



BULGARIA: New government's reform ambitions to face reality check

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Economic activity in Bulgaria remained sluggish throughout most of 2014; weak GDP growth is likely to continue in 2015, driven mainly by household consumption and net exports. Some acceleration of economic activity might be expected over the period 2016-2017 on account of improving external conditions. The newly elected government that lacks strong political backing faces the challenge of implementing an ambitious reform agenda in a weak economic environment.

The early elections held in October 2014 did not produce clear-cut winners and a new, rather broad coalition government was formed with the participation of four centrist and centre-right parties. The most remarkable outcome, however, was that these elections brought back Boyko Borisov as Prime Minister – the first time anyone returned to the top political position in post-communist Bulgaria. To his credit, Mr. Borisov manoeuvred rather skilfully through the post-election horse trading phase and managed to mobilise a coalition around him. It only remains to be seen whether it will be able to survive for long in Bulgaria's turbulent and unstable political environment.

Another novelty in Bulgaria's political life was the fact that the new government came forth rather fast with a comprehensive and detailed programme which envisages a wider-ranging reform agenda, covering many important spheres of economic and social life. As regards the economy, the programme puts the emphasis on innovation, new technologies and export-oriented competitiveness, which would be supported by a better business environment and an efficient public administration. Other important areas of targeted reforms include the pension system, the health care system and the judiciary.

While there is nothing novel in the stated objective and desirable outcomes, what is striking is the overambitious range of detailed measures that the government has included in its wish-list: the programme contains 423 specific objectives and 1,155 measures in 21 different spheres. Some analysts estimated that if the government serves its full term in office, it will have to implement at least one measure per working day during this term – something that appears highly unlikely even if regarded purely in its technical aspect. In any case, a key challenge for the government will be to ensure lasting political support for the declared reform agenda by a rather heterogeneous political coalition with divergent political orientation and objectives. Another key challenge for the authorities will be to invigorate economic activity and growth so as to ensure a broader political support for the envisaged reforms.

Bulgaria's economic performance has been anaemic during the past several years and there are no indications of a possible notable upturn in the short run. Annual GDP growth in 2014 was marginally higher than in 2012 and 2013 and not much different from that in the EU as a whole. The catch-up process which was quite perceptible in the previous decade has all but petered out since the global financial turmoil of 2008/2009.

2014 was also marked by visible deflation, which was among the most pronounced in the EU. Bulgaria's deflation, however, does not appear to be domestically driven but rather imported. An important piece of evidence to this effect is the fact that domestic demand (both private consumption and gross fixed capital formation) grew in 2014 and made a positive contribution to GDP growth. There were also positive developments in the labour market in 2014: employment registered a modest upturn after several years of contraction. Hence one does not observe the typical signs of a vicious deflationary spiral (shrinking domestic demand exerting a downward pressure on prices and contributing to output contraction, labour shedding and further weakening of demand). Rather, being a small economy, dips in international prices are being transmitted through the channels of external trade.

On the supply side, it was the sectors of manufacturing and construction that contributed to the positive GDP growth in 2014. The external environment was not particularly favourable and net trade made a negative contribution to GDP growth. Bulgaria did suffer casualties related to the economic downturn in Russia and the conflict in Ukraine: in nominal terms exports to Russia in 2014 dropped by almost 10% from their 2013 level while exports to Ukraine dived by more than half. Positive growth was only registered in exports to the EU which supported the modest upturn in manufacturing.

The saga of the Corporate Commercial Bank failure ended with the closure of the bank and the initiation of a bankruptcy procedure. The Bulgarian National Bank postponed this decision until after the October elections in the expectation of a possible bailout by the newly elected government, something that did not materialise. The irony is that while there was no formal government bailout, the closure of CCB had serious implications for public finances due to the legal obligation to guarantee deposits of up to EUR 100,000 in accordance with the EU rules. As the Deposit Insurance Fund was not sufficiently endowed with resources to repay the full amount of CCB deposits, the government extended to the Fund, through an amendment in the 2014 budget, a 5.5-year loan amounting to BGN 2 billion (slightly more than EUR 1 billion) at an annual rate of 2.95%.¹ Repayments started at the beginning of December and within one month after the start of these operations, some BGN 3.25 billion of the estimated BGN 3.6 billion eligible for repayment were in fact restituted to their title holders.

In any case, there was no contagion from the CCB failure which remained strictly limited to that specific bank. Moreover, the overwhelming share of the repaid guaranteed deposits never left the banking system at all – they were just transferred to other banks. Overall, apart from the failed CCB, the Bulgarian banking system remains financially sound and has continued operating without interruptions. However, it is not clear yet what the fate of the asset side of the CCB balance sheet will be as the bankruptcy litigation (which has not started yet) hints at possible lengthy legal battles ahead.

¹ Earlier in the year, BNB had argued that a speedy government bailout to keep the bank afloat would ultimately cost the public sector less. However, by that time, the previous government resigned and the parliament was dissolved so this option could not be acted upon.

Bulgaria's fiscal balance deteriorated considerably in 2014. In addition to the CCB intervention, the fiscal outturn was negatively affected by the deflationary trends (e.g. the falling oil prices resulted in lower excise revenue); for the year as a whole, fiscal revenue was some BGN 1 billion below the target. In November, the newly elected parliament voted amendments to the 2014 budget equivalent to a significant increase in the cash deficit, de facto legitimising the expected outturn (BGN 3 billion or some 3.7% of GDP). Given the large-scale deposit insurance commitments that the government took in 2014, the accrual deficit for the year is expected to be significantly higher.

One somewhat striking feature of Bulgaria's recent economic performance (which continued in 2014 as well) has been the persistent robust rise in real wages, by far surpassing productivity growth. In this divergent dynamics, Bulgaria is a clear outlier not only in Central and Eastern Europe but also within the EU. The recent deflationary trend is undoubtedly an important component in this equation; the low absolute level of nominal wages (by far the lowest in the EU) is probably another. However, the most important factor is probably a built-in inertia in the wage formation mechanisms, offsetting by and large its association with productivity. In 2013-2014 these effects were reinforced by some policy moves such as the increase in minimum wages as well as wage rises in the public sector. So far, there are no indications of competitiveness losses related to these developments.

In the final days of December, the parliament approved the 2015 budget under a rather conservative macroeconomic framework: GDP growth of 0.8% in 2015 and a cash deficit of 3% of GDP. However, the pessimistic growth assumption seems to be more an ex ante precautionary justification of possible overspending in the year. While there is no ground to expect a robust recovery, the recent short-term indicators suggest that in 2015 the real economy could probably fare better than these assumptions.

The short-term outlook for the Bulgarian economy has deteriorated only marginally from the autumn of 2014. Thus the current expectations are that in 2015 GDP will grow by some 1.5%, a rate similar to that registered in 2014 thanks to a modest support both from private consumption (the 2015 budget envisages two consecutive hikes in the minimum wage) and net exports. Lower oil prices should also have a beneficial effect on Bulgaria's real economic performance. The expected further upturn in the sectors of manufacturing and construction should allow for modest improvements in the labour market as well. Given the current external environment, inflation is likely to stay close to zero while the current account balance will probably remain in the positive territory.

No major changes in this pattern of economic performance can be expected in 2016 and 2017. Nevertheless, if there will be an overall amelioration in economic conditions in Europe in these years, as envisaged in the most recent EU Economic Forecast, chances are that there will also be a further gradual improvement in Bulgaria's economic performance with GDP growth figures of around 2%, also slightly below the autumn 2014 forecast.

Table 1 / Bulgaria: Selected Economic Indicators

	2010	2011	2012	2013	2014 ¹⁾	2015	2016	2017
						Forecast		
Population, th pers., average ²⁾	7,396	7,348	7,306	7,265	7,260	7,250	7,230	7,200
Gross domestic product, BGN mn, nom. ³⁾	71,904	78,434	80,044	80,282	81,500	82,700	85,100	88,400
annual change in % (real) ³⁾	0.7	2.0	0.5	1.1	1.6	1.5	1.9	2.3
GDP/capita (EUR at exchange rate)	5,000	5,500	5,600	5,700	5,700	5,800	6,000	6,300
GDP/capita (EUR at PPP)	11,200	12,200	12,400	12,300	12,600	.	.	.
Consumption of households, BGN mn, nom. ³⁾	45,533	48,470	52,140	49,863	49,700	.	.	.
annual change in % (real) ³⁾	0.4	1.9	3.8	-2.3	1.6	1.0	2.5	2.5
Gross fixed capital form., BGN mn, nom. ³⁾	16,431	16,685	17,246	17,108	16,300	.	.	.
annual change in % (real) ³⁾	-18.3	-6.6	4.2	-0.1	3.0	0.0	3.0	5.0
Gross industrial production ⁴⁾								
annual change in % (real)	2.1	5.8	-0.3	-0.1	1.9	2.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	-6.0	-2.5	-10.0	14.2	-5.0	.	.	.
Construction industry ⁵⁾								
annual change in % (real)	-14.9	-12.8	-0.7	-5.3	3.3	.	.	.
Employed persons, LFS, th, average ⁶⁾	3,053	2,950	2,934	2,935	2,981	3,010	3,040	3,070
annual change in %	-6.2	-3.4	-1.1	0.0	1.6	1.0	1.0	1.0
Unemployed persons, LFS, th, average ⁶⁾	348	372	410	436	385	370	360	320
Unemployment rate, LFS, in %, average ⁶⁾	10.2	11.2	12.3	12.9	11.5	11.0	10.5	9.5
Reg. unemployment rate, in %, end of period	9.2	10.4	11.4	11.8	10.7	.	.	.
Average monthly gross wages, BGN	648.1	685.8	731.1	775.1	827.8	.	.	.
annual change in % (real, gross)	3.9	1.5	3.5	5.1	8.3	.	.	.
Consumer prices (HICP), % p.a.	3.0	3.4	2.4	0.4	-1.6	0.0	1.0	1.5
Producer prices in industry, % p.a.	8.5	9.2	4.4	-1.5	-1.2	.	.	.
General governm.budget, EU-def., % of GDP								
Revenues	34.1	32.6	34.7	37.1	38.0	.	.	.
Expenditures	37.4	34.7	35.2	38.3	43.0	.	.	.
Net lending (+) / net borrowing (-)	-3.2	-2.0	-0.5	-1.2	-5.0	-3.0	-2.5	-2.0
Public debt, EU-def., % of GDP	15.9	15.7	18.0	18.3	23.1	25.7	27.5	28.5
Central bank policy rate, % p.a., end of period ⁷⁾	0.18	0.22	0.03	0.02	0.02	.	.	.
Current account, EUR mn ⁸⁾	-534	33	-454	1,215	800	500	300	-200
Current account, % of GDP ⁸⁾	-1.5	0.1	-1.1	3.0	1.9	1.2	0.7	-0.4
Export of goods, BOP, EUR mn ⁸⁾	15,562	20,265	20,771	21,208	21,250	21,500	22,000	22,800
annual change in %	33.0	30.2	2.5	.	0.2	1.2	2.3	3.6
Import of goods, BOP, EUR mn ⁸⁾	18,326	22,421	24,231	24,099	24,350	24,800	25,500	26,700
annual change in %	15.4	22.3	8.1	.	1.0	1.8	2.8	4.7
Exports of services, BOP, EUR mn ⁸⁾	5,012	5,354	5,696	6,860	7,400	7,600	7,800	8,100
annual change in %	2.0	6.8	6.4	.	7.9	2.7	2.6	3.8
Imports of services, BOP, EUR mn ⁸⁾	3,143	3,037	3,426	4,124	4,500	4,700	4,800	5,000
annual change in %	-13.1	-3.4	12.8	.	9.1	4.4	2.1	4.2
FDI inflow (liabilities), EUR mn ⁸⁾	1,152	1,330	1,142	1,353	1,450	1,500	1,600	1,800
FDI outflow (assets), EUR mn ⁸⁾	174	117	270	266	300	.	.	.
Gross reserves of NB excl. gold, EUR mn	11,612	11,788	13,935	13,303	15,276	.	.	.
Gross external debt, EUR mn	37,026	36,295	37,714	36,924	38,800	.	.	.
Gross external debt, % of GDP	100.7	90.5	92.1	90.0	93.1	.	.	.
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	0.8680	0.8780	0.8817	0.8982	0.8921	.	.	.

1) Preliminary and wiiw estimates. - 2) According to census February 2011. - 3) According to ESA 2010. - 4) Enterprises with 10 and more employees. - 5) All enterprises in public sector, private enterprises with 5 and more employees. - 6) From 2012 according to census February 2011. - 7) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board). - 8) From 2013 BOP 6th edition, 5th edition before.
Source: wiiw Databases incorporating Eurostat and national statistics.