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## **Bulgaria: Will the export-led recovery be sustained?**

***GDP grew by 1.5% year on year in the first quarter of 2011 thanks to a continuing export boom. The unusually robust export performance contributed to a reversal in the current account balance; the latter turned positive in 2011. However, domestic demand has remained depressed, with both private consumption and fixed investment, in particular, shrinking still further in the first quarter. The outlook for 2011 and thereafter is moderately positive, yet uncertainties prevail with respect to the sustainability of the current export-led recovery.***

The extraordinary export boom that started in 2010 continued in the first months of the current year: in current euro terms, exports of goods (BOP definition) in the first quarter of 2011 were 56% higher than a year earlier and by 30% higher than in the first quarter of the pre-crisis 2008. The concomitant recovery in the manufacturing industry also strengthened considerably in the first quarter of 2011 with quarterly gross output some 14% higher than a year earlier.

An additional indication of the unusual strength of the export boom has been the reversal in the current account balance. The rolling 12-month current account balance turned positive in 2011 (something that had not been experienced since 1998) and this tendency will likely prevail in the course of 2011 and probably afterwards. This was a rather spectacular turnaround given the fact that the current account deficit was above 20% of GDP only three years earlier.

In terms of the direction of trade, exports grew substantially both to traditional EU partners (such as Germany, Greece, Belgium, Romania) and to non-EU countries (in particular, Turkey, Russia, China). Minerals and fuels still account for a large share of exports (partly reflecting higher prices in recent months) but there is also a continuing rise in the share of higher value added manufactured products in the total composition of trade.

While these figures are positive signs, the overall picture of Bulgaria's economic performance in the beginning of 2011 was not so rosy. In contrast to exports, domestic

demand has remained depressed with both private consumption and especially fixed investment shrinking further in the first quarter, after two consecutive years of sharp contraction. Thus real private consumption in the first quarter of 2011 was more than 10% down from the pre-crisis first quarter of 2008 and real gross fixed capital formation was almost 40% below its level of the years earlier. Accordingly, the construction sector has remained deeply depressed.

Against the backdrop of these contrasting developments, GDP in the first quarter grew by 1.5% from a year earlier, well below the 3.1% rate of growth recorded in the fourth quarter of 2010 yet much more than in the pre-year first quarter. Domestic demand as a whole made a significant negative contribution to GDP growth, reversing the situation from the previous quarter. The positive GDP growth in the first quarter was exclusively due to a large positive contribution of net exports which offset the negative impact of contracting domestic demand.

Poor domestic demand conditions are a reflection of several negative factors. At the macroeconomic level, economic policy during the past two years or so has been extremely hectic and unsupportive to economic activity, combining lack of clear policy direction with drastic cuts in public investment and ill conceived tax measures. The continuing reduction in public investment has been especially detrimental to economic activity: in the first quarter of 2011 total nominal budgetary spending on public investment was a mere 53% of the amount spent a year earlier (bearing in mind the retrenchment already effectuated in 2010!). This has undoubtedly added to the further contraction in gross fixed capital formation. In addition, the budget still has large overdue liabilities to the business sector. The process of piling up such liabilities started in the last months of 2009 when their amount snowballed to BGN 800 million. Although their absolute level has been declining in 2010, at the end of March 2011 they still amounted to BGN 432 million.

Second, financial flows in the economy by and large reversed their direction as compared to the situation before the crisis. While in that period commercial banks were systematically borrowing funds abroad and channelling these funds to the corporate and household sectors in the form of credit, at present banks are mostly borrowing from the household sector in the form of deposits and then channelling these funds abroad, paying back maturing liabilities and reducing their foreign exposures. In the context of a currency board arrangement (implying absence of monetary policy) the authorities have no policy instruments to address such reversals of financial flows. Consequently, banks' domestic credit activity remains fairly limited with aggregate net new credit for the economy as a whole close to zero in the first month of the year. The picture is similar in cross-border

inter-firm loans (reflected in the FDI statistics): recently there have been large repayments of old cross-border inter-firm loans. In some months in the beginning of 2011 this has even resulted in negative overall FDI inflows.

Such a reversal in macroeconomic financial flows has affected adversely liquidity in the corporate sector, with negative implication for both current economic activity and firms' investment. Another indication of this situation is the continuing surge in substandard and non-performing loans which reached the level of 19.3% at the end April, up from 13.7% a year earlier. At these levels, bad loans are already becoming a burden to the banking system; their further escalation may pose risks to its overall stability. Nevertheless, at present the banking system as a whole is generally perceived as stable, in particular, thanks to its strong capital base. Bulgarian banks do not have exposure to Greek debt and the main source of external risk can mainly be associated with potential contagion in the case of a possible escalation of the Greek crisis which could trigger massive withdrawal of funds by foreign creditors from emerging markets in general.

The picture is mixed also regarding other aspects of macroeconomic performance. After a seasonal upturn during the winter, inflationary pressures seem to be subsiding and are not likely to resurge in the short run in view of the weak domestic demand. As to unemployment, the two available measures point in the opposite direction: according to registration statistics, the unemployment rate has been on a downward trend since the start of the year whereas LFS statistics suggests an upsurge in the unemployment rate compared to the previous quarter. This discrepancy may well suggest a rise in those discouraged to maintain their status of registered unemployed.

Despite a relative improvement in the cash balance of the consolidated government in the first quarter of 2011 compared to the same period of the previous year, both tax revenues and the fiscal balance have been below current year targets. Compared to the previous year, there has been a moderate rise in revenue from VAT and excises and a decrease in public expenditure (the latter mostly due to the cuts in public investment). The cash deficit of the consolidated general government at the end of March stood at almost BGN 1 billion (1.4% of annual GDP) given that the government target for the year as a whole is BGN 2.2 billion. The government has been financing the deficit mostly by drawing deeper into the fiscal reserve: at the end of March, the reserve stock dropped by a further BGN 1.3 billion (almost 2% of annual GDP) from its level at the end of December 2010.

As the pace of output in recent months has been rather uneven, the sustainability of the current export-led recovery is still questionable. Importantly, there is no evidence yet of

improving consumer and, especially, investor confidence. The export boom was made possible thanks to higher rates of utilization of production capacities and/or new capacity put into operation in recent years. However, if business investment remains subdued, this would undermine the supply-side potential to maintain the pace of export growth even if external demand remains strong (which in itself is not guaranteed).

On balance, the unexpectedly strong export boom provides some room for a possible, though conditional, upgrade of Bulgaria's growth forecasts. Under the assumptions that exports would continue to grow strongly and that private consumption turns the corner in the course of the year, GDP for 2011 as a whole could grow by some 3%. The U-turn in the current account balance has already gathered sufficient momentum to suggest that it may well remain in positive territory for the year as a whole. By contrast, the labour market has been performing below expectations in the beginning of the year suggesting higher rates of unemployment than initially expected. There have been no major developments regarding the prices dynamics, with annual average inflation rates expected to remain moderate. If these trends are sustained in 2011, they could also provide room for a moderate upgrade of the growth forecasts in 2012 and 2013.

Future macroeconomic performance, however, hinges very much on how economic policy would respond to the current and forthcoming challenges. The past two years did not provide evidence of any countercyclical policy efforts, or efforts to support economic activity on the part of the government. The economy has now started to recover despite, rather than thanks to, the effects of the government policy stance. This situation adds further uncertainty as to the short-term outlook for the Bulgarian economy.

Table BG

## Bulgaria: Selected Economic Indicators

	2007	2008	2009	2010 <sup>1)</sup>	2010 1st quarter	2011	2011	2012	2013
							Forecast		
Population, th pers., average	7659.8	7623.4	7585.1	7534.3	.	.	7540	7520	7500
Gross domestic product, BGN mn, nom.	60184.6	69295.0	68321.6	70474.3	14319.3	15902.8	75500	81500	88000
annual change in % (real)	6.4	6.2	-5.5	0.2	-4.8	1.5	3	3.5	3.5
GDP/capita (EUR at exchange rate)	4000	4600	4600	4800	.	.	.	.	.
GDP/capita (EUR at PPP)	10100	10900	10400	10600	.	.	.	.	.
Consumption of households, BGN mn, nom.	41300.8	45765.7	42942.1	42844.4	9619.8	9980.6	.	.	.
annual change in % (real)	9.1	3.4	-7.6	-1.3	-5.8	-2.1	1	1.5	2
Gross fixed capital form., BGN mn, nom.	17263.9	23282.6	19724.3	16546.4	3170.2	3109.1	.	.	.
annual change in % (real)	11.8	21.9	-17.6	-16.5	-22.1	-12.4	-5	5	10
Gross industrial production <sup>2)</sup>									
annual change in % (real)	9.6	0.6	-17.4	1.1	-4.4	10.3	10	8	8
Gross agricultural production									
annual change in % (real)	-21.0	33.0	-1.6	-3.3	.	.	.	.	.
Construction industry <sup>3)</sup>									
annual change in % (real)	27.9	12.6	-14.5	-17.9	-26.1	-14.8	.	.	.
Employed persons - LFS, th, average	3252.6	3360.7	3253.6	3052.8	3011.3	2890.7	3000	3050	3100
annual change in %	4.6	3.3	-3.2	-6.2	-7.7	-4.0	-1.7	1.7	1.6
Unemployed persons - LFS, th, average	240.2	199.7	238.0	348.1	341.0	395.5	.	.	.
Unemployment rate - LFS, in %, average	6.9	5.6	6.8	10.2	10.2	12.0	11	10	9
Reg. unemployment rate, in %, end of period	6.9	6.3	9.1	9.2	10.1	9.5	.	.	.
Average gross monthly wages, BGN	430.6	524.5	591.8	642.0	619.0	671.0	.	.	.
annual change in % (real, gross)	10.4	8.4	9.8	5.9	9.0	6.1	.	.	.
Consumer prices (HICP), % p.a.	7.6	12.0	2.5	3.0	1.9	4.5	4	4	4
Producer prices in industry, % p.a.	7.7	10.9	-6.5	8.6	4.0	13.2	.	.	.
General governm.budget, EU-def. % GDP									
Revenues	40.8	39.3	36.0	34.5	38.2	.	.	.	.
Expenditures	39.7	37.6	40.7	37.7	45.0	.	.	.	.
Net lending (+) / net borrowing (-)	1.1	1.7	-4.7	-3.2	-6.8	.	-3	-2.5	-2
Public debt, EU-def., in % of GDP	17.2	13.7	14.6	16.2	14.9	14.7	17	18	19
Central bank policy rate, % p.a., end of period <sup>4)</sup>	4.6	5.8	0.6	0.2	0.2	0.2	.	.	.
Current account, EUR mn	-7756	-8162	-3117	-356	-554	253	1000	500	0
Current account in % of GDP	-25.2	-23.0	-8.9	-1.0	-7.6	3.1	2.6	1.2	0.0
Exports of goods, BOP, EUR mn	13512	15203	11699	15589	3058	4758	19000	21000	23000
annual growth rate in %	12.5	12.5	-23.0	33.3	15.0	55.6	22	11	10
Imports of goods, BOP, EUR mn	20758	23800	15874	18002	3625	4711	20500	23000	25500
annual growth rate in %	18.1	14.7	-33.3	13.4	-4.9	29.9	14	12	11
Exports of services, BOP, EUR mn	4760	5375	4918	5282	742	816	5800	6100	6400
annual growth rate in %	13.7	12.9	-8.5	7.4	-6.7	9.9	10	5	5
Imports of services, BOP, EUR mn	3586	4045	3617	3380	736	682	3400	3700	4000
annual growth rate in %	9.9	12.8	-10.6	-6.6	-12.3	-7.3	1	9	8
FDI inflow, EUR mn	9046	6729	2413	1639	53	-5	1500	1500	1800
FDI outflow, EUR mn	207	516	-86	180	29	22	.	.	.
Gross reserves of NB excl. gold, EUR mn	11216	11928	11943	11612	10083	9261	.	.	.
Gross external debt, EUR mn	29017	37157	37724	36679	37268	36099	.	.	.
Gross external debt in % of GDP	94.3	104.9	108.0	101.8	103.4	93.5	.	.	.
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.956	1.956	1.956
Purchasing power parity BGN/EUR	0.7838	0.8358	0.8686	0.8790	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2.

1) Preliminary. - 2) Enterprises with 10 and more employees. - 3) Private enterprises with 5 and more employees, all enterprises in public sector. -

4) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board).

Source: wiw Database incorporating Eurostat and national statistics. Forecasts by wiw.