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Bulgaria: Economy at the freezing point

Bulgaria's economy kept losing steam in the first quarter of 2012 against the backdrop of weakening exports and weak domestic demand. The fiscal stance remains under the reigns of an austerity strive in the absence of policy creativity. There is little chance of reversing this situation in the short run so current expectations are that the economy is likely to stagnate in 2012.

Bulgaria's economy failed to sustain a recovery course in the environment of an enduring debt debacle in Europe and a lasting instability in international financial markets. The weakening of economic activity which could be observed in the final months of 2011 continued in 2012 as well. The main factor behind this was the sharp deterioration in export performance which in itself mirrored weak demand in Europe. Consequently net exports made a negative contribution to GDP growth in the first quarter, reversing the situation prevailing in the period 2009-2011. By contrast, domestic demand made a positive contribution to GDP growth in the first quarter, mostly thanks to a modest upturn in private consumption.

Overall, it is difficult to draw far-reaching conclusions from these facts as the economy remains close to the freezing point, with quarterly GDP growing by a 0.9% year on year according to preliminary statistics. However, the preliminary national accounts data tend to be rather unreliable. For example, these data suggest that real aggregate value added produced in the Bulgarian economy in the first quarter dropped by 0.9% from the same period of 2011. The reported positive GDP figure was exclusively due to a large positive contribution of FISIM (financial intermediation services indirectly measured), which is an adjustment item in the System of National Accounts. Moreover, different short-term indicators point to different directions of recent trends that are in some case the opposite of those implied by the quarterly national accounts data. Thus real retail sales in the first quarter were on the decline year-on-year while national accounts point to an increase in private consumption. Similarly, national accounts suggest a year-on-year increase in value added produced in construction, while according to monthly data quarterly gross construction production fell from the same period of 2011.

The most disappointing recent development has been the weakening in export performance which had kept the economy afloat during the past couple of years. In the first quarter of 2012, the growth of merchandise exports was negative (albeit slightly) both in nominal and in real terms for the first time since 2009. In this period, the biggest retrenchment was recorded in exports to the EU while exports to third parties were less affected. Mirroring this, manufacturing output also went into the red in the first quarter. By contrast, after almost two years of decelerating import growth, imports started picking up speed in the first months of 2012.

The divergent trends in export and import performance affected the dynamics of Bulgaria's external balances and since the beginning of 2012 the current account has been in the negative territory. Overall, net capital outflow continued in the first months of 2012, mostly due to the ongoing amortization of loans borrowed externally by commercial banks and very little, if any at all, new such borrowing. Consequently, gross foreign debt also continued to fall. At the same time, there have been no signs of an invigoration of FDI inflows.

The negative shocks experienced during the crisis have largely been transmitted to the labor market which acted as one of the main shock absorbers in the Bulgarian economy. With some lags, these negative effects continue to pass through and, given the failure of the economy to embark on a path of sustained recovery, net job destruction still prevails as a trend. Hence, unemployment was on the rise in the first months of 2012 although seasonal factors may reverse this in the summer months.

Another worrisome development has been the continuing deterioration in commercial banks' portfolios due to a persistent rise in substandard loans. Overall, credit activity remains very subdued and selective, both due to the uncertain economic prospects and the liquidity constraints that banks themselves are facing: with the drying up of external funding, savings in bank deposits have become the main source of new funds. Against this backdrop, the share of non-performing and restructured loans kept rising in the opening months of 2012 and reached 18.6% of total loans in April, up from 15.2% a year earlier and an average of 16.2% for 2011 as a whole.

Nevertheless, the banking system as a whole remains relatively stable thanks to its high degree of capitalization as required by local regulations which are considerably tougher than Basle-2 requirements. Thus, at the end of 2011, the average capital adequacy ratio of the commercial banking system in Bulgaria was 17.5% which allowed most banks facing

bad loans problems to provision heftily without suffering a serious burden. Anyway, 10 out of 31 commercial banks in Bulgaria reported a loss for 2011 as a whole.

Fiscal policy remains as one of the most controversial aspects of macroeconomic management in Bulgaria. In terms of its fiscal balance, Bulgaria can appear as one of the “star performers” in the EU as, with the exception of the years 2009-2010 it has not only been within the 3 per cent deficit range but actually had been reporting fiscal surpluses from 2004 to 2008. However, the rationale of Bulgaria’s fiscal policy has often been disputed. The two questions that have been posed most often are: 1) Whether the degree of fiscal austerity in Bulgaria was really justified? and 2) Whether the allocation of public spending within the targeted fiscal position was efficient?

The answers to both questions are not straightforward. While there were good reasons to maintain a fiscal surplus during the boom years (in line with the structural fiscal balance), the degrees of fiscal austerity during the crisis years are probably more difficult to justify, moreover given the very low level of public debt in the country. Targeted one-off policy measures during this period could probably have helped for a certain dampening of the negative external shocks. In this sense, the unduly tight fiscal stance has probably resulted in growth and employment sacrifices in this period.

What is even more debatable is the internal adjustment of public spending within the targeted overall balance. In the first place, fiscal policy in recent years has suffered from very low transparency. Thus the current government (in power since 2009) never declared its concrete policy priorities during its mandate (especially, during the crisis) and how these would translate into public spending. In addition, the government has throughout its term in office avoided unpopular large-scale fiscal measures and therefore major structural reforms have continuously been put on hold. By contrast, on several occasions, the government did retreat into populist moves under pressure from the streets. Thus de facto public spending – and spending cuts – have been a reflection of what the government could commit within a generally austere fiscal stance with least resistance from the public.

The fiscal policy stance implied by the 2012 budget and currently being executed by the government follows the same paradigm. The main victim of this political economy has been public investment financed from national sources which has suffered continuous subsequent cuts since 2009. A certain increase in the absorption of EU investment funds in 2010 and 2011 could not compensate for the cutbacks in local financing. In this sense, the government de facto abandoned one of the few instruments available at its disposal for

providing support to economic activity in the country, adding to the growth and employment sacrifices attributable to economic policy.

In the present circumstances, most factors point to continuing sluggishness in economic activity in the short run. Exports keep losing their momentum while there are no signs pointing towards a more proactive domestic policy stance. Investor sentiment remains subdued. The possible modest recovery in private consumption will hardly be sufficient to act as a visible growth driver. Adding to that the prevailing overall economic weakness in Europe, most likely Bulgaria's economy will be close to stagnation in 2012 taken as a whole. In the absence of more pro-active policy measures it is also difficult to expect a notable amelioration in the labor market situation.

This course of economic performance in an environment of persistent uncertainties in Europe also implies lower than earlier expected growth performance in 2012 and 2013. Under the currency board straightjacket, Bulgaria's economy – and its growth prospects – are largely a hostage of capital inflows and these are unlikely to materialize in the coming years. Therefore the most likely medium-term scenario is probably the switch to a rather moderate growth path.

Table BG

Bulgaria: Selected Economic Indicators

	2008	2009	2010	2011 ¹⁾	2011 1st quarter	2012	2012 Forecast	2013	2014
Population, th pers., average ²⁾	7623.4	7585.1	7534.3	7348.4	.	.	7330	7300	7270
Gross domestic product, BGN mn, nom.	69295	68322	70511	75265	15971	15705	77900	81400	85500
annual change in % (real)	6.2	-5.5	0.4	1.7	2.1	0.9	0.5	1.5	2.0
GDP/capita (EUR at exchange rate)	4600	4600	4800	5200	.	.	.	.	.
GDP/capita (EUR at PPP)	10900	10300	10700	11300	.	.	.	.	.
Consumption of households, BGN mn, nom.	45766	42942	43990	45386	9981	10725	.	.	.
annual change in % (real)	3.4	-7.6	0.0	-0.6	-3.1	2.0	2	2	2
Gross fixed capital form., BGN mn, nom.	23283	19724	16077	15743	3637	3093	.	.	.
annual change in % (real)	21.9	-17.6	-18.3	-9.7	-2.4	1.3	0	3	6
Gross industrial production ³⁾									
annual change in % (real)	0.6	-17.4	1.1	5.8	12.0	-2.6	-4	2	5
Gross agricultural production (EAA)									
annual change in % (real)	33.0	-1.6	-6.0	-2.1	.	.	.	.	.
Construction industry ⁴⁾									
annual change in % (real)	12.2	-14.4	-14.5	-12.9	-15.1	-1.6	.	.	.
Employed persons - LFS, th, average ⁵⁾	3360.7	3253.6	3052.8	2949.6	2904.4	2853.2	2920	2950	3000
annual change in %	3.3	-3.2	-6.2	-3.4	.	-1.8	-1.0	1.0	1.6
Unemployed persons - LFS, th, average ⁵⁾	199.7	238.0	348.0	372.3	402.0	421.4	.	.	.
Unemployment rate - LFS, in %, average ⁵⁾	5.6	6.8	10.2	11.2	12.2	12.9	12	11	9
Reg. unemployment rate, in %, end of period ²⁾	6.3	9.1	9.2	10.4	9.5	11.5	.	.	.
Average gross monthly wages, BGN	544.8	609.1	648.1	706.5	671.7	731.0	.	.	.
annual change in % (real, gross)	12.6	8.8	3.9	4.6	3.8	6.8	.	.	.
Consumer prices (HICP), % p.a.	12.0	2.5	3.0	3.4	4.5	1.9	3	3	3
Producer prices in industry, % p.a.	10.9	-6.5	8.6	9.4	13.2	3.9	.	.	.
General governm.budget, EU-def., % GDP									
Revenues	40.0	36.3	34.3	33.1	35.4	.	.	.	.
Expenditures	38.3	40.7	37.4	35.2	36.7	.	.	.	.
Net lending (+) / net borrowing (-)	1.7	-4.3	-3.1	-2.1	-1.3	.	-1.8	-1.5	-1.5
Public debt, EU-def., in % of GDP	13.7	14.6	16.3	16.3	15.5	.	18	18	19
Central bank policy rate, % p.a., end of period ⁶⁾	5.77	0.55	0.18	0.22	0.18	0.15	.	.	.
Current account, EUR mn	-8182	-3116	-375	362	-87	-346	-500	-1000	-1500
Current account in % of GDP	-23.1	-8.9	-1.0	0.9	-1.1	-4.3	-1.3	-2.4	-3.4
Exports of goods, BOP, EUR mn	15203	11699	15562	20228	4784	4626	19300	19800	21200
annual growth rate in %	12.5	-23.0	33.0	30.0	57.7	-3.3	-5	3	7
Imports of goods, BOP, EUR mn	23802	15874	18326	22202	4985	5429	22200	23200	25300
annual growth rate in %	14.7	-33.3	15.4	21.2	35.5	8.9	0	5	9
Exports of services, BOP, EUR mn	5355	4916	5164	5409	829	803	5400	5600	6000
annual growth rate in %	12.5	-8.2	5.0	4.7	15.1	-3.1	0	4	7
Imports of services, BOP, EUR mn	4045	3617	3148	3121	690	723	3150	3300	3600
annual growth rate in %	12.8	-10.6	-13.0	-0.9	-0.3	4.8	1	5	9
FDI inflow, EUR mn	6728	2438	1208	1341	-42	237	1000	1300	1500
FDI outflow, EUR mn	522	-68	174	137	44	21	.	.	.
Gross reserves of NB excl. gold, EUR mn	11928	11943	11612	11788	10918	11594	.	.	.
Gross external debt, EUR mn	37246	37816	37051	35385	36464	35274	.	.	.
Gross external debt in % of GDP	105.1	108.3	102.8	91.9	94.8	88.6	.	.	.
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	0.8355	0.8712	0.8729	0.9033	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary. - 2) From 2011 according to census February 2011. - 3) Enterprises with 10 and more employees. - 4) All enterprises in public sector, private enterprises with 5 and more employees. - 5) Quarterly data according to census February 2011. - 6) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board).

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