

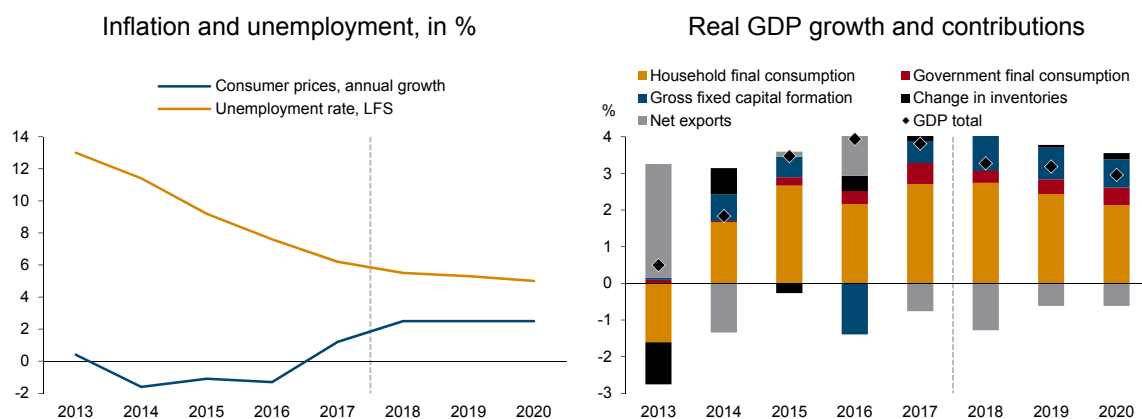


BULGARIA: Further moderation of growth

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GDP grew by 3.3% in the first half of 2018 which was below the rates of growth in the three preceding years. The moderation in output growth coincided with a slowdown in exports. The labour market tightened further and labour costs continued to rise. CPI accelerated due to rising energy prices and growing cost-push inflationary pressure. We expect GDP growth for 2018 as a whole of around 3.3%, and it should stay at a similar level in the coming years.

Figure 39 / Bulgaria: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Bulgaria's GDP grew by 3.2% year on year in the second quarter after rising by 3.5% in first three months. The 3.3% average rate of GDP growth in the first half of the year was below the rates recorded in the three preceding years.

The moderation in output growth coincided with a slowdown in export growth, which started in 2017 and continued during the first half of 2018. This pattern of export performance reflects the combined outcome of two opposite trends: a decline in exports to non-EU countries and continued growth of exports to the EU. The reported drop in exports to the non-EU area in the second half of 2017 and the first half of 2018 is at least partly owing to a high base period, which had resulted from large one-off export deals executed in 2016. There have been signs that exports to the EU were also losing steam in the course of 2018.

Manufacturing output in the first three months remained relatively strong, at 4% year on year.

However, its growth decelerated considerably in the following months (to 1.4% year on year in the second quarter) and recent business sentiment surveys suggest that this slowdown is likely to continue mostly due to decreasing new orders, especially for exports.

Aggregate output growth in the first six months of 2018 was exclusively driven by domestic demand. Both private consumption and fixed investment contributed positively to GDP growth while net exports made a large negative contribution. Gross fixed capital formation rebounded strongly in the first half of the year, reflecting the full-scale resumption of public investment programmes supported by EU funds. Thus public investment in the period January-August was up by 54.3% from the same period of the previous year. Private consumption strengthened considerably in the second quarter supported by rising real incomes and an upturn in household credit.

There was a moderate revival in credit activity in the first half of the year. This mostly refers to household credit the stock of which increased by 10.0% year on year at the end of July. During the same period the stock of credit to the corporate sector grew by 5.4%.

The labour market continued to tighten and labour shortages intensified, especially for skilled labour. According to recent reports by the Employment Agency, labour shortages are the most acute in four economic branches: mechanical engineering, electrical engineering, health care and transportation. In these sectors, the number of posted vacancies was roughly equal to the number of employed in September 2018. According to some estimates, at present about 68% of Bulgarian firms face difficulties in filling their vacancies.

Labour shortages are already exerting visible constraints on output growth. A clear indication of this situation is the fact that some businesses have started to turn down new orders quoting this factor as their motive. At present the business sector is lobbying the government to increase the quotas for admitting non-EU citizens to the local labour market.

Given the situation in the labour market, it is not surprising that nominal wages continued to rise fast during the first half of 2018. The resulting cost push effect is exerting strong inflationary pressure, and the CPI has also started to rise since the start of 2018, reversing the trends prevailing in the previous five years. Further inflationary pressure was added by higher energy and food prices (the latter was due to the poor vegetable harvest). The resurgence of inflation has somewhat dampened the rise in real wages in 2018, although the latter still remains above productivity growth.

There have been concerns that the disproportionate rise in real unit labour costs in recent years would erode international competitiveness. If this were indeed the case, one could have expected a worsening in the country's external balances in recent years. However, this has not been happening; on the contrary, Bulgaria recorded a record-high positive current account balance in 2017. The current account remained in the positive territory in the first half of 2018 as well, although for the year as a whole the surplus is likely to be lower than its 2017 level.

Such dynamics of the current account balance has several possible explanations. In the first place, the 2017 current account figure may be regarded as an outlier due to the presence of strong one-off trade effects as discussed above. Second, in absolute terms, Bulgaria's unit labour costs still remain

well below not only those of the older EU Member States but also below those in most EU-CEE countries. A third factor has been the relatively rapid growth in the exports of services in recent years: the positive balance in services trade roughly offsets the negative balance in goods trade. In any case, if real unit labour costs continue their disproportionate growth, sooner or later this will backfire in the form of inflation and widening external imbalances; hence some policy corrections may be needed at some point in the near future.

The fiscal situation has remained comfortable thanks to rising revenue. In the period January-August total public revenue increased by 11.6% from the same period of the previous year, a rate of growth that surpassed that of nominal aggregate output. This made it possible for the government to envisage increases in spending above the budget targets. Despite that, the cash fiscal balance until September 2018 was in positive territory, and one could expect that the accrual balance will also remain positive for 2018 as a whole.

The authorities have made further efforts towards achieving their declared intention for Bulgaria to enter the ERM II. Although the country formally meets all the criteria, the negotiations with the ECB and the European Commission have been difficult for a number of reasons, including the reluctance of some members of the eurozone to discuss its enlargement before reforming the single currency area itself. As per the latest semi-official communications, Bulgaria could possibly join simultaneously both the ERM II and the Banking Union in mid-2019. Whether this will happen in reality will depend not only on Bulgaria's macroeconomic fundamentals but also on the dynamics of the internal discussions on the future of the eurozone.

The political situation in the country has been subject to growing instability. The government comprises a heterogeneous coalition of centrist and nationalist parties and on many occasions it has been difficult to find compromise solutions. So far Boyko Borisov, the longest serving Prime Minister in Bulgaria's recent history, has been able to engineer such compromises, often thanks to ad hoc populist moves. The comfortable fiscal position generates sufficient cushions for such moves. As an example, the government has recently announced its plans to raise wages in the public sector by 10% on average in 2019.

The prevailing expectations at present are for somewhat weak external demand and moderation of growth. The ongoing turmoil in the Turkish financial markets may further exacerbate these effects. Thus domestic demand will remain the main growth driver in the short run but obviously it has its limits. Coupled with the effect of intensifying supply constraints caused by labour shortages, the short-term prospects are for continued moderation in economic growth.

The average GDP growth for 2018 as a whole is expected to be around 3.3% and it should stay in the range of 3% or slightly higher in the coming years. Inflation will remain in positive territory but should be confined to a range between 2% and 3% provided that growth in labour costs remains under control. There appear to be no imminent threats to macroeconomic stability in the short run.

Table 14 / Bulgaria: Selected economic indicators

	2014	2015	2016	2017 ¹⁾	2017 January-June	2018	2018 Forecast	2019 Forecast	2020
Population, th pers., average	7,224	7,178	7,128	7,076	.	.	7,000	6,950	6,900
Gross domestic product, BGN mn, nom.	83,756	88,575	94,130	101,043	45,277	48,291	107,000	113,200	119,500
annual change in % (real)	1.8	3.5	3.9	3.8	3.8	3.4	3.3	3.2	3.0
GDP/capita (EUR at PPP)	12,900	13,700	14,200	15,100	.	.	.	.	.
Consumption of households, BGN mn, nom.	51,963	54,831	56,715	60,694	27,834	31,146	.	.	.
annual change in % (real)	2.7	4.3	3.5	4.5	4.4	7.9	4.5	4.0	3.5
Gross fixed capital form., BGN mn, nom.	17,653	18,612	17,484	18,717	8,344	9,382	.	.	.
annual change in % (real)	3.4	2.7	-6.6	3.2	3.3	8.5	7.0	4.5	4.0
Gross industrial production ²⁾									
annual change in % (real)	1.8	2.9	2.7	3.4	4.4	1.4	2.0	2.0	2.0
Gross agricultural production									
annual change in % (real)	-0.6	-8.2	1.7	-0.5	.	.	.	.	.
Construction industry ³⁾									
annual change in % (real)	7.0	11.1	-16.7	4.6	3.4	3.1	.	.	.
Employed persons, LFS, th, average	2,981	3,032	3,017	3,150	3,104	3,128	3,200	3,230	3,260
annual change in %	1.6	1.7	-0.5	4.4	3.3	0.8	1.5	1.0	1.0
Unemployed persons, LFS, th, average	385	305	247	207	219	185	190	180	170
Unemployment rate, LFS, in %, average	11.4	9.2	7.6	6.2	6.6	5.6	5.5	5.3	5.0
Reg. unemployment rate, in %, eop	10.7	10.0	8.0	7.1	6.8	5.7	.	.	.
Average monthly gross wages, BGN	821.7	877.9	948.3	1,060.4	1,023.3	1,100.8	1,150	1,240	1,330
annual change in % (real, gross)	7.5	7.0	8.9	9.6	8.0	5.2	6.0	5.5	5.0
Consumer prices (HICP), % p.a.	-1.6	-1.1	-1.3	1.2	3.6	5.7	2.5	2.5	2.5
Producer prices in industry, % p.a.	-1.2	-2.2	-3.1	5.0	4.7	4.1	4.0	3.5	3.0
General government budget, EU-def., % of GDP									
Revenues	36.6	39.1	35.2	35.3	.	.	36.5	36.0	36.0
Expenditures	42.0	40.7	35.0	34.4	.	.	36.0	36.0	36.0
Net lending (+) / net borrowing (-)	-5.4	-1.6	0.2	0.9	.	.	0.5	0.0	0.0
General gov.gross debt, EU def., % of GDP	26.9	26.0	29.0	24.8	.	.	24.5	23.0	21.0
Stock of loans of non-fin.private sector, % p.a.	-8.2	-1.6	1.0	3.3	2.1	3.5	.	.	.
Non-performing loans (NPL), in %, eop	16.7	20.4	18.3	14.8	17.0	13.1	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.02	0.01	0.00	0.00	0.00	0.00	0.0	0.0	0.0
Current account, EUR mn	531	-15	1,244	3,368	967	-14	1,600	600	500
Current account in % of GDP	1.2	0.0	2.6	6.5	4.2	-0.1	2.9	1.0	0.8
Exports of goods, BOP, EUR mn	21,027	21,920	23,104	26,951	12,901	12,624	26,800	27,300	28,000
annual change in %	-0.9	4.2	5.4	16.6	20.3	-2.1	-0.6	1.9	2.6
Imports of goods, BOP, EUR mn	23,803	24,542	24,088	27,716	13,327	14,282	29,500	31,000	32,000
annual change in %	-1.4	3.1	-1.8	15.1	18.1	7.2	6.4	5.1	3.2
Exports of services, BOP, EUR mn	6,787	6,967	7,688	7,813	3,126	3,456	8,200	8,600	9,000
annual change in %	15.3	2.7	10.3	1.6	-3.0	10.5	4.9	4.9	4.7
Imports of services, BOP, EUR mn	4,244	3,964	4,628	5,048	2,399	2,448	5,200	5,400	5,600
annual change in %	31.2	-6.6	16.8	9.1	5.0	2.1	3.0	3.8	3.7
FDI liabilities, EUR mn	803	2,342	1,390	1,896	582	556	900	.	.
FDI assets, EUR mn	657	101	774	817	162	506	600	.	.
Gross reserves of NB excl. gold, EUR mn ⁵⁾	15,276	19,022	22,475	22,257	22,555	22,114	.	.	.
Gross external debt, EUR mn ⁵⁾	39,338	33,493	34,221	33,397	34,220	33,476	33500	33000	32500
Gross external debt, % of GDP ⁵⁾	91.9	74.0	71.1	64.6	66.2	61.2	61.0	57.0	53.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary. - 2) Enterprises with 10 and more employees. - 3) Enterprises with 5 and more employees. - 4) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board). - 5) BOP 5th edition.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.