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Bulgaria:
In the trap of macroeconomic mismanagement

The Bulgarian government has grossly mishandled the crisis thus prolonging and deepening the economic slump in the country. While most of Europe was turning the corner in the first quarter of 2010, Bulgaria's GDP plunged by 3.6% year-on-year, making it one of the worst performing economies on the continent in this period. Given the openness of Bulgaria's economy and its relatively healthy position before the crisis hit, the origins of this dismal outcome seem to be mostly of domestic nature.

The crisis triggered a drastic macroeconomic adjustment away form the previous pattern of growth which was led by domestic demand. For 2009 as a whole, domestic absorption contracted by 14.4% (against a GDP decline by 5.0%) and in the first quarter of the year, domestic absorption plunged by a further 8.8%. At the same time exports started to recover already in the last months of 2009 and this continued in 2010: in the first quarter, real exports of goods and services (national accounts definition) grew by 7.6% year-on-year.

While – given the large current account deficit – a switch towards more reliance on export-led growth was up to a point a needed macroeconomic correction, the disproportionate contraction in final domestic demand has to a great extent contributed to the bleak macroeconomic picture in the country. Thus despite the robust recovery in exports in the first quarter, the manufacturing industry remained in recession, with quarterly manufacturing sales dropping by 3% year-on-year. Construction was the worst affected sector with total construction output dropping by 26.7% in the first three months, after a 15.3% annual drop recorded in 2009.

There was a slight surge in consumer price inflation in the first quarter but it was largely due to rises in administrative prices. In turn, the rise in producer prices mostly reflects price movement in international markets. Overall, there do not seem to be major inflationary pressures. During the crisis, the rate of unemployment rose from the low of 5.8% (recorded in August 2008) to 10.3 (in February 2010). However, it is widely believed that the peak of unemployment has been reached and that situation in the labour market will start improving.

Final domestic demand (particularly fixed investment) was adversely affected by more difficult access to credit due to stringent screening by banks. Overall, credit activity generally remains stagnant but there has been no net withdrawal of funds by banks from the economy: the stock of credit to the non-government sector in March 2010 was 2.6% higher than a year earlier. Therefore more difficult access to credit can only explain part of the drop in domestic demand.

The continuing sharp contraction in domestic demand and, in particular, in private consumption (real retail sales dropped by 12.3% in the first quarter after a decline by 8.9% in 2009 as a whole) is all the more surprising given the fact that wage incomes never stopped to grow through the crisis: real average monthly wages in 2009 increased by some 9% and continued to grow at roughly the same rate in the first quarter of 2010. Consequently, at the end of March 2010, the stock of total household deposits was by 13.4% higher than a year earlier. Overall, the continuing decline in final domestic demand seems to be driven by an ongoing sharp drop in confidence by both consumers and investors which affects negatively their behaviour.

If one takes for granted that the currency board requires a fiscal balance (in a weaker formulation, this should hold over the cycle), the authorities have zero degree of freedom as regards the balance but do have room for manoeuvre as regards the composition of revenue and spending. A skilful restructuring of revenue and, especially, spending in times of crisis can in principle produce a robust countercyclical effect. However, it is in this territory that the government produced a series of blunders by introducing measures which were counterproductive as regards their declared fiscal goals, turned out to be procyclical (rather than countercyclical) and ultimately affected negatively the overall fiscal balance.

The fact is that since taking office in July 2009, the government has never come up with a coherent strategy and polices of dealing with the crisis. The only explicitly stated policy objective – fast entry into ERM2 – was obviously unrealistic and was announced at the wrong time, especially in view of the collateral damage of the Greek debt crisis.

Fiscal policy in this period has translated into a series of hectic and inconsistent measures, which more often than not led to wasteful outcomes. Probably the most damaging – and procyclical – fiscal step has been the curbing of public investment which started in mid-2009 and continued in 2010 as well (in the first quarter, public investment expenditure financed from local sources was 8% below the level of the same period of 2009). Another irrational step has been the withholding of payments due from the budget, especially to firms involved in public procurement, in a misguided attempt to curtail the cash fiscal deficit (which is an irrelevant measure in the context of ESA'95). The substitution of policy stimulus with cash austerity resulted in overcooling of the economy: these steps did next to nothing in terms of the overall fiscal position but had a damaging effect on economic activity and investor confidence.

At the same time, the initially declared policy of fiscal stringency was de facto abandoned in 2010 and degenerated into lavish populist spending in spheres with no countercyclical effect. Fearing a loss of popular support, the government has put on hold the envisaged reforms in the health care and pension systems as well as in education, prolonging wasteful public spending in these areas. There was no attempt (as of May 2010) to curb the growth of wages which notably outpaced productivity growth during the crisis.

But probably it is policy incoherence itself and the ever changing policy signals and measures that have had the most damaging effect on investor and consumer confidence. The absence of a clear policy direction and the unpredictability of the economic environment have translated into growing precautionary savings rather than spending, prolonging the current economic slump. These detrimental developments also act as further deterrent to FDI, amplifying the negative effects of the crisis. Coupled with the withdrawal of policy stimulus and the discontinuation of public investment projects, this led to erosion of the tax base by margins that exceeded by far the drop of output.

The aggregate fiscal outcomes in the first quarter of 2010 were disastrous. Compared to the same period of the previous year, consolidated general government revenue dropped by 19.2%, a disproportionate plunge vis-à-vis the fall in GDP. The main factor behind this was the sharp fall in tax revenue, largely due to an eroding tax base and poor tax collection. At the same time public expenditure ballooned by 17.0% (despite the cuts in public investment), an obviously unsustainable expansion even if the economy were growing. As a result, the overall fiscal balance for this quarter was a staggering negative 12% of GDP.

There was also one farcical development in this period. When the government reported ESA'95 fiscal balance for 2009, the deficit was unexpectedly downgraded from the initial estimate of 1.9% to 3.9%. No explication of this revision was given and some analysts have suggested that, faced with the prospect of a large deficit in 2010, the government might have over-reported in the 2009 accrual balance some committed long-term spending which will be due in 2010, so that to shift the responsibility to the previous government. The irony is that as a result of this reported 2009 deficit number, which exceeds the Maastricht threshold, the European Commission has invoked an excessive budget deficit procedure against Bulgaria, despite the harsh cash austerity measures undertaken in 2009.

At present the government is contemplating a major revision of the budget for 2010 with a view to reversing the negative trends, mostly by spending cuts. However, for the time being the economy remains in a largely self-inflicted vicious circle of an economic downswing and a swelling fiscal imbalance. If macroeconomic mismanagement continues, a further deterioration of the situation cannot be excluded.

The short-term outlook for the Bulgarian economy remains skewed towards the downside. The continuing slump in domestic demand seems to outweigh the recovery in exports and as long as this will be the case, one could not possibly expect a recovery in aggregate output. Even if there will be a change towards a more supportive policy stance, the negatives already accumulated in the first months of the year would pool back the outcome for GDP growth in 2010 as a whole. In the years after, the re-orientation towards an export-led model of growth should continue but this would not be sufficient to achieve high rates of GDP expansion. As long as domestic demand remains subdued, no major resurgence of inflation can be expected. The one positive outcome of the crisis has been the notable reduction in the current account deficit; the latter can be expected to remain in the lower range in the foreseeable future.

Table BG

Bulgaria: Selected Economic Indicators

	2006	2007	2008	2009 1)	2009	2010	2010	2011	2012
					1st quarter			Forecast	
Population, th pers., average	7699.0	7659.8	7623.4	7591.7	.	.	7560	7540	7520
Gross domestic product, BGN mn, nom.	49361.0	56519.8	66728.1	66256.3	13961.1	14050	68000	72000	76500
annual change in % (real)	6.3	6.2	6.0	-5.0	-3.5	-3.6	0	2.5	3
GDP/capita (EUR at exchange rate)	3300	3800	4500	4500	.	.	.	.	.
GDP/capita (EUR at PPP)	8600	9400	10400	9800	.	.	.	.	.
Consumption of households, BGN mn, nom.	34554.3	38826.5	45200.7	43047.9	10260.3	9530.0	.	.	.
annual change in % (real)	9.5	5.3	4.9	-6.4	-6.4	-7.3	-2	0	2
Gross fixed capital form., BGN mn, nom.	12805.2	16832.5	22253.9	16420.1	3615.7	3170.2	.	.	.
annual change in % (real)	14.7	21.7	20.4	-27.0	-14.1	-14.9	-10	4	8
Gross industrial production 2)									
annual change in % (real)	6.0	9.6	0.6	-17.4	-17.6	-3.8	3	6	10
Gross agricultural production									
annual change in % (real)	-0.1	-21.0	33.0	-0.4	.	.	.	.	.
Construction industry 3)									
annual change in % (real)	23.9	27.9	-3.3	-14.5	-6.4	-25.9	.	.	.
Employed persons - LFS, th, average	3110.0	3252.6	3360.7	3253.6	3262.8	3011.3	3050	3100	3150
annual change in %	4.3	4.6	3.3	-3.2	-0.8	-7.7	-6.3	1.6	1.6
Unemployed persons - LFS, th, average	305.7	240.2	199.7	238.0	222.2	341.0	.	.	.
Unemployment rate - LFS, in %, average	9.0	6.9	5.6	6.8	6.4	10.2	9.0	8.5	8
Reg. unemployment rate, in %, end of period	9.1	6.9	6.3	9.1	6.9	10.1			
Average gross monthly wages, BGN	360.3	431.2	524.5	591.8	563.0	619.0	.	.	.
annual change in % (real, gross)	3.7	10.4	8.3	9.8	10.6	9.0	.	.	.
Consumer prices (HICP), % p.a.	7.4	7.6	12.0	2.5	5.1	1.9	3	3	3
Producer prices in industry, % p.a.	12.0	7.7	10.9	-6.5	-3.4	4.0	.	.	
General governm.budget, EU-def., % GDP									
Revenues	39.5	41.5	39.1	36.9	.	.	.	.	.
Expenditures	36.5	41.5	37.3	40.7	.	.	.	.	.
Net lending (+) / net borrowing (-)	3.0	0.1	1.8	-3.9	.	.	-4	-3	-2
Public debt, EU-def., in % of GDP	22.7	18.2	14.1	14.8	12.7	14.9	19	21	22
Base rate of NB % p.a., end of period 4)	3.3	4.6	5.8	0.6	3.5	0.2	.	.	.
Current account, EUR mn	-4647.0	-7756.0	-8199.0	-3196.0	-1249.0	-427.0	-1800	-1600	-1800
Current account in % of GDP	-18.4	-26.8	-24.0	-9.4	-17.8	-5.9	-5.2	-4.3	-4.6
Exports of goods, BOP, EUR mn	12012.0	13512.0	15203.0	11785.0	2681.3	3009.2	13500	14800	16200
annual growth rate in %	26.9	12.5	12.5	-22.5	-26.6	12.2	14.6	9.6	9.5
Imports of goods, BOP, EUR mn	17575.0	20758.0	23800.0	15890.0	3822.8	3633.4	16800	18000	19700
annual growth rate in %	26.7	18.1	14.7	-33.2	-29.5	-5.0	5.7	7.1	9.4
Exports of services, BOP, EUR mn	4187.0	4760.0	5375.0	4879.0	794.2	715.0	5300	5700	6200
annual growth rate in %	17.5	13.7	12.9	-9.2	-2.7	-10.0	8.6	7.5	8.8
Imports of services, BOP, EUR mn	3264.0	3586.0	4045.0	3326.0	795.5	658.1	3500	3800	4200
annual growth rate in %	18.9	9.9	12.8	-17.8	-16.3	-17.3	5.2	8.6	10.5
FDI inflow, EUR mn	6221.0	9046.0	6696.0	3213.0	926.0	-21.9	1500	1300	1000
FDI outflow, EUR mn	141.0	207.0	484.0	-98.0	21.7	19.3	.	.	.
Gross reserves of NB excl. gold, EUR mn	8309.1	11215.9	11927.6	11942.8	10928.6	11182.1	.	.	.
Gross external debt, EUR mn	20690.9	29016.8	37100.1	37705.8	36834.6	37146.6	.	.	.
Gross external debt in % of GDP	82.0	100.4	108.7	111.3	108.7	106.8	.	.	.
Average exchange rate BGN/EUR	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956
Purchasing power parity BGN/EUR	0.745	0.787	0.847	0.899	.	.	.	.	.

Note: Gross industrial production, construction output and producer price index refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 10 and more employees. - 3) Private enterprises with 5 and more employees, all enterprises in public sector. - 4) The BNB basic interest rate is not a policy rate but a monthly reference rate computed by the BNB as the average interbank LEONIA rate of previous month (valid from 2005).

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