**Highlights**

- **Economic growth edged up in 2015 while deflation continued.** The Bulgarian economy grew by 3.6 per cent in 2015, on the back of net exports, boosted by the weakening of the euro and higher exports to the European Union (EU). Lower global oil and food prices led to deflation, with an inflation rate of -0.6 per cent as of September 2016.

- **Efforts to reinforce budgetary measures continued.** The mid-term fiscal framework foresees a gradual decline of the budget deficit towards 0.5 per cent of GDP in 2019, on the back of better tax collection, and higher efficiency of budget expenditure.

- **Major steps were taken to restore confidence in banking.** Following completion of some modules of the Financial Sector Assessment Programme (FSAP) in 2015, an Asset Quality Review (AQR) of the banking sector was completed in August 2016, with almost all banks comfortably meeting local capital requirements. In addition, the Bulgarian National Bank (BNB) took measures to strengthen its banking supervision.

**Key priorities for 2017**

- **Further progress under the Cooperation and Verification Mechanism (CVM) is needed.** The detailed blueprints of national strategies on judicial reform and the fight against corruption are positive developments, although their implementation remains a challenge. The passing of the revised anti-corruption law by the parliament in June 2016 is a positive step, although the real political commitment to it will be clear when the final version of the law comes into force, probably in early 2017.

- **Efforts to improve the business environment should continue.** To support economic growth, work should continue on improving the business environment and removing obstacles regarding getting electricity, paying taxes and starting a business.

- **Further reforms are required in the energy sector.** Steps should be taken to reduce the public sector share in electricity generation, and fulfil the government’s commitment to bring electricity prices in the regulated segment of the market towards full cost recovery, and provide a stable support system for renewable energy.
Macroeconomic performance

Economic growth edged up in 2015. Following domestically driven growth of 1.3 per cent in 2014, the Bulgarian economy grew by 3.6 per cent in 2015, on the back of net exports, boosted by a weakening of the euro and higher exports of investment goods to the European Union. Domestic demand emerged as the driver of growth in the first half of 2016, with the economy growing 3.0 per cent year-on-year. Declining global oil prices and falling food prices, partly affected by the Russian import ban, have led to persistent deflation since August 2013, with the inflation rate standing at -0.6 per cent as of September 2016.

The fiscal deficit narrowed in 2015. Against the revised target of 3.3 per cent of GDP, the consolidated budget deficit stood at 2.9 per cent of GDP in 2015. The deficit was mainly driven by higher capital spending, due to higher investment under EU programmes covering 2007-13. Higher spending for subsidies and social payments, and interest payments, contributed to the deficit. Meanwhile, revenues and grants increased by 9.5 per cent year-on-year, on the back of higher tax collection and a significant increase in grants, including EU funds. Public debt stood at a moderate 27.2 per cent of rolling GDP in 2015, while the composition of total debt shifted slightly towards external government debt, with its share rising to 18.5 per cent of GDP in 2015 from 16.9 per cent of GDP in 2014.

Growth is expected to remain at around 2.8 per cent in 2016 and 2017, with inflation remaining subdued. In 2016 and 2017, domestic demand will likely be the main driver of growth, supported by higher disposable income on the back of an increase in the minimum wage of 9.5 per cent and wage hikes for teachers as of 2017, as well as improving labour market conditions. Rising consumption will limit the contribution of net exports to growth. Alongside fiscal consolidation and spending discipline, this will keep growth at a forecasted 2.8 per cent in 2016 and 2017. Key risks to the outlook are prolonged weakness in major trade partners and a worsening of investor sentiment towards emerging markets. The potential for further convergence towards EU living standards, with Bulgaria’s GDP per capita (purchasing power parity adjusted) standing at 45 per cent of the EU average in 2014, suggests positive growth prospects in the medium term, which will be supported if structural reforms are reinvigorated.

Major structural reform developments

Progress under the Cooperation and Verification Mechanism (CVM) has continued but challenges remain. In its January 2016 report, the European Commission (EC) acknowledged that putting judicial reform on the agenda, after a period of political instability, is a positive development. Although the EC welcomed the detailed blueprints of national strategies on judicial reform and the fight against corruption, their implementation remains a key challenge. The EC emphasised the importance of changing the current model of the Supreme Judicial Council (SJC), casting doubts over the independence of the judicial system. In addition, the rejection of the anti-corruption strategy by the parliament in September 2015 underlines the lack of political consensus on this issue.
Business environment conditions remain favourable, with room for improvement in some areas. Bulgaria ranked 39th out of 190 countries in ease of doing business, according to the World Bank *Doing Business 2017* report. Procedures for getting electricity, paying taxes and starting a business remain burdensome. Meanwhile, according to the EC’s 2016 Annual Growth Survey and accompanying documents evaluating the major challenges to the investment environment, bureaucracy, corruption and political instability are considered to be the main hindrances to doing business in Bulgaria.

Efforts to maintain fiscal sustainability continued. Following the adoption in April 2015 by the National Assembly of the Law on the Creation of an Independent Fiscal Council, along with automatic correction mechanisms, members of the council were appointed in November 2015. In April 2016, the government approved the medium-term fiscal framework to continue the fiscal consolidation process. The EC, in its assessment of the Convergence Programme and National Reform Programme update, acknowledged the steps taken to improve the cost effectiveness of the healthcare system and to enhance tax compliance. The new fiscal framework foresees a reduction of the budget deficit to 0.5 per cent of GDP in 2019, on the back of higher budget expenditure efficiency, and lower tax fraud and tax evasion. Following the approval of a pension reform package in July 2015 by the parliament, the retirement age has started to increase gradually, effective from 2016, to maintain the sustainability of the state pension system. However, the withdrawal of the proposal for a legal basis of the second-pillar pension scheme was a set-back to the goal of introducing further improvements to the social security system.

Progress in liberalising the energy market has occurred, although some key issues remain. Energy market liberalisation is on track as the IBEX day-ahead market became operational in January 2016. Yet the exchange is still far from being sufficiently deep and liquid. The development of open-price competition is somewhat hindered by the large share of the public sector in electricity generation, which stands above 40 per cent. Bulgaria has already met its 2020 target for renewable energy production, but the country is still the most carbon- and energy-intensive economy in the European Union. While generous public support and feed-in-tariff payment schemes encouraged expansion of renewable energy sources in the past, the support system suffered from political interventions, denting investment opportunities. In addition, Bulgaria depends on a limited number of suppliers and a single route for primary energy imports. The country initiated work to develop gas infrastructure, such as increasing the capacity of underground gas storage and expanding domestic gas transmission, as well as constructing planned gas interconnectors with neighbouring countries, of which the Bulgarian-Romanian interconnector is the most advanced, with commissioning scheduled by the end of 2016.

Significant steps were taken to restore confidence in the banking sector. Following challenges in the banking sector in summer 2014, the authorities have taken firm steps in the past two years to restore public confidence. The BNB and the Financial Supervision Commission, in cooperation with the European Central Bank, started a comprehensive third-party review of the financial sector. Following completion of some modules of the FSAP in 2015, an AQR of the banking sector, followed by a stress test, was completed in August 2016. The AQR showed that almost all banks comfortably meet local minimum capital adequacy requirements, with foreign-owned banks performing particularly well, while two domestic-owned banks had their capitalisation significantly trimmed, albeit still remaining above the minimum required. In addition, the BNB developed a plan in October 2015, to reform and improve its banking supervision. The plan set measures to improve the governance structure and internal organisation of the banking supervision department, enhance the regulatory framework, develop an institutional framework for crisis management, provide IT and communication support for supervisory activities and enhance coordination and information exchange with other institutions. Although the deadline for implementation of the plan is the end of 2016, the plan has already helped restore confidence in the sector and was perceived as credit positive by the market. An AQR in the insurance and pension sectors also started in July 2016.