*Anton Mihailov*

# Bulgaria:
## coping with multiple external shocks

The economic situation in Bulgaria has changed dramatically over the past several months owing to the combined effect of a series of external shocks. The problems caused by waning export demand and the dearth of external funds as a result of the global economic and financial crisis were compounded by the stoppage of gas supplies from Russia and, more recently, the blockade of the Greek border by protesting Greek farmers. Bulgaria's current economic prospects have deteriorated considerably – in stark contrast to the robust growth performance observed over the past six years.

On average GDP growth in 2008 still looks impressive, yet aggregate output performance dropped markedly in the fourth quarter. Output even declined in some sectors, especially in manufacturing. This mirrored the weakening of exports (also on the decline in year on year terms in the final months of 2008) associated with the global economic crisis, more specifically, the slump in European economic activity.

Another important factor contributing to the economic downturn has been the considerable tightening of credit, reflecting a worsening in both supply and demand conditions on the domestic credit market. On the one hand, the global credit crunch has put the brakes on borrowing by Bulgarian banks abroad, which hitherto had been the main source of the domestic credit boom. On the other hand, domestic banks have become much more cautious in their lending practices given the growing economic uncertainties. Although domestic credit has not been completely suppressed, the flow of new lending to the non-government sector in December 2008 was reduced to a fraction (less than 10%) of the flow recorded a year earlier. In view of these developments, the Bulgarian National Bank (BNB) has stepped in – as far as its limited powers permit – with some monetary relief, reversing its previously restrictive stance. As of 1 January 2009, BNB lowered its mandatory reserve ratio on funds borrowed abroad from 10% to 5%: a measure which is expected to provide the banks with extra liquidity of the order of BGN 1.5 billion (equivalent to some 3% of the banks' total claims on the non-government sector).

Two unanticipated external shocks in January only served to aggravate the economic situation. Bulgaria was totally unprepared for the stoppage of Russian gas supplies. Given the country's inadequate reserve capacity (reserves were only enough to meet a third of the country's daily gas requirements for a limited period of time), the authorities began rationing gas. Gas supplies were radically diverted from a number of manufacturing firms to heating plants as a matter of priority. According to tentative estimates, the cumulative negative effect of the gas crisis could amount to close on one percentage point of annual GDP growth. The gas crisis was followed by the Greek farmers blocking the border crossings to Greece: a manoeuvre which interrupted road traffic and commercial shipments in both directions for a prolonged period.

All these negative developments, albeit belatedly, have affected the labour market, which hitherto had enjoyed seven consecutive years of improvement. Firms already started announcing projected layoffs in November 2008: a process which has only intensified since that time. Although these developments are still to be reflected in current statistics, there is no doubt that the trend is towards further deterioration in the labour market. By contrast, the cooling down of the economy coupled with a considerable drop in energy prices has resulted in a notable easing of inflationary pressures: a trend which is likely to continue in 2009.

As far back as autumn 2008, the authorities were beginning to get alarmed about the negative economic trends. In principle, Bulgaria had some macro-economic buffers that they could use to dampen somewhat the effect of those shocks. Thus, at the end of September 2008, the official foreign exchange reserves amounted to some 41% of annual GDP (covering 180% of M0); the cash fiscal reserves (accumulated over the years from the budgetary surplus) stood at some 17% of annual GDP. In cash terms, the general government balance also showed a large surplus in 2008 (at the end of October, the surplus was estimated at 7.8% of annual GDP). The government subsequently initiated a series of short- and medium-term anti-crisis measures. At the very core of the programme was public investment in infrastructure, but it also included development investment targeting higher competitiveness of businesses and regions and investment in the reform of the social security and health care systems. One of the initiatives in support of the economy was the launching of a Development Bank (initially funded with BGN 500 million): a public fund designed to support SMEs via different financial instruments. Public investment in 2009 is planned at BGN 5.6 billion (over 8% of GDP), a significant increase in both absolute and relative terms (it was some 6.4% of GDP in 2008). It is envisaged that funding the anti-crisis measures will entail drawing down part of the government's fiscal reserves. The implementation of a large-scale programme of this kind will bear major fiscal implications, with a number of commitments having already been entered into in late 2008. Thus, while in cash terms the government still reported a positive general fiscal balance for 2008 (at some 3% of GDP), in ESA '95 terms, the 2008 balance will most likely have slipped into negative territory. Given the envisaged increase in public spending and the negative economic trends, the ESA '95 deficit is likely to increase in 2009.

With the current worsening of the external environment and a more pronounced deterioration in Bulgaria's economic performance, the risks associated with the country's most acute macro-economic problem, the current account deficit, have also increased. In 2008, this deficit dipped further in both absolute and relative terms, standing at more than 20% of GDP for a second consecutive year. While over the past few years a large share of the deficit has been covered by FDI, the growing external imbalance also mirrors an ongoing process of private borrowing abroad which has resulted in a sharp increase in foreign debt (it stood at over 110% of GDP at the end of 2008). Obviously, this process is unsustainable; one way or another, one can expect a current account adjustment in the near future.

Despite the planned massive intervention by the government, the outlook for the Bulgarian economy has taken a turn towards the negative; there are no signs of a possible upturn in the immediate future. Much will depend on a possible turnaround in the global economy – more particularly in the large EU economies, which form the core of Bulgaria's export market. The current trends indicate a significant deterioration in export performance in 2009, which, in turn, will translate into a notable downturn in manufacturing output. The trend towards Bulgarian banks reducing their foreign borrowing abroad is also likely to continue; the direction of net flows may actually change in 2009. Thus, in the domestic credit market we should see further tightening in the course of the coming year, with negative implications for both private consumption and investment. Should export demand recover somewhat and these negative trends be reversed in the second half of the year, the average rate of GDP growth may be around zero for 2009 as a whole. However, if deterioration continues in the second half of the year, the economy may plunge into open recession. A downturn in aggregate output would naturally be accompanied by deteriorating conditions in the labour market and rising unemployment.

Private domestic demand (both private consumption and private fixed investment) has been weakening since the second half of 2008; it will deepen further in 2009. The planned rise in public spending will not be sufficient to invigorate economic growth in the short run. Faltering domestic demand and the drop in prices of energy and other primary commodities are likely to cause an abrupt reversal in the domestic price dynamics. In fact, signs of such a reversal were already evident in the final months of 2008, in both the CPI dynamics (two consecutive months of negative price changes) and, more pronouncedly, the PPI dynamics (four months of falling prices resulting in a cumulative 10% drop in PPI). In year-on-year terms, 2009 may turn out to be a deflationary year in Bulgaria.

While price dynamics of this kind are associated with their own risks, they may also be instrumental in triggering the necessary current account adjustment. With a fixed nominal exchange rate, falling domestic prices bring about a depreciation of the real exchange rate; this could ultimately lead to a lowering of the trade and current account imbalances. In fact, this is, theoretically at least, one of the currency board's built-in 'automatic levers' intended to prop up macro-economic stability. This notwithstanding, the current account deficit in the foreseeable future is still expected to remain relatively high, funded by continuing FDI and remittances inflows.

Table BG

## Bulgaria: Selected Economic Indicators

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 1) | 2009 | 2010 Forecast | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| Population, th pers., average | 7823.6 | 7781.2 | 7739.9 | 7699.0 | 7659.8 | 7621.2 | . | . | . |
| Gross domestic product, BGN mn, nom. 2) | 34627.5 | 38822.6 | 42797.4 | 49361.0 | 56519.8 | 66096 | 67500 | 70000 | 74500 |
| annual change in % (real) 2) | 5.0 | 6.6 | 6.2 | 6.3 | 6.2 | 6 | 0 | 1 | 3 |
| GDP/capita (EUR at exchange rate) | 2300 | 2600 | 2800 | 3300 | 3800 | 4400 | . | . | . |
| GDP/capita (EUR at PPP) | 6700 | 7300 | 7800 | 8600 | 9300 | 10000 | . | . | . |
| Consumption of households, BGN mn, nom. 2) | 24182.6 | 26732.0 | 29841.5 | 34554.3 | 38826.5 | 51000 | . | . | . |
| annual change in % (real) 2) | 5.4 | 5.9 | 6.1 | 9.5 | 5.3 | 5 | 0 | 1 | 3 |
| Gross fixed capital form., BGN mn, nom. 2) | 6694.4 | 7969.4 | 10346.5 | 12805.2 | 16832.5 | 21807 | . | . | . |
| annual change in % (real) | 13.9 | 13.5 | 23.3 | 14.7 | 21.7 | 18.4 | -8 | 0 | 6 |
| Gross industrial production | | | | | | | | | |
| annual change in % (real) 3) | 13.8 | 17.3 | 6.7 | 5.9 | 9.2 | 0.8 | -6 | 0 | 4 |
| Gross agricultural production | | | | | | | | | |
| annual change in % (real) | -9.9 | 6.6 | -6.0 | -0.1 | -21.0 | 32.4 | . | . | . |
| Construction industry (build.& civil engin.) 4) | | | | | | | | | |
| annual change in % (real) | 5.3 | 35.2 | 31.8 | 13.5 | 20.0 | 11.9 | . | . | . |
| Employed persons - LFS, th, average | 2834.8 | 2922.5 | 2981.9 | 3110.0 | 3252.6 | 3360 | 3220 | . | . |
| annual change in % | 3.5 | 3.1 | 2.0 | 4.3 | 4.6 | 3.3 | -4.2 | . | . |
| Unemployed persons - LFS, th, average | 448.7 | 399.7 | 334.4 | 305.7 | 240.2 | 207 | 280 | . | . |
| Unemployment rate - LFS, in %, average | 13.7 | 12.0 | 10.1 | 9.0 | 6.9 | 5.8 | 8 | 9 | 8 |
| Reg. unemployment rate, in %, end of period | 13.5 | 12.2 | 10.7 | 9.1 | 6.9 | 6.3 | 8 | 9 | 8 |
| Average gross monthly wages, BGN | 273.3 | 292.4 | 323.7 | 360.3 | 431.2 | 524.5 | . | . | . |
| annual change in % (real, gross) | 3.7 | 0.8 | 5.4 | 3.7 | 10.4 | 8.3 | . | . | . |
| Consumer prices (HICP), % p.a. | 2.4 | 6.1 | 6.0 | 7.4 | 7.6 | 12.0 | 2 | 2 | 3 |
| Producer prices in industry, % p.a. 5) | 4.9 | 6.0 | 7.9 | 12.1 | 8.4 | 10.6 | -5 | . | . |
| General governm.budget, EU-def., % GDP 6) | | | | | | | | | |
| Revenues | 40.0 | 41.3 | 41.2 | 39.5 | 41.6 | 40.0 | . | . | . |
| Expenditures | 40.3 | 39.7 | 39.3 | 36.5 | 41.5 | 40.5 | . | . | . |
| Net lending (+) / net borrowing (-) | -0.3 | 1.6 | 1.9 | 3.0 | 0.1 | -0.5 | -2.0 | -2.0 | -1.0 |
| Public debt, EU-def., in % of GDP 6) | 45.9 | 37.9 | 29.2 | 22.7 | 18.2 | 15.3 | . | . | . |
| Base rate of NB % p.a., end of period 7) | 2.8 | 2.4 | 2.1 | 3.3 | 4.6 | 5.8 | . | . | . |
| Current account, EUR mn | -972.3 | -1306.9 | -2705.7 | -4501.0 | -6304.0 | -8278.4 | -4500 | -4200 | -3900 |
| Current account in % of GDP | -5.5 | -6.6 | -12.4 | -17.8 | -21.8 | -24.5 | -13.0 | -11.7 | -10.2 |
| Exports of goods, BOP, EUR mn | 6668.2 | 7984.9 | 9466.3 | 12012.0 | 13512.0 | 15272.8 | 12500 | 12500 | 13000 |
| annual growth rate in % | 10.0 | 19.7 | 18.6 | 26.9 | 12.5 | 13.0 | -18.2 | 0 | 4 |
| Imports of goods, BOP, EUR mn | 9093.8 | 10938.4 | 13876.1 | 17575.0 | 20815.0 | 24105.5 | 18500 | 18200 | 18500 |
| annual growth rate in % | 14.5 | 20.3 | 26.9 | 26.7 | 18.4 | 15.8 | -23.3 | -1.6 | 1.6 |
| Exports of services, BOP, EUR mn | 2728.7 | 3262.1 | 3564.1 | 4186.0 | 4625.0 | 5226.3 | 4500 | 4500 | 4700 |
| annual growth rate in % | 11.1 | 19.5 | 9.3 | 17.4 | 10.5 | 13.0 | -13.9 | 0 | 4.4 |
| Imports of services, BOP, EUR mn | 2176.0 | 2605.8 | 2745.2 | 3259.0 | 3510.0 | 4083.1 | 3300 | 3300 | 3400 |
| annual growth rate in % | 11.6 | 19.8 | 5.3 | 18.7 | 7.7 | 16.3 | -19.2 | 0 | 3 |
| FDI inflow, EUR mn | 1850.5 | 2735.9 | 3152.1 | 6006.0 | 6510.0 | 5430.2 | 3300 | 3000 | 3000 |
| FDI outflow, EUR mn | 23.3 | -165.6 | 249.1 | 138.0 | 201.0 | 460.8 | . | . | . |
| Gross reserves of NB excl. gold, EUR mn | 4981.3 | 6443.1 | 6813.9 | 8309.1 | 11215.9 | 11927.4 | . | . | . |
| Gross external debt, EUR mn | 10640.6 | 12658.5 | 15268.2 | 20369.9 | 28854.3 | 38000 | . | . | . |
| Gross external debt in % of GDP | 60.1 | 63.8 | 69.8 | 80.7 | 99.8 | 112.4 | . | . | . |
| Average exchange rate BGN/EUR | 1.949 | 1.953 | 1.956 | 1.956 | 1.956 | 1.956 | 1.956 | 1.956 | 1.956 |
| Purchasing power parity BGN/EUR | 0.659 | 0.685 | 0.715 | 0.743 | 0.791 | 0.869 | . | . | . |

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

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Enterprises with more than 10 employees. - 4) Enterprises with more than 5 employees. - 5) Until 2003 domestic output prices. - 6) According to ESA'95, excessive deficit procedure. - 7) 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.