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Bulgaria: trying to rein in a growing external imbalance

The growth of aggregate output in Bulgaria picked up speed in the first quarter of 2004 boosted by an improving external environment and booming final domestic demand. In year-on-year terms, quarterly GDP rose by 5.3% and has been on an accelerating path since the fourth quarter of 2002. On the demand side, total final consumption grew at par with GDP (by 5.2% year-on-year) while fixed investment surged by an impressive 21.4%.

All indications are that the present economic upturn is broadly based. The export-led recovery in the manufacturing industry strengthened further, with virtually all industries benefiting from growing external demand. Gross industrial output grew by more than 16% year-on-year in the first quarter, the fifth consecutive quarter of double-digit rates of growth. The boom in the tourism industry also continues with tourism revenues in the first quarter by some 30% higher (in EUR terms) than a year before. There is also a rush in construction activity (especially in hotels and residential construction), driven by an expectation that the real estate prices will continue to rise in relative terms. In the first quarter of 2004, retail sales were up by 12.5% year-on-year, an evidence of the strong consumer demand for both food and non-food products. The strengthening of growth has had a positive effect on the labour market, contributing to rising employment and falling unemployment in the first months of the year. Inflation has been relatively low at the beginning of 2004, but this is likely to be reversed in the second half of the year due to the effect of the rising oil prices.

At the same time, there are growing fears that the current pattern of growth – accompanied by a widening external imbalance – is unsustainable, and this has become a major source of concern for Bulgarian policy makers. While the lasting surge in final domestic demand has provided support to domestic economic activity during the past couple of years, it has also been associated with an ever-growing current account deficit which reached 8.5% of GDP in 2003 and continued to expand in the first quarter of 2004 (boosted further by the rising oil prices).

One of the key factors behind the enduring strength in domestic demand has been a lasting credit boom which continues, at an accelerating pace, for the fourth consecutive year. In the first quarter of 2004, credit to the non-government sector was growing at a year-on-year rate of around 50% (the rate of growth of corporate credit was around 40% while household credit was growing at a rate of some 80%). On the one hand, the surge in credit is a sign of growing consumer and investor confidence and an indication of improving financial intermediation (which had come to a virtual halt in the aftermath of the 1996-97 financial crisis). Notably, despite the monetary expansion, monetization in Bulgaria (measured by both M1 and broad money) is still below its pre-crisis level. On the other hand, the rapid credit growth, by amplifying consumer and investment demand, has undoubtedly boosted imports, thus contributing to the widening of the current account deficit.

While the problem with the external balance is indeed partly associated with the accelerating monetary expansion, under the currency board arrangement the authorities have limited policy options to address it. Practically they have no instruments for direct monetary intervention that could cool down the rising money demand. Besides, with public finances close to balance, the government itself until now has not contributed much to the monetary expansion. Thus while the current situation may be calling for a policy reaction, the latter can only be constrained to some specific and non-conventional policy measures.

In April, the government announced, as part of a policy package drafted in the preparation of a new agreement with the IMF (expected to be rubber-stamped in July), a series of measures aiming to curb the growth of money demand. One of these quasi-monetary measures is the withdrawal of government funds (which are part of its fiscal reserve) deposited in commercial banks in order to reduce the level of liquidity in the banking system. Thus in the first half of May alone, the government withdrew funds amounting to BGN 300 million and it is estimated that in 2004 as a whole these withdrawals may reach up to BGN 750 million, which is about 8.5% of the total deposit base of the Bulgarian banking system. In addition, the central bank decided to broaden the definition of the deposit base on which it requires mandatory reserves from the commercial banks. Although formally the mandatory reserve ratio has not been raised, this measure in effect amounts to an increase in mandatory reserves and will hence curb money supply. There are early indications that the quasi-monetary measures undertaken in May did trigger a general rise in domestic interest rates. However, it remains to be seen what will be their longer-term effect, after the initial shock is channelled through the market.

Another measure agreed upon with the IMF was the decision to target a lower budget deficit in 2004 (0.4% of GDP, instead of the 0.7% incorporated in the official budget for the year). The IMF also strongly opposed plans to use funds from the fiscal reserve (which accumulates public funds that are not earmarked for immediate spending and that guarantee foreign debt payments) to finance additional public spending, including the recapitalization of some state-owned firms and the financing of public infrastructure projects. If these projects (which formally were not part of the official budget figures but were recorded ‘below the line’) had gone ahead, they would have pushed the actual 2004 deficit to 2.2%. Anyway, after the IMF intervention these projects have been put on hold. So the actual additional fiscal tightening effort undertaken by the government may be close to 2% of GDP. The government will also consider the possibility to use part of the fiscal reserve (which, thanks to the accumulation of privatization revenue, at the moment is around BGN 4.5 billion, while the minimum agreed upon with the IMF is BGN 2.5 billion) to reduce the foreign public debt, in particular to the IMF. One of the possible implications of these cost cutting measures is that Bulgaria will probably also put on hold the Eurobond issues planned for this year.

In these circumstances, two main factors are likely to affect economic performance in the short run. The notable effective tightening of macroeconomic policy will undoubtedly curb final domestic demand and hence may have a negative impact on economic activity. In addition, rising energy prices can also be expected to have a negative effect not only on the current account but – through rising costs – on the real economy as well. In view of this the government has revised downwards its forecast for GDP growth for 2004 as a whole (from 5.3% to 5.0%). Given the size of the expected fiscal tightening, the actual outcome for the year may be even lower.

Table BG

Bulgaria: Selected Economic Indicators

	1999	2000	2001	2002	2003 [1]	2003	2004	2004	2005
						1st quarter		forecast	
Population, th pers., end of period	8190.9	8149.5	7891.1	7845.8	7801.3	.	.	.	.
Gross domestic product, BGN mn, nom.	23790.4	26752.8	29709.2	32335.1	34410.2	7290.9	8055.5	38000	41000
annual change in % (real)	2.3	5.4	4.1	4.9	4.3	3.5	5.3	4.5	4
GDP/capita (EUR at exchange rate)	1481	1674	1920	2101	2249	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5120	5560	6080	6360	6830	.	.	.	.
Gross industrial production									
annual change in % (real)	-8.0	8.3	1.5	6.5	8.3	19.3	16.7	12	8
Construction output total									
annual change in % (real)	8.8	8.0	15.0	1.9	-17.2	.	.	.	.
Actual final consump.of househ., BGN mn, nom.	453.3	634.6	917.2	1151.4	1451.2	6042.4	6529.4	.	.
annual change in % (real)	-1.1	0.2	6.8	3.1	7.1	6.8	4.9	.	.
Gross fixed capital form., BGN mn, nom.	3600.5	4206.0	5415.2	5908.5	6733.1	1213.1	1505.9	.	.
annual change in % (real)	20.8	15.4	23.3	8.5	13.8	11.6	21.4	.	.
LFS - employed persons, th, avg.	2875.3	2794.7	2698.8	2739.6	2834.8	2704.3	2783.8	.	.
annual change in %	-5.3	-2.8	-3.4	1.5	3.5	2.1	2.9	.	.
Reg. employees in industry, th pers., avg.	722.5	662.0	658.4	666.8	664.2	671.4	673.9	.	.
annual change in %	-10.0	-8.4	-0.5	1.3	-0.4	3.5	0.4	.	.
LFS - unemployed persons, average	534.0	566.8	663.9	592.4	448.7	499.6	428.8	480	460
LFS - unemployment rate in %, average	15.7	16.9	19.7	17.8	13.7	15.6	13.3	13	12.5
Reg. unemployment rate in %, end of period	16.0	17.9	17.3	16.3	13.5	15.7	13.7	13	12.5
Average gross monthly wages, BGN	201.0	224.5	240.0	257.6	284.0	265.7	283.0	.	.
annual change in % (real, gross)	6.9	1.3	-0.5	1.5	7.8	3.1	0.1	.	.
Consumer prices, % p.a.	2.6	10.3	7.4	5.8	2.3	0.6	6.4	7	4
Producer prices in industry, % p.a.	2.8	17.5	3.8	1.2	4.9	7.9	1.8	.	.
General governm.budget, nat.def., % GDP									
Revenues	40.7	41.4	39.8	38.7	40.9	44.2	45.1	.	.
Expenditures	41.6	42.4	40.7	39.4	40.9	42.7	42.3	.	.
Deficit (-) / surplus (+), % GDP	-0.9	-1.0	-0.9	-0.7	0.0	1.5	2.8	.	.
Public debt in % of GDP	79.3	73.6	66.2	53.2	46.2	.	44.8	45	40
Base rate of NB % p.a., end of period	4.5	4.7	4.7	3.4	2.9	2.6	2.6	.	.
Current account, EUR mn	-586.9	-761.4	-1101.7	-925.5	-1498.5	-391.3	-481.4	-1500	-1600
Current account in % of GDP	-4.8	-5.6	-7.3	-5.6	-8.5	-10.5	-11.7	-7.7	-7.6
Gross reserves of NB excl. gold, EUR mn [2]	2878.7	3390.6	3734.0	4247.1	4981.0	4070.8	5038.1	.	.
Gross external debt, EUR mn [3]	10863.9	12038.5	12046.0	10768.6	10330.1	10574.7	10950.4	.	.
FDI inflow, EUR mn	775.0	1103.3	903.4	980.0	1253.9	260.0	294.1	1400	1200
FDI outflow, EUR mn	16.3	3.5	10.8	28.9	19.2	2.4	13.7	.	.
Exports of goods, BOP, EUR mn	3733.7	5253.1	5714.2	6062.9	6662.6	1633.1	1718.0	7000	7700
annual growth rate in %	-0.4	40.7	8.8	6.1	9.9	20.3	5.2	5	10
Imports of goods, BOP, EUR mn	4741.4	6533.0	7492.6	7754.7	8858.8	1924.7	2227.0	9500	10500
annual growth rate in %	16.3	37.8	14.7	3.5	14.2	17.3	15.7	7	10.5
Exports of services, BOP, EUR mn	1686.2	2366.2	2384.8	2478.9	2790.6	409.5	495.6	3000	3400
annual growth rate in %	5.2	40.3	0.8	3.9	12.6	2.3	21.0	7.5	13
Imports of services, BOP, EUR mn	1380.6	1818.6	1930.3	1992.9	2266.7	467.1	532.9	2500	2800
annual growth rate in %	10.5	31.7	6.1	3.2	13.7	13.0	14.1	10	12
Average exchange rate BGN/USD	1.838	2.124	2.185	2.077	1.733	1.822	1.564	1.7	.
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, wiiw	0.518	0.547	0.570	0.603	0.591	.	.	.	.
Purchasing power parity BGN/EUR, wiiw	0.566	0.590	0.618	0.646	0.644	.	.	.	.

Notes: 1) Preliminary. - 2) Converted from the national currency to EUR at the official exchange rate. - 3) Up to 2001 converted from USD to NCU, and from NCU to EUR at the official exchange rates.

Source: wiiw Database incorporating national statistics; wiiw forecasts.