

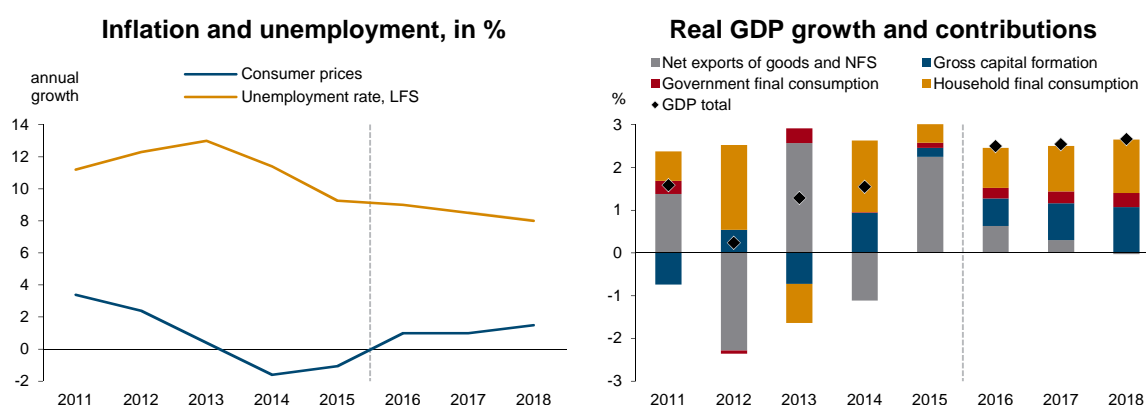


## BULGARIA: Growth in 2015 exceeds expectations, but can it be sustained?

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Driven by a combination of positive domestic and external factors, GDP growth in 2015 outperformed expectations. The economy, however, is mired in chronic structural problems that policy-makers have systematically neglected. While GDP is expected to continue growing at a rate of 2% to 3% per annum over the short term, the absence of policy reforms may lead to an accumulation of macroeconomic imbalances.

Figure 39 / Bulgaria: main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

In 2015 Bulgaria's economy performed significantly better than had been expected a year earlier: for the year as a whole, the rate of GDP growth was by some 1.0-1.5 percentage points above the ex-ante expectations of both the government and the majority of analysts. Moreover, for the first time in years, growth in 2015 was relatively balanced in the sense that it was supported by both domestic and external factors. In statistical terms, all three main components of final demand: private consumption, gross fixed capital formation and net export made positive contributions to GDP growth.

The relative weight of the main drivers of GDP growth was changing in the course of the year: in the first half, it was the unexpected surge in exports that gave the most significant boost to overall economic activity. Later on, while exports were losing steam in the second half, domestic demand (both private consumption and fixed investment) started picking up, thereby contributing to a relatively even pace of overall macroeconomic activity.

On the other hand, when analysing the current macroeconomic data one needs to factor in some purely statistical effects: recent backward revisions of Bulgaria's national accounts by the National Statistical Institute resulted in lower 2014 numbers and therefore produced an additional 'statistical boost' to the 2015 growth figures. This can be traced when comparing the revised quarterly national accounts for 2015 with the earlier published statistics for the first half of the year. In turn, the unusual export boom of the first months of 2015 partly reflected seasonal factors related to the schedule of export shipments contracted back in 2014.

One additional factor that may have added a further upward statistical bias was the massive emigration of Greek businesses to Bulgaria. Reportedly, many small businesses are opting to transfer their legal headquarters from Greece to Bulgaria mostly for tax purposes and to escape growing administrative hurdles in the home country. According to anecdotal evidence, some 60,000 small Greek businesses migrated to Bulgaria in 2015 alone.

Be that as it may, all indications are that the Bulgarian economy was recovering in 2015. According to monthly statistics, manufacturing output consistently reported positive growth in 2015, repeating the same pattern of the previous year. The picture is identical as regards engineering construction. Importantly, the 2015 average LFS rate of unemployment fell below 10% for the first time since 2009. The economic upturn also contributed to a better than earlier expected fiscal outcome: according to preliminary estimates, the deficit for the year as a whole should be below the 3% mark.

Private consumption started recovering in 2015 despite the continuing deflationary trend. Consistently rising real wages and incomes undoubtedly contributed to such an outcome. The upturn in gross fixed capital formation in the second half of the year was largely driven by a recovery in public investment which, in turn, was boosted by a notable improvement in the absorption of EU structural funds. For the year as a whole, public capital expenditure backed by EU funds in nominal terms was some 60% higher than in 2014. There was also a modest revival in credit activity both to corporate customers and households although the recent monetary statistics are difficult to interpret due to the statistical effect of the closure of the big Corporate Commercial Bank (CCB) in 2014. The significant upturn in exports (mostly due to a surge in exports to the EU) contributed to maintaining a positive current account balance in 2015 and a further reduction in the gross external debt.

However, these positive outcomes need to be considered against the background of the overall economic environment. In particular, despite the recent slight improvement, the budgetary statistics reveal a considerable loosening of the fiscal stance in 2014-2015. While the huge deficit incurred in 2014 (5.8%) was largely due to the budgetary implications of the CCB failure in 2014 (more specifically, the large-scale fiscal commitments undertaken by the public sector in the context of the ensuing bankruptcy procedure), the recognition of such an ad hoc liability seems to have incited an atmosphere of moral hazard giving rise to a spree of claims to the public sector that the government did not manage to resist.

A clear sign of the deteriorating fiscal management was the revision of the 2015 budget voted in December (together with the 2016 budget) which, as per the remarks by government officials, was undertaken due to considerable overspending by various ministries and regions. The revision allowed for BGN 880 million additional spending (some 3% of total expenditure) in 2015. Luckily for the government, windfall public revenue – likely reflecting cyclical effects – contributed to curbing the overall fiscal deficit.

Another example of the overall fiscal loosening was the adoption by parliament, under strong pressure from the government, of a medium-term public sector borrowing programme covering the period

2015-2017 allowing the government to borrow a total of BGN 16 billion (some EUR 8 billion) in this period. What is peculiar in this case is that the government was granted such borrowing options without linking them to any specific spending programme or purpose: de facto, the parliament signed the government a blank cheque amounting to a stunning 18% of GDP.

Apart from the visible signs of fiscal laxity, there are risks to public sector finances coming from some chronic but concealed threats. The most conspicuous among these is the energy sector. This sector, which is still largely in public hands (through publicly owned energy companies), has been persistently generating losses which are equivalent to contingent fiscal liabilities. These losses are rooted in different sources, including government guarantees, explicit and implicit price subsidies, government support for the development of renewable energy sources, etc. According to some estimates, these contingent fiscal liabilities at present amount to more than BGN 4 billion (nearly 5% of GDP) and keep growing. These have been piling over the years, with different governments taking various commitments to the energy sector and passing these to subsequent governments. However, this cannot go on forever and at some point, the government in office will need to address the fiscal implications of reckless past and current energy policies.

Such systemic vulnerabilities are indicative of the general failure by the Borisov government to tackle chronic structural problems in the economy despite the generous promises for reforms at the beginning of its term in office. Being a heterogeneous and large coalition, the political forces behind the government find it increasingly difficult to agree on a common denominator for policy reforms: all policy-related legislation that has been adopted since the 2014 elections have only been superficial and cosmetic in nature. One key problem is the absolute lack of declared vision and objectives as regards the future directions of Bulgaria's policy course. Most of the policy moves undertaken by the government are only of a passive nature, in response to acute emergencies and are often of populist character. In turn, this governance style tends to generate political tensions within the coalition, resulting in frequent ministerial changes.

The 2016 budget adopted in December was also indicative of the eclectic nature of the current policy course. The budgetary legislation did not formulate any clear policy objectives, thereby protracting a non-reform agenda; at the same time, the parliament again signed a blank cheque to the government for generous non-targeted borrowing which, as per previous experience, is mostly used for ad hoc populist moves. Such a setting is a recipe for perpetuating the current fiscal laxness.

In the absence of reforms and targeted policies, the Bulgarian economy will continue to be driven by domestic inertia and external factors. The current forecast assumes that both recovering domestic demand and exports will continue to give a moderate positive impetus to economic growth. These, however, will hardly be sufficient for further invigoration of economic activity – moreover, given that some of the 2015 growth factors were of a one-off nature. Thus the surge of public investment based on EU funds reflected a late start of the new EU financing cycle whereas there are no signs of recovery in private fixed investment. The export surge in the first half of 2015 partly reflected a statistical effect related to seasonal factors whereas exports in the second half nearly came to a standstill. The expected gradual recovery in the EU economy will likely contribute to positive export growth in 2016 but it would not be realistic to expect a repeat of the 2015 figures. So in general the expectations are for a continuing moderate recovery in the Bulgarian economy both in 2016 and in the two following years with an annual GDP growth rate in the range between 2% and 3%. While there are no visible imminent threats to macroeconomic stability, the chronic structural problems do suggest possible increasing risks in the medium term.

Table 8 / Bulgaria: selected economic indicators

	2011	2012	2013	2014	2015 <sup>1)</sup>	2016	2017 Forecast	2018
Population, th pers., average	7,348	7,306	7,265	7,224	7,200	7,150	7,100	7,050
Gross domestic product, BGN mn, nom.	80,100	81,544	81,971	83,612	87,000	90,100	93,300	97,300
annual change in % (real)	1.6	0.2	1.3	1.5	3.0	2.5	2.5	2.7
GDP/capita (EUR at exchange rate)	5,600	5,700	5,800	5,900	6,200	6,400	6,700	7,100
GDP/capita (EUR at PPP)	11,800	12,200	12,200	12,800	13,600	.	.	.
Consumption of households, BGN mn, nom.	49,582	53,022	50,906	52,207	53,100	.	.	.
annual change in % (real)	1.1	3.2	-1.4	2.7	0.7	1.5	1.7	2.0
Gross fixed capital form., BGN mn, nom.	16,896	17,443	17,365	17,653	18,000	.	.	.
annual change in % (real)	-4.4	1.8	0.3	3.4	1.0	3.0	4.0	5.0
Gross industrial production <sup>2)</sup>								
annual change in % (real)	5.8	-0.4	-0.1	1.8	2.8	3.0	3.0	3.0
Gross agricultural production								
annual change in % (real)	-2.5	-10.0	14.2	-0.6	-10.2	.	.	.
Construction industry <sup>3)</sup>								
annual change in % (real)	-12.8	-0.8	-3.7	1.8	-1.5	.	.	.
Employed persons, LFS, th, average <sup>4)</sup>	2,950	2,934	2,935	2,981	3,032	3,080	3,130	3,180
annual change in %	-3.4	-1.1	0.0	1.6	1.7	1.5	1.5	1.5
Unemployed persons, LFS, th, average <sup>4)</sup>	372	410	436	385	305	300	290	280
Unemployment rate, LFS, in %, average <sup>4)</sup>	11.2	12.3	13.0	11.4	9.3	9.0	8.5	8.0
Reg. unemployment rate, in %, end of period	10.4	11.4	11.8	10.7	10.0	.	.	.
Average monthly gross wages, BGN	685.8	731.1	775.1	821.7	882.0	940	990	1,030
annual change in % (real, gross)	1.5	3.5	5.1	7.5	7.4	5.0	4.0	3.0
Consumer prices (HICP), % p.a.	3.4	2.4	0.4	-1.6	-1.1	1.0	1.0	1.5
Producer prices in industry, % p.a.	9.2	4.4	-1.5	-1.2	-2.0	1.0	1.0	1.5
General governm.budget, EU-def., % of GDP								
Revenues	32.1	34.0	36.9	36.3	37.0	37.0	37.0	37.0
Expenditures	34.1	34.7	37.6	42.1	39.5	40.0	40.0	40.0
Net lending (+) / net borrowing (-)	-2.0	-0.6	-0.8	-5.8	-2.5	-3.0	-3.0	-3.0
Public debt, EU-def., % of GDP	15.3	17.6	18.0	27.0	29.4	30.5	32.4	34.1
Central bank policy rate, % p.a., end of period <sup>5)</sup>	0.22	0.03	0.02	0.02	0.01	.	.	.
Current account, EUR mn	375	-108	765	495	542	300	0	-200
Current account in % of GDP	0.9	-0.3	1.8	1.2	1.2	0.7	0.0	-0.4
Exports of goods, BOP, EUR mn	19,056	19,668	21,208	21,017	22,265	22,600	23,000	23,500
annual change in %	34.4	3.2	7.8	-0.9	5.9	1.5	1.8	2.2
Imports of goods, BOP, EUR mn	21,704	23,615	24,099	23,752	24,150	24,800	25,500	26,300
annual change in %	22.5	8.8	2.0	-1.4	1.7	2.7	2.8	3.1
Exports of services, BOP, EUR mn	6,471	6,845	6,860	6,749	6,744	6,800	6,900	7,000
annual change in %	6.0	5.8	0.2	-1.6	-0.1	0.8	1.5	1.4
Imports of services, BOP, EUR mn	3,571	4,114	4,124	4,219	4,194	4,200	4,300	4,400
annual change in %	3.5	15.2	0.3	2.3	-0.6	0.1	2.4	2.3
FDI liabilities (inflow), EUR mn	1,537	1,383	1,509	1,486	1,573	.	.	.
FDI assets (outflow), EUR mn	348	315	266	650	62	.	.	.
Gross reserves of NB excl. gold, EUR mn	11,788	13,935	13,303	15,276	19,022	.	.	.
Gross external debt, EUR mn <sup>6)</sup>	36,295	37,714	36,936	39,356	34,600	33000	32000	31000
Gross external debt, % of GDP <sup>6)</sup>	88.6	90.5	88.1	92.1	77.8	72.0	67.0	62.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
Purchasing power parity BGN/EUR	0.9261	0.9167	0.9224	0.9039	0.8887	.	.	.

1) Preliminary and wiiw estimates. - 2) Enterprises with 10 and more employees. - 3) All enterprises in public sector, private enterprises with 5 and more employees. - 4) From 2012 according to census February 2011. - 5) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board). -

6) BOP 5th edition.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.