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Bulgaria: entering the EU in high gear

Bulgaria's entry into the EU coincided with the tenth anniversary of the peak of a severe economic and financial crisis, and the contrasts could not have been starker. In the winter of 1996/97 the economy was in shatters: ruined public finances, a disintegrating banking system, failing currency and hyperinflation. At the moment of Bulgaria's entry into the EU, its economy is in excellent shape after nine years of uninterrupted and recently accelerating growth (GDP grew by more than 50% between 1998 and 2006). Indeed, Bulgaria is turning into a success story, hardly imaginable ten years ago, but achieved at the price of particularly painful transformation reforms.

In recent years Bulgaria experienced a pre-accession boom, similarly to other EU entrants in the past. In 2006, the pace of economic expansion picked up further, the rate of GDP growth reaching its highest level in more than two decades. Also in 2006, Bulgaria's GDP finally surpassed its 1988 level, the highest pre-transition benchmark. Given that the country's population in this period shrank by more than 1 million people, the level of GDP per capita is now already considerably higher than it was at the end of the 1980s.

Economic growth in 2006 was underpinned by an export-led surge in manufacturing. Actually, value-added produced in industry grew even faster than gross industrial production (the corresponding year-on-year rates for the first three quarters of 2006 were 9.8% and 6.7%, respectively), the increasing value-added content likely suggesting quality upgrading of products. Another positive development has been the lasting surge in manufacturing productivity, which during the past several years outpaced by a large margin the growth in real wages. The implied decline in real unit labour costs suggests a significant improvement in international competitiveness. Therefore it is not surprising that the FDI-led revival in Bulgaria's manufacturing in recent years (real gross manufacturing output doubled between 2000 and 2006) has been matched by a strong surge in exports and increased openness of the economy. The value of total merchandise exports (in current euro terms) in 2006 was twice as large as that in 2002; during the same four-year period, the share of exports in GDP increased from 36.7% to 48.9%.

Robust domestic demand has been an important pillar of Bulgaria's economic revival and continued to provide strong support to economic activity in 2006. Real private consumption and fixed investment grew at similar rates to those recorded in 2005 despite a considerable slowdown in the pace of credit expansion in most recent months. The buoyant domestic demand added further steam also to merchandise imports, which grew (in euro value terms) by 25% in 2006, reaching some 70% of GDP.

The situation in the labour market continued to improve and in 2006 the unemployment rate fell to single digits, comparable to the EU average rate. The rise in total employment during the past several years exceeded the reduction in the number of unemployed, suggesting an increasing economy-wide activity rate, thanks to new entrants to the labour market and comebacks from inactivity of previously discouraged people. There are growing shortages of high-skilled labour as well as of certain specific skill categories (in particular construction workers and operatives in the tourist industry). At the same time, the pool of unemployed remains relatively large, comprising mostly persons with low or inadequate skills. The mounting labour market tensions are already exerting upward pressures on wages. Nevertheless, so far there are no wage-related concerns regarding competitiveness, given the rapid growth in productivity.

In terms of the actual outturn, the fiscal stance remained rather tight in 2006, partly under the continuing pressure by the IMF (the precautionary agreement was extended to March 2007) but also due to positive developments that are not easy to envisage *ex ante*. Thus in recent years (2006 included), the actual fiscal revenue has persistently exceeded the *ex ante* projections, despite concomitant reductions in the statutory tax burden, largely due to ongoing continuous improvements in tax collection. While there is probably little room left for further improvements in the efficiency of tax collection, such 'windfall fiscal gains' have allowed the government to retire large amounts of public debt prior to its maturity. Upon EU accession, there will be a major changeover in the administration of VAT (possibly with negative implications on collection): most of it was until now collected by the customs offices, which will no longer perform this function with respect to intra-EU imports.

The large current account deficit appears as one of the few adverse features that taint this seemingly rosy picture. So far the Bulgarian authorities (and, for that matter, their advisors from the IMF) have not been able – despite numerous attempts – to come up with effective policy instruments to arrest its widening; it is not clear whether such measures can at all be conceived, given Bulgaria's macroeconomic policy framework. Actually, so far there have not been any visible negative macroeconomic implications of this deficit (moreover, in 2006 it was fully matched by inward FDI), apart from the accumulated private foreign debt, which amounted to slightly over 50% of GDP at the end of 2006. Perhaps the main focus of future public policies in this area should be on prudential measures related to the prevention of excessive and unjustifiable risks associated with such borrowing.

Bulgaria has all the potential to remain on a fast-track catch-up path, provided that politicians avoid the traps of policy complacency. This is probably the greatest risk for Bulgaria's policy makers after the EU entry, when they may be tempted to see their long-term mission as accomplished, and when they will no longer be under the scrutiny of the IMF's watchful eye. As clearly seen by the experience of some of the new EU members of the 2004 wave, the risks of policy complacency are real and not insignificant.

In any case, the short-term outlook for the Bulgarian economy is positive. In 2007 GDP is expected to continue to grow at a rate similar to that seen in 2006. The situation in the labour market should continue to improve further, in terms of both growing employment and falling unemployment rates. The expected wage rises could add to the inflationary pressures, with the rate of inflation remaining relatively high by EU standards. The general government budget will likely remain in surplus, but one of a smaller magnitude compared to 2006.

Table BG

Bulgaria: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006 ¹⁾	2007 forecast	2008 forecast
Population, th pers., end of period	8149.5	7891.1	7845.8	7801.3	7761.0	7718.8	7680	.	.
Gross domestic product, BGN mn, nom.	26752.8	29709.2	32335.1	34546.6	38275.3	41948.1	48000	53500	59000
annual change in % (real)	5.4	4.1	4.9	4.5	5.7	5.5	6.2	6	5.5
GDP/capita (EUR at exchange rate)	1674	1920	2101	2258	2515	2771	3190	.	.
GDP/capita (EUR at PPP - wiiw)	5320	5840	6090	6740	7230	7730	8500	.	.
Gross industrial production									
annual change in % (real)	8.3	1.5	6.5	14.1	13.8	8.4	5.9	5	6
Gross agricultural production									
annual change in % (real)	-9.9	1.1	5.3	-9.9	6.6	-6.0	0.6	.	.
Construction output total									
annual change in % (real)	8.0	14.2	2.7	5.6	35.2	1.0	.	.	.
Actual final consump. of househ., BGN mn, nom.	20687.8	23009.1	24822.9	26846.0	29324.5	33066.7	37000	.	.
annual change in % (real)	4.9	4.6	3.4	7.1	4.9	7.4	7	6	5.5
Gross fixed capital form., BGN mn, nom.	4206.0	5415.2	5908.5	6694.4	7969.4	9971.1	12000	.	.
annual change in % (real)	15.4	23.3	8.5	13.9	13.5	19.0	18	15	15
LFS - employed persons, th, avg.	2794.7	2698.8	2739.6	2834.8	2922.5	2980.0	3100	3200	3300
annual change in %	-2.8	-3.4	1.5	3.5	3.1	2.0	4	3	3
Reg. employees in industry, th pers., avg.	662.0	658.4	666.8	689.5	695.8	693.0	.	.	.
annual change in %	-8.4	-0.5	1.3	3.4	0.9	-0.4	.	.	.
LFS - unemployed, th pers., average	566.8	663.9	592.4	448.7	399.7	334.2	310	280	250
LFS - unemployment rate in %, average	16.9	19.7	17.8	13.7	12.0	10.1	9	8	7
Reg. unemployment rate in %, end of period	17.9	17.3	16.3	13.5	12.2	10.7	9.1	8.5	7.5
Average gross monthly wages, BGN	224.5	240.0	257.6	273.3	292.4	323.7	355	.	.
annual change in % (real, gross)	1.3	-0.5	1.5	3.7	0.8	5.4	2.2	.	.
Consumer prices, % p.a.	10.3	7.4	5.8	2.3	6.1	5.0	7.3	5	5
Producer prices in industry, % p.a.	17.5	3.8	1.2	4.9	6.0	6.9	9.4	6	5
General governm. budget, nat. def., % GDP									
Revenues	41.4	39.8	38.7	40.7	41.4	42.9	41.7	.	.
Expenditures	42.0	40.4	39.4	40.7	39.7	39.7	38.1	.	.
Deficit (-) / surplus (+), % GDP	-0.6	-0.6	-0.7	0.0	1.7	3.2	3.7	1	1
Public debt in % of GDP ²⁾	73.6	66.2	53.2	46.2	38.8	29.9	25	21	17
Gross external debt in % of GDP	86.9	78.6	65.1	60.2	64.2	70.5	.	.	.
Base rate of NB % p.a., end of period	4.7	4.7	3.4	2.9	2.4	2.1	3.3	.	.
Current account, EUR mn	-761.4	-855.2	-402.5	-972.3	-1131.3	-2427.0	-3878.8	-3700	-4000
Current account in % of GDP	-5.6	-5.6	-2.4	-5.5	-5.8	-11.3	-15.8	-13.5	-13.3
Gross reserves of NB excl. gold, EUR mn	3390.6	3734.0	4247.1	4981.0	6443.0	6815.7	8309.0	.	.
Gross external debt, EUR mn	11882.7	11934.9	10768.9	10640.6	12571.6	15110.7	18726.5 ^{xi)}	.	.
Gross external debt in % of GDP	86.9	78.6	65.1	60.2	64.2	70.5	.	.	.
FDI inflow, EUR mn	1103.3	903.4	980.0	1850.5	2727.5	2326.0	4015.0	4000	3800
FDI outflow, EUR mn	3.5	10.8	28.9	23.3	-165.6	249.1	88.2	.	.
Exports of goods, BOP, EUR mn	5253.1	5714.2	6062.9	6668.2	7984.9	9466.3	11982.6	14000	15700
annual growth rate in %	40.7	8.8	6.1	10.0	19.7	18.6	26.6	17	12
Imports of goods, BOP, EUR mn	6533.0	7492.6	7940.9	9093.8	10938.4	13809.2	17267.6	19800	22000
annual growth rate in %	37.8	14.7	6.0	14.5	20.3	26.2	25.0	15	11
Exports of services, BOP, EUR mn	2366.2	2428.7	2455.0	2728.7	3261.8	3482.9	3897.0	4250	4700
annual growth rate in %	40.3	2.6	1.1	11.1	19.5	6.8	11.9	10	11
Imports of services, BOP, EUR mn	1818.6	2097.7	1949.6	2176.0	2569.3	2805.3	3317.6	3750	4200
annual growth rate in %	31.7	15.3	-7.1	11.6	18.1	9.2	18.3	14	12
Average exchange rate BGN/USD	2.124	2.185	2.077	1.733	1.575	1.574	1.559	.	.
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	0.541	0.561	0.582	0.555	0.574	0.588	0.608	.	.
Purchasing power parity BGN/EUR	0.616	0.643	0.675	0.655	0.681	0.701	0.734	.	.

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

1) Preliminary. - 2) According to ESA'95, excessive deficit procedure.

Source: wiiw Database incorporating national statistics; wiiw forecasts.