Monitoring Bulgaria: An autopilot economy reaching its limits

Faced with the prospects of an eighth general election since 2021, the Bulgarian economy has largely maintained its strength. That said, delays in EU-required reforms and pressure for large increases in public expenditure are testing the limits of the current status quo. The chances of joining the eurozone in 2025 are minimal, in our view

- **GDP growth driven by private consumption:** Bulgaria's GDP growth improved to 2.3% in the first nine months of 2024, primarily due to sustained wage increases boosting private consumption. However, investment lagged, and the country's ability to benefit from EU funds was hindered by political instability. We keep our 2.3% GDP growth forecast for 2024 and 2.6% for 2025.
- **Industrial activity continued to struggle**, contracting by 3.0% to 4.0% in 2024, though it remains above pre-pandemic levels. The outlook for 2025 includes potential benefits from regional projects and Schengen ascension, but political instability may continue to weigh on investment and reforms.
- **Inflation in Bulgaria is expected to rise slightly** due to tax changes, wage growth, and

increased retail sales, despite lagging investments and a weak industrial sector. The removal of VAT reductions for restaurants and catering services will also contribute to this increase.

- **Fiscal challenges and euro adoption:** Bulgaria's budget deficit is projected to increase to the 3.0% of GDP limit, with fiscal uncertainty prevailing until a new government is established. The likelihood of euro adoption in 2025 is low, in our view, due to question marks around the sustainability of the inflation and budget deficit criteria, both exacerbated by the political instability. 2026 remains a more realistic deadline for adopting the euro, though clouds are gathering around this timeline as well.

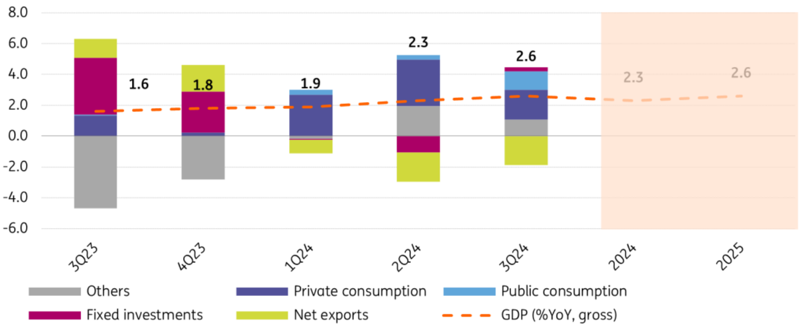
GDP Growth: Improving but not for the best reasons

After more than halving in 2023 to 1.9%, annual GDP growth in Bulgaria picked up some momentum throughout 2024, reaching 2.3% in the first nine months of the year. Private consumption was the main positive contributor to this stronger growth, driven by a sustained increase in wages. Meanwhile, imports began to recover some of the losses incurred in 2023, outpacing more subdued exports and weighing on growth. What's more, investments started to lag, and the country's ability to benefit from EU funds was visibly impacted by persistent episodes of political instability. Unmet RRF commitments, primarily related to energy and anti-corruption, led the EC to suspend the second payment of EUR 653 million for six months. Meanwhile, on the 2021-2027 Multiannual Financial Framework, data published by the Ministry of Finance shows that the gap between EU Funds absorption and the amounts spent has widened throughout 2024, weighing on investments.

On the supply side of the economy, GDP data shows positive developments in the services sector (both private and public), as well as a partial recovery in industrial activity.

On the outlook, we continue to see growth picking up at 2.3% in 2024 as a whole and then to 2.6% in 2025. Private consumption will likely remain strong, continuing to benefit from the recent wage growth advancements, and potentially from an expansionary fiscal policy. Moreover, the Schengen ascension is set to streamline export operations and improve productivity throughout Bulgaria and the region. Broader regional projects like the Vertical Gas Corridor, NATO-led infrastructure upgrades, and the Three Seas Initiative should also bring some early benefits to activity. That said, the outlook for investments remains less positive. The increasing likelihood of an eighth general election since 2021 could prolong the delicate political situation through 2025, hindering the necessary reforms included in the RRF targets. Such developments could continue to impact FDIs and amplify voter fatigue, ultimately leading to a slower advancement of the productive potential.

GDP growth (%) and contributions (ppt)



Source: NSI, ING Research

Industry: Bottoming out?

Industrial activity has continued to struggle, in line with the persistent weakness in German activity. Data up to October shows that activity is set to decline by less than it did last year but still post a 3.0% to 4.0% contraction. Still, industrial output remains above pre-pandemic levels, by 3.6%, as of October. This is chiefly driven by manufacturing activity, which is 6.7% above pre-pandemic levels, weighed down by mining and energy output. Sub-sectors that have picked up or recovered from contraction year-to-date are, among others, chemicals, basic metals, pharma products and printing output. On the other hand, electrical equipment, transport equipment, and computer production performed quite poorly. The relatively subdued growth prospects in German industry and the ripple effects of this are likely to remain a limiting factor for Bulgaria's industry ahead. However, the Schengen accession and regional infrastructure developments should help alleviate some of the pressure somewhat.

Industry remains in a weak state

Source: NSI, Ifo Institute, ING

Trade and the balance of payments: Geopolitics continues to play a major role

After improving in 2023, the trade deficit is expected to reverse most of the gains in 2024. From January to September 2024, the deficit was 23% higher than the same period last year. Two notable factors stand out: the rather negative one is the visible worsening in the food and oils sector, which also poses an upside risk for inflation. On the positive side, there is a visibly stronger trade surplus in manufactured goods, which offsets some of the negative trade developments.

Looking at the breakdown of trade by countries, what stands out is the visible worsening of Bulgaria’s trade balance with Romania, which was partially compensated for by an improving trade balance with Germany. A likely explanation could be a rearrangement of value chains. Moreover, there were significantly smaller imports from Russia, also partially a result of the recent oil import ban starting from 1 March 2024. Likely as a result, imports from Kazakhstan picked up visibly. They were followed in size by stronger imports from Egypt, Turkey and Norway, most of which are also likely energy-related rearrangements.

In 2024, the current account should benefit from another likely increase in tourist levels. Strong real income gains in Romania will likely add a boost to the revenues of Bulgarian resorts while the quasi-stagnation of the European economy could, at the margin, lead more Western tourists towards cheaper holiday alternatives. As such, services export gains should continue to at least partly offset some of the deficit pressures still foreseen ahead.

Concerning other BoP categories, the capital account and secondary income are unlikely to benefit substantially from EU funding as long as the political turmoil carries on. Even after a new government takes power, it will take some time for political risk to rank lower on foreign investors' heatmaps, keeping near-term risks for FDIs on the downside. Year-to-date, FDIs fell to EUR 1,241mn in January-September 2024, compared to EUR 3,381mn over the same period last year, mainly due to declines in reinvested earnings. At least part of this decline could be attributed to significant legislative changes brought by the recently adopted FDI screening regime in February this year. Overall, the regional context involving the Vertical Corridor, the Three Seas Initiative, and some NATO-led investments could provide small tailwinds for FDIs and partially offset the negative impact of delayed reforms.

Inflation: A small acceleration on the radar

We think that inflation is set to face some mild upside pressure in the near term on the back of tax changes, magnified by demand channel pressures in the context of accelerating retail sales growth and double-digit wage growth. On top of this, the unemployment rate continued its downward trend through the year amid persistent labour shortages. What's more, as of 31 December 2024, the removal of VAT reductions for restaurants and catering services will kick in.

That said, lagging investments and a still weak industrial sector, coupled with our view that export growth is unlikely to recover meaningfully, are set to temper some of the internal demand pressures (including for labour) mainly fuelled by wages and pension growth. Further increases in the tax burden to accommodate fiscal needs are an upside risk. A key factor to watch is also if and when the liberalisation of the electricity market will unfold. All told, we expect CPI inflation to end this year at 2.4% and next year at 3.2%.

Fiscal: Remaining within the Maastricht criteria is not a given

So far in 2024, consolidated budget data up to October shows a deficit of just above EUR 2bn, close to 2.0% of this year's projected GDP. This is a significant increase compared to the same period of last year, where data until October 2023 shows a deficit of just EUR 0.7bn. Throughout 2024, employee compensation was 3.4 times larger than capital expenditure, a deterioration compared to 2023. This trend aligns with the ongoing debates about the sustainability of current public wage trends.

The 2025 budget project was recently presented, signalling that expansionary fiscal policy is set to continue. More specifically, the key policy questions ahead revolve around the spending outlined in the 2025 consolidated fiscal programme, which could reach 46% of GDP. In a rather rare occurrence, the plan also drew criticism in an official central bank statement.

Ultimately, until a new government is sworn in, fiscal uncertainty is likely to prevail. That said, the risk of failing to meet another Maastricht criterion may prompt only a minimal response from authorities, especially considering Bulgaria's strong track record on fiscal discipline. Potential tax hikes are now the key factor to watch.

All told, our base case is now for the budget deficit to edge higher in 2024 to 3.0% and remain constant in 2025.

As for the possibility of euro adoption, we maintain our already long-held view that this is unlikely to happen in 2025. While the inflation criteria has a good chance of being met in early 2025, we think that this will be temporary and that the European Commission might question how sustainable this is. On top of this, the fiscal stance has been gradually turning from prudent to expansionary and remaining within the 3.0% of GDP deficit will be increasingly difficult, possibly raising another eyebrow at the EC on the sustainability of the achievement. Without a stable government to structurally tackle these issues, we think that the chances for euro adoption in 2025 are minimal. We maintain our base case for the country to join the eurozone in 2026, though we must admit that some clouds are starting to gather around this forecast as well.

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