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Bulgaria: a lasting upswing

The economic upswing in Bulgaria continued in the first quarter of 2005 with a healthy GDP growth of 6% over the same period of 2004. Economic activity remained buoyant across the board and even gained further momentum in sectors such as manufacturing, construction and market services. Both the robust domestic demand (in particular private consumption) and the strong export performance provided solid support to domestic economic activity; nevertheless the foreign trade deficit increased.

The export-led surge in the manufacturing industry continued in the first quarter, although there was a certain deceleration in the rates of industrial output growth as compared to the exceptionally fast rates seen in 2004. In current euro terms, merchandise exports grew by almost 21% year on year in the first quarter, but this was also below the 31% rate of change in the last quarter of 2004. Despite the modest slowdown, this growth pattern is expected to continue in the short run as new export-oriented production capacity is coming on stream.

Judging from labour force surveys, there was further improvement in the labour market both in terms of growing employment and a decreasing rate of unemployment. The temporary discontinuation of some public works programmes in January (they were re-initiated later) led to a one-off hike in the number of registered unemployed in the first quarter. However, this one-off effect will probably be phased out in the course of the year.

Consumer demand remained buoyant, with real retail sales increasing by nearly 13% year on year in the first quarter. Consumer spending was underpinned by a renewed surge in household credit: in April 2005 the stock of outstanding bank claims on households was 81% higher than a year earlier. This also remained a major point of contention between the authorities and the IMF, as the latter is concerned that the credit boom is fuelling the current account deficit. In 2004 the authorities undertook a series of measures seeking to check the growth of credit (including tightening of the banks' mandatory reserve requirements); however, these measures did not bring about the expected effect. In March 2005 the central bank introduced strict ceilings on the credit activity of commercial banks and further tightened the banks' capital adequacy regulations. There are some first signs that after these new measures the growth of commercial credit may be slowing down.

In January the government went ahead with the planned 25% increase in minimum wages despite strong objections from the IMF. Disputes continued for several months and in the end, during the March review of the two-year precautionary agreement, the IMF grudgingly accepted the unilateral decision of the Bulgarian government. In return, the government

agreed with the IMF's insistence to further tighten its fiscal stance and aim for a consolidated general budget surplus of BGN 415 million (1% of GDP) in 2005 (the budget bill adopted in late 2004 envisaged a deficit 0.5%). Obviously, this is a commitment that will have to be fully implemented by the next government that will take office after the June parliamentary elections. However, in view of the excellent fiscal outturn in the early months of 2005, this goal seems to be within easy reach: by end-April public finances were already in a healthy surplus of BGN 673 million, largely thanks to more efficient tax collection. As to the repercussions of the minimum wage hike, so far it has been relatively limited: the average salaries of the employed on labour contracts in the first quarter of 2005 increased by 8.8% year on year, compared to an average rate of growth of 6.4% in 2004 as a whole. So far there has been no discernible pro-inflationary impact either.

While the ongoing bargaining with the IMF continued to lay its fingerprint on the day-to-day policy agenda, the most visible, positive development in the international arena was the signing in April, together with Romania, of the Accession Treaty to the European Union, in accordance with which the two countries are set to become full EU members in January 2007. This is an unequivocal acknowledgement of Bulgaria's progress in market reforms and an undoubted success for the governments that implemented these reforms.

The continuing economic rebound in Bulgaria seems to reflect a virtuous cycle of strong growth and accelerating reforms in the run-up to full EU membership. A similar process could be observed in the Central European and the Baltic countries prior to their accession to the EU, but also now in Romania and, partly, in Croatia and Turkey. As evidenced by the experience of these countries (now including Bulgaria), the realistic prospect of EU accession, especially when it is accompanied by a definite timetable, can generate a powerful impetus to economic growth through its anchoring effect on the expectations of both investors and consumers. At the same time, it strengthens the government's incentives to push ahead with its commitments for market reforms, amplifying the positive effect on expectations. The resulting investment boom, in particular the surge in inward FDI, gives a solid boost to economic growth.

At present, however, there are a number of uncertainties, both internal and external, as to the sustainability of this benign scenario in Bulgaria, and in fact risks related to the actual timetable for the country's accession to the EU. On the external side, one should point out the new situation in the EU after the two negative popular votes (in France and the Netherlands) on the EU constitutional treaty. It is not yet clear what specific impact these two negative votes may have on the prospects and timing of Bulgaria's accession to the EU, but definitely they have increased the downside risks. In principle, since both Bulgaria and Romania are considered to be an inherent part of the ongoing round of EU enlargement (together with the ten countries that acceded in 2004), in the framework of established rules, there should be no formal impediments to the completion of this round as envisaged.

However, the change in sentiment within the EU may have negative implications for the speed of this process and the EU might be more stringent in scrutinizing the progress made by the two countries in their commitments to implement the required reforms. Moreover, the two Accession Treaties contain a safeguard clause that allows the EU Council, upon a recommendation from the EC, to postpone accession by one year in the case of serious delays in the implementation of the *acquis* in some important areas.

On the domestic side, the greatest risks are related to the possible outcomes of the June parliamentary elections and the capacity of the new government to finalize the pre-accession reform agenda. The main risk related to the political cycle would be an eventual inability of the new parliament to designate a government backed by strong parliamentary support. The absence of such support may be an important impediment for the completion of the remaining pre-accession reform agenda, which includes some rather politically sensitive areas. Thus, considerable delays seem to have been incurred in the envisaged overhaul of the judiciary system, which requires the adoption of a broad package of related legislation (within the domain of justice and home affairs).

These were supposed to be passed by the outgoing parliament but were put on hold due to the absence of a wider consensus (both political and among the judiciary itself) on the nature of the reforms, as well as due to internal infighting within the governing coalition. The new parliament will thus be faced with the formidable task to accelerate these reforms, which may be even more difficult in the absence of a strong governing parliamentary core. Similarly, there have been serious delays in the implementation of commitments related to agricultural reforms, largely due to a populist pre-election shift in the outgoing government's policy stance. Pushing these ahead will again require strong political backing. The latest reminder from the EC contains also remarks on reforms in the domains of company law, environment and some services.

Despite some political rhetoric, in particular regarding the future of nuclear power in Bulgaria, the risks of a possible deviation of a new government from the commitments made by previous ones seem to be minimal. According to the Accession Treaty (and following a series of previous protocols), Units 3 and 4 of the Kozloduy nuclear power plant are due to be closed in 2006, after closing Units 1 and 2 in 2003. This has been a hot potato in Bulgarian politics during the past decade, with all parties blaming each other for insufficiently protecting the national interest in the negotiations with the EU. During the pre-election campaign some political forces even called for re-opening the energy chapter in order to push for a delay in the deadline for closure. However, the negative results of the referenda in France and the Netherlands seem to have had a sobering effect on the political establishment and even the most vocal Kozloduy proponents have recently kept silence on this issue. Moreover, Bulgaria managed to negotiate a relatively generous direct financial assistance from the EU, amounting to EUR 210 million, for the closure of the four reactors.

Overall, it seems that the emergence of a strong government after the June election would be the key for the successful implementation of the pre-accession reform agenda. The stakes of EU accession are very high, including the crucial detail as to which political party will claim the credit for leading the country into the EU. In this sense, if the newly elected government, regardless of its political leaning, is confident in its strength, it may eventually give up on its own ideological bias for the more pragmatic goal of timely implementation of the *acquis*. Understandably, the opposite scenario entails much greater risks.

In any case, the expected change in government after the elections is unlikely to affect the short-term outlook for the Bulgarian economy, which remains generally positive. The curbing of bank lending may result in some moderation in the pace of aggregate output growth in the second half of the year but nevertheless GDP is expected to increase by more than 5% in 2005 as a whole, and the macroeconomic fundamentals are set to remain stable. Strong growth should support further improvements in the labour market. While the current account deficit is likely to remain high, its financing should not pose major problems, as the surge in FDI continues.

Table BG

Bulgaria: Selected Economic Indicators

	2000	2001	2002	2003	2004 ¹⁾	2004 1st quarter	2005	2005 forecast	2006 forecast
Population, th pers., end of period ²⁾	8149.5	7891.1	7845.8	7801.3	7761.0	.	.	.	.
Gross domestic product, BGN mn, nom.	26752.8	29709.2	32335.1	34546.6	38008.4	8003.7	8690.1	41500	45500
annual change in % (real)	5.4	4.1	4.9	4.5	5.6	4.5	6.0	5.5	5.3
GDP/capita (EUR at exchange rate)	1674	1920	2101	2258	2497	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5310	5820	6070	6340	6680	.	.	.	.
Gross industrial production									
annual change in % (real) ³⁾	8.3	1.5	6.5	14.1	18.3	14.8	11.1	10	8
Construction output total									
annual change in % (real)	8.0	15.0	2.7	5.6	12.9	.	.	.	.
Actual final consump. of househ., BGN mn, nom.	20687.8	23009.1	24822.9	26846.0	29136.4	6529.4	7276.2	.	.
annual change in % (real)	4.9	4.6	3.4	7.1	4.9	4.8	7.3	.	.
Gross fixed capital form., BGN mn, nom.	4206.0	5415.2	5908.5	6694.4	7957.3	1505.9	1762.6	.	.
annual change in % (real)	15.4	23.3	8.5	13.9	12.0	22.1	9.2	8	10
LFS - employed persons, th, avg.	2794.7	2698.8	2739.6	2834.8	2922.5	2783.8	2838.4	.	.
annual change in %	-2.8	-3.4	1.5	3.5	3.1	2.9	2.0	.	.
Reg. employees in industry, th pers., avg.	662.0	658.4	666.8	689.5	680.0	687.4	675.8	.	.
annual change in %	-8.4	-0.5	1.3	3.4	-1.4	1.0	-1.7	.	.
LFS - unemployed, th pers., average	566.8	663.9	592.4	448.7	399.7	428.8	362.3	350	330
LFS - unemployment rate in %, average	16.9	19.7	17.8	13.7	12.0	13.3	11.3	10.3	9.5
Reg. unemployment rate in %, end of period	17.9	17.3	16.3	13.5	12.2	13.7	12.7	11	10
Average gross monthly wages, BGN	224.5	240.0	257.6	273.3	299.0	281.0	308.0	.	.
annual change in % (real, gross)	1.3	-0.5	1.5	3.7	-1.9	0.0	5.5	.	.
Consumer prices, % p.a.	10.3	7.4	5.8	2.3	6.2	6.4	3.8	4	4
Producer prices in industry, % p.a.	17.5	3.8	1.2	4.9	5.9	1.8	6.2	.	.
General governm. budget, nat. def., % GDP									
Revenues	41.4	39.8	38.7	40.7	41.7	45.1	47.9	.	.
Expenditures	42.0	40.4	39.4	40.7	40.0	42.3	42.4	.	.
Deficit (-) / surplus (+), % GDP	-0.6	-0.6	-0.7	0.0	1.7	2.8	5.5	1	-0.5
Public debt in % of GDP ⁴⁾	73.6	66.2	53.2	46.2	38.8	44.8	32.5 ^{Feb}	33	28
Base rate of NB % p.a., end of period	4.7	4.7	3.4	2.9	2.4	2.6	1.9	.	.
Current account, EUR mn	-761.4	-1101.7	-925.5	-1630.2	-1447.1	-499.4	-704.4	-1600	-1500
Current account in % of GDP	-5.6	-7.3	-5.6	-9.2	-7.4	-12.2	-15.9	-7.5	-6.4
Gross reserves of NB excl. gold, EUR mn	3390.6	3734.0	4247.1	4981.0	6443.0	5038.1	6325.1	.	.
Gross external debt, EUR mn	11882.7	11934.9	10768.9	10638.7	12245.9	11452.1	12854.8	.	.
FDI inflow, EUR mn	1103.3	903.4	980.0	1850.5	2114.2	362.6	289.1	1600	1400
FDI outflow, EUR mn	3.5	10.8	28.9	23.3	-174.8	-8.3	-15.6	.	.
Exports of goods, BOP, EUR mn	5253.1	5714.2	6062.9	6668.2	7993.9	1719.2	2077.6	9300	10400
annual growth rate in %	40.7	8.8	6.1	10.0	19.9	5.1	20.8	16	12
Imports of goods, BOP, EUR mn	6533.0	7492.6	7754.7	8867.8	10711.8	2227.6	2729.2	12000	13200
annual growth rate in %	37.8	14.7	3.5	14.4	20.8	15.7	22.5	12	10
Exports of services, BOP, EUR mn	2366.2	2384.8	2478.9	2790.9	3361.8	494.1	537.9	3750	4150
annual growth rate in %	40.3	0.8	3.9	12.6	20.5	20.6	8.9	12	11
Imports of services, BOP, EUR mn	1818.6	1930.3	1992.9	2267.7	2638.3	522.4	613.6	2900	3200
annual growth rate in %	31.7	6.1	3.2	13.8	16.3	11.8	17.5	10	10
Average exchange rate BGN/USD	2.124	2.185	2.077	1.733	1.575	1.564	1.492	.	.
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	0.543	0.564	0.597	0.599	0.612	.	.	.	.
Purchasing power parity BGN/EUR	0.617	0.645	0.677	0.696	0.731	.	.	.	.

Notes: 1) Preliminary. - 2) From 2001 according to census March 2001. - 3) Different methodology for quarterly data. - 4) According to ESA'95, excessive deficit procedure.

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