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Bulgaria:
withdrawal of policy stimulus delays recovery

The economic slump in Bulgaria continued through the final months of 2009 with GDP for the year as a whole contracting by some 5%. Weak domestic demand was responsible for most of the contraction as exports gradually started to gain pace in the second half of the year. The abrupt withdrawal of policy stimulus initiated by the newly elected centre-right government (GERB party) which took office in July has undoubtedly added to the weakness of domestic demand, thus contributing to the anaemic economic performance in the second semester.

This pattern of macroeconomic performance reflects the ongoing major adjustment towards more reliance on export-led growth, reversing the pattern that prevailed during the period 2001-2008. While domestic demand remained subdued in the second half of 2009, exporters benefited from the recovery in the manufacturing sector of some of the large EU economies. Merchandise exports gradually started to recover, at first on a month-on-month basis, and by November in year-on-year terms. In statistical terms, net exports contributed a positive 13.9 percentage points to GDP growth in the third quarter, up from 8.1 points in the first quarter and 12.1 points in the second quarter. Although the current account balance remained negative (and large in absolute terms), the deficit has shrunk by almost two thirds compared to the previous year.

Against the backdrop of weak domestic demand, deflationary trends prevailed during most of the year. PPI dropped by several percentage points both year-on-year and in average annual terms. The average annual rate of consumer prices remained in the positive territory mostly due to carryover effects from the previous year. With the nascent recovery in exports, the slowdown in manufacturing started to decelerate in the final months of 2009. Unemployment kept rising steadily in the second semester. Many of those that joined the pool of unemployed were made redundant by small and medium-sized enterprises, which are less prepared to shelter their workforce during a recession. The gap between officially registered unemployment and LFS measures continued to widen, suggesting an increasing shift towards the informal labour market. Notwithstanding that, the labour market adjustment is far from over, with no end to the rise in unemployment in sight.

After coming to a standstill at mid-2009, credit to the corporate sector experienced a modest recovery in the second half of the year. However, access to bank finance remains difficult mostly due to much more stringent credit screening. Generally there are no signs of a liquidity crunch in the banking system as evidenced by the fall in interest rates on the interbank market in the second half of the year. By contrast, while there was no further rise in borrowing rates in the same period, their level remained elevated reflecting still high risk premia. The share of non-performing loans more than doubled in 2009 but at some 6.4% at the end of the year they are not considered as a threat to the stability of the financial system.

A major change in the policy stance since the new government took over in July has also affected the macroeconomic outcome. This change amounted to the early withdrawal of a large chunk of the policy stimulus installed by the previous government, especially as regards public investment. Under the dictum of re-balancing the budget, the new government undertook major cuts in public spending, with disproportionately drastic cuts in public capital expenditure. Thus, while during the first seven months of the year (under the Socialist-led Stanishev government) capital expenditure accounted for 15.3% of all public expenditure in the consolidated government budget, in the period August to November (under the centre-right GERB government led by Boyko Borisov) this share dropped to 12.4%. Moreover, if public expenditure financed from EU transfers are excluded from this count, the share of public capital expenditure dropped by more than 5 percentage points (from 13.1% in January-July to 7.8% in August-November).

Given the current macroeconomic situation in Bulgaria, the new policy of drastic fiscal austerity appears puzzling. The resulting major downsizing of public investment projects as well as the downgrading of automatic stabilizers (the social safety net as well as some income support measures introduced by the previous government were also scaled back) amount to a switch from a countercyclical towards a procyclical policy stance, suppressing further economic activity, which is hard to justify in the current economic environment.

Although an amendment of the 2009 budget was probably unavoidable in view of the shortfall in revenue caused by the recession, the magnitude of the fiscal adjustment, and especially the early and drastic withdrawal of policy stimulus, seem unwarranted and unjustified. The deterioration in the fiscal outcome in 2009 was mostly a cyclical outcome, whereas there was no evidence that the structural fiscal balance was endangered (between 2004 and 2008, Bulgaria recorded five consecutive years of large fiscal surpluses). Furthermore, one of the functions of the large fiscal reserve accumulated during the surplus years (amounting to some 12% of GDP) is exactly to act as a buffer dampening the negative effects of a cyclical downturn such as the current one. The main argument put forward for the switch in the policy stance – a fast-track entry into ERM-2 – is also difficult to justify in view of the sound structural fiscal balance. The fact is that Bulgaria could have easily stayed within the range of the Maastricht deficit criterion with less economic pain.

The same policy stance of drastic fiscal restrictions has been incorporated in the 2010 budget. Firstly, the budgetary framework is based on very conservative estimates of public revenue (under the assumption of a drop in GDP by 2% in 2010) and, consequently, of planned expenditure. Secondly, within this conservative framework, the consolidated budget balance targets a deficit of 0.7% of GDP. Therefore, if there is no subsequent upward amendments to planned spending, this would amount to a further tightening of the fiscal stance. The public investment targets are more than modest: planned public expenditure financed from local sources amount to 7.9% of all public expenditure in the consolidated government budget. This is a reduction by one half in relative terms as compared to 2008 when this share amounted to 15.8%. By contrast, the 2010 budget envisages that approximately the same amount of public capital expenditure would be financed from EU sources, which may be wishful thinking in terms of the country's absorptive capacity regarding EU funds (in relative terms, this is more than double the amount of EU investment funding absorbed in 2009). Employment protection and support have also been downsized in the 2010 budget.

Raising the capacity of the economy to absorb EU funds is perhaps the greatest economic policy challenge that Bulgaria faces at present: during the first three years of EU membership, the level of fund absorption in Bulgaria has been close to nil and the lowest in the EU as a whole. This challenge is related to the inefficiency, lack of transparency and perceived high level of corruption in the workings of the public administration. The GERB government that took over in July 2009 won its electoral victory on a ticket pledging the eradication of corruption and raising considerably the level of absorption of EU funds. While there have been a number of positive steps in this direction, the results so far have fallen below expectations. Thus the government still faces the daunting task of removing or at least reducing the existing institutional and other barriers and re-organizing and streamlining the related administrative procedures so as to ensure a fair and efficient channelling of EU funds.

Against this background, there is not much room for optimism in the economic outlook for Bulgaria in 2010. Importantly, sluggish domestic demand will remain a major drag on the economy. The expected cuts in public investment and subdued private investor confidence are likely to depress further overall fixed investment. Private consumption will probably stagnate due to cautious consumer spending and more difficult access to consumer credit. Recovering exports (under the assumption of a stronger Western European import demand) can be expected to be the main growth driver in the short run but this would hardly be sufficient to pull overall economic growth into the positive territory. Therefore, unless there is a radical change in policies towards a more supportive policy stance, the economy as a whole can be expected to stagnate in 2010. Given the economic weakness and the withdrawal of some support measures, unemployment will keep rising as labour continues to adjust further downwards. On the positive side, sluggish domestic demand would contribute to a further downward adjustment in the current account deficit in 2010. In the absence of either cost-push or demand-pull factors, inflation will also remain low.

Developments in 2011-2012 will depend on both the strength of the global (and, especially, Western European) recovery and on possible changes in the domestic policy stance. In any case, it is clear that there will be no return to the pre-crisis pattern of economic performance when economic growth was mostly driven by an unsustainable expansion in domestic demand which, in turn, was fuelled by external private borrowing. So, under a moderately optimistic assumption of continuing recovery in the major European economies, predominantly export-led growth in Bulgaria, and a more supportive domestic economic policy stance, annual GDP growth in the next two years could be in the range of 3.0-3.5%. Under the same assumptions, one could expect relatively low inflationary pressures and a modest recovery in employment towards the end of the period. While the current account deficit will probably start rising along with the recovery, it will stay much below the highs seen in the past several years.

Table BG

Bulgaria: Selected Economic Indicators

	2004	2005	2006	2007	2008	2009 [1]	2010	2011 Forecast	2012
Population, th pers., average	7781.2	7739.9	7699.0	7659.8	7623.4	7591.7	7560	7540	7520
Gross domestic product, BGN mn, nom.	38822.6	42797.4	49361.0	56519.8	66728.1	66197	67500	71500	76000
annual change in % (real)	6.6	6.2	6.3	6.2	6.0	-5.1	0	3	3.5
GDP/capita (EUR at exchange rate)	2600	2800	3300	3800	4500	4500	.	.	.
GDP/capita (EUR at PPP)	7300	7800	8600	9400	10400	10000	.	.	.
Consumption of households, BGN mn, nom.	26732.0	29841.5	34554.3	38826.5	45200.7	41500	.	.	.
annual change in % (real)	5.9	6.1	9.5	5.3	4.9	-6	0	3	3.5
Gross fixed capital form., BGN mn, nom.	7969.4	10346.5	12805.2	16832.5	22253.9	16936	.	.	.
annual change in % (real)	13.5	23.3	14.7	21.7	20.4	-24.9	-6	6	10
Gross industrial production [2]									
annual change in % (real)	12.8	7.0	6.0	9.6	0.6	-17.4	3	6	10
Gross agricultural production									
annual change in % (real)	6.6	-6.0	-0.1	-21.0	33.0	-0.4	.	.	.
Construction industry [3]									
annual change in % (real)	35.1	31.9	23.9	27.9	-3.3	-15	.	.	.
Employed persons - LFS, th, average	2922.5	2981.9	3110.0	3252.6	3360.7	3250	3100	3150	3180
annual change in %	3.1	2.0	4.3	4.6	3.3	-3	-4.6	1.6	1.0
Unemployed persons - LFS, th, average	399.7	334.4	305.7	240.2	199.7	235.0	.	.	.
Unemployment rate - LFS, in %, average	12.0	10.1	9.0	6.9	5.6	6.7	9.0	8.5	8
Reg. unemployment rate, in %, end of period	12.2	10.7	9.1	6.9	6.3	9.1			
Average gross monthly wages, BGN	292.4	323.7	360.3	431.2	524.5	585.1	.	.	.
annual change in % (real, gross)	0.8	5.4	3.7	10.4	8.3	8.6	.	.	.
Consumer prices (HICP), % p.a.	6.1	6.0	7.4	7.6	12.0	2.5	2	3	3
Producer prices in industry, % p.a.	5.5	7.9	12.0	7.7	10.9	-6.5	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	41.3	41.2	39.5	41.5	39.1	38.1	.	.	.
Expenditures	39.7	39.3	36.5	41.5	37.3	38.9	.	.	.
Net lending (+) / net borrowing (-)	1.6	1.9	3.0	0.1	1.8	-0.8	-0.5	0	0.5
Public debt, EU-def., in % of GDP	37.9	29.2	22.7	18.2	14.1	15.2	15.5	14.5	13.5
Base rate of NB % p.a., end of period [4]	2.4	2.1	3.3	4.6	5.8	0.6	.	.	.
Current account, EUR mn	-1306.9	-2705.7	-4647.0	-7275.0	-8653.0	-2912.2	-2700	-3100	-3600
Current account in % of GDP	-6.6	-12.4	-18.4	-25.2	-25.4	-8.6	-7.8	-8.5	-9.3
Exports of goods, BOP, EUR mn	7984.9	9466.3	12012.0	13512.0	15203.0	11783.5	12800	13800	15000
annual growth rate in %	19.7	18.6	26.9	12.5	12.5	-22.5	8.6	7.8	8.7
Imports of goods, BOP, EUR mn	10938.4	13876.1	17575.0	20758.0	23800.0	15867.3	16700	18200	20000
annual growth rate in %	20.3	26.9	26.7	18.1	14.7	-33.3	5.2	9.0	9.9
Exports of services, BOP, EUR mn	3262.1	3564.1	4187.0	4745.0	5369.0	5047.7	5400	5800	6300
annual growth rate in %	19.5	9.3	17.5	13.3	13.2	-6.0	7.0	7.4	8.6
Imports of services, BOP, EUR mn	2605.8	2745.2	3264.0	3990.0	4597.0	3680.5	3900	4200	4600
annual growth rate in %	19.8	5.3	18.9	22.2	15.2	-19.9	6.0	7.7	9.5
FDI inflow, EUR mn	2735.9	3152.1	6221.0	8589.0	6549.0	2844.9	2500	2800	3500
FDI outflow, EUR mn	-165.6	249.1	141.0	207.0	486.0	115.4	.	.	.
Gross reserves of NB excl. gold, EUR mn	6443.1	6813.9	8309.1	11215.9	11927.6	11942.8	.	.	.
Gross external debt, EUR mn	12658.5	15506.9	20690.9	28988.8	36973.8	36700	.	.	.
Gross external debt in % of GDP	63.8	70.9	82.0	100.3	108.4	108.4	.	.	.
Average exchange rate BGN/EUR	1.953	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956
Purchasing power parity BGN/EUR	0.685	0.715	0.745	0.787	0.847	0.872	.	.	.

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

1) Preliminary and wiiw estimates. - 2) Enterprises with 10 and more employees. - 3) Pirvate enterprises with 5 and more employees, all enterprises of 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.