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## **Bulgaria: weathering the global turmoil**

In the first quarter of 2008, Bulgaria's economy performed better than earlier expected with GDP increasing by 7% year-on-year. On the supply side, both manufacturing and services contributed to this positive outcome, while agriculture has still not recovered from the slump experienced in the second half of 2007. Notably, there have been some important recent shifts in the composition of final demand. Since the second quarter of 2007, the growth contribution of net exports has been improving and in the first quarter of 2008, net exports made a positive contribution to quarterly GDP growth, which has happened for the first time since the third quarter of 2004. These shifts mostly resulted from improving export performance while both private consumption and fixed investment remained buoyant in this period.

### **Consumer boom continues**

The direct effects of the global financial crisis on Bulgaria's economic performance have so far been insignificant. The most visible negative consequence has been a deterioration in the external borrowing conditions for Bulgarian banks which, in turn, has been passed on to the domestic credit market. It is estimated that this has resulted in a rise in the cost of domestic borrowing by some 1-2 percentage points. Despite the rising borrowing costs, the credit boom in Bulgaria is far from over: in April, the stock of outstanding claims on the corporate sector was still growing at close to 60% year-on-year while the rate of growth of household credit was around 50%. There was no rise in the share of substandard and dubious loans. Financial leasing is also booming: the total amount of leasing companies' claims at the end of March 2008 increased by 85% compared to a year earlier.

During the first months of 2008, the pace of inflation remained high. In May, the 12-month rolling average rate of CPI growth reached 12.2%, up from 8.4% in December 2007. Both the government and independent analysts consider that the inflation rate will slow down in summer (in part, in view of the expected good harvest). Nevertheless, due to carryover effects, the average annual CPI figure for 2008 as a whole is likely to be much higher than previously envisaged. The main factors for the surge in inflation have been similar to those in other Central and East European countries (high food and energy prices, strong domestic demand, pro-inflationary pressures emanating from the tight labour market as well as ongoing price convergence at par with real convergence). However, some of these effects were more pronounced in Bulgaria as compared to other countries. Thus in April 2008, the annual increase in food prices in Bulgaria (25.4% year-on-year) was by far the highest in the EU.

In view of the currency board arrangement, policy has limited options in countering this inflationary surge. The fiscal response has been inconsistent and somewhat controversial. On the one hand, when drafting the 2009 budget, the government announced that it would continue to stick to its 3% surplus target in 2009 as well (which was a change from earlier intentions of a lower surplus). On the other hand, income policies have succumbed to populist pressures with several subsequent wage increases for different categories of public servants. The latest in this series was the tripartite agreement covering the healthcare sector signed in early June, which envisages doubling of the minimum wages in the sector and significant rises in other wage categories. The government also plans to raise average pensions by 10% in July 2008 and by a further 20% in October, while the draft budget for 2009 envisages increasing the economy-wide minimum wage by 9% to 240 BGN.

With persistently high labour demand, the labour market remains very tight. Employment in the first quarter of 2008 grew by more than 5% year-on-year (LFS data) partly thanks to increasing re-entries from inactivity. In an attempt to address the growing labour shortages, the authorities adopted a labour migration strategy for 2008-2015 seeking to attract workers from abroad based on a 'green card' system and bilateral agreements with other countries. The government is also considering dismantling the remnants of its active labour market policies and discontinuing subsidized employment as well as further reducing the maximum duration of the unemployment benefit.

### **Widening of current account deficits slowed down**

With exports outpacing imports, the pace of widening of the current account deficit slowed down somewhat in the first quarter but there are no indications of a possible major reversal in the short run. Private foreign debt also continued to rise and total external debt is likely to top 90% of GDP in 2008. Inward FDI was below expectations in the first months of 2008 but the factors behind this are not yet clear.

By contrast, fiscal outturns continued to outperform expectations: the consolidated budget surplus in the first four months of the year (BGN 2.70 billion) was more than double that in the same period of 2007. In this period, the government executed early repayment of some EUR 300 million of official external obligations (to the World Bank and the Japan Bank for International Cooperation) which resulted in further reduction in the level of public debt in both absolute and relative terms. While part of the current surplus is attributable to delays in some spending plans (in particular, for co-financing of EU-backed projects), the surplus for the year as a whole is likely to exceed the 3% budget target.

Following a series of political and corruption-related scandals, there was a major government reshuffle in April resulting in the replacement of the interior, defence, agriculture, and health ministers. A new deputy prime minister without portfolio was appointed, responsible for monitoring the implementation of EU-funded projects. Bulgaria still faces the threat of freezing of EU funds due to failure to deliver on its commitments to reform the justice system and combat corruption and organized crime. Nevertheless, the three-party coalition appears to be stable and likely to complete its term in office (the next parliamentary elections are due in mid-2009).

**Upbeat outlook despite external uncertainties**

The government remains upbeat about the economic outlook for 2009-2010 with official annual GDP growth forecasts in the range of 6.5% to 7.0%. However, given the lingering uncertainties in the external environment, these forecasts may be somewhat optimistic. Nevertheless, on balance, sound GDP growth is likely to continue in the next two years, driven by solid domestic demand and improving export performance. Fixed investment – a key driver of both GDP growth and of the current account deficit – is set to remain robust, boosted by massive FDI, public investment in infrastructure and vigorous private construction activity. On the supply side, labour shortages will pose some constraints on higher growth and will at the same time continue to feed inflationary pressures. Despite that, unemployment rates will remain relatively high due to persistent structural problems. Inflation is likely to remain high, at par with dynamic economic activity.

Table BG

**Bulgaria: Selected Economic Indicators**

	2004	2005	2006	2007 <sup>1)</sup>	2007 1st quarter	2008	2008	2009	2010
							Forecast		
Population, th pers., end of period	7761.0	7718.8	7679.3	7640.2	.	.	.	.	.
Gross domestic product, BGN mn, nom. <sup>2)</sup>	38822.6	42797.4	49361.0	56519.8	11287.5	13483.5	66500	76000	85000
annual change in % (real) <sup>2)</sup>	6.6	6.2	6.3	6.2	5.5	7.0	6	6	6.2
GDP/capita (EUR at exchange rate)	2551	2827	3278	3773	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	7290	7890	8640	9490	.	.	.	.	.
Gross industrial production									
annual change in % (real) <sup>3)</sup>	13.9	10.0	9.7	9.3	9.4	3.7	6	8	9
Gross agricultural production									
annual change in % (real)	6.6	-6.0	-0.1	-21.9	.	.	.	.	.
Construction output total									
annual change in % (real)	35.2	31.8	23.9	15.5	.	.	.	.	.
Actual final consump. of househ., BGN mn, nom.	30155.5	33556.4	38558.9	43152.3	9495.3	11389.7	.	.	.
annual change in % (real)	5.3	5.5	8.5	5.1	7.0	5.7	5	5.5	6.0
Gross fixed capital form., BGN mn, nom.	7969.4	10346.5	12805.2	16832.5	3196.0	4100.8	.	.	.
annual change in % (real)	13.5	23.3	14.7	21.7	35.9	15.5	15	14	14
LFS - employed persons, th, avg.	2922.5	2980.0	3110.0	3252.6	3135.4	3289.9	3420	.	.
annual change in %	3.1	2.0	4.4	4.6	6.6	4.9	5.1	.	.
Reg. employees in industry, th pers., avg.	695.8	693.0	711.6	710.0	705.3	712.6	.	.	.
annual change in %	0.9	-0.4	2.7	-0.2	0.7	1.0	.	.	.
LFS - unemployed, th pers., average	399.7	334.2	305.7	240.2	272.7	228.8	210	.	.
LFS - unemployment rate in %, average	12.0	10.1	9.0	6.9	8.0	6.5	6.0	5.6	5.2
Reg. unemployment rate in %, end of period	12.2	10.7	9.1	6.9	8.9	6.8	6.2	.	.
Average gross monthly wages, BGN	292.4	323.7	360.3	431.2	384.3	484.3	540	.	.
annual change in % (real, gross)	0.8	5.4	3.7	10.4	11.1	11.2	11.8	.	.
Consumer prices, % p.a.	6.1	5.0	7.3	8.4	5.2	13.3	12	8	5
Producer prices in industry, % p.a.	6.0	6.9	9.2	8.6	7.4	14.3	10	.	.
General governm. budget, EU-def., % GDP <sup>4)</sup>									
Revenues	41.2	41.0	39.4	41.2	.	.	.	.	.
Expenditures	39.7	39.2	36.4	37.8	.	.	.	.	.
Net lending (+) / net borrowing (-)	1.4	1.8	3.0	3.4	.	.	.	.	.
Public debt, EU-def., in % of GDP <sup>4)</sup>	37.9	29.2	22.7	18.2	.	.	15	.	.
Base rate of NB % p.a., end of period	2.4	2.1	3.3	4.6	3.5	4.8	.	.	.
Current account, EUR mn	-1306.9	-2705.7	-4490.5	-6219.9	-1574.0	-1670.8	-6800	-7200	-7200
Current account in % of GDP	-6.6	-12.4	-17.8	-21.5	-27.3	-24.2	-20.0	-18.5	-16.6
Gross reserves of NB excl. gold, EUR mn	6443.0	6815.7	8309.0	11215.5	8343.4	11355.5	.	.	.
Gross external debt, EUR mn	12658.5	15268.2	20369.9	28123.7	21048.2	29212.0	.	.	.
Gross external debt in % of GDP	63.8	69.8	80.7	97.3	.	.	.	.	.
FDI inflow, EUR mn	2735.9	3152.1	5961.0	6108.9	897.2	740.0	6000	6000	6000
FDI outflow, EUR mn	-165.6	249.1	136.8	190.8	-7.6	391.3	360	.	.
Exports of goods, BOP, EUR mn	7984.9	9466.3	12011.9	13473.6	2899.1	3643.3	16500	19000	21500
annual growth rate in %	19.7	18.6	26.9	12.2	8.5	25.7	22.5	15.2	13.2
Imports of goods, BOP, EUR mn	10938.4	13876.1	17574.1	20830.6	4474.1	5428.1	24500	27500	30000
annual growth rate in %	20.3	26.9	26.7	18.5	19.5	21.3	17.6	12.2	9.1
Exports of services, BOP, EUR mn	3262.1	3564.1	4186.4	4619.4	719.1	801.2	5100	5600	6100
annual growth rate in %	19.5	9.3	17.5	10.3	16.7	11.4	10.4	9.8	8.9
Imports of services, BOP, EUR mn	2605.8	2745.2	3259.6	3507.6	779.1	946.2	4000	4500	5000
annual growth rate in %	19.8	5.3	18.7	7.6	8.9	21.4	14.0	12.5	11.1
Average exchange rate BGN/USD	1.575	1.574	1.559	1.429	1.493	1.305	.	.	.
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	0.576	0.593	0.624	0.655	.	.	.	.	.
Purchasing power parity BGN/EUR	0.685	0.701	0.742	0.777	.	.	.	.	.

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

1) Preliminary. - 2) According to ESA'95 (FISIM adjusted and real change based on previous year prices). - 3) Quarterly data refer to enterprises with more than 10 employees. - 4) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; wiiw forecasts.