

GLOBAL & REGIONAL FOCUS NOTES

Bulgaria: On the verge of joining the Eurozone

Structural challenges for medium-term economic growth

- Economy has significantly converged with the EU average in the last 20 years
- Still, chronic structural weaknesses (institutional, social, technological, etc) persist, keeping the country at a distance from the EU core economies
- According to reputable institutions, the country lags mainly in government effectiveness, transport infrastructure, rule of law and digitalisation
- Tackling these weaknesses will require greater utilisation of EU funds, as well as the implementation of policy recommendations from widely accepted institutions
- Bulgaria not only has competitive advantages in low-tech industries relative to the EU, but also in medium and high-complexity sectors which could support its growth

Introduction

Bulgaria's stabilising price growth has brought the country extremely close to clearing the last remaining hurdle to Eurozone entry.¹ As a result, the finance minister and the governor of the country's central bank jointly requested the European Commission and the ECB to prepare convergence reports assessing Bulgaria's readiness to adopt the euro. Provided that the country will be positively assessed also by other EU institutions (Eurogroup, ECOFIN, European Council), it could join the Eurozone in January 2026. However, to fully benefit from Eurozone membership and become a competitive economy, Bulgaria must address soon its chronic structural drags (institutional, social, technological etc). This report first presents the most significant of these structural weaknesses. Then, it outlines strategies for addressing them, primarily through increased utilisation of EU funds and implementation of policy recommendations from international organisations.

Significant structural drags and their implications

Bulgaria's economy has converged significantly towards the EU average in the last 20 years. The average annual GDP growth rate between in 2003 and 2023 was 3.2%, more than double that of the rest of the EU (1.4% per annum).² GDP per capita in Purchasing Power Standards (PPS) relative to the EU average (=100

¹ The price stability criterion says that the difference between the country's 12-month average inflation rate and the average of the three best-performing EU member states should not exceed 1.5 percentage points (ppts). January's 12-month average inflation rate of 2.6%YoY narrowed this gap to 0.07ppts.

² Based on DG ECFIN AMECO database data

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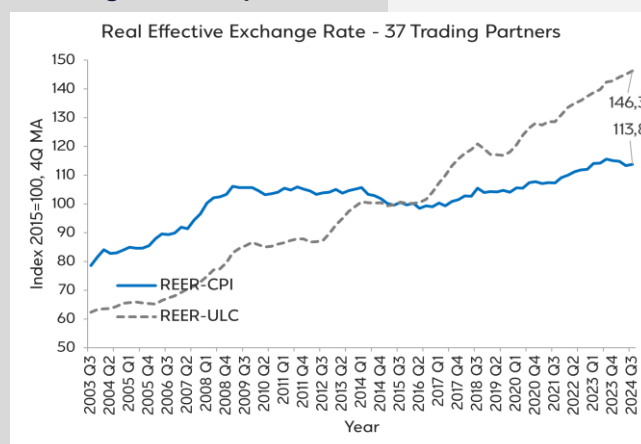
each year), a measure for productivity, nearly doubled between 2003 and 2023, from 33.7 to 63.8. Despite the remarkable improvement, Bulgaria's GDP per capita in PPS in 2023 was the lowest in the EU and well below its average, suggesting that there is a long way still to go.

The main GDP growth drivers from 2003 to 2023 were private consumption and gross fixed capital formation. Conversely, the average annual impact of external trade on GDP was slightly negative throughout this 20-year period, at -0.3 percentage points of GDP (ppts), driven entirely by the negative effects of declining net exports of goods (-0.4ppts). Although exports of goods accounted for 39.1% of GDP over the period 2003-2023, imports of goods were significantly larger, at 49.9% of GDP. Such levels of imports and exports of goods relative to GDP usually indicate that part of the external trade concerns transit trade. This is evident from the linkages between the mainly imported and exported goods in Bulgaria, including crude oil, natural gas and copper coming in, and refined petroleum products, natural gas, refined and raw copper going out. The average goods deficit in real terms from 2003 to 2023 (-10.7% of GDP) indicates the weak competitiveness of Bulgaria's products, which was not counterbalanced by the significant services surplus (8.1% of GDP), resulting to a negative real external balance (-2.6% of GDP).

Another widely accepted measure of a country's competitiveness, is the real effective exchange rate (REER). The REER is a measure of the value of a country's currency relative to a weighted average of the currencies of its principle competitors, adjusted for either consumer prices or a measure of producer costs, such as the unit labour cost index (ULC). Bulgaria's ULC-based REER has been increasing over time against a set of 37 trading partners, including EU countries and 10 significant industrial economies outside the EU (Figure 1). Given that the Bulgarian lev has been pegged to the euro since 1999 at a stable rate,³ the rise in the ULC-REER is mainly driven by the faster increase in the ULC domestically compared to the competing economies. Another factor putting upward pressure on Bulgaria's REER is that Turkey, whose currency has been continuously depreciating against the euro, is Bulgaria's most important trading partner outside the currency union. The appreciation of Bulgaria's CPI-based REER started in 2017 and has been less than that of the ULC-REER.

According to the International Monetary Fund's (IMF) most recent Article IV report for Bulgaria, released in 2024, after twenty years of improvement until the onset of the global financial crisis, the country's integration in Global Value Chains (GVCs) stagnated in 2011-2020.⁴ Although well diversified, Bulgaria's

Figure 1: Based on the Real Effective Exchange Rate, Bulgaria's competitiveness has deteriorated



Source: Eurostat, Eurobank Research

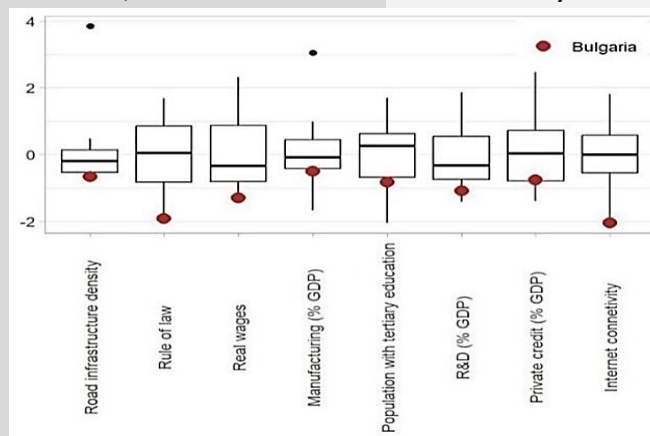
³ €1 = BGN1.9558

⁴ IMF (2024) – 2024 Article IV report

participation in GVCs remains mostly concentrated in low-technology industries. In the next section of our report, medium and high-complexity industries with competitive advantages in Bulgaria are identified.

Based on the same IMF report, the main drivers of GVC integration in EU countries, in order of importance, are road infrastructure density, rule of law, the share of the manufacturing sector in GDP, the share of the population with tertiary education and R&D spending as a percentage of GDP. In contrast, real wage increases were found to be a deterrent to GVC integration. In a boxplot analysis of the EU countries' values for these and some other indicators concerning factors potentially affecting participation in GVCs in 2021, Bulgaria was found in the lowest quartile of the distribution in all cases except private sector credit as a share of GDP (Figure 2). In road infrastructure density, rule of law and internet connectivity, the country was at the lower tail of the distribution.

Figure 2: Among the drivers of GVC integration in the EU, Bulgaria is particularly weak in road infrastructure, rule of law and internet connectivity*

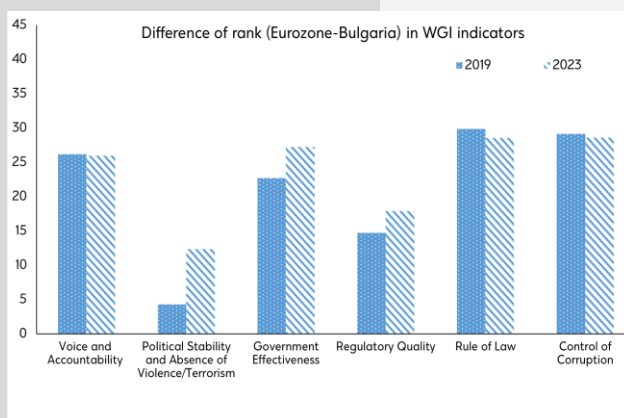


Source: IMF, Eurobank Research

*Boxplot analysis based on the centred and normalized values of indicators for all EU countries

According to the World Bank's Worldwide Governance Indicators (WGIs), Bulgaria also performs poorly in other aspects of quality of governance besides the rule of law, such as government effectiveness, control of corruption and regulatory quality.⁵ In 2023, the country's performance in rule of law and control of corruption improved relative to pre-pandemic levels (2019). However, these were the dimensions of quality of governance where Bulgaria was weakest, which made improvement easier to achieve. This is also evident from the fact that, despite improvement, the distance from the Eurozone average remains the largest among all the dimensions of quality of governance assessed by the World Bank (Figure 3). By contrast, Bulgaria deteriorated after the pandemic on issues of government effectiveness and regulatory quality. The worsening in the government effectiveness indicator during the said period, is partly due to the lack of a stable government since April 2021 and five parliamentary elections that took place up to

Figure 3: Bulgaria underperforms relative to the Eurozone in all aspects of the quality of governance



Source: World Bank, Eurobank Research

⁵ The WGIs are composite indicators based on over 30 underlying data sources. These data sources are rescaled and combined to create the six aggregate indicators using a statistical methodology known as an Unobserved Components Model (UCM). More information on the WGIs can be found here: <https://www.worldbank.org/en/publication/worldwide-governance-indicators/documentation#1>

April 2023. Such adverse effects are mostly evident in the strong decline in the policy stability and absence of violence indicator. Accordingly, the distance from the EU average in these three dimensions of the quality of governance increased from 2020 to 2023.

A 2023 OECD report shed more light on the inefficiencies at the central and local government level in planning and delivering public investment in infrastructure, reflected at the weak government effectiveness.⁶ The main causes of inefficiencies, delays and even failures in infrastructure projects and public works in general, with implications for growth dynamics and productivity, are the following:

- ⌚ The decentralised investment budgeting system of ministries, which is not coordinated by the Ministry of Finance with line ministries, prevents synergies and efficiencies.
- ⌚ Lack of a unified methodology for the evaluation and prioritisation of infrastructure projects, (e.g., cost-benefit analysis). The main criteria for selecting projects are “project readiness”, “urgency” and the capacity to fund projects from year to year.
- ⌚ Lack of strategic planning with clear priorities, objectives and Key Performance Indicators (KPIs), from the highest government level to the implementing bodies, preventing continuous tracking of progress on each goal’s implementation.

Mihailova, M. & Ivanov, B. (2023) highlighted disparities in Bulgaria between urban and rural areas, related to public infrastructure in the transport, education and health sectors.⁷ They pose obstacles to the inclusive and balanced development of the country and lead to the gradual depopulation of rural regions. Some of the significant dimensions of these disparities that are considered to affect Bulgaria’s long-term growth prospects are:

Poor quality of transport infrastructure

- ⌚ In 2019, over 50% of roads in rural municipalities were in unsatisfactory or poor condition.
- ⌚ In over 30% of rural municipalities, no new transport infrastructure has been created to optimise accessibility in the last 30 years.
- ⌚ For more than 70% of rural settlements, there is no prospect of upgrading their transport system, such as through national infrastructure upgrades or changes in spatial planning regarding the transport network.
- ⌚ The population transport mobility (number of trips and kilometres travelled per resident per year) in rural municipalities is below 50% of the national average.

Significant decline in general education infrastructure

- ⌚ Although the number of active schools in primary-secondary education significantly declined between the 2007/2008 and 2019/2020 school years (-20.6%), the drop in rural areas was even more pronounced (-26.9%).

⁶ OECD (2023) – Public Investment in Bulgaria: Planning and delivering infrastructure

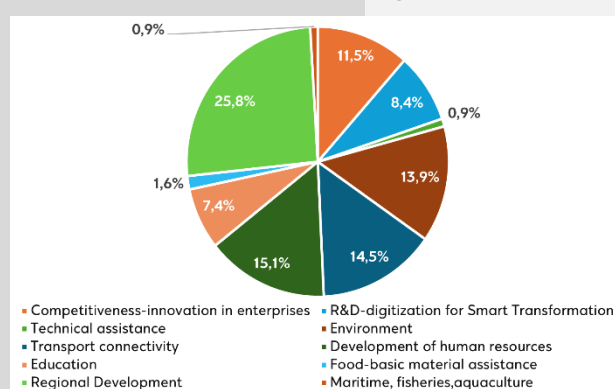
⁷ Mihailova, M. & Ivanov, B. (2023) - The change in social infrastructure in rural Bulgaria, Rural Areas and Development, 18, pp. 37–52

Opportunities for addressing structural weaknesses and related challenges

The previous section focused on tracing the causes of Bulgaria's structural economic weaknesses. This section looks at existing opportunities and means for addressing those weaknesses. The most significant tools available to strengthen Bulgaria's structural capabilities and improve its growth prospects (e.g., transport infrastructure, rule of law, control of corruption, participation in education, digitalisation, participation of manufacturing in economic activities, regulatory quality) are the unutilised funds from the EU's Multiannual Financial Framework 2021-2027 (MFF) and the Recovery and Resilience Fund (RRF).

In July 2022, the Commission validated its Partnership Agreement with Bulgaria, which set out the country's investment strategy under the EU Cohesion Policy for the programming period 2021-2027 (PA 2021-2027). The projected EU financing amounts to €10.8bn, and national (state) participation is expected to reach €2.2bn. The total co-financed budget is €13bn (in 2020 prices). More than 40% of it concerns programmes that could support improvement in transport infrastructure, ICT penetration, education, R&D activity, the role of the manufacturing sector in the economy and improvement of business competitiveness (Figure 4). The strategic programmes dedicated to these purposes are competitiveness-innovation in enterprises (co-financing of €1.5bn or 11.5% of the total budget), R&D-digitalisation for Smart Specialisation (€1.1bn or 8.4%), transport connectivity (€1.9bn or 14.5%) and education (€1.0bn or 7.4%).

Figure 4: Bulgaria's Partnership Agreement with the EU 2021-2027 co-funding distribution



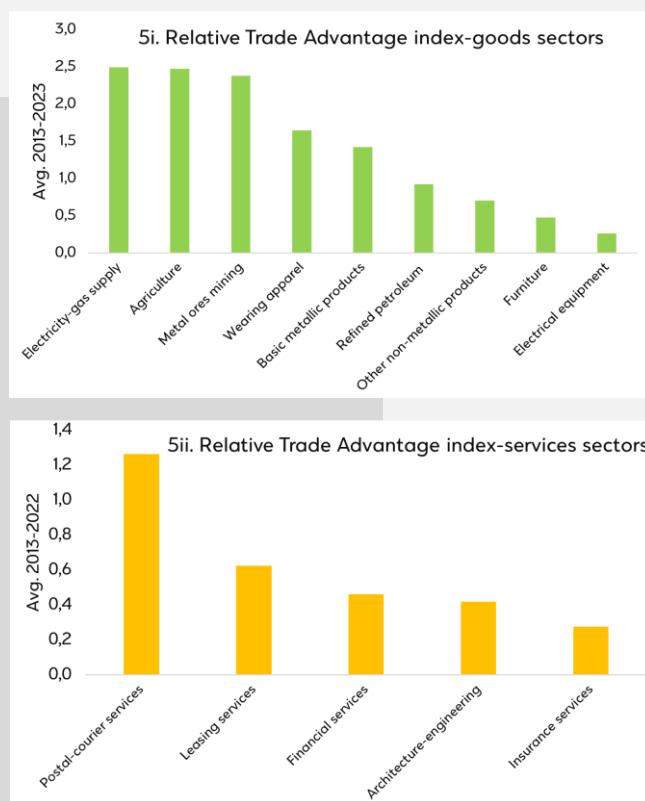
Source: European Commission, Eurobank Research

Bulgaria's Innovation Strategy for Smart Specialisation 2021-2027 has already defined five sectors where the country has a competitive advantage and capacity for smart specialisation.⁸ They could, therefore, be supported financially by the relevant strategic programme. These sectors are informatics and ICT; mechatronics and microelectronics; healthy living; bioeconomy and biotechnology; new technologies in the creative and recreational industries; clean technology; and circular and low-carbon economy.

⁸ <https://www.fmfib.bg/en/knowledgehub/document/39/overview>

Based on the Relative Trade Advantage (RTA) index, which considers both exports and imports trends at the sector level in a country relative to those of the same sector in a group of competing countries, and using data for 2013-2023, we also identified goods sectors in Bulgaria likely to have some strong comparative advantages compared to the rest of the EU (Figure 5i).⁹ These include not only low-sophistication goods (agricultural products, minerals mining etc.) but mainly medium-or-higher complexity products (wearing apparel, furniture, electrical equipment, other non-metallic mineral products manufacturing). These sectors could be prioritised by EU co-financed programmes, such as the “competitiveness-innovation in enterprises” programme. Using the same index, we identified services sectors with comparative advantages relative to the rest of the EU, including postal-courier services, leasing services and financial services (Figure 5ii).

Figure 5: Bulgaria has goods and services sectors with trade advantages relative to the rest of the EU



Source: Eurobank Research

The significant potential for improving structural aspects of Bulgaria’s state, overall economy and society through the EU Cohesion Policy is limited by the low absorption rate of EU funds. Up to the end of 2024, Bulgaria had disbursed only 8.4% out the total €10.8bn of funds available in the context of the PA 2021-2027, i.e., €0.9bn. Although this rate is slightly higher than the EU average (6.4%), Bulgaria’s absorption pace needs to be much higher to gradually catch up with Eurozone countries. On the other hand, this implies a high availability of EU resources for the remainder of the programming period 2021-2027, which could be channelled towards growth-enhancing investment.

Bulgaria lags the rest of EU in terms of utilisation of RRF financial resources. Out of an allocation of €5.69bn in total RRF funds, exclusively in grants, only the first tranche, amounting to €1.37bn, was disbursed in December 2022. Another €480.1mn in grants will be added to available financing once Bulgaria submits a REPowerEU chapter. In October 2023, the country requested the second RRF tranche (€724mn). In November 2024, the Commission released its preliminary assessment of this payment request, informing Bulgaria that a number of key milestones and targets were not satisfactorily fulfilled.¹⁰ Specifically, the Commission

⁹ Relative Trade Advantage index (RTA) = Revealed Comparative Advantage index (Balassa Index) minus Revealed Import Advantage index (RMA). When $RTA_{ik} > 0$, then industry i in country k has a comparative advantage in terms of international trade relative to the same industry in the examined group of countries.

¹⁰ https://ec.europa.eu/commission/presscorner/detail/es/ip_24_6102

found that eight reforms concerning the energy sector, anti-corruption measures, mandatory judicial mediation, public procurement and entrepreneurship support had not been fully implemented. Besides unlocking RRF funding, most of these reforms are related to factors influencing competitiveness, making them crucial for the country's integration to the Eurozone.

The urgency of implementing these and other reforms outlined in Bulgaria's National Recovery and Resilience Plan (NRRP) is highlighted by the fact that in February 2025, Deputy Prime Minister Tomislav Donchev stated that the country may lose the second RRF tranche due to the unimplemented milestones. Furthermore, even if one accounts for the milestones and targets considered implemented for the not-yet-approved second RRF tranche, Bulgaria has so far fulfilled approximately 17% of the total 321 milestones and targets included in its NRRP. It is important to note that the regulation establishing the RRF requires all reforms within the countries' RRFs to be completed by August 2026.

Regarding the improvement of government effectiveness, recent reports and papers (e.g., OECD (2023), Hallaert J.J., and Primus, K., (2022)¹¹) provide specific policy proposals for several policy areas (public investment, public procurement, social protection, education, health etc.) that could remedy chronic inefficiencies and upgrade the role of the state in fuelling economic growth.

Regarding the strengthening of the rule of law and the reduction of corruption, Bulgaria has fulfilled its policy commitments prior to its ERM II entry in July 2020, concerning the strengthening of its anti-money laundering (AML) framework, through the transposition into national legislation of the fourth and fifth AML EU directives (AMLD4 and AMLD5). In October 2023, the country's anti-corruption authority, the Commission for Anti-Corruption and Illegal Asset Forfeiture (CACIAF), was split into two new organisations, the Commission for Anti-Corruption (CAC) and the Commission for Illegal Asset Forfeiture (CIAF). The aim of the restructuring was to empower the new authorities with a renewed mandate, enabling them to prevent and combat corruption more effectively.¹² Also in October 2023, the country made a high-level political commitment to work with the Financial Action Task Force (FATF)¹³ and MONEYVAL¹⁴ to strengthen the effectiveness of its Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) framework. According to the last Follow-Up Mutual Evaluation Report by MONEYVAL on adhering to AML/CFT standards undertaken in 2024, Bulgaria was deemed partially compliant with 13, compliant with 5, and largely compliant with 22 of the FATF's 40 recommendations.¹⁵ The country should remain focused on closely collaborating with the AML/CFT bodies and implementing the relevant reforms.

To sum up, Bulgaria's efforts in the last decade to access the Eurozone should continue, perhaps even with greater vigour, making use of all the available financing and policy-shaping tools, in order for the country to adapt to the continuously growing challenges within the common currency area.

¹¹ Hallaert J.J., and Primus, K., (2022) - Strengthening Public Expenditure Efficiency in Bulgaria, IMF Working Paper, WP/22/100

¹² OECD (2025) - Reforming Bulgaria's Anti-corruption Authorities

¹³ The international standard setting body on anti-money laundering and countering the financing of terrorism

¹⁴ Permanent monitoring body of the Council of Europe entrusted with the task of assessing compliance with the principal international standards to counter money laundering and the financing of terrorism

¹⁵ <https://rm.coe.int/moneyval-2024-1-bg-5through-1stehfur/1680afca6a>

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