. The debt-to-GDP ratio of the other subsectors of local government and social security funds is 0.8% of GDP for 2023, primarily related to investment projects, including those financed by the EU. Municipal debt poses a potential fiscal risk if beneficiaries fail to comply with the EU requirements and must repay funds under the European projects. The share of external debt of the central government increased by 0.5 percentage points of GDP compared to 2022. Despite the low level of government debt-to-

GDP ratio, the demographic situation with an ageing population and net migration suggests a potential shortening of this fiscal advantage.

Figure 6. Fiscal performance of the Consolidated Fiscal Program for 2022 and 2023 (cash basis, % of GDP)

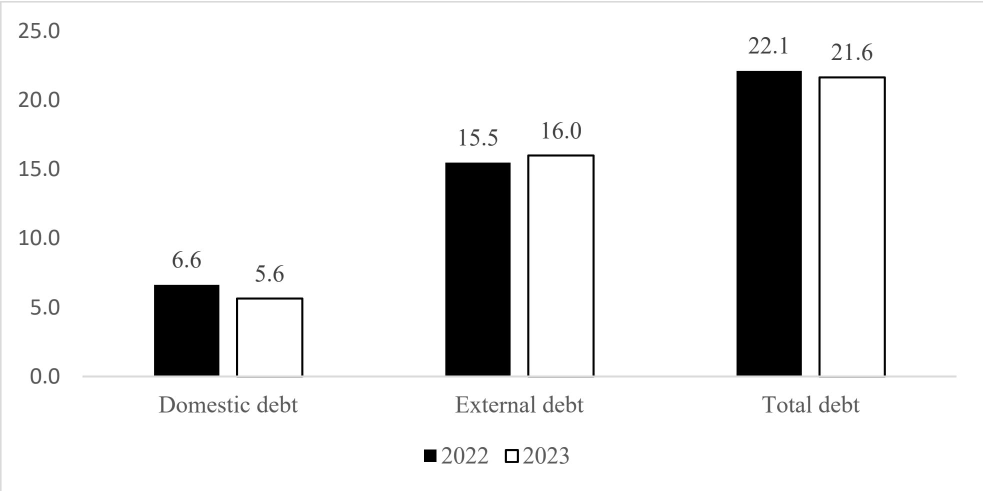


Source: Ministry of Finance, EDP Notification Tables (April 2024).

Government-guaranteed debt is still at a low level of 0.4% of GDP. However, financing strategic projects in the energy sector, achieving higher energy efficiency, and supporting the green transition are expected to significantly increase government-guaranteed debt in the coming years. Projections for 2024 indicate that government-guaranteed debt could rise to 2.3% of GDP, which may lead to an increase in government debt in the event of the guarantees being activated.

Maintaining the fiscal reserve at the mandatory level set by the annual state budget law provides buffers in the event of crises and a liquidity resource when state guarantees are activated. This amount is well above the mandatory level but represents a decrease as a percentage of GDP compared to 2022 when the first tranche from the Recovery and Resilience Mechanism was received.

Figure 7. Debt of Central Government sector for 2022 and 2023 by sources of financing (% of GDP)



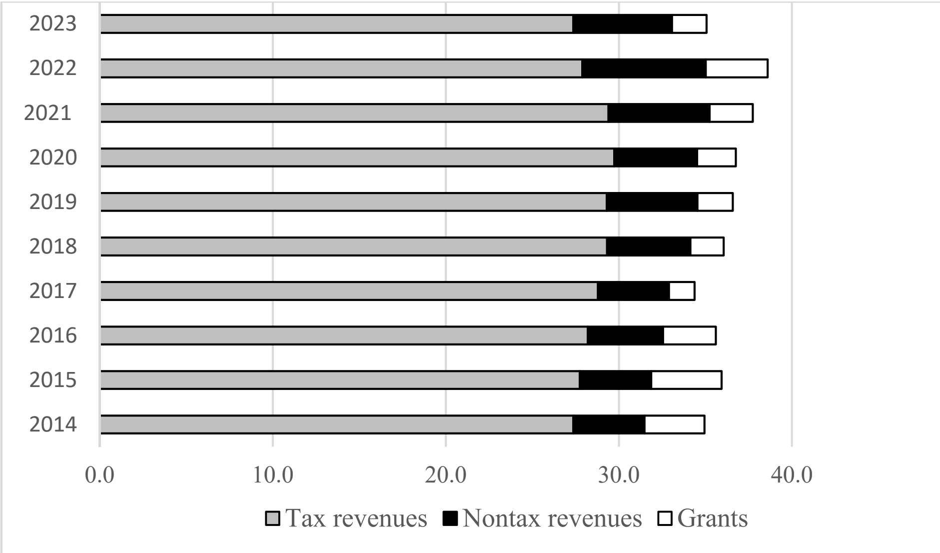
Source: Ministry of Finance.

Negotiations for the Partnership Agreement and the National Recovery and Resilience Plan's (NRRP) projects are ongoing. However, the implementation and payment of NRRP projects by the Recovery and Resilience Mechanism are expected to be delayed. This poses a fiscal risk, as projects not completed by the end of 2026 will require national funding. Although budgeted for 2023, the second tranche is expected in 2024, due to delays in the first milestones and targets. Despite reform in the management of state-owned enterprises and improved transparency of public procurement, the 2022 OECD report for Bulgaria points to the need to create a more modern platform to promote investment.

2.2. Budget revenues and tax policy

In 2023, budget revenues increased by 3.5% on an annual basis, but decreased by 2.1 percentage points as a ratio to GDP compared to 2022, amounting to 36.5% of GDP (Figure 8). The significant change in the revenue-to-GDP ratio was mainly due to less revenue from the European funds in 2023. The delayed second tranche from the Recovery and Resilience Mechanism affected the reduction in grant revenue. An additional negative effect resulted from the reduction of nontax revenues primarily due to the abolition of the duty to end-users of electricity charges on the free market and energy producers and suppliers. This charge was partially offset by the new tax on energy suppliers' windfall profits introduced in accordance with Regulation (EU) 2022/1854. In 2023, tax revenues were slightly below the level of 2022 as a ratio to GDP, and the planned indirect taxes of about BGN 2.4 billion were not realized. The income policy aimed at compensating for the declining purchasing power of households as a result of inflation and gradually reaching the average European levels led to an increase in the share of direct taxes in the structure of tax revenues.

Figure 8. Budget revenues for the period 2014-2023 (% of GDP)



Source: Ministry of Finance.

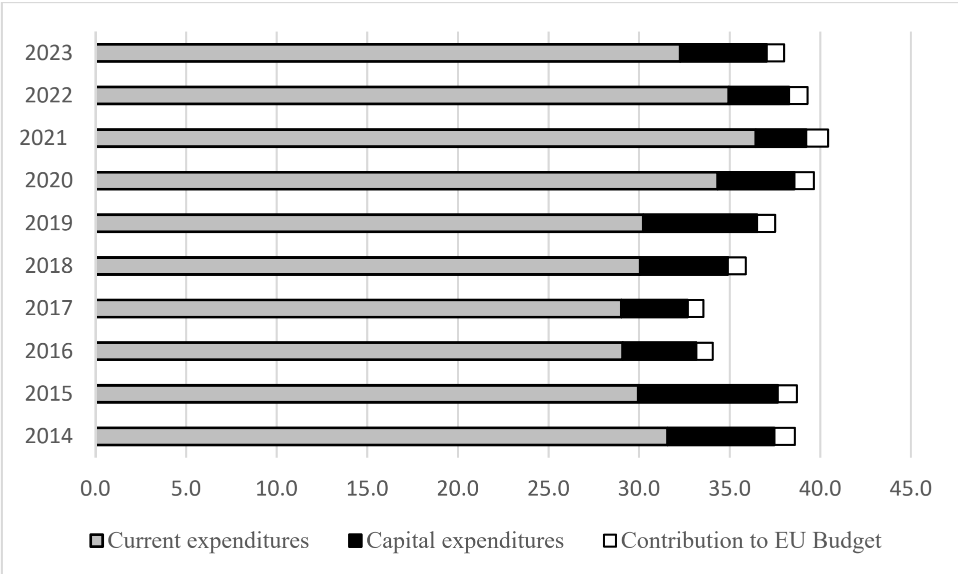
In July 2022, the European Council recommended that Bulgaria take action to ensure that in 2023 the growth of nationally financed current expenditure would align with the neutral policy stance. As a result, in 2023 current expenditures were reduced by 1.5 percentage points of GDP compared to 2022, thereby formally complying with the recommendation. However, in order to also achieve a reduction in current expenditures in the medium run, the efficiency of public spending should become a priority, which will allow long-term needs to be met within the planned fiscal trajectory.

2.3. Government expenditures and fiscal policy

In 2023, the total budgetary expenditure under the Consolidated Fiscal Program (CFP) was about 39% of GDP (Figure 9). The elimination of subsidies for compensating domestic and non-domestic final customers of electricity reduced subsidies to the non-budgetary sector by 3% of GDP, from 6.2% in 2022 to 3.2% in 2023. Meanwhile, the implementation of investment projects with European funding increased to 4.8% of GDP, up from 3.2% in 2022. This increase was anticipated, given that 2023 was the final year for payments under the 2014-2020 program period.

Over the years, expenditures by functions remain relatively constant as a percentage of GDP, with education and health at around 4% and 5% of GDP, respectively. However, the low educational results measured by the OECD Program for International Student Assessment (PISA) indicate a need for serious structural reforms of educational programs. This includes ensuring lifelong learning, as well as continuous improvement of the qualifications of teachers in secondary education, who are the main driver of changes in the quality of knowledge and the qualification of the future labour force.

Figure 9. Budget expenditures in 2014-2023 (% of GDP)



Source: Ministry of Finance.

The primary reason for the growth of current expenditure as a ratio to GDP in recent years has been the anti-crisis fiscal measures to support households and businesses in coping with the consequences of the COVID-19 pandemic. The cancellation of one-time fiscal measures for households and subsidies led to a reduction in current expenditure by 2 percentage points of GDP. However, the persistent upward trend in public social spending as a ratio of GDP, driven by an ageing population and ongoing net migration, poses a major risk to the labour market and, consequently, to the fiscal position in the medium term.

Capital spending increased to 4.8% of GDP in 2023 (from 3.3% of GDP in 2022). These capital expenditures have been crucial for the green transition, the improvement of infrastructure and trans-European connectivity, and modernizing educational and social infrastructure. In 2023, the anticipated acceleration of European investment projects for the EU program period 2014-2020 has been justified, resulting in a roughly 60% annual increase in capital expenditure. Part of the final payments for European projects from the 2014-2020 program period were refinanced with national funds in 2023, pending the final audit by the European Commission.

The recovery of the European funds improves the fiscal space, but it is primarily an advocacy process for European funding, which has no impact on the budget balance according to the EU methodology.

2.4. Fiscal policy outlook in the short run

Fiscal space to address long-term education, social and investment needs imply improving spending efficiency and reviewing taxation to increase the fairness of the tax system and have a greater impact on inequality. Restoring uniform VAT rates for restaurants, gyms and tour operators is expected to create a level playing field for businesses and increase tax revenues, enabling new spending policies to be pursued. Continuous reviews of the structure of public spending and an increase in public investment at the expense of current spending are expected to provide a fiscal stimulus to economic growth in the medium run. Opportunities for gradual fiscal consolidation are emerging. Maintaining fiscal buffers under an uncertain external environment will require fiscal prudence.

The Next Generation EU funds are expected to provide investments in renewable energy, energy efficiency and digitalization of the economy. This will reduce the carbon footprint and improve the efficiency of public services. By prioritizing sustainable and growth-enhancing investments to meet the 2030 Digital Transition priorities, the introduction of digital public services will be facilitated. This will reduce direct contact with tax administration, thereby improving the efficiency of public administration and optimizing its size.

3. External economic environment and external sector

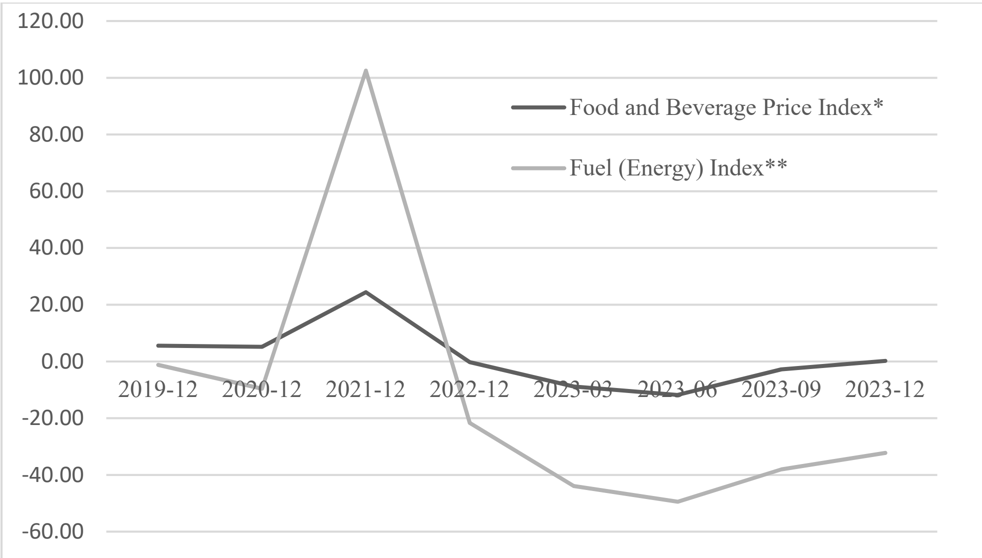
3.1. Global trade and price dynamics

In 2023, world trade in goods declined by 5% primarily due to weaker domestic demand in the advanced economies as a result of tighter financing conditions by central banks, disinflation, and ongoing constraints in global supply chains from the post-COVID-19 period. The global trade in services rose by 8%, with a significant increase in tourism, reflecting the still high savings accumulated under the COVID-19 period and higher prices. Although the COVID-19 anti-epidemic measures were fully lifted, the Middle East military conflict and trade difficulties in the Red Sea and the Suez Canal caused higher shipping prices and longer transportation periods. These issues significantly impeded trade between China and Europe, leading to a fragmentation of world trade in combination with weaker trade growth in East Asia and Latin America and signs of deglobalization exacerbated by the COVID-19 pandemic.

In 2023, global inflation slowed to 6.4%, with the EU experiencing a rate of 3.4% and the euro area of 2.9%. According to the International Monetary Fund, the average annual decline in the global energy price index was 32% in 2023 and the food price index saw an average annual decline of 5%, following the easing of supply constraints (Figure 10). Therefore, the core inflation (excluding food and energy prices) declined, partially offsetting the still higher contribution of service prices to headline inflation in developed countries. Another key factor for disinflation was the contraction of domestic demand as a result of tighter macroeconomic policies. The gradual reduction of fiscal support implemented during the COVID-19 pandemic in the EU and the euro area contributed to lowering inflation. Tighter financing conditions in the euro area squeezed consumption and investment, further reducing inflation.

Additionally, the EU Green Deal initiatives, which effectively add taxation to economic activity, constrained domestic demand and output. In contrast, the macroeconomic policy strategy in the USA focused more on stimulating the long-term drivers of economic growth. This difference in policy approach reflects the varied methods countries have adopted to manage inflation and promote economic stability.

Figure 10. Annual change in food and energy price indices (%)



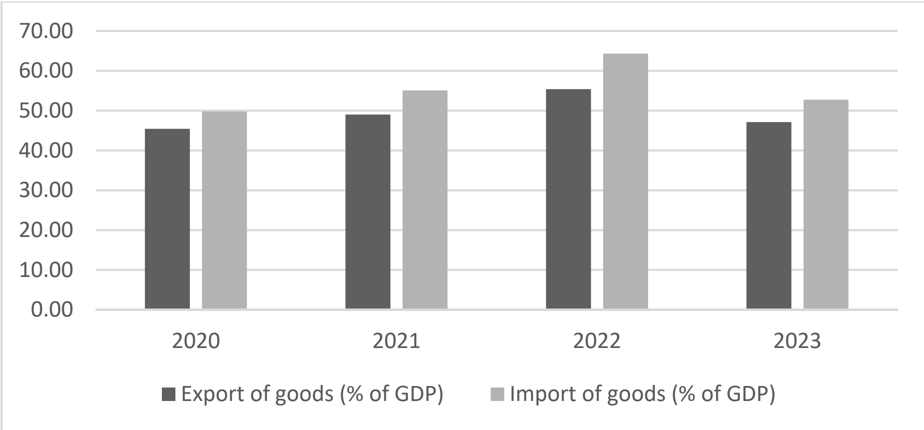
* Food and Beverage Price Index, 2016 = 100, includes Food and Beverage Price Indices.
** Fuel (Energy) Index, 2016 = 100, includes Crude oil (petroleum), Natural Gas, Coal Price, and Propane Indices.

Source: International Monetary Fund.

3.2. Bulgarian foreign trade in goods

In 2023, Bulgaria's exports of goods declined by 6.9%, while imports of goods fell by 10.2% on an annual basis. The trade balance remained negative at -5.6% of GDP, roughly the same as it was in 2020 and 2021 (Figure 11). In the structure of exports by commodity group, the dominance of machinery, equipment and vehicles became more evident, accounting for 11.2% of GDP in 2023 with an annual growth of 9.1%. Additionally, the share of exports of manufactured goods classified chiefly by material (precious and non-ferrous metals, textiles, paper, rubber, leather, etc.), remained relatively stable at 9.4% of GDP in 2023. This process illustrates the still volatile adjustment of Bulgarian exports to higher-tech production and foreign trade in investment goods. Bulgarian foreign trade remains strongly dependent on raw materials, energy resources and military goods, making it susceptible to fluctuations in global markets and international relations. This dependency serves as a direct channel for cyclical fluctuations to impact Bulgaria's highly trade-open economy.

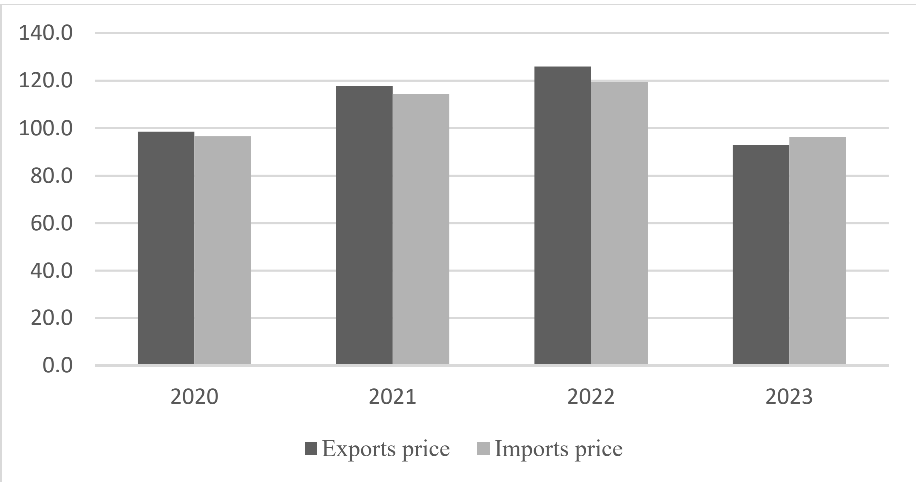
Figure 11. Foreign trade in goods in 2020-2023 (% of GDP)



Source: National Statistical Institute.

In 2023, there was a larger annual decline in the export price index (-26%) compared to the import price index (-19%) (Figure 12). Despite the overall deterioration in the terms of trade, the terms of trade for investment and industrial goods improved noticeably in 2023, which is a favourable indicator for the technological restructuring of Bulgarian exports.

Figure 12. Price indices for exports and imports of goods in 2020-2023



Source: National Statistical Institute.

Bulgaria's main trade partners in the export of goods are Germany, Romania, Italy, Greece and Turkey – together accounting for approximately 40% of total exports of goods in 2023 (19.5% of GDP). A similar concentration is observed in the import of goods. This high concentration of exports of goods to EU Member States and the lack of significant trade diversification to other countries make Bulgarian exports highly dependent on the economic conditions in these countries and predetermine the high share of foreign value added in the exports.

The comparative advantages in trade with Germany, Romania, Italy, Greece and Turkey can be traced through the export-import coverage ratio, which measures the ratio between exports and imports from a given trading partner by commodity group (Table 2).

Table 2. Export-import coverage ratio in 2023 by commodity group and main trading partner (%)

Trade partner / Commodity group	Germany	Romania	Italy	Greece	Turkey
Total	***98.05***	***121.13***	***95.19***	***112.49***	***63.17***
Food and live animals	62.99	135.26	82.44	170.08	136.32
Beverages and tobacco	22.76	33.39	19.06	28.67	34.62
Crude materials, inedible, except fuels	906.91	33.01	46.13	83.40	72.91
Mineral fuels, lubricants and related materials	22.15	120.29	127.42	16.96	27.16
Animal and vegetable oils, fats and waxes	69.73	22.85	923.33	229.37	544.32
Chemicals and related products, n.e.s.	35.20	193.39	76.13	93.12	49.02
Manufactured goods are classified chiefly by material	129.80	162.88	154.48	130.68	52.80
Machinery and transport equipment	85.00	109.47	48.77	103.73	83.57
Miscellaneous manufactured articles	140.37	150.54	149.78	165.48	30.22
Commodities and transactions not classified elsewhere in the SITC	15.98	0.20	1697.78	20.13	143.92

Source: Eurostat, author's calculations.

The most balanced trade is achieved with Germany and Italy, where the export-import coverage ratio is close to 100%. Substantial export trade advantages with Germany are observed for crude materials whose prices fell in 2023 due to shrinking domestic demand and economic stagnation. On the import side, there is a significant imbalance in bilateral trade (higher imports relative to exports) in beverages and tobacco, as well as in mineral fuels, lubricants and related materials, where prices halved in 2023.

Imports of machinery, transport equipment and crude materials from Italy are higher than their exports. Bulgarian companies have an advantage in exports to Italy in animal and vegetable oils, fats and waxes (whose prices decline by 62% in 2023), as well as in household goods, clothing and medical equipment. The export potential in textiles is based on the Italian investments in small and medium enterprises with low-tech production and a low-qualified labour force made during Bulgaria's transition to market economy.

Bulgaria has advantages over all its main trading partners except Turkey only in miscellaneous manufactured articles (furniture, furnishings, clothing, footwear, travel goods, medical appliances and devices). The prevalence of imports over exports in the case of Turkey is clearly visible in almost all commodity groups due to the depreciation of the Turkish lira. Bulgaria has export advantages in trade with animal and vegetable oils, fats and waxes, as well as food and live animals, driven by high domestic demand in Turkey amid very high inflation (65% in December 2023).

In 2023, Bulgaria realized most trade advantages in exports of goods with Romania. The significant potential in exports to Romania is a result of strong domestic demand and investment activity in recent years (according to Eurostat, Romania ranked second in the EU in economic growth in the third quarter of 2023). Romania is increasingly establishing itself as Bulgaria's leading foreign trade partner within the EU. Given the economic turmoil in the euro area and Germany in particular, Bulgarian exports of goods can be redirected to the Romanian market. Exports to Romania are steadily replacing the Greek market as a preferred destination for Bulgarian firms, which is a direct consequence of the accelerated growth rates of the Romanian economy and the shrinking purchasing power in Greece following the euro area debt crisis in 2012. Relative trade advantages for Bulgarian exports to Greece are realized in agricultural products. Exports of machinery and transport equipment to both Romania and Greece exceed imports.

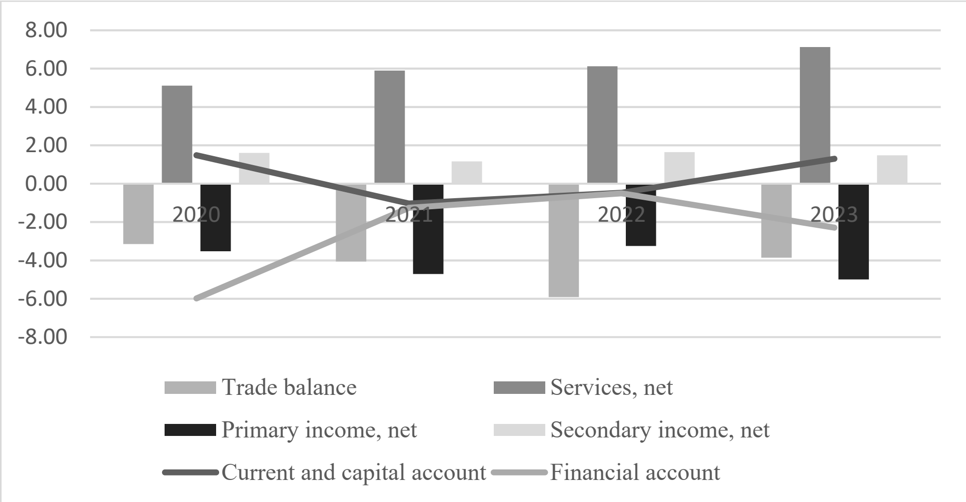
When comparing Bulgarian export profile to other EU Member States, Bulgaria is closely followed by Latvia, Lithuania, Estonia, and Croatia. In terms of exports of food and crude materials, Bulgaria ranks closest to Slovakia, and closest to Latvia and Greece in trade with mineral fuels and chemicals. The exports of investment goods bring Bulgaria closer to Slovenia and even Ireland, whose GDP per capita in PPP terms is more than 3.5 times higher than Bulgaria’s in 2023. Bulgaria's foreign trade profile in 2023 resembles that of countries with much higher purchasing power and an accelerated rate of convergence towards the euro area which is a prerequisite for a smooth trade integration when joining the currency union.

Despite the strong orientation of Bulgarian exports towards the EU, opportunities for diversification should not be neglected. In 2022, exports of food and live animals to Algeria increase 21-fold, accounting for 8% of total exports in this commodity group in 2023. Exports of beverages and tobacco to Egypt and Morocco increase steadily in 2022 and 2023, tripling in the 4 years between 2020 and 2023. A similar trend can be observed for exports of mineral fuels, lubricants and related materials to Egypt, which increased 10-fold over the same four-year period and accounted for 15% of Bulgaria's total exports in this commodity group.

3.3. Balance of payments and trade flows

In 2023, the current and capital account balance improved relative to 2022, reaching 0.66% of GDP (Figure 13). The main contributor to this improvement is the positive balance of the services. Exports of services reached 15% of GDP in 2023 as a result of rising domestic demand in main trading partners, higher price dynamics, the lifting of the COVID-19 restrictions and a stronger use of accumulated household savings. In the structure of services exports in 2023, telecommunications, computer and information services account for approximately 1/4, followed by tourism (4% of GDP) and transport services (2.6% of GDP). Among business services, consulting, technical and trade-related services emerged as the most important. This underscores the increasing importance of the outsourcing sector for the economy of Bulgaria.

Figure 13. Key balance of payments indicators in 2020-2023 (% of GDP)



Source: Bulgarian National Bank.

In 2023, significant deterioration was recorded in the net primary income, primarily due to the higher outflow of foreign direct investment (FDI) income, amounting to BGN 12.7 billion (6.9% of GDP), which is an extremely unfavourable trend that is worsening. The persistent inability to create sufficiently good conditions for the reinvestment of profits from direct investments in Bulgaria does not allow for restructuring and the widespread adoption of digital technologies in the production process. The negative balance of the financial account deepened to -2.3% of GDP following higher FDI inflows (4.3% of GDP), a decrease in residents' currency and deposits abroad by BGN 4.1 billion, and portfolio investment abroad exceeding 3.2% of GDP.

3.4. Prospects for the development of foreign trade in 2024 and in the medium term

The dynamics of Bulgarian exports in 2024 are expected to be influenced by divergent factors. The economic recession and stagnation in Germany are likely to have a significant impact on Bulgaria's foreign trade flows. However, Romania has become increasingly important as a trading partner. Given the declining importance of the Italian and Greek markets for Bulgarian exports and the persistence of high inflation in Turkey, a more limited effect on Bulgaria's foreign trade is expected from the economic situation in these countries.

The deteriorating terms of trade due to the disinflation and global trade fragmentation, along with the still dominant share of lower value-added goods in the export structure, are factors that will limit growth in 2024. The export ban on oil and petroleum products produced from Russian oil to countries other than Ukraine adversely impacts both foreign trade and customs duty revenues to the government budget. Given that around 6% of Bulgaria's exports consist of petroleum oils and products, this ban poses a significant challenge.

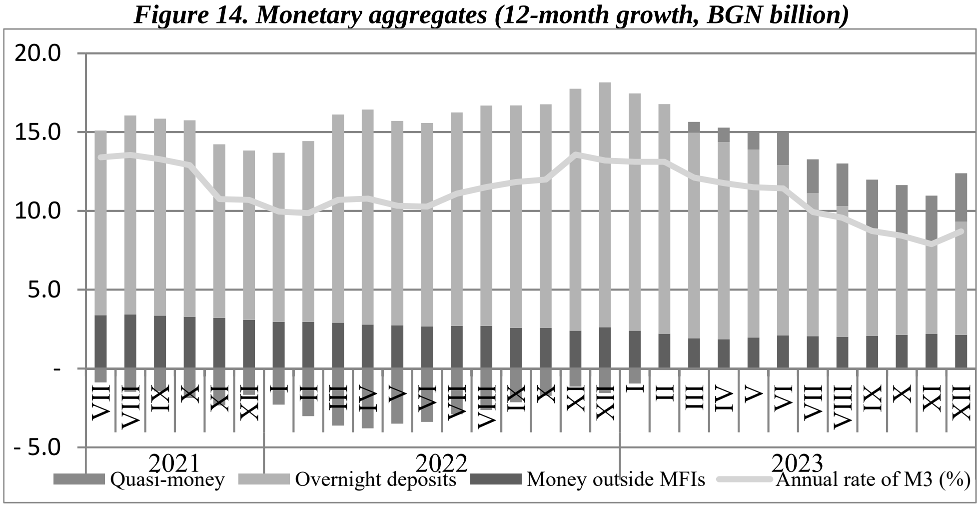
4. Banking sector and capital market

4.1. Dynamics of monetary aggregates

The dynamics of the money supply visibly slowed down, with the reported growth of overnight deposits for December 2023 on an annual basis being half of the previous year's rate, reaching BGN 7.2 billion (Figure 14). This slowdown is due to the gradual downsizing of the anti-inflationary fiscal measures and the slowing growth of the funds from non-financial enterprises. Corporate deposit growth, particularly in the first half of 2023, also slowed due to decreased nominal turnover in retail trade and a contraction in the industrial sector. The most significant decrease in deposits in the first six months of 2023 was observed in sectors most directly affected by sanctions against Russia – transport and trade. This indicates that the main reason for the limited supply of corporate deposits is the disrupted rhythmicity of income and the need to compensate for the resulting shortfall with own funds in order to ensure business continuity.

Broad money (monetary aggregate M3) continues to grow, but since the beginning of 2023, its annual rate has steadily slowed. Both firms and households continue to save mostly in local currency. Since the second half of 2021, quasi-money started to rise again after the end of the first quarter of 2023 as a result of the gradual recovery of interest rates on deposits.

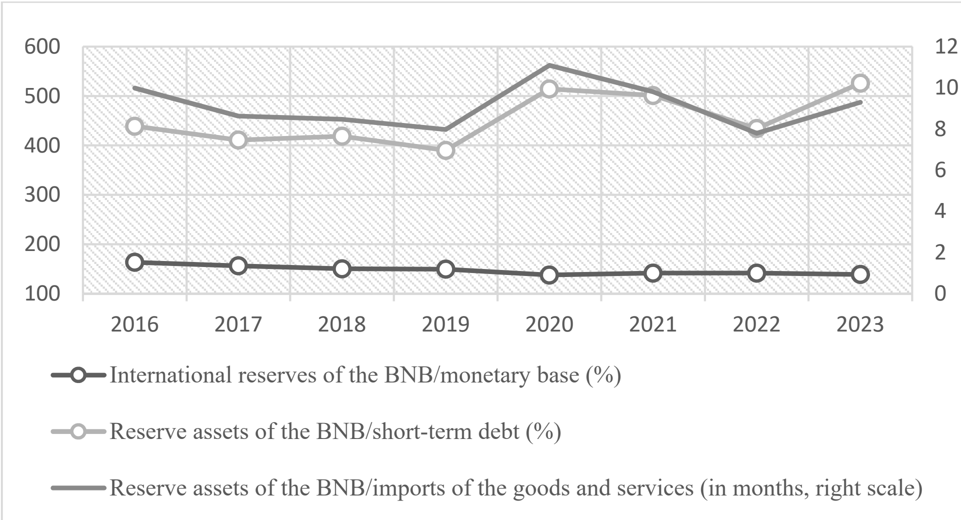
Figure 14. Monetary aggregates (12-month growth, BGN billion)



Source: Bulgarian National Bank, author's calculations.

The market value of the BNB's international reserves reached BGN 81.99 billion at the end of 2023, increasing by BGN 6.85 billion compared to 2022 (Figure 15). This increase was primarily due to the rise in the balance sheet value of the government securities (by BGN 27.99 billion). This gain was partially offset by the decrease in cash and deposits provided in foreign currency, which fell by BGN 21.58 billion. Insignificant increases were registered in the remaining components of international currency reserves (monetary gold and special drawing rights).

Figure 15. Key Indicators for the Currency Board Arrangements



Source: Bulgarian National Bank, author's calculations.

The total growth of the BNB's international reserves significantly compensates for the growth of the monetary base, resulting in their ratio remaining almost unchanged (138.81% for 2023 versus 141.63% for 2022). The lagging growth in imports of goods and services, as well as short-term debt, has led to an improvement in the ratio between them. However, maintaining this ratio unchanged in 2024 will be challenging due to reduced investor confidence and a slowdown in domestic manufacturing.

4.2. Banking sector performance

In 2023, the banking sector operated in a volatile environment, primarily driven by the disruption and rerouting of some logistics chains as a result of sanctions, imposed on Russia and Belarus in response to the military conflict between Russia and Ukraine. The transmission of effects from the ECB's monetary policy led to a slowdown in inflationary processes, although with a certain delay due to the inherent time lag. The rise of interest rates led to some cooling of lending to non-financial enterprises.

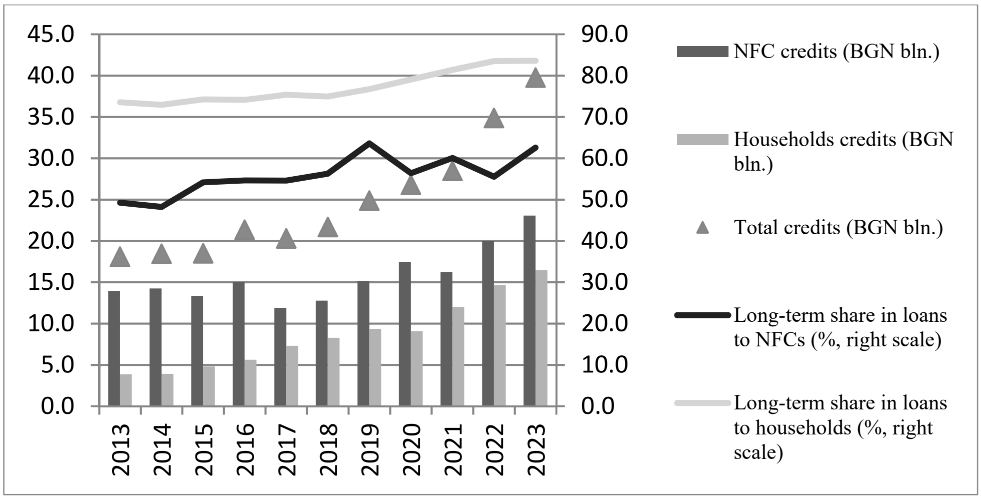
The banking system is adapting to the changing conditions and with automatically increasing interest rates on loans, gross interest income increased by 62% on an annual basis, while gross loans grew by only 13.1%. Gross bank revenues from fees and commissions rose by 5.9%, reaching BGN 1,862 billion in 2023. Combined with the increased net interest margin, this led to a record profit for the banking sector, amounting to BGN 3,417 billion after taxes, which is by 65.9% more than in 2022. Despite serious challenges in the economic and regulatory environment, Bulgarian banks remain sustainable and profitable, maintaining high levels of liquidity and capital buffers.

In addition to the continued profit increase, significant trends in 2023 include the digitization of banking products and services, as well as the initial phase of introducing new requirements for the disclosure of information on climate change, announced in March 2023 by the European Central Bank and the European supervisory authorities.

Bank concentration continued to increase, as it has throughout the entire period since the start of the COVID-19 pandemic. In 2023 alone, the share of the five largest banks increases from 67.2 to 76.8% as a result of the merger between UBB and KBC Bank Bulgaria. Regarding digitization and transformation of banking services, customer migration remains focused on larger banks, enclosing greater investments in the development of new market channels, as well as more active information campaigns for their promotion.

Analysis of the monetary statistics (Figure 16) shows that the positive growth trend in new business loans for non-financial corporations (NFC) continues. The volume of new business loans reached a record value of BGN 23.1 billion, and the ratio between the volumes of new business for NFC and the reported value of gross loans to this segment reached 47.58% at the end of 2023.

Figure 16. Annual volumes of new business loans



Source: Bulgarian National Bank, author's calculations.

Interest rates in Bulgaria remain lower than those in the euro area which can be explained by the desire of commercial banks to expand their market share. The excess of liquid funds allows most of them to engage in price competition, which rises the risk of artificially underestimating the risk premium.

Gross loans (excluding those to banking institutions) are growing, with total loans increasing by 9.6% in 2023. When excluding loans to credit institutions, the growth rate reached 12.14% annually. This dynamic is driven by the increase in interest rates on new business (especially in the corporate segment), and the yield on new issues of public debt, leading to a decrease of the relative attractiveness of other categories. Consequently, the share of loans to financial institutions decreased at the expense of the shares of all others, except for loans to enterprises. The share of the last category decreased with 112 b. p. to 45.6% due to partially reduced demand for corporate loans as interest rates in this segment normalized more quickly and financial intermediaries sought better diversification by increasing household exposures. Loans to non-bank institutions continued to grow, outpacing even the most intense levels seen in this segment in 2017-2018. In 2023, the total amount of receivables from other financial enterprises increased by 32.4%, which is 3 times more than what was achieved in 2022. Financial institutions are motivated not so much by excess liquidity but by the objective to offload high-risk-weight assets onto the balance sheets of (usually affiliated) non-bank institutions, thus preventing deterioration of capital adequacy ratios.

The volumes of new business in retail lending continued to grow, reaching BGN 16.45 billion in 2023 which is BGN 1.80 billion more than in 2022. Mortgage loan activity remained strong, which is somewhat surprising given the decreasing number of real estate transactions and the increasing share of bank financing in real estate transactions (at the expense of self-financing).

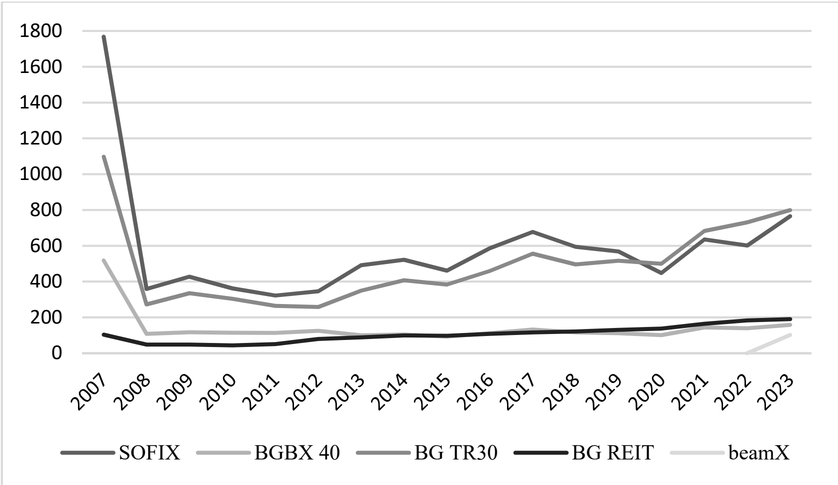
Depositors continue to increase their savings, motivated by the rising deposit interest rates. The total value of the resources from the non-financial sector grew by 8.4% on an annual basis, which is twice the rate reported in 2022. This growth is mainly driven by households, whose savings growth contributes to over 3/4 of the total growth of the deposit base. The sharp decrease in the activity of legal entities is striking. After the intense increase in savings by BGN 16.84 billion in 2022 (despite the effect of additional fees), legal entities limited their propensity to save at the beginning of 2023, resulting in zero growth of the attracted resources from this source in the first six months of the year.

4.3. Capital market development

In 2023, there was an upward trend in the development of the Bulgarian Stock Exchange (BSE) indices. The SOFIX reached 795.12 points, marking a 27.2% increase compared to 2022. The broad BGBX40 and BGTR30 indices also increased by 13.35% and 9.33% respectively. However, the sectoral BGREIT index rose at a slower rate, with a 3.89% increase. The BeamX index for the emerging growth market reached 101.85 points. Figure 17 illustrates that after more than a decade, the BSE is gaining strength, with the main SOFIX index reaching its highest point in 15 years. This surge is mainly due to the shares of two companies – Shelley Group (formerly Alterco) and Sopharma. However, the index values have not yet surpassed those realized before the global financial and economic crisis of 2008.

By the end of 2023, the market capitalization of segments organized by the BSE indicates a significant 48.6% decrease compared to the end of 2022. Among BSE trades in 2023, the Standard shares segment dominated with a share of 50% (BGN 7,745.94 million), followed by the Premium shares segment with 19.9% (BGN 3,083.13 million).

Figure 17. Values of market indices



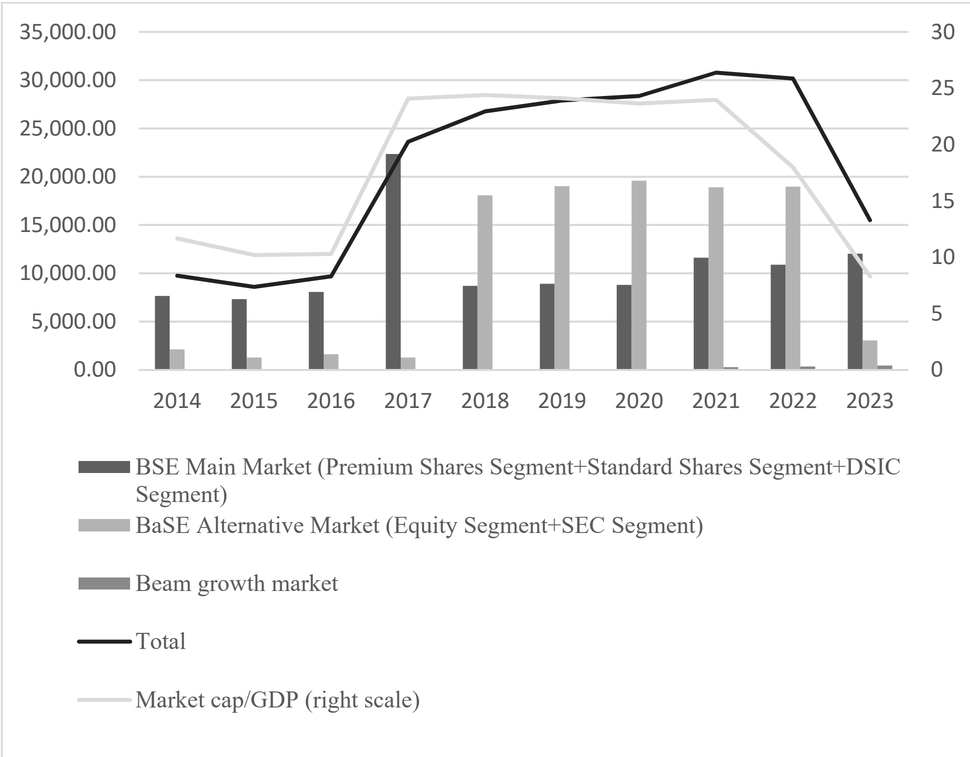
Source: Bulgarian Stock Exchange, author's calculations.

Notably, in 2023, the market capitalization of the primary BSE market claimed a substantial portion of the total market capitalization, continuing a trend seen since 2017. The Beam Growth Market has sustained consistent interest since its inception in 2021, with its market capitalization steadily growing, reaching BGN 436 million in 2023. The BSE's market capitalization relative to GDP was 8.3% at the end of 2023, continuing a downward trend that began after 2021 (Figure 18). According to this metric, the Bulgarian capital market significantly lags behind and remains notably underdeveloped compared to established capital markets.

In 2023, 33 new issues were registered for trading on the BSE, a significant decrease from the 240 issues recorded in 2022. No initial public offerings (IPOs) of shares took place on the regulated market. However, bond trading (excluding government securities) continued to grow, increasing by 72.7%. On December 15, 2023, Finance Plus Management Holding successfully conducted the first primary offering of bonds on the regulated market of the BSE, raising BGN 40.40 million. Given the uncertain equity markets and low interest rates on bank deposits, bonds remain an attractive option for many investors seeking yield.

On the Beam Growth Market, there were 4 primary public issues of shares and 1 primary public issue of bonds registered. The Multilateral Trading System (MTF) BSE International recorded only 1 share issue in 2023, a significant decrease compared to 2022, which can be attributed to investor outflows amid global economic uncertainty.

Figure 18. Market capitalization by types of markets (volumes in million BGN and ratio to GDP)

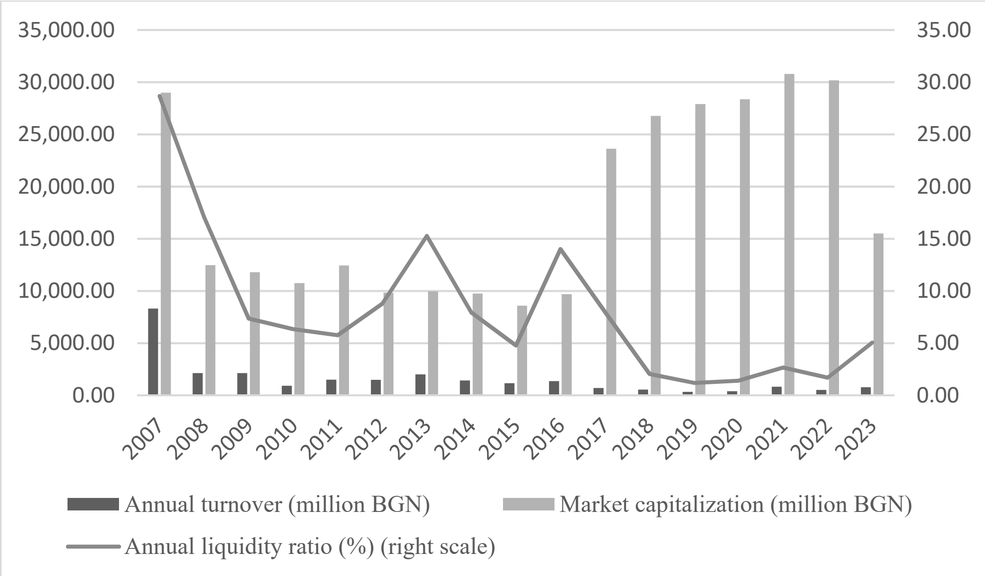


Source: Bulgarian Stock Exchange, author's calculations.

Financial and insurance activities dominated the turnover on the BSE main market in 2023 (Figure 19), accounting for BGN 303.5 million (63% of the total turnover). Real estate activities followed with a turnover of BGN 76 million and the electricity, gas, steam and air conditioning supply sector with BGN 64 million (13.35% of the total share). Professional, scientific, technical, administration and support service activities ranked fourth, contributing 10.54% of the total turnover with BGN 50.7 million.

In 2023, 38 intermediaries facilitated stock exchange transactions – 7 of them generating turnovers exceeding BGN 100 million. ABV Investments led with transactions totalling approximately BGN 262 million, followed by Real Finance with BGN 219 million. Carol led in the number of executed transactions, with 49,653 executed transactions accounting for approximately 66% of all transactions in 2023. Elana Trading and Benchmark Finance followed with over 10,000 transactions each, totalling 26,234 and 13,846 transactions, respectively.

Figure 19. Annual liquidity ratio of the BSE in 2007-2023 (%)



Source: Bulgarian Stock Exchange, author's calculations.

Despite international market turmoil fueled by concerns over rising interest rates and a potential recession, SOFIX and the Bulgarian capital market have remained relatively resilient. Recent years have witnessed increased market activity due to new companies listing on the stock market and a general uptick in positive market sentiment. The detachment from global events may provide some level of protection against more severe crises in global markets. However, such detachment may not be sustainable indefinitely and could deter investors, potentially leading to a downward spiral. To attract new high-quality issuers and enhance liquidity, concerted efforts from the BSE and comprehensive policies for capital market development in Bulgaria are necessary.

4.4. Prospects for the financial sector in the medium run

Global economic uncertainty leads to more pessimistic expectations for the banking system. The slowdown in economic growth is expected to negatively affect banks' profitability, increase the share of non-performing loans, and necessitate higher provisions. Another significant factor that will influence the banks' behaviour in 2024 is the anticipated effect of Bulgaria's expected accession to the euro area.[8]

[8] A detailed analysis was made in Rangelova, R., Bobeva, D., Sariyski, Gr., Zlatinov, D., Atanasov, At. (2023). The Euro area and economic prospects for Bulgaria. Sofia: Publishing House of BAS Prof. Marin Drinov, ISBN 978-619-245-324-4.

The main trends in the banking sector will be shaped by economic processes related to the military conflict in Ukraine; attempts to limit risks arising from expected changes in key interest rates; balance between lending conditions and standards against the backdrop of a deteriorating macroeconomic environment; intensive processes of digital transformation and management of the processes related to the green transition. In 2024, the European Banking Authority is set to establish requirements for financial institutions to identify, measure, manage, and monitor risks related to environmental and social management, including plans to address the risks arising from the transition to a climate-neutral EU economy. This will cause a further increase in the administrative burden and a tightening of the borrower's requirements.

The Bulgarian capital market is expected to grapple with ongoing challenges related to low liquidity, largely due to the market's small scale and limited investment culture among the population. The number of active participants in the Bulgarian capital market is expected to remain small, with individual investors with modest to moderate capital predominating. Investors will continue to seek secure income, placing value on companies that prioritize transparency and dividend payments, particularly those with a track record of consistent dividend increases. Institutional investors, notably pension funds, are likely to reduce their presence in the market as asset values decline. There is a potential to enhance liquidity on the BSE by introducing new instruments, such as derivatives trading, short selling, and secondary trading in government securities, accessible to individual investors.

5. Forecast for the Bulgarian economy until 2026

The macroeconomic forecast of the Economic Research Institute at the Bulgarian Academy of Sciences is based on a structural model that includes key macroeconomic indicators. This forecast relies on assumptions about medium-term economic development (until 2026) concerning international prices, external demand, and the economic policies outlined in the Medium-Term Budget Forecast in 2024-2026. The macroeconomic forecast is based on macroeconomic information available as of March 12, 2024.

The main assumptions related to the presented forecast are based on the following evaluations and expectations:

- The military conflict between Russia and Ukraine is expected to persist beyond the US presidential elections. Sanctions against Russia and Belarus will continue, with the possibility of intensification. Military tensions in the Middle East will continue to negatively impact the global economy.
- The prices of primary energy resources will remain high compared to the average values of the previous three years but are expected to gradually decline. Economic growth in EU Member States will slightly accelerate but remain low and below potential.
- External demand for Bulgarian exports will decline, especially in 2024. This will be countered by increased production and export of military products in 2024 and potentially beyond, along with Romania's ascending economic trajectory, positioning it as a key trade partner.

- Financial flows to Bulgaria will be primarily determined by the funds from European structural funds and the Recovery and Resilience Mechanism under the Next Generation EU initiative.
- Economic activity will remain subdued, influenced by both the unstable external environment and internal political situation. The early parliamentary elections in mid-2024 are expected to encourage populist actions and hinder the implementation of serious economic reforms.
- In the absence of new shocks in energy prices, the economy will enter a period of disinflation, though this process will be rather slow. Meeting the Maastricht criterion for inflation is unlikely within the forecast period, suggesting that the country's accession to the euro area in 2025 will be postponed.
- There is significant uncertainty regarding the labour market. Unemployment is not a major economic problem, despite the increase in labour costs at the end of 2023 and the beginning of 2024. Instead, a labour shortage is observed largely due to the worsening demographic situation and continued labour emigration rather than a slowdown in economic activity.
- The state of public finances will be strongly dependent on political stability and the realization of projects funded by European structural funds and the Recovery and Resilience Mechanism. Compliance with the Maastricht criterion for the general government sector deficit and consolidated public debt in 2023 provides grounds for gradual fiscal consolidation.
- Public debt will slowly increase but remain below 30% of GDP by 2026. The increase in public debt will finance the budget deficit and maintain the fiscal reserve, ensuring liquidity in the event of activating state-guaranteed debt.

The forecast assumes that the parameters and policies in the medium-term budget framework remain unchanged, with no significant alterations in the tax system and targeted efforts for fiscal consolidation to meet the Maastricht criteria for euro area accession.

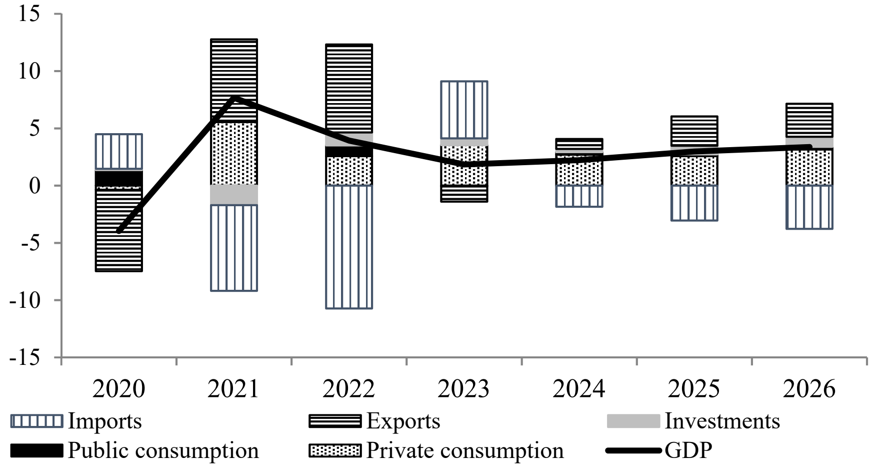
5.1. Dynamics of key macroeconomic indicators during the forecast period

Given the unfavourable external and internal economic conditions, real GDP growth is projected to remain below potential, with an expected rate slightly above 2% in 2024. By 2026, growth is anticipated to gradually recover to the average pre-pandemic levels, with domestic demand continuing to be the main driver of economic growth. In the medium term, economic growth in Bulgaria is expected to be within the range of 3.0-3.5% annually. The increase in investments will primarily be driven by the progress of the programming period and the assumptions of accelerated absorption of European funds under the National Recovery and Resilience Plan.

The dynamics of consumption will be determined by wage growth, moderate increases in employment, and low but still positive growth in credit activity. Investments will mainly be influenced by the rate of absorption of EU funds.

For the entire period of 2024-2026, the contribution of net exports to economic growth will remain negative (Figure 20). Given the expected weak economic growth among Bulgaria's main trading partners, external demand will remain relatively low, leading to a deterioration in the balance of payments throughout the period of 2024-2026.

Figure 20. Contributions to economic growth (p.p.)



Source: National Statistical Institute, author's calculations.

During the entire forecast period, inflation will gradually decrease but will remain higher than usual compared to the previous decade. This is largely due to external factors as well as some discretionary government measures (such as an income policy not sufficiently aligned with actual budget capabilities). These factors contribute to a higher rate of inflation compared to the average values for the EU Member States.

During the period 2024-2026, employment will continue to be determined by the pace of economic growth, constrained by the demographic situation. At this stage, no significant change is observed in the labour supply due to the refugee wave from Ukraine. This is because nearly one-third of the refugees are below working age and the remaining part (at least for now) does not show a desire for permanent settlement in Bulgaria. Unemployment is forecasted to remain at current levels, potentially slightly decreasing in 2025 and 2026. It is expected that the dynamics of wage growth will remain positive in real terms, though lower than in previous years.

Given the overall macroeconomic background, expectations for 2024 include a cooling of lending to both businesses and households amid increasing risks in the economic environment, the imposition of a higher risk premium and a gradual increase in interest rates on loans.

Table 3. Macroeconomic Forecast 2024-2026

	Provisional data	Forecast		
	2023	2024	2025	2026
Real sector (%)				
GDP	1.8	2.2	3.0	3.4
Private consumption	5.4	4.0	3.7	4.5
Public consumption	-0.4	1.3	1.0	1.4
Investments	-18.1	1.5	4.2	4.8
Exports of goods and services	-1.9	1.3	3.8	4.2
Imports of goods and services	-6.3	2.5	4.2	5.1
Price dynamics (%)				
HICP (average)	8.6	3.9	3.2	2.9
GDP deflator	7.5	3.6	2.8	2.3
Labor market				
Employment rate (15-64)	66.4	67.7	68.8	69.4
Unemployment rate (15-64)	4.4	4.0	3.7	3.7
Average monthly wage (BGN)	1995	2154	2316	2477
Wage growth (%)	12.7	8.0	7.5	7.0
External sector (% of GDP)				
Current account	0.3	-0.2	-0.5	-0.5
Trade balance	3.2	2.2	1.6	0.9
Capital account	1.4	1.5	1.6	1.8
Financial account (incl. foreign reserves)	1.5	1.2	1.1	1.2
FDI inflows	4.0	4.1	4.0	3.9
Gross foreign debt	48.0	47.6	47.5	47.8
Financial sector (annual change, %)				
Monetary aggregate M3	8.7	8.1	7.5	7.4
Loans to non-financial sector	12.0	5.3	4.0	5.0
Fiscal sector (% of GDP)				
Budget revenue	36.5	37.2	37.0	36.5
Budgetary expenditure	39.6	39.5	39.0	38.4
Budget balance (cash-based)	-3.1	-2.3	-2.0	-1.9
General government debt	23.3	24.6	25.4	28.4

5.2. External and internal growth constraints and risks

The risks of a possible escalation of the military conflict between Russia and Ukraine, and its potential transition from a local to a global conflict, cannot be overstated. In addition to these known risks, we must consider the risk of escalating tensions in the Middle East and additional restrictions on global trade. The potential consequences of a sharp escalation in military conflicts would render any forecasts meaningless, so they will not be considered. The focus is only on other constraints and risks:

- Political tension in Bulgaria persists, with ongoing challenges and unclear economic policy parameters following the early parliamentary elections in June 2024. Progress on Schengen and euro area accession and judicial reform is still unsatisfactory.
- The external environment remains unfavourable, with risks of further deterioration if the Russia-Ukraine military conflict isn't resolved, US-China trade disputes escalate, or the

Middle East conflict deepens. The euro area economic slowdown is a fact, but it's uncertain if the European Central Bank will adjust its restrictive monetary policy.

- The Bulgarian economy is near full employment, limiting the positive impact of new job creation on economic growth. Solutions involving foreign labour attraction depend largely on Bulgaria's political situation.
- Inflation risks are asymmetrical and upward. Previously an 'importer of inflation,' Bulgaria's recent expansionist fiscal policy significantly impacts inflation dynamics. An unstable economic environment, excess liquidity, and rising public debt contribute to higher inflation expectations.
- Optimistically, resolving the Russia-Ukraine military conflict and accelerating EU-funded programs could boost economic growth, though this is unlikely.

Conclusions

The analysis of the Bulgarian economy in 2023 and forecasts until 2026 lead to several policy recommendations aimed at addressing structural challenges and promoting sustainable development:

- While pursuing euro area membership, focus on both nominal and real convergence to avoid overshadowing the need for genuine economic progress.
- Enhance socio-economic welfare by improving the legal and institutional framework, building infrastructure, and addressing the skilled labour shortage by attracting educated workers from abroad and encouraging the return of Bulgarian professionals.
- Extend compensatory measures for subsidized recruitment of at-risk groups and implement specific policies for sectors and regions in the green and digital transition. Provide specialized support for employees in the Maritsa East, Bobov Dol, and Pernik energy complexes.
- Reform vocational training for older people to support lifelong learning, introduce micro-qualifications, and focus on acquiring green and digital skills.
- Gradually move towards a balanced budget to ensure macroeconomic stability and meet new fiscal governance requirements. Shift from expansionary to counter-cyclical fiscal policy to support growth and the EU's green and digital transitions. Expand fiscal space for education, social, and investment needs by revising taxation and restoring uniform VAT rates to increase revenues.
- Continuously review public expenditure structure and increase public investment at the expense of current expenditure. Redirect subsidies and price caps towards vulnerable households and maintain fiscal prudence amid demographic changes and euro area membership.
- Improve mechanisms for transparent spending and accountability, enforce public procurement requirements, and monitor project quality.

- Build capacity at central and municipal levels for effective maintenance of public infrastructure and efficient use of budgeted funds.
- Develop foreign trade with emerging African countries through enhanced economic and trade diplomacy and bilateral agreements to diversify markets.
- Limit property market risks by increasing reserve requirements. Facilitate the transition to new reference interest rates as Bulgaria approaches euro area accession.
- Enhance corporate governance, provide tax incentives, and reduce income inequalities to attract quality issuers and improve liquidity in the Bulgarian capital market.

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