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Bulgaria: surging FDI keeps economy steadfast

Buoyant fixed investment drives GDP growth

GDP growth slowed down in the third quarter of last year but this was mostly due to an extremely bad harvest; performance in other sectors remained buoyant. Nevertheless, there are other indications of a possible future slowdown. In particular, there has been a notable deceleration in the growth of real retail sales. With private consumption slowing its pace, fixed investment (boosted by FDI) at present appears to be the key driver of aggregate growth.

After EU accession, the massive FDI inflows intensified and reached almost 20% of GDP in 2007. Nearly 60% of these inflows were channelled to the real estate market, including greenfield construction (up from some 35% in the previous two years). The red-hot Bulgarian real estate market topped the global charts in terms of the rise in housing prices in 2007. During the visit by President Putin in January 2008, Bulgaria finalized three big energy deals with Russia with long-term cross-border effects: the South Stream pipeline to transport Russian gas to Europe through Bulgaria; the construction of two nuclear reactors at Belene on the Danube river; and the Bourgas-Alexandroupolis oil pipeline to transport Russian oil to the Greek coast of the Aegean Sea.

Surging construction and fixed investment have been supported by an ongoing credit boom. In the past, the monetary authorities had made several attempts to cool down bank lending through administrative measures but these had to be lifted with Bulgaria's accession to the EU. In a renewed effort to restrain bank lending, the Bulgarian National Bank raised its mandatory reserve requirement from 8% to 12% in September 2007 but so far this intervention has not had the desired effect. In fact, credit to the non-government sector registered the fastest growth on record during 2007: the stock of outstanding claims grew by 62.5% year on year in December. Corporate lending grew faster than household credit (at rates of 70% and 52%, respectively), but household mortgage lending alone increased by some 75%.

One of the principal sources of the domestic credit boom has been external borrowing by Bulgarian commercial banks, most of which is subsequently channelled to domestic borrowers. So far the global financial turmoil has not affected the domestic credit market although borrowing from abroad softened somewhat in the last two months of 2007. There has been no deterioration in the quality of banks' portfolios so far either: at the end of November 2007, the share of substandard loans in the banking system as a whole amounted to 4.8% of all loans whereas the share of overdue credit was only 2%. However,

banks are not immune to the adverse effects of an eventual economic slowdown or a downturn in the local housing market.

The labour market is tight and wage pressures push up inflation

In 2007 as a whole, the number of employed persons rose by some 5% while the average rate of unemployment dropped by 2 percentage points, repeating the labour market dynamic of 2006. Importantly, this has been accompanied by increases in the activity rate, with the economically active population increasing by 4.5% in the period 2006-2007. The inflows from inactivity have been largely concentrated in the middle-aged cohorts. In Sofia city alone – which now accounts for a third of Bulgaria's population – the rate of registered unemployment in December was just 1.5%. Long-term unemployed (those without a job for more than a year) accounted for 56.6% of all unemployed. The share of older persons (aged 50 or more) accounted for 38.2% of all unemployed. In 2007, both these groups increased their shares in the total pool.

Labour shortages, in particular for skilled workers but also for some categories of unskilled labour, are becoming endemic and now affect virtually all sectors of economic activity. The situation is aggravated by the continuing leaks of skilled labour to higher-paid jobs abroad. Labour shortages are becoming important supply constraints in a number of sectors and may cause delays in the implementation of some big construction projects (such as highways, new power plants and other energy projects). A new policy measure to further stimulate job search was introduced in January, stipulating that those registered unemployed who systematically decline employment offers will be excluded from the social safety net. The government is also considering easing the restrictions on hiring migrant workers from abroad.

Consumer prices surged in 2007 (to 12.5% year on year in December) largely surpassing ex ante forecasts which stood at half that level. An important factor for the higher inflation, especially in the second half of the year, was the rise in food prices (by more than 20% year on year), reflecting poor harvests both in Bulgaria and internationally. The fast growth of wages in 2007 – due to pressures caused by the tightness of the labour market but also some populist moves by the government – was another pro-inflationary factor.

The outlook is still positive but downward revisions in forecasts are possible

The recent weakening of growth calls for a slight downward revision of earlier forecasts. Even if the causes of this slowdown are of a one-off nature (reflecting the dismal performance in agriculture), it now appears unlikely that GDP growth for 2007 as a whole will be above 6% as envisaged earlier. Moreover, it is likely that the slowdown might spill over to 2008. There are downside risks associated both with final demand and with some supply factors. One clearly visible trend is the slowdown in private consumption which was

an important (though not single) growth driver in the past few years. Another important risk is associated with the possible fallout of the global financial turmoil. An externally-triggered liquidity squeeze on the domestic credit market could have a negative effect on both fixed investment and consumption. There are also uncertainties regarding external demand. Losses in competitiveness – associated with the fact that wage growth outpaces productivity – may also curb the growth of exports. The supply constraints associated with the tight labour market are also becoming more and more visible. In view of all these factors it appears that the most recent official mid-term forecast (prepared before the publication of the third quarter GDP figures) which envisaged annual GDP growth in the range between 6.5% and 7% for the period 2008-2010 probably needs to be trimmed down somewhat.

Due to the slowdown in private consumption, the positive contribution of domestic absorption to GDP growth was on the decline during 2007, but so was also the negative contribution of net exports. In principle, this is a healthy trend as it suggests less reliance of growth on domestic demand. However, as noted, a future surge in exports is less than certain. In any case, if growth becomes more export-oriented, the current account deficit might drop somewhat in relative terms while its absolute size will still remain significant.

Fixed investment (by both domestic and foreign investors) is likely to continue to be buoyant, providing a solid support to GDP growth. In November 2007, when the surplus in the consolidated general government budget was approaching BGN 4 billion (more than 7% of annual GDP), the government hastily approved extra spending of some BGN 1.4 billion, most of which was earmarked for infrastructure projects, adding to the activity of private investors. Nevertheless, it is obvious that the extraordinarily high pace of fixed investment seen in 2007 is not sustainable in the medium term.

Labour demand is likely to remain high, contributing to a growing tightness in the labour market. Employment should continue to rise mostly thanks to new entrants to the labour market and re-entries from inactivity. At the same time, unemployment rates are likely to stay relatively high due to structural problems such as skill mismatches and low domestic labour mobility.

All indications are that inflation rates will remain high in 2008. As of January, the minimum wage was raised considerably (from BGN 180 to BGN 220 monthly) in an attempt to offset the negative effect of the newly introduced flat 10% personal income tax on the disposable income of low-wage earners (the non-taxable income threshold of BGN 200 was scrapped in the context of this reform). Apart from this, all public servants were compensated through wage increases for possible negative implications of this tax. In addition, wages in the public sector will rise by 10% in July, while pensions will go up 9.5%. Undoubtedly, all wages in the economy will adjust upward in response to these changes, adding further

pro-inflationary pressures. Some recent policy measures (such as the rise in excise taxes on cigarettes by 34% in January and the planned increase in regulated energy prices) will have a similar effect. One has also to take into account the carryover effects due to the inflationary surge in the second half of 2007. Thus, even if the government's rather optimistic forecast of 4% end-year inflation proves accurate (which is highly unlikely), the average annual inflation in 2008 will still be around 9% only due to carryover effects. A higher – but probably more realistic, in view of the factors outlined above – assumption of 8% end-year inflation would yield an average annual inflation above 11%.

The medium-term outlook for the Bulgarian economy remains generally positive. While downside risks have recently increased, overall they are not expected to have a major impact on growth performance. The political situation is relatively stable and the current three-party centre-left coalition is likely to complete its full term in office. Entry to the eurozone remains an important policy challenge, with high inflation being the main stumbling block. The authorities have at present set the target EMU entry date for 2011.

Table BG

Bulgaria: Selected economic indicators

	2002	2003	2004	2005	2006	2007 ¹⁾	2008	2009	2010
	Forecast								
Population, th pers., end of period	7,846	7,801	7,761	7,719	7,679	7,640	.	.	.
Gross domestic product, BGN mn, nom.	32,335	34,628	38,823	42,797	49,091	56,000	64,500	72,500	80,000
annual change in % (real)	4.5	5.0	6.6	6.2	6.1	6	5.5	6	6.2
GDP/capita (EUR at exchange rate)	2,101	2,263	2,551	2,827	3,260	3,740	.	.	.
GDP/capita (EUR at PPP - wiiw)	6,310	6,710	7,290	7,890	8,600	9,390	.	.	.
Gross industrial production									
annual change in % (real)	6.5	14.1	13.9	10.0	8.2	8.5	8	9	10
Gross agricultural production									
annual change in % (real)	5.3	-9.9	6.6	-6.0	-0.1	-21.9	.	.	.
Construction output total									
annual change in % (real)	2.7	5.6	35.2	31.8	4.5
Actual final consump. of househ., BGN mn, nom.	24,823	27,444	30,155	33,556	37,897	42,000	.	.	.
annual change in % (real)	3.4	6.3	5.3	5.5	7.1	5.8	5.5	5.8	6.0
Gross fixed capital form., BGN mn, nom.	5,909	6,694	7,969	10,347	12,878	15,700	.	.	.
annual change in % (real)	8.5	13.9	13.5	23.3	17.6	24.0	18	16	14
LFS - employed persons, th, avg.	2,740	2,835	2,923	2,980	3,110	3,270	3,420	.	.
annual change in %	1.5	3.5	3.1	2.0	4.4	5.1	4.6	.	.
Reg. employees in industry, th pers., avg.	666.8	689.5	695.8	693.0	694.3
annual change in %	1.3	3.4	0.9	-0.4	0.2	0.1	.	.	.
LFS - unemployed, th pers., average	592.4	448.7	399.7	334.2	305.7	245	220	.	.
LFS - unemployment rate in %, average	17.8	13.7	12.0	10.1	9.0	6.9	6.0	5.6	5.2
Reg. unemployment rate in %, end of period	16.3	13.5	12.2	10.7	9.1	6.9	6.2	.	.
Average gross monthly wages, BGN	257.6	273.3	292.4	323.7	354.6	415	480	.	.
annual change in % (real, gross)	1.5	3.7	0.8	5.4	2.1	7.9	5.1	.	.
Consumer prices, % p.a.	5.8	2.3	6.1	5.0	7.3	8.4	10	6	5
Producer prices in industry, % p.a.	1.2	4.9	6.0	6.9	9.2	8.6	7	.	.
General governm. budget, EU-def., % GDP ²⁾									
Revenues	39.6	40.3	42.0	41.6	40.3	39.7	.	.	.
Expenditures	39.7	40.3	39.7	39.6	37.1	36.7	.	.	.
Net lending (+) / net borrowing (-)	-0.1	0.0	2.3	2.0	3.2	3.0	.	.	.
Public debt, EU-def., in % of GDP ²⁾	53.6	45.9	37.9	29.2	22.8	20	18	.	.
Base rate of NB % p.a., end of period	3.4	2.9	2.4	2.1	3.3	4.7	.	.	.
Current account, EUR mn	-403	-972	-1,307	-2,622	-3,935	-6,175	-6,200	-6,300	-6,400
Current account in % of GDP	-2.4	-5.5	-6.6	-12.0	-15.7	-21.6	-18.8	-17.0	-15.6
Gross reserves of NB excl. gold, EUR mn	4,247	4,981	6,443	6,816	8,309	11,215	.	.	.
Gross external debt, EUR mn	10,769	10,641	12,658	15,090	20,111	26,248 ^{xii}	.	.	.
Gross external debt in % of GDP	65.1	60.1	63.8	69.0	80.1	91.8 ^{xii}	.	.	.
FDI inflow, EUR mn	980	1,851	2,736	3,103	4,364	5,687	5,200	5,000	5,000
FDI outflow, EUR mn	29	23	-166	249	137	188	.	.	.
Exports of goods, BOP, EUR mn	6,063	6,668	7,985	9,466	12,012	13,412	15,300	17,200	19,000
annual growth rate in %	6.1	10.0	19.7	18.6	26.9	11.7	14.1	12.4	10.5
Imports of goods, BOP, EUR mn	7,941	9,094	10,938	13,876	17,574	20,831	23,000	25,200	27,200
annual growth rate in %	6.0	14.5	20.3	26.9	26.7	18.5	10.4	9.6	7.9
Exports of services, BOP, EUR mn	2,455	2,729	3,262	3,564	4,143	4,529	4,900	5,300	5,700
annual growth rate in %	1.1	11.1	19.5	9.3	16.2	9.3	8.2	8.2	7.5
Imports of services, BOP, EUR mn	1,950	2,176	2,606	2,745	3,172	3,515	3,860	4,250	4,650
annual growth rate in %	-7.1	11.6	19.8	5.3	15.5	10.8	9.8	10.1	9.4
Average exchange rate BGN/USD	2.077	1.733	1.575	1.574	1.559	1.429	.	.	.
Average exchange rate BGN/EUR (ECU)	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956	1.956
Purchasing power parity BGN/USD	0.556	0.557	0.576	0.593	0.624	0.637	.	.	.
Purchasing power parity BGN/EUR	0.651	0.659	0.685	0.701	0.742	0.779	.	.	.

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics, Eurostat; wiiw forecasts.