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Bulgaria: A painful rebalancing

The most notable feature of Bulgaria's economic performance since the start of the global economic and financial crisis in 2008 was a spectacular macroeconomic adjustment which is best visible in the dynamics of the current account balance: the current account deficit dropped from unsustainable 25% of GDP in the years 2007-2008 to around 10% in 2009 and to some 1.5% in 2010. The dramatic rebalancing reflects a major re-positioning of economic growth drivers. For almost a decade, up to 2009, GDP growth in Bulgaria was nearly entirely driven by domestic demand (which, in turn, was fuelled by foreign borrowing) while net exports remained a drag on economic activity. In 2009-2010 this picture reversed dramatically and net exports turned out to be the only final demand item making a positive (and large in absolute terms) contribution to GDP growth while investments (especially in 2009) and household consumption (2010) fell sharply.

Concomitantly, there was a major re-orientation of sales by local manufacturers towards export markets: in current EUR terms, exports of goods in 2010 exceeded those of the pre-crisis in 2008 (and were up by one third from 2009 onwards), when real gross industrial output was about 20% higher than that in 2010. The ability to rapidly take advantage of emerging opportunities in international markets (on such a scale this happens for the first time in post-transition Bulgaria) is a sign of a maturing and vibrant private manufacturing sector. Among the export commodities that reported the highest growth in 2010 are both traditional items such as refined oil products (reflecting the newly installed production capacity in the LUKOIL refinery) and metals, but also mechanical and electrical engineering goods, which is a new development, thanks to new investment in these sectors in recent years. There are also new aspects in the directions of exports, with increasing share of emerging market countries, such as China, India, Brazil, and Korea.

However, the process of rebalancing has been rather painful: the cumulative decline of private consumption during 2009-2010 amounted close to 10% while gross fixed investment in this period dropped by some 35% in cumulative terms. The sharp fall in private consumption is difficult to rationalize in terms of macroeconomic performance indicators only. It comes against the backdrop of continued growth of real wages (by some

10% and 7% in 2009 and 2010, respectively) and of household savings (by some 13% year-on-year both in 2009 and 2010). Unemployment did jump in 2010 but not so dramatically as in other countries and not to the extent to explain the retrenchment in private consumption. As to fixed investment, apart from the drying up of the sources of external borrowing, the disproportionate fall also mirrors the drastic cutbacks in budgetary spending on public investment: domestically financed public investments were cut by more than 16% in 2010, after a reduction by 31% in 2009.

The chaotic management of public finances reflects the eclectic nature of the policy stance of the authorities. Since it came to power in July 2009, the (self-declared as “centre-right”) GERB government never came up with any clearly formulated economic objectives and policies to pursue such objectives. At the same time, the government has already accumulated a record of ceding to pressures from interest groups, very often translating into openly populist moves. The management of public finances leaves the perception that it is not the government that seeks to lead the economy but instead is trailing behind it, in a crisis management pattern.

The few intentional policy moves in the area of public finances have been largely unproductive, resulting in outcomes exactly opposite to those originally targeted. Thus the above mentioned cuts in public investment had a highly damaging economic effect on economic activity in general. Another equally disastrous move was the increase in the tobacco excises in 2010. The net fiscal outcome of this move was negative due to increased tax evasion and a rise in grey economy tobacco sales: total net revenue from excises in 2010 dropped by more than 7% since 2009, despite the fact that the excise revenue from fuels increased thanks to higher prices. Overall, after years of improvements in the efficiency of tax collection, there has been a major reversal in this area in 2009-2010.

Although the outlook for the Bulgarian economy has been improving in the course of 2010, there are no signs of an imminent rapid recovery and robust growth in the short run. Thus the construction sector remained deeply in negative territory through 2010, mirroring the level of investment activity. While the decline in private consumer demand has been decelerating in the final months of 2010, it was still months away from a possible bottoming up. Both government consumption and public investment remained a major drag on economic activity throughout the whole year 2010. Given these trends, all main components of final domestic demand have been making negative contributions to GDP growth in 2010. It is thus only thanks to the robust export performance that the rate of GDP growth for the year could move into positive territory.

The outlook for 2011 can be briefly characterized as an expectation for a modest recovery supported by an upturn in domestic demand. The gradual revival of the economy will mostly be driven by a recovery in private consumption and especially of private investment, whereas the public sector is not likely to give a boost to economic activity. The latter follows behind the 2011 budget targets, including the stipulated volumes and structure of public spending.

The 2011 budget envisages a further decline of consolidated budget revenue as a share in GDP which is an implicit recognition of a further deterioration in the efficiency of tax collection. Mirroring that, consolidated public expenditure would also drop as percentage of GDP, the target being to keep the budget deficit within the Maastricht range. The government has not given up on its declared objective to enter ERM-2 as soon as possible (and as early as the second half of 2011, according to recent statements) but it remains to be seen whether these are realistic goals or wishful thinking. The bottom line is that spending items key to economic activity such as public investment are expected to undergo further cuts in relative terms. The budget envisages also a freeze in public sector wages. These as well as other similar features underscore the unsupportive fiscal policy stance in 2011.

On the other hand, as noted earlier, both private consumption and especially fixed investment dropped to very low levels after two years of contraction. In purely statistical terms this suggests a very low base and hence a statistically measured recovery, say, in construction activity, that shows up as “strong” (in terms of the magnitude of the number) this could merely reflect a higher rate of capacity utilization. There are some first signs that capacity utilization in the construction sector is indeed starting to rise, which can be taken as an early indication of a forthcoming recovery in investment activity. An expected modest upturn in FDI would provide further support to fixed investment in 2011. Recent trends suggest that real retail sales in year-on-year terms could move into positive territory in the first or second quarters of 2011. If this trend continues, private consumption for 2011 as a whole should also be on a moderate rise.

Export performance is likely to remain strong in 2011, maintaining some of the accumulated momentum. However, it is difficult to expect rates of growth comparable to those seen in 2010 due to supply constraints. The fact is that manufacturers are already operating close to their production capacity limits (at least as regards exportable goods). Maintaining such high rates of export growth would thus require increases in production capacities, respectively, new investment and time. In view of this it is more likely that export growth will moderate in 2011 and in the following years. The revival of imports kept

accelerating throughout the year and can be expected to continue in 2012 supported by the upturn in private investment and consumption. Overall – as a result of such trends – it can be expected that both the trade and the current account balance will deteriorate in 2011 but they will remain in a range that will not pose serious macroeconomic concerns.

Given the current domestic policy stance and the structural characteristics of the Bulgarian economy, it can be expected that similar macroeconomic trends will prevail in 2012 and 2013 as well. Overall GDP growth is likely to remain modest, curbed by both supply and demand constraints; on the one hand, supply constraints are likely to restrain the growth of manufacturing (hence exports); on the other hand the growth in private demand is likely to be contained by tight borrowing conditions, in particular abroad. It is highly unlikely that a demand-drive pattern of high growth similar to that seen in the period 2004 – 2008 could be repeated in the years ahead.

Domestic policy in coming years will continue to face a range of chronic structural problems, which have been neglected by several subsequent governments, including the current one. The healthcare sector – and the related health insurance system – present some of the most acute policy problems. Several ill-conceived reform attempts in this area already failed which not only contributed to further accumulation of problems but also damaged the credibility of the authorities in dealing with them. In addition, the solvency of the pension system was eroded by short-sighted populist moves; a major reform of this system is also urgently needed. Other chronic problems of the Bulgarian economy – and society in general – include corruption and crime. Although the present government largely came to power on an anti-corruption, anti-crime ticket, real progress in these spheres has been modest. Similarly, although the utilization of EU funds increased somewhat, the country's absorptive capacity regarding such funds remains very low. Progress in any of these areas could bring considerable economic benefit; however, it appears that the current government does not have the political will and/or the capacity to undertake the necessary reforms.

Table BG

Bulgaria: Selected Economic Indicators

	2005	2006	2007	2008	2009	2010 ¹⁾	2011	2012	2013
	Forecast								
Population, th pers., average	7739.9	7699.0	7659.8	7623.4	7585.1	7560	7540	7520	7500
Gross domestic product, BGN mn, nom.	45483.8	51783.1	60184.6	69295.0	68537.2	71900	76500	82000	88000
annual change in % (real)	6.4	6.5	6.4	6.2	-4.9	0.3	2.5	3	3
GDP/capita (EUR at exchange rate)	3000	3400	4000	4600	4600	4900	.	.	.
GDP/capita (EUR at PPP)	8200	9000	10000	10900	10400	10600	.	.	.
Consumption of households, BGN mn, nom.	31309.0	34761.9	41300.8	45765.7	44985.6	44000	.	.	.
annual change in % (real)	6.9	8.7	9.1	3.4	-3.5	-6	3	3	3
Gross fixed capital form., BGN mn, nom.	11711.3	14297.5	17263.9	23282.6	16720.1	16500	.	.	.
annual change in % (real)	30.8	13.1	11.8	21.9	-29.0	-8	9	8	8
Gross industrial production ²⁾									
annual change in % (real)	7.0	6.0	9.6	0.6	-17.4	1.2	6	8	8
Gross agricultural production									
annual change in % (real)	-6.0	-0.1	-21.0	33.0	-1.6	-3.3	.	.	.
Construction industry ³⁾									
annual change in % (real)	31.9	23.9	27.9	26.5	-34.7	-17.3	.	.	.
Employed persons - LFS, th, average	2981.9	3110.0	3252.6	3360.7	3253.6	3052.8	3100	3150	3200
annual change in %	2.0	4.3	4.6	3.3	-3.2	-6.2	1.5	1.6	1.6
Unemployed persons - LFS, th, average	334.4	305.7	240.2	199.7	238.0	348.1	.	.	.
Unemployment rate - LFS, in %, average	10.1	9.0	6.9	5.6	6.8	10.2	9	8	7
Reg. unemployment rate, in %, end of period	10.7	9.1	6.9	6.3	9.1	9.2	.	.	.
Average gross monthly wages, BGN	323.7	360.3	430.6	524.5	591.8	642.0	.	.	.
annual change in % (real, gross)	5.4	3.7	10.4	8.4	9.8	5.9	.	.	.
Consumer prices (HICP), % p.a.	6.0	7.4	7.6	12.0	2.5	3.0	4	4	4
Producer prices in industry, % p.a.	7.9	12.0	7.7	10.9	-6.5	8.6	.	.	.
General government budget, EU-def., % GDP									
Revenues	40.7	36.2	40.8	39.3	35.9	33.5	.	.	.
Expenditures	39.7	34.4	39.7	37.6	40.6	37.4	.	.	.
Net lending (+) / net borrowing (-)	1.0	1.9	1.1	1.7	-4.7	-3.9	-3	-2.5	-2
Public debt, EU-def., in % of GDP	27.5	21.6	17.2	13.7	14.7	15.3	17	18	19
Central bank policy rate, % p.a., end of period ⁴⁾	2.1	3.3	4.6	5.8	0.6	0.2	.	.	.
Current account, EUR mn	-2705.7	-4647.0	-7756.0	-8191.0	-3477.0	-282.7	-1500	-1900	-2300
Current account in % of GDP	-11.6	-17.6	-25.2	-23.1	-9.9	-0.8	-3.8	-4.5	-5.1
Exports of goods, BOP, EUR mn	9466.3	12012.0	13512.0	15203.0	11699.0	15554.2	16800	17800	18800
annual growth rate in %	18.6	26.9	12.5	12.5	-23.0	33.0	8.0	6.0	5.6
Imports of goods, BOP, EUR mn	13876.1	17575.0	20758.0	23800.0	15874.0	17955.3	20000	21500	23000
annual growth rate in %	26.9	26.7	18.1	14.7	-33.3	13.1	11.4	7.5	7.0
Exports of services, BOP, EUR mn	3564.1	4187.0	4760.0	5375.0	4915.0	4954.7	5250	5500	5750
annual growth rate in %	9.3	17.5	13.7	12.9	-8.6	0.8	6.0	4.8	4.5
Imports of services, BOP, EUR mn	2745.2	3264.0	3586.0	4045.0	3617.0	3062.4	3300	3500	3700
annual growth rate in %	5.3	18.9	9.9	12.8	-10.6	-15.3	7.8	6.1	5.7
FDI inflow, EUR mn	3152.1	6221.0	9046.0	6685.0	3283.0	1359.5	1300	1500	1800
FDI outflow, EUR mn	249.1	141.0	207.0	483.0	-90.0	149.8	.	.	.
Gross reserves of NB excl. gold, EUR mn	6813.9	8309.1	11215.9	11927.6	11942.9	11611.8	.	.	.
Gross external debt, EUR mn	15506.9	20690.9	29016.8	37112.4	37808.1	36918.3	.	.	.
Gross external debt in % of GDP	66.7	78.1	94.3	104.7	107.9	100.4	.	.	.
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.956	1.956	1.956
Purchasing power parity BGN/EUR	0.7154	0.7454	0.7837	0.8357	0.8682	0.8987	.	.	.

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

1) Preliminary and wiw estimates. - 2) Enterprises with 10 and more employees. - 3) Private enterprises with 5 and more employees, all enterprises in public sector. - 4) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board).

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