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Bulgaria: accelerated restructuring is revitalizing the economy

Compared to other Central and Eastern European countries, the Bulgarian economy fared relatively well in 2003. Throughout the year the economy continued to grow at a steady pace: in January-September GDP increased by 4.2% year on year and a rate of some 4.5% is expected for the year as a whole. In 2003 manufacturing, for the first time since the start of economic transformation, became the most dynamic sector of the economy, making a major contribution to GDP growth. Growth in the services sector also remained solid while agriculture was badly affected by the severe and prolonged droughts and subtracted from the growth of aggregate output.

The main factor behind this relatively sound performance (against the background of a continuing economic weakness in Western Europe) is an ongoing process of economic restructuring. Its effect has been especially pronounced in manufacturing. The surge in investment (including FDI) after 1998 has resulted in the setting-up of numerous new (mostly small and medium-sized) production facilities and has contributed to the gradual upgrading and modernization of existing privatized firms. Most of the new manufacturing capacity is export-oriented and is often part of some form of international partnership; new types of international industrial cooperation such as outsourcing and subcontracting have supplemented the more traditional ones such as outward processing. In 2003 Bulgaria's gross industrial output rose by some 14% and manufacturing exports also registered a solid growth.

But the fruits of active restructuring are also evident in other sectors of the economy. There is an ongoing investment boom in the tourist industry, mostly along the Black Sea coast but also in the mountain ski resorts. The number of tourists in 2003 rose some 18% over the previous year, reaching more than 3.5 million persons. Tourism makes an important and growing contribution to the country's balance of payments: tourism revenues amounted to more than EUR 1 billion. Residential construction in large cities is also booming; an evidence of the growing demand for housing is the fact that in 2003 real estate prices jumped on average by some 20%. The retail trade sector has undergone a complete overhaul, mostly thanks to massive investment by several international supermarket chains.

The process of investment-led restructuring has been greatly facilitated by improved financial intermediation thanks to the renaissance in the banking system. With the sale in 2003 of Bank DSK (the former state savings bank) to the Hungary's OTP, the Bulgarian banking system has been fully privatized, with the overwhelming share of assets being held by foreign banks. The financial rehabilitation of the privatized banks, the improving

expectations of consumers and investors and the growing competition in the banking sector have given rise to a genuine boom in credit activity. Credit expansion accelerated sharply in 2003: during the year credit to the non-government sector grew on average by 47%, after increasing by 20% in 2002. The most dynamic segment of the credit market has been household credit, which rose by more than 75% in 2003. The resurgence in both consumer credit (facilitated by the rapid proliferation of credit cards) and mortgage loans gave an important boost to final consumer demand and residential construction. Easier access to credit has in general been an important support to fixed investment in the country which grew by close to 20% in 2003.

The continuing robust recovery has contributed to a notable improvement of the situation in the Bulgarian labour market. According to preliminary data, the total number of employed persons in the third quarter of 2003 was 4.6% higher than a year earlier while employment in industry grew by almost 2% during the same period. In turn, unemployment fell sharply in 2003 and the rate in December (13.5%) was almost 3 percentage points lower than that a year earlier. Apart from the growing labour demand in the business sector, active labour market policies (including public works) also contributed to this improvement.

During most of the year, inflation remained low and in October the CPI index pointed to a price increase of just 1.9% compared to December 2002. However, consumer prices rose fast in the last two months, bringing the year-on-year inflation rate to 5.6% in December. This acceleration was mostly due to increases in the prices of some basic foods (such as bread) related to the exceptionally poor grain harvest. In average annual terms, CPI inflation remained low at 2.4% but the effects of the latest price increases will be carried forward into 2004.

On the negative side, the most alarming development in 2003 has been the rapid (and quite unexpected) deterioration in the current account balance. The current account deficit has been widening and is expected to reach almost 9% of GDP for 2003 as a whole. The most important factor for the worsening of the external balance has been the unexpected surge in the demand for merchandise imports which outpaced the (rather high) growth of merchandise exports. Although the balance on the services account improved in 2003 (thanks to higher tourism revenues), this could not offset the rapidly expanding gap in the balance on goods trade. The credit expansion has also contributed to the widening of the current account deficit.

The widening current account deficit has been a source of concern for the authorities but they have fairly limited policy instruments to address this problem. The currency board arrangement precludes the conduct of an independent monetary policy. Besides, one specific feature of the present situation is that the deficit is rooted in the private, not in the public sector: in the past several years, public finances have been close to balance.

Hence, while further fiscal tightening could lead to some improvement in the current account balance, it is difficult to expect that fiscal measures alone could bring about its radical reversal. In fact, as part of the latest deal negotiated with the IMF, the Bulgarian government undertook to target a zero deficit in the consolidated general government fiscal balance in 2003 in return for the IMF agreement to a somewhat higher fiscal deficit in 2004. Another policy measure that is due to come into effect in 2004 is a change in the capital adequacy requirements of commercial banks which would mandate them to set aside larger provisions (and hence would put certain brakes on their credit expansion).

Nevertheless, while the current account deficit is indeed quite large, it probably does not entail very serious problems for the Bulgarian economy at present. The additional resources mobilized abroad seem to be directed mainly into productive activity. They provide additional support to the ongoing economic restructuring and will boost the future growth potential of the country. In addition, the deficit is closely associated with the acceleration of inward FDI: in the period January-November, the inflow of FDI covered almost 100% of the current account deficit in this period. Bulgaria has regained access to international financial markets and can raise additional funds from abroad to finance the deficit, if necessary.

In general, the prospects for 2004 remain positive. The government's official GDP growth target for the year is 5.3%; while this may be somewhat optimistic, most likely economic activity will remain buoyant. After the expiration in February 2004 of the current stand-by agreement with the IMF, the authorities intend to seek a new two-year agreement, but of a 'precautionary' type (in which funds will be allocated but in general will not be expected to be drawn). The government plans to maintain a relatively tight fiscal stance in 2004 (the budget deficit target for the year finally agreed upon with the IMF is 0.7%), despite the lowering of some taxes (as of January 2004, the basic corporate income tax has been lowered from 23.5% to 19.5% and the taxation of the lower ranges of personal income has also been reduced). It is envisaged that higher tax revenue from other sources such as excises and customs duties (partly thanks to further improvements in tax collection) will more than offset the reduced revenue from corporate and personal taxation. Average annual inflation will likely be somewhat higher than in 2003: apart from the carry-over effects of the recent price increases, some regulated prices (fuels, cigarettes) were also raised in January, in line with the gradual harmonization of excise duties with the EU.

Table BG

Bulgaria: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002	2003 ¹⁾	2004 forecast	2005 forecast
Population, th pers., end of period	8283.2	8230.4	8190.9	8149.5	7891.1	7845.8	.	.	.
Gross domestic product, BGN mn, nom.	17432.6	22421.1	23790.4	26752.8	29709.2	32323.7	35000	38400	41000
annual change in % (real)	-5.6	4.0	2.3	5.4	4.1	4.8	4.5	4.5	4
GDP/capita (EUR at exchange rate)	1106	1377	1481	1674	1920	2100	2290	.	.
GDP/capita (EUR at PPP -wiw)	4570	4860	5120	5550	6080	6360	6900	.	.
Gross industrial production									
annual change in % (real)	-5.4	-7.9	-8.0	8.2	1.6	0.6	14	10	8
Gross agricultural production									
annual change in % (real)	13.7	-1.5	2.7	-9.4	-0.1	4.1	.	.	.
Goods transport, public, mn t-kms ²⁾	92021	84308	88538	88136	81937	76377	.	.	.
annual change in % ²⁾	15.2	-8.4	5.0	.	-7.0	-6.8	.	.	.
Gross fixed capital form., BGN mn, nom.	1913.5	2919.8	3600.5	4206.0	5415.2	5858.9	.	.	.
annual change in % (real)	-20.9	35.2	20.8	15.4	23.3	9.3	18	.	.
Construction output total									
annual change in % (real)	-4.4	-0.2	8.0	8.1	12.8	-22.3	.	.	.
Dwellings completed, units	7452.0	4942.0	9824.0	8795.0	5937.0	6153.0	.	.	.
annual change in %	-8.0	-33.7	98.8	-10.5	-32.5	3.6	.	.	.
Employment total, th pers., average	3157.4	3152.6	3087.8	2980.1	2968.1	2992.2	.	.	.
annual change in %	-3.9	-0.2	-2.1	-3.5	-0.4	0.8	.	.	.
Employees in industry, th pers., average	838.7	802.5	722.5	662.0	658.4	649.1	.	.	.
annual change in %	-2.7	-4.3	-10.0	-8.4	-0.5	-1.4	.	.	.
Reg. unemployed, th pers, end of period	523.5	465.2	610.6	682.8	662.3	602.5	500.7	480	460
Reg. unemployment rate in %, end of period	13.7	12.2	16.0	17.9	17.3	16.3	13.5	13	12.5
LFS - unemployment rate in %, average	14.4	14.1	15.7	16.9	19.7	17.8	14.5	14	13
Average gross monthly wages, BGN	127.9	183.3	201.0	224.5	240.0	272.0	282	.	.
annual change in % (real, gross)	-16.6	20.7	6.9	1.3	-0.5	7.1	1.2	.	.
Retail trade turnover, BGN mn	5469.3	7214.2	8023.3	9725.9	10867.8	11642.0	.	.	.
annual change in % (real)	-34.8	18.6	12.3	12.7	4.8	1.6	.	.	.
Consumer prices, % p.a.	1058.4	18.7	2.6	10.3	7.4	5.8	2.4	5	3
Producer prices in industry, % p.a.	971.1	18.7	2.8	17.5	3.8	1.2	3.7	.	.
Central government budget, BGNmn									
Revenues	3143.5	4449.5	5199.3	6120.9	6525.3	7289.4	8441.6	.	.
Expenditures	3769.7	4156.0	4736.8	6304.8	7189.5	7286.0	8552.2	.	.
Deficit (-) / surplus (+)	-626.3	293.6	462.5	-183.8	-664.2	3.4	-110.6	.	.
Deficit (-) / surplus (+), % of GDP	-3.6	1.3	1.9	-0.7	-2.2	0.0	-0.3	.	.
Money supply, BGN mn, end of period ³⁾									
M1, Money	2433.1	2960.7	3305.2	3976.0	4883.2	5542.3	6801.0	.	.
Broad money	5947.5	6646.7	7535.6	9856.6	12421.5	13966.8	16822.2	.	.
Base rate of NB % p.a., end of period	6.8	5.2	4.5	4.7	4.7	3.4	2.9	.	.
Current account, EUR mn	925.2	-28.5	-586.9	-761.4	-928.4	-812.4	-1600	-1400	-1300
Current account in % of GDP	10.1	-0.3	-4.8	-5.6	-6.1	-4.9	-8.9	-7.1	-6.2
Gross reserves of NB excl. gold, EUR mn ⁴⁾	1899.4	2290.9	2878.7	3390.6	3734.0	4247.1	4981.0	.	.
Gross external debt, EUR mn ⁵⁾	9362.9	9295.0	10863.9	12038.5	12046.0	10750.0	10600	.	.
Exports total, fob, EUR mn ⁴⁾⁶⁾	4368.3	3841.2	3733.8	5253.1	5714.2	6062.8	6600	7100	7500
annual change in %	12.0	-12.1	-0.4	40.7	8.8	6.1	9	8	6
Imports total, cif, EUR mn ⁴⁾⁶⁾	4361.4	4475.8	5139.9	7084.9	8127.8	8411.2	9500	10000	10500
annual change in %	7.8	2.6	16.4	37.8	14.7	3.5	13	6	5
Average exchange rate BGN/USD	1.677	1.760	1.838	2.124	2.185	2.077	1.733	1.7	.
Average exchange rate BGN/EUR (ECU)	1.896	1.972	1.956	1.956	1.956	1.956	1.956	1.956	1.956
Purchasing power parity BGN/USD, wiw	0.414	0.507	0.518	0.547	0.570	0.602	0.597	.	.
Purchasing power parity BGN/EUR, wiw	0.459	0.559	0.566	0.590	0.618	0.646	0.651	.	.

Notes: 1) Preliminary. - 2) From 2000 new methodology. - 3) According to International Accounting Standards. - 4) Converted from the national currency to EUR at the official exchange rate. - 5) Up to 2001 converted from USD to NCU, and from NCU to EUR at the official exchange rates. - 6) From 1999 new methodology.

Source: wiw Database incorporating national statistics; wiw forecasts.