

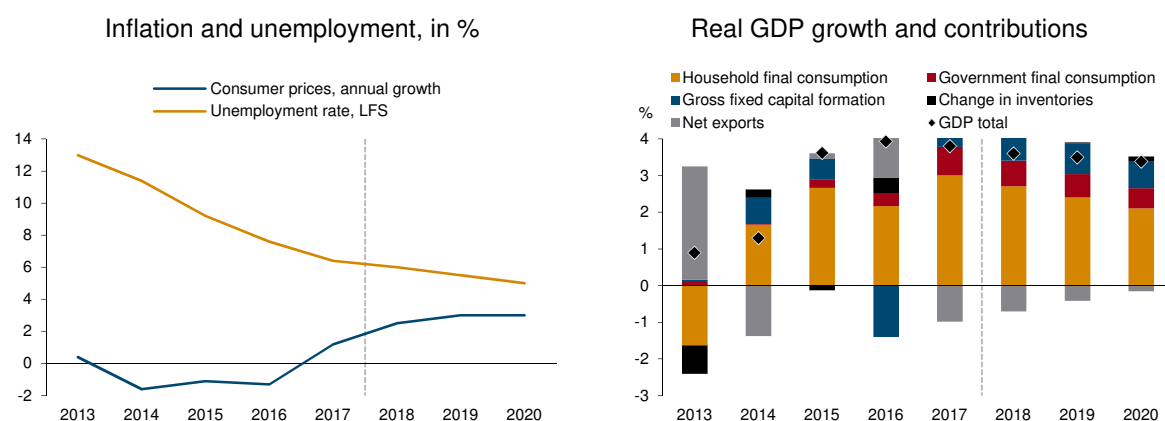


## BULGARIA: Growth continues but may be close to the limits

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In 2017, Bulgaria's GDP grew by close to 4%, similarly to the previous year. The pattern of growth switched from being export led in 2016 to being driven by domestic demand in 2017. Manufacturing, tourism and business services remained the main growth drivers. The rise in labour demand led to a labour shortage, which is turning into a constraint on growth. The Bulgarian economy is poised to preserve its momentum in the short run; however, it is unlikely that GDP growth will accelerate in the near future.

**Figure 43 / Bulgaria: Main macroeconomic indicators**



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**The Bulgarian economy has fully recovered from the prolonged slump that followed the global financial crisis**, with GDP growing by close to 4% in 2017, replicating the performance of the previous year. While the present GDP growth rates are below the highs recorded prior to the crisis, growth is much more balanced and is not accompanied by visible macroeconomic imbalances.

**Both private consumption and gross fixed capital formation rebounded strongly in 2017 and contributed positively to GDP growth.** Consequently, the pattern of growth changed: whereas in 2016 it was predominantly export driven, in 2017 the main growth impetus came from domestic demand. The pace of growth in private consumption in 2017 exceeded that of aggregated output and made a hefty contribution to GDP growth. The dynamics of fixed investment changed radically: while gross fixed capital formation plunged sharply (by 6.6% year on year) in 2016, mostly due to delays in the start of

public investment programmes co-funded by the EU, it rebounded by some 4% in 2017, when these programmes were gradually brought back on track. Although exports of goods and services also continued to grow strongly, they were outpaced by the growth of imports – which, in turn, reflected the surge in domestic demand. Overall this resulted in a negative contribution of net exports to GDP growth.

**On the supply side, economic expansion continued across the board**, but manufacturing, tourism and business services remained the main growth drivers, repeating the pattern of the last few years. Gross manufacturing output grew by 6.0% in 2017, 2 percentage points above the growth rate in 2016, supported by the upturn in EU import demand. Outsourcing services have become the most dynamic sector of the Bulgarian economy: 2017 was the seventh consecutive year with double-digit rates of growth for outsourcing output and exports. At present, this sector accounts for almost 4% of Bulgaria's GDP. The boom in the tourism industry also continued: while 2016 was regarded as an exceptional year (due to the diversion of Russian tourist flows from Turkey), the total number of tourists grew by a further 7% in 2017. Construction activity mirrored the pattern of fixed investment in the previous two years: construction output started to recover in 2017 after a dismal performance in 2016.

**Bulgaria's macroeconomic fundamentals are sound and stable, with a positive current account balance and balanced public finances.** The current account reported large surpluses in both 2016 and 2017, reflecting the surge in exports of services, but also a declining deficit in goods trade thanks to the sharp rebound in the exports of goods in these years.

**The fiscal outturn in 2017 was also better than expected, largely thanks to cyclical effects** that produced windfall revenue, and public finances ended the year with a large cash surplus. However, repeating fiscal practices in other similar cases, the government engaged in an extravagant spending spree in December, allocating some BGN 1.5 billion (1.5% of GDP) of the surplus revenue to spontaneous public spending unforeseen in the 2017 budget. Some of these extra spending items pursued obviously populist goals. This notwithstanding, public finances still ended the year with an estimated cash surplus of BGN 0.8 billion (0.8% of GDP).

**After three years of deflation (from 2014 to 2016), consumer price inflation turned positive in 2017, but remained low.** Under the currency board arrangement, and in the absence of large capital flows or domestic cost-push factors, Bulgaria to a large extent follows the price dynamics of its largest markets. This is what happened in the previous three years. But 2017 saw an end to this pattern, and one of the main factors was the changed situation in the labour market.

**The improving business expectations translated into a rise in labour demand and a tightening labour market**, as firms competed to hire workers from a shrinking pool of candidates. The rate of unemployment in 2017 fell to levels close to its historic lows, while the employment rate reached its highest level since the end of central planning. The number of employed persons grew by 4.4%, a pace of expansion not seen since 2007.

**The long period of negative or low inflation, coupled with the ongoing rise in labour demand, has allowed for a prolonged surge in real wages**, which grew by 40% between 2011 and 2017. This boosted consumer confidence and buoyed up spending not only on basic necessities, but also on consumer durables and housing. On the other hand, wage pressures and robust consumer demand were among the factors that produced the turnaround in the dynamics of inflation. Domestic producer prices also increased notably in 2017.

**However, the labour market is becoming increasingly tight, which creates supply bottlenecks, especially as regards skilled workers.** This is now becoming the main constraint on the future expansion of businesses: in January 2018, 40% of the firms surveyed reported that labour shortages were hampering the expansion of their business. In macroeconomic terms, this suggests certain limits to economic growth in the short run. At the same time, the average share of gross fixed capital formation in Bulgaria has been relatively low compared to other central and eastern European countries, which does not suggest that capital accumulation could become a key growth driver in the immediate future. FDI has also been moderate in recent years, and the accumulation of such investment does not suggest major new sources of growth originating in foreign capital. Moreover, even if there is a future surge in FDI (which does not seem likely), the economy will face difficulties in absorbing the extra, due to the shortages of skilled labour. A medium-term change to this pattern is probably only possible if there is a notable upturn in factor productivity, which could require an upgrade of production models and/or be associated with a surge in FDI.

**In 2017, there were no significant developments in the macroeconomic policy agenda;** in fact, the government was visibly absent from the economic arena. The budget for 2018 closely follows the structure of its predecessors, which implies no change in policy priorities. Given the ongoing cyclical upturn, it is not excluded that the fiscal year 2018 will also end with a cash surplus, providing the authorities with a free ride on the windfall. However, a persistent repeat of this pattern may lead to a systemic deterioration in the structural fiscal balance.

**The one important policy development at the beginning of 2018 was the assumption (from Estonia) of the rotating Presidency of the Council of the EU**, a role that Bulgaria is playing for the first time. While this is largely a technical function that places extra strain on the public administration, the Bulgarian authorities are seeking to present it to the local public as something more momentous. The government will obviously also seek to capitalise on this role in its relations with its Western Balkan neighbours. In fact, the deepening of economic and integrative ties between the EU and the Western Balkans has been widely publicised as Bulgaria's No.1 priority during the Presidency. However, the bulk of the Presidency agenda closely follows the European Commission work programme for the first half of 2018.

**At the beginning of 2018, the Bulgarian authorities announced that in the course of the year they would seek to negotiate with the European Central Bank an entry date to ERM-II.** Such a move had been widely expected, but the timing of its announcement was likely chosen to coincide with the start of the Presidency.

**Overall, the Bulgarian economy appears to be in relatively good shape.** The short-term prospects remain positive, with growth being predominantly driven by domestic demand. Both private consumption and fixed investment are expected to rise steadily, contributing positively to GDP growth. By contrast, imports may continue to outpace exports, and thus the contribution of net exports could remain negative.

**In the current circumstances, however, it is unlikely that GDP growth in Bulgaria will speed up in the near future,** as labour shortages are likely to get worse. Some signs of a deceleration of growth could actually be discerned in the final months of 2017. Thus, we envisage GDP growing by 3.6% in 2018 and possibly decelerating slightly more in 2019-2020.

**There are no obvious macroeconomic risks, and growth should remain balanced in the forecast period.** Inflation is expected to rise, but should remain in the low single-digit range. Unemployment will continue to fall, but given the situation in the labour market, a significant further rise in employment levels is unlikely.

**Table 13 / Bulgaria: Selected economic indicators**

	2013	2014	2015	2016	2017 <sup>1)</sup>	2018	2019	2020	
							Forecast		
Population, th pers., average	7,265	7,224	7,178	7,128	7,080	7,000	6,950	6,900	
Gross domestic product, BGN mn, nom.	82,166	83,634	88,571	94,130	99,080	105,200	112,100	119,400	
annual change in % (real)	0.9	1.3	3.6	3.9	3.8	3.6	3.5	3.4	
GDP/capita (EUR at PPP)	12,200	12,900	13,700	14,200	14,900	.	.	.	
Consumption of households, BGN mn, nom.	50,660	51,963	54,831	56,715	59,700	.	.	.	
annual change in % (real)	-2.5	2.7	4.3	3.5	5.0	4.5	4.0	3.5	
Gross fixed capital form., BGN mn, nom.	17,365	17,653	18,612	17,484	18,800	.	.	.	
annual change in % (real)	0.3	3.4	2.7	-6.6	4.0	4.5	4.5	4.0	
Gross industrial production <sup>2)</sup>									
annual change in % (real)	-0.2	1.8	2.9	2.6	3.5	4.0	4.0	3.5	
Gross agricultural production									
annual change in % (real)	14.2	-0.6	-8.2	1.7	-0.5	.	.	.	
Construction industry <sup>3)</sup>									
annual change in % (real)	-3.7	7.0	11.2	-16.8	4.5	.	.	.	
Employed persons, LFS, th, average	2,935	2,981	3,032	3,017	3,150	3,200	3,230	3,260	
annual change in %	0.0	1.6	1.7	-0.5	4.4	1.5	1.0	1.0	
Unemployed persons, LFS, th, average	436	385	305	247	207	200	190	170	
Unemployment rate, LFS, in %, average	13.0	11.4	9.2	7.6	6.2	6.0	5.5	5.0	
Reg. unemployment rate, in %, eop	11.8	10.7	10.0	8.0	7.1	.	.	.	
Average monthly gross wages, BGN	775.1	821.7	877.9	948.3	1,057.8	1,160	1,270	1,390	
annual change in % (real, gross)	5.1	7.5	7.0	8.9	9.3	7.0	6.5	6.0	
Consumer prices (HICP), % p.a.	0.4	-1.6	-1.1	-1.3	1.2	2.5	3.0	3.0	
Producer prices in industry, % p.a.	-1.5	-1.2	-1.9	-3.1	4.8	3.0	2.5	2.5	
General government budget, EU-def., % of GDP									
Revenues	37.2	36.6	39.1	34.9	36.5	36.0	36.0	36.0	
Expenditures	37.6	42.1	40.7	35.0	36.0	36.0	36.0	36.0	
Net lending (+) / net borrowing (-)	-0.4	-5.5	-1.6	0.0	0.5	0.0	0.0	0.0	
General gov.gross debt, EU def., % of GDP	17.0	27.0	26.0	29.0	26.5	25.5	24.0	22.0	
Stock of loans of non-fin.private sector, % p.a.	0.0	-8.2	-1.6	1.0	3.3	.	.	.	
Non-performing loans (NPL), in %, eop	16.9	16.7	20.4	18.3	14.8	.	.	.	
Central bank policy rate, % p.a., eop <sup>4)</sup>	0.02	0.02	0.01	0.00	0.00	0.0	0.0	0.0	
Current account, EUR mn	536	35	-17	2,561	2,050	1,300	1,000	800	
Current account in % of GDP	1.3	0.1	0.0	5.3	4.0	2.4	1.7	1.3	
Exports of goods, BOP, EUR mn	21,218	21,027	21,920	23,104	26,000	27,500	29,000	30,200	
annual change in %	7.8	-0.9	4.2	5.4	12.5	5.8	5.5	4.1	
Imports of goods, BOP, EUR mn	24,151	23,803	24,542	24,088	28,000	30,000	31,500	33,000	
annual change in %	2.0	-1.4	3.1	-1.8	16.2	7.1	5.0	4.8	
Exports of services, BOP, EUR mn	5,889	6,738	6,967	7,591	7,700	8,100	8,500	8,800	
annual change in %	1.2	14.4	3.4	8.9	1.4	5.2	4.9	3.5	
Imports of services, BOP, EUR mn	3,235	4,224	3,964	4,498	4,650	4,900	5,100	5,300	
annual change in %	0.2	30.6	-6.2	13.5	3.4	5.4	4.1	3.9	
FDI liabilities, EUR mn	1,509	1,539	2,430	1,042	850	.	.	.	
FDI assets, EUR mn	266	657	101	702	600	.	.	.	
Gross reserves of NB excl. gold, EUR mn <sup>5)</sup>	13,303	15,276	19,022	22,475	22,257	.	.	.	
Gross external debt, EUR mn <sup>5)</sup>	36,936	39,338	33,317	34,046	32,200	31,800	31,200	31,000	
Gross external debt, % of GDP <sup>5)</sup>	87.9	92.0	73.6	70.7	64.0	59.0	54.0	51.0	
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	

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

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