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## **Bulgaria: economy in good shape despite recent slowdown**

As expected, the growth of aggregate output slowed down noticeably in the third quarter of 2005: the year-on-year rate of GDP growth fell to 4.6%, after the record high 6.4% seen in the second quarter. Several factors contributed to this outcome. The heavy summer floods caused serious economic damage to agriculture. Compared to the same period of 2004, value-added produced in agriculture in January-September was down by 5.5% and this was a major drag on aggregate output as a whole. There were disruptions in other sectors of economic activity as well (in particular, transport) with adverse effects for services as a whole. Exports also lost some steam in the third quarter resulting in a deceleration of the growth of manufacturing output. Still, thanks to the fast pace of economic expansion in the first half of the year, the rate of GDP growth for the period January-September still amounted to 5.6%.

Notwithstanding the difficulties, the main causes of the slowdown (those related to the floods) were of a one-off nature and are not expected to deepen further. Export activity has been picking up speed in the fourth quarter, raising hope of a new upturn in manufacturing. Damage repair construction works undertaken in the second half of the year and financed by extra public funding were also adding to the invigoration of aggregate output growth. Domestic demand (both private consumption and investment) remained buoyant throughout the year, thus providing a lasting impetus to economic activity.

The situation in the labour market continued to improve steadily. In the third quarter of 2005, the LFS rate of unemployment fell to single-digit levels (to 9.2%) for the first time since internationally comparable labour force surveys were initiated in 1997. Mirroring this, total employment kept on growing for the fourth consecutive year. At the same time, secondary effects of the rising energy prices caused an acceleration of both CPI and PPI in the second half of the year. Also the persistently high domestic demand probably contributed to the upturn in inflation.

The combination of robust domestic demand and slowing down (in the second and third quarters) exports contributed to an escalation of the current account deficit, despite all policy efforts to arrest its further widening. Although the series of credit restrictions introduced in 2004 and 2005 finally helped to put a certain brake on credit expansion (one of the factors underpinning the buoyant consumer and investment spending), this seems to have been partly offset by purchases financed by leasing and other forms of innovative financing. The high energy prices also added to the widening of the merchandise trade deficit. Anyway, despite its magnitude, the current account deficit does not seem to pose immediate threats to macroeconomic and financial stability.

While the fiscal policy stance remained restrictive in terms of the overall general government fiscal balance in 2005, total public spending overshot the budgetary provisions for the year thanks to better than projected fiscal revenue. The latter reflects an ongoing improvement in tax collection as a result of the strengthening of the tax administration and other institutional reforms. Part of the supplementary spending was allocated to finance damage repair, and another part for an early repayment of public debt. At the end of December 2005 and in early January 2006, the government retired some EUR 339 million of outstanding debt to the IMF and the World Bank, all of which was formally reported as 2005 spending.

The 2006 budget was formally adopted with a zero budget deficit. The IMF had been pressing for a much more restrictive budget (a fiscal surplus of 3%); however, the government strongly resisted this due to internal political pressures. Anyway, it appears that, in order to avoid a formal IMF reprimand, the authorities have informally committed themselves to end 2006 with a fiscal surplus similar to that in 2005. The legislative package of the 2006 budget included some important changes in taxation. Thus payroll taxes were reduced by a total of some 6 percentage points, a move aimed at lowering labour costs and thus stimulating investment. At the same time, the workers' own social security contributions were raised, though by a smaller margin. The most important excises (on gasoline, alcohol and tobacco) were also raised steeply, de facto absorbing most of the envisaged increases through 2008. This move seeks to reduce the inflationary pressures after 2007, when Bulgaria hopes to accede to both the EU and ERM II, and when it will strive to meet the Maastricht criteria of nominal convergence in preparation for entry to the euro zone (the current target date of EMU accession is 2009).

The 2005 monitoring report of the European Commission (published in October) was moderately critical of Bulgaria's progress towards accession. While noting that Bulgaria meets the main political criteria for membership and has a functioning market economy, the report pointed out that a number of shortcomings still exist. Among those explicitly mentioned are the problems in the justice system which reduce its efficiency in combating organized crime and corruption. The report also noted the need for further effort in integrating the Roma minority and in improving the environment for doing business. Nevertheless, the report also stated that despite the remaining hurdles, Bulgaria still has chances to accede to the EU in January 2007, provided that it accelerates its efforts in resolving the existing problems. The European Commission's final recommendation on the date of Bulgaria's accession is expected in March.

The outlook for the Bulgarian economy remains positive. Given the seasonal nature of the recent slowdown, it is expected that economic growth in 2006 will remain robust, with GDP increasing by more than 5%. The ongoing economic expansion will be beneficial for the labour market and the rate of unemployment should continue to fall. Average annual

inflation in 2006 will remain relatively high due to the repercussions of elevated energy prices and the recent excise hikes, which will push up administrative prices. The fiscal stance will remain moderately tight, with a likely small fiscal surplus in 2006. The adopted credit restrictions (the monetary authorities are now contemplating some further restrictive measures and controls on leasing activities) are expected to be fully in place which should help contain both the credit boom and the further widening of the current account deficit.

Table BG

## Bulgaria: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004	2005 <sup>1)</sup>	2006 forecast	2007 forecast
Population, th pers., end of period <sup>2)</sup>	8190.9	8149.5	7891.1	7845.8	7801.3	7761.0	7730	.	.
Gross domestic product, BGN mn, nom.	23790.4	26752.8	29709.2	32335.1	34546.6	38008.4	41800	46500	50800
annual change in % (real)	2.3	5.4	4.1	4.9	4.5	5.6	5.5	5.3	5
GDP/capita (EUR at exchange rate)	1481	1674	1920	2101	2258	2497	2760	.	.
GDP/capita (EUR at PPP - wiiw)	4900	5330	5840	6090	6470	6880	7490	.	.
Gross industrial production									
annual change in % (real)	-8.0	8.3	1.5	6.5	14.1	18.3	8	12	10
Gross agricultural production									
annual change in % (real)	2.7	-9.1	-0.1	4.2	-1.0	2.7	.	.	.
Construction output total									
annual change in % (real)	8.8	8.0	15.0	2.7	5.6	12.9	.	.	.
Actual final consump. of househ., BGN mn, nom.	18791.2	20687.8	23009.1	24822.9	26846.0	29136.4	.	.	.
annual change in % (real)	9.3	4.9	4.6	3.4	7.1	4.9	7.5	.	.
Gross fixed capital form., BGN mn, nom.	3600.5	4206.0	5415.2	5908.5	6694.4	7957.3	.	.	.
annual change in % (real)	20.8	15.4	23.3	8.5	13.9	12.0	16	14	12
LFS - employed persons, th, avg.	2875.3	2794.7	2698.8	2739.6	2834.8	2922.5	3000	3100	3200
annual change in %	-5.3	-2.8	-3.4	1.5	3.5	3.1	2.7	3	3
Reg. employees in industry, th pers., avg.	722.5	662.0	658.4	666.8	689.5	695.8	678.0 <sup>HX</sup>	.	.
annual change in %	-10.0	-8.4	-0.5	1.3	3.4	0.9	-1.4 <sup>HX</sup>	.	.
LFS - unemployed, th pers., average	534.0	566.8	663.9	592.4	448.7	399.7	330	300	270
LFS - unemployment rate in %, average	15.7	16.9	19.7	17.8	13.7	12.0	10	9	8
Reg. unemployment rate in %, end of period	16.0	17.9	17.3	16.3	13.5	12.2	10.7	9.5	8.5
Average gross monthly wages, BGN	201.0	224.5	240.0	257.6	273.3	292.4	320	.	.
annual change in % (real, gross)	6.9	1.3	-0.5	1.5	3.7	0.8	4.2	.	.
Consumer prices, % p.a.	2.6	10.3	7.4	5.8	2.3	6.1	5.0	6	4
Producer prices in industry, % p.a.	2.8	17.5	3.8	1.2	4.9	6.0	6.9	5	4
General governm. budget, nat. def., % GDP									
Revenues	40.7	41.4	39.8	38.7	40.7	41.7	43.0	.	.
Expenditures	40.5	42.0	40.4	39.4	40.7	40.0	40.7	.	.
Deficit (-) / surplus (+), % GDP	0.2	-0.6	-0.6	-0.7	0.0	1.7	2.4	1	0.5
Public debt in % of GDP <sup>3)</sup>	79.3	73.6	66.2	53.2	46.2	38.8	30.5	26	23
Base rate of NB % p.a., end of period	4.5	4.7	4.7	3.4	2.9	2.4	2.1	.	.
Current account, EUR mn	-586.9	-761.4	-1101.6	-925.5	-1630.2	-1648.2	-3000	-2800	-2500
Current account in % of GDP	-4.8	-5.6	-7.3	-5.6	-9.2	-8.5	-14.0	-11.8	-9.6
Gross reserves of NB excl. gold, EUR mn	2878.7	3390.6	3734.0	4247.1	4981.0	6443.0	6815.7	.	.
Gross external debt, EUR mn	10846.6	11882.7	11934.9	10768.9	10640.6	12522.1	13410.2 <sup>X</sup>	.	.
FDI inflow, EUR mn	866.0	1103.3	903.4	980.0	1850.5	2278.2	1600	2200	2000
FDI outflow, EUR mn	16.3	3.5	8.7	29.0	23.3	-168.3	250	.	.
Exports of goods, BOP, EUR mn	3733.7	5253.1	5714.2	6062.9	6668.2	7984.9	9500	10800	12300
annual growth rate in %	-0.4	40.7	8.8	6.1	10.0	19.7	19	14	14
Imports of goods, BOP, EUR mn	4741.4	6533.0	7492.6	7754.7	8867.8	10713.8	13600	15200	16700
annual growth rate in %	16.3	37.8	14.7	3.5	14.4	20.8	27	12	10
Exports of services, BOP, EUR mn	1686.2	2366.2	2384.8	2478.9	2790.9	3361.6	3600	4000	4400
annual growth rate in %	5.2	40.3	0.8	3.9	12.6	20.4	7	11	10
Imports of services, BOP, EUR mn	1380.6	1818.6	1930.3	1992.9	2267.7	2638.3	3000	3300	3600
annual growth rate in %	10.5	31.7	6.1	3.2	13.8	16.3	14	10	9
Average exchange rate BGN/USD	1.838	2.124	2.185	2.077	1.733	1.575	1.574	.	.
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	0.517	0.541	0.561	0.582	0.583	0.607	0.610	.	.
Purchasing power parity BGN/EUR	0.591	0.614	0.643	0.675	0.683	0.710	0.721	.	.

Notes: 1) Preliminary. - 2) From 2001 according to census March 2001. - 3) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; wiiw forecasts.