BULGARIA

Highlights

- **The economy grew by 1.5 per cent in 2014.** Domestic demand was the main driver of growth in 2014, boosted by a rise in the minimum wage and deflation, as well as lower unemployment, while the contribution from net exports remained subdued. However, net exports emerged as the main driver of growth in the first half of 2015, leading to a year-on-year growth rate of 2.3 per cent in the second quarter of 2015.
- **Budgetary measures have been reinforced, although the fiscal deficit widened.** In April 2015, parliament adopted the Law on Fiscal Council and Automatic Correction Mechanisms. In June 2015, parliament approved a pension reform; however a strategy for the sustainability of the social security system is yet to be adopted. This happened against the widening fiscal deficit of 5.8 per cent of GDP, partly as a result of funding provided to the deposit insurance fund to pay out insured deposits in the collapsed Corporate Commercial Bank (CCB).
- **Progress under the Cooperation and Verification Mechanism (CVM) remained limited.** The judicial reform strategy was updated in December 2014 to improve judges' accountability and enhance the transparency of the justice system, but the effectiveness of its implementation remains to be seen.

Key priorities for 2016

- **The business environment should be further improved.** Some of the areas where efforts should be concentrated in order to improve the business environment and achieve higher potential growth are: cutting "red tape", streamlining insolvency procedures for businesses, fighting corruption and enhancing effectiveness of the judiciary.
- **Efforts to improve competition and efficiency in the energy sector should be further intensified.** Recent amendments to the Energy Act will help reduce the tariff deficit of the state-owned electricity company, but a more comprehensive strategy to liberalise the energy sector and improve the operational capacity of the regulator is needed to increase efficiency and competition in the energy market. Ongoing and prospective regional interconnection of gas infrastructure is crucial for both gas market development and security of supply.
- **Restoring and maintaining full confidence in the financial sector is critical.** Efforts should continue to strengthen corporate governance and further improve financial sector supervision. Ongoing plans to pursue an independent asset quality review (AQR) and complete the planned Financial Sector Assessment Program (FSAP) are adequate steps in that direction.

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Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	1.6	0.2	1.3	1.5	1.8
Inflation (average)	3.4	2.4	0.4	-1.6	-1.0
Government balance/GDP	-2.0	-0.6	-0.8	-5.8	-2.0
Current account balance/GDP	0.1	-1.1	2.3	0.0	1.0
Net FDI/GDP (neg. sign = inflows)	-3.0	-2.1	-2.7	-2.4	-2.5
External debt/GDP	85.7	94.2	93.9	87.4	n.a.
Gross reserves/GDP	31.5	39.0	33.1	37.6	n.a.
Credit to private sector/GDP	67.5	67.9	67.8	60.7	n.a.

Macroeconomic performance

Economic growth edged up in 2014. Amid difficulties in the banking sector in June 2014, the Bulgarian economy grew by 1.5 per cent in 2014. Domestic demand emerged as a major contributor to growth, on the back of higher wages and deflation, as well as lower unemployment. Investment growth recovered somewhat, as industrial confidence edged up. Net exports growth remained limited in 2014, due to declining exports to the European Union (EU) and Russia. However net exports became the main driver of growth in the first half of 2015, resulting in a year-on-year growth rate of 2.3 per cent in the second quarter. Declining global oil prices and falling food prices, partly affected by the Russian import ban, led to persistent deflation since August 2013. Inflation stood at -0.9 per cent as of September 2015.

The fiscal deficit widened significantly. Against the target of 1.8 per cent of GDP, the fiscal deficit widened to 5.8 per cent of GDP in 2014. This increase was mainly driven by revenue underperformance and the failure to adjust expenditure levels in this context. Expenditure was driven by subsidies, higher capital spending, funding provided to the deposit insurance fund to pay out insured deposits in the collapsed CCB, and financing EU-funded projects from the national budget after a payment suspension by the European Commission (EC). Fiscal spending was also boosted by pension indexation and a cancellation of the planned rise in the retirement age. Public debt increased to 27.0 per cent of GDP in 2014, from 18.0 per cent in 2013, due to additional borrowing in December 2014 to provide funding for the deposit insurance fund, but it has moderated since and still remains the third lowest in the EU relative to GDP.

Growth is expected to edge up to 1.8 per cent in 2015 and 2.0 per cent in 2016, with inflation remaining subdued. Net exports will take over as the main driver of growth in 2015 and 2016, on the back of slightly improved growth prospects in the eurozone and mild gains in competitiveness due to currency weakening relative to the dollar. But still-moderate domestic demand, as the cost of funding rises due to a higher country risk premium and moderating global liquidity, will keep growth at 1.8 per cent in 2015. Inflation is expected to remain negative in 2015, on the back of lower global oil prices and reductions in heating and gas prices. Growth is likely to improve slightly in 2016, towards 2.0 per cent. Key risks to the short-term economic outlook are prolonged financial sector difficulties, further weaknesses in major trade partners and worsening tensions in Ukraine. The EU convergence space, given Bulgaria's GDP per capita which stood at only 45 per cent of the EU average in 2014, suggests positive growth prospects for Bulgaria in the medium term, which might be challenged if structural reforms are not reinvigorated.

Major structural reform developments

Progress under the Cooperation and Verification Mechanism (CVM) remained slow. In its January 2015 report, the EC concluded that overall progress remained slow in judicial reform, the fight against corruption and tackling organised crime. On a positive note, problems were acknowledged and solutions identified in some areas, such as changing the Supreme Judicial Council (SJC) structure towards higher independence and achieving transparency in high-level

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judicial appointments. The government updated the judicial reform strategy in December 2014 to increase accountability of judges and enhance the transparency of the justice system, yet the effectiveness of implementation remains to be seen.

Business environment conditions remain moderate, with more effort needed in some areas. According to the latest World Bank *Doing Business 2016* report, Bulgaria ranked 38th out of 189 countries, a slight deterioration compared with the previous year. The report identified getting electricity and paying taxes as two major hindrances. To coordinate further action in the fight against corruption, identified as an impediment in the CVM, the government established a national Anti-corruption Council in May 2015.

Efforts to reinforce budgetary measures are slowly continuing. After approving a draft law on the establishment of an independent fiscal council, an advisory body on fiscal governance issues, in late-2013 the government approved a draft budget law for its creation only in early 2015 and the National Assembly adopted the Law on Fiscal Council and Automatic Correction Mechanisms in April 2015. Adopting a strategy for sustainability of the social system remains a challenge, given that social spending is an important contributor to the fiscal deficit. In July 2015, parliament approved a pension reform, which included a gradual increase of the retirement age starting from 2016, limited early retirement options for public employees and a gradual hike in social security contributions in 2016 and 2017.

Progress has occurred in the energy sector, but significant challenges remain. The preparation for the move towards a liberalised market is ongoing. The Independent Bulgarian Energy Exchange (IBEX) was established in 2014 and the power exchange is expected to become operational at the end of 2015. The public sector still owns a large share of around 45 per cent in electricity generation, curbing the development of open-price competition. Electricity prices for the regulated segment of the market are not cost reflective, limiting the uptake of energy efficiency measures. Bulgaria has already met its 16 per cent renewable energy production target for 2020, on the back of significant increases in renewable energy-installed capacity under feed-in-tariff payment schemes, but the renewable energy support system suffers from stop-go political interventions, which have an adverse effect on the investment climate. In addition, the country's dependence on primary energy imports from a limited number of suppliers, along with shortfalls in energy infrastructure, pose a risk for sustainable uninterrupted supply. Developing regional gas infrastructure, such as ongoing and prospective work on cross-country interconnectors, and expanding capacity of the domestic gas transmission and storage system are crucial both to market development and security of supply.

Bank runs in summer 2014 revealed some deficiencies in bank corporate governance, but were quickly dealt with. Bank runs on CCB and First Investment Bank in June 2014 and the events that followed until CCB's licence was revoked, revealed shortcomings in legislation, supervision and banks' corporate governance. To contain the bank runs and restore public confidence, the authorities have publicly expressed the intention to enter a close cooperation agreement with the European Central Bank (otherwise known as "opting in" to the European Single Supervisory Mechanism), and to complete an FSAP assessment and credible AQR of the banking sector. These are steps in the right direction, and some of the FSAP assessment modules had been already completed in 2015.