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Bulgaria: populist pressures on the rise

Strong economic growth continued in the first quarter with GDP rising by 6.2% year-on-year underpinned by robust performance in manufacturing and services. Buoyant domestic demand remained the main growth driver: gross fixed capital formation surged by an impressive 35.9% year-on-year while private consumption increased by 8.1% compared to the same period of 2006. By contrast, net exports made a highly negative contribution to GDP growth in the first quarter.

The closure of two nuclear reactors at the Kozloduy power plant at the end of 2006 (a controversial condition for EU accession that had been pressed on Bulgaria almost a decade ago, before the reversal in global public attitude towards nuclear energy) had the effect of a one-time negative shock on industrial output and will have a lasting negative impact on exports as Bulgaria will no longer be in the position of a net exporter of electricity. This outcome was clearly visible in the dynamics of Bulgaria's total exports, which slowed down considerably in the first quarter, both in value and in volume terms. However, the other short-term repercussions of the closure seem to be waning as the rest of the economy adjusted to its effects.

The situation in the labour market continued to improve steadily with the LFS rate of unemployment dropping to 8.0% in the first quarter. LFS data also suggest a robust rise in the level of employment (by 6.6% year-on-year). The shrinking pool of unemployed is largely made up of low-skilled job seekers with little chance of entering gainful employment. Labour shortages are becoming a chronic feature of many sectors of the Bulgarian economy, exerting an upward pressure on real wages, which have been on the rise. While so far there were no visible spillovers on domestic prices, this may only be a matter of time if the present wage rise continues.

In early 2007, the National Statistical Institute reported revised national accounts for the period 2002-2005. These revisions were the result of methodological changes (such as fully applying EU statistical standards in the balance of payments methodology and in the distribution of financial intermediation services in the national accounts) and also reflected the final statistical data for 2005. The revised data considerably changed the picture of Bulgaria's economic growth – indeed, the growth trend – in this period (see Table BG). In the light of the new figures, GDP growth peaked in 2004 and decelerated slightly thereafter, including in 2006 when it increased by 6.1%.

With the euphoria of EU accession subsiding and the farewell shake-hand with the IMF (the final precautionary agreement expired in March 2007), Bulgarian politicians seem to be regaining new appetite for policy activism. Regrettably, they seem to be bowing to a

wave of rising populist pressures – mirroring the overall upward pressure on wages – both within the ruling tripartite coalition dominated by the Socialist Party and generally in the country. Incomes policy – whose tightness until now had been one of the pillars of macroeconomic stability and national competitiveness – seems to be the first line of defence that is giving way. Succumbing to the threat of a strike by public transport employees in Sofia in the run-up to the first election of Bulgarian members of the European Parliament in May, the authorities agreed to an increase in their wages that is hardly justifiable on economic grounds. Concomitantly, the government significantly softened the regulations preventing loss-making state-owned firms from raising their wages. These policy acts – constituting a typical situation of moral hazard – provoked a wave of new demands for wage increases, in the first place, by unionized public sector employees, which will be difficult to arrest given the weakened credibility of the authorities. Undoubtedly, there will be repercussions on wage formation in the private sector as well. In turn, it can be expected that the ensuing income rises will have a negative effect on both inflation and the current account balance. The demands for wage hikes are not the only source of populist pressure on fiscal spending. Other claims have also been on the rise, in particular, for pension hikes but also from farmers, for compensations due to unfavourable weather conditions.

While these medium-term risks remain, there has been no immediate fallout on the fiscal stance as higher spending was more than offset by continuing windfall gains in fiscal revenue. In January-April, the consolidated general government revenue was up by 17.6% year-on-year while expenditure was up by 8.9%, resulting in a surplus which was 45% higher than a year earlier. This was a somewhat unexpected outcome as it had been widely believed that the changeover in the administration of VAT after EU accession would have negative implications on tax collection. The sources of the current windfall are still unclear so it remains to be seen how the fiscal situation will develop through the year. In April, the Bulgarian government retired ahead of schedule the remainder of the country's debt to the IMF, paying back SDR 204.8 million (some BGN 450 million), which was the third and last operation on advanced debt repayment to the IMF.

On the negative side, the current account deficit continued to expand, both in absolute and in relative terms, under the combined effect of several factors such as the rise in real wages, the deceleration of export growth and a renewed surge in domestic credit. After the lifting of credit restrictions at the end of 2006, the credit expansion has resumed but at more moderate rates than those seen a couple of years ago. In retrospective, the empirical evidence indicates that bank lending to the corporate sector was rather sensitive to these administrative controls (in mid-2006, net new bank lending to the corporate sector went to a standstill), whereas lending to households was less affected. This sensitivity now works in the reverse direction, with corporate lending recovering much faster than lending to

households. Despite its widening, the current account deficit is almost fully covered by inward FDI, mitigating to a certain extent the short-term risks associated with it.

Nevertheless, the current account deficit, together with the persistently high (by EU standards) inflation, remain the main stumbling blocks on Bulgaria's road towards adopting the euro. Upon EU accession, Bulgaria voiced its intention for a fast-track entry to the euro zone, in particular, by entering ERM-2 already in 2007, with a view to acceding to the EMU around 2010-11. While in principle endorsing Bulgaria's intention to join ERM-2, the ECB seems a bit hesitant about fast-track entry to the euro zone on the grounds that Bulgaria needs a longer catch-up period during which fast economic growth will be accompanied by higher inflation. Obviously, the timing of EMU accession will be subject to further discussions.

The short-term outlook for the Bulgarian economy is little changed from the previous quarter. Both in 2007 and 2008, GDP is expected to grow at around 6% per annum, bringing about a further rise in employment and a fall in the rate of unemployment. With labour shortages becoming more acute, cost-push inflation in the form of wage pressure is becoming the key pro-inflationary factor in the country. Under the present coalition government, the considerable wage rises already experienced in the first quarter are set to continue and therefore no major progress in disinflation can be expected in the short run. Despite the pressures for higher public spending, the general government budget will remain in surplus but its magnitude is difficult to predict. If public revenues remain as buoyant as they were in the first quarter, the surplus may be comparable to that recorded in 2006, but this is something to follow over the course of the year. With real wages rising, export revenues dampened by the discontinuation of electricity exports and FDI continuing to surge, no options for curbing the current account deficit are in sight in the short run.

Table BG

Bulgaria: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006	2007	2007	2008
						1st quarter		forecast	forecast
Population, th pers.. end of period	7845.8	7801.3	7761.0	7718.8	7679.3	.	.	.	.
Gross domestic product, BGN mn. nom.	32401.6	34627.5	38822.6	42797.4	49090.6	9978.6	11493.4	53500	59000
annual change in % (real)	4.5	5.0	6.6	6.2	6.1	5.5	6.2	6	6
GDP/capita (EUR at exchange rate)	2101	2263	2551	2827	3260	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	6100	6760	7330	7890	8740	.	.	.	.
Gross industrial production									
annual change in % (real) ²⁾	6.5	14.1	13.8	8.4	5.8	7.3	7.3	7	7
Gross agricultural production									
annual change in % (real)	5.3	-9.9	6.6	-6.0	0.6	.	.	.	.
Construction output total									
annual change in % (real)	2.7	5.6	35.2	1.0	.	.	.	.	.
Actual final consump.of househ.. BGN mn. nom.	25630.2	27444.4	30155.5	33556.4	37897.3	8418.5	9452.5	.	.
annual change in % (real)	4.0	6.3	5.3	5.5	7.1	5.7	8.1	7	7
Gross fixed capital form.. BGN mn. nom.	5908.5	6694.4	7969.4	10346.5	12878.3	2345.2	3386.2	.	.
annual change in % (real)	8.5	13.9	13.5	23.3	17.6	17.1	35.9	25	20
LFS - employed persons, th. avg.	2739.6	2834.8	2922.5	2980.0	3110.0	2940.5	3135.4	3200	3300
annual change in %	1.5	3.5	3.1	2.0	4.4	3.6	6.6	3	3
Reg. employees in industry, th pers.. avg.	666.8	689.5	695.8	693.0	694.3	700.6	705.3	.	.
annual change in %	1.3	3.4	0.9	-0.4	0.2	-2.5	0.7	.	.
LFS - unemployed, th pers.. average	592.4	448.7	399.7	334.2	305.7	315.2	272.7	260	240
LFS - unemployment rate in %, average	17.8	13.7	12.0	10.1	9.0	9.7	8.0	7.5	7
Reg. unemployment rate in %, end of period	16.3	13.5	12.2	10.7	9.1	10.8	8.9	8.0	7.5
Average gross monthly wages, BGN	257.6	273.3	292.4	323.7	354.6	329.0	384.0	410	450
annual change in % (real, gross)	1.5	3.7	0.8	5.4	2.1	1.9	10.9	10	5
Consumer prices, % p.a.	5.8	2.3	6.1	5.0	7.3	8.0	5.2	5	5
Producer prices in industry, % p.a.	1.2	4.9	6.0	6.9	9.4	8.4	7.4	6	5
General governm.budget, nat.def.. % GDP									
Revenues	38.7	40.6	40.8	42.0	40.8	43.9	44.0	.	.
Expenditures	39.3	40.6	39.1	38.9	37.2	39.6	39.3	.	.
Deficit (-) / surplus (+), % GDP	-0.7	0.0	1.7	3.2	3.7	4.3	4.7	3	2.5
Public debt in % of GDP ³⁾	53.2	46.2	38.8	29.9	23.0	24.9	20.8	20	16
Base rate of NB % p.a.. end of period	3.4	2.9	2.4	2.1	3.3	2.3	3.6	.	.
Current account, EUR mn	-402.5	-972.3	-1306.9	-2621.9	-3977.9	-1093.6	-1501.7	-4500	-4500
Current account in % of GDP	-2.4	-5.5	-6.6	-12.0	-15.8	-21.4	-25.6	-16.5	-15
Gross reserves of NB excl. gold, EUR mn	4247.1	4981.0	6443.0	6815.7	8309.0	6399.6	8343.4	.	.
Gross external debt, EUR mn	10768.9	10640.6	12658.5	15089.6	19669.9	16112.2	20294.1	.	.
Gross external debt in % of GDP	65.0	60.1	63.8	69.0	78.4	.	.	.	.
FDI inflow, EUR mn	980.0	1850.5	2735.9	3103.3	4104.5	789.6	770.8	4300	4500
FDI outflow, EUR mn	28.9	23.3	-165.6	249.1	121.8	22.8	10.1	.	.
Exports of goods, BOP, EUR mn	6062.9	6668.2	7984.9	9466.3	11982.6	2672.3	2837.3	13200	14500
annual growth rate in %	6.1	10.0	19.7	18.6	26.6	28.4	6.2	10	10
Imports of goods, BOP, EUR mn	7940.9	9093.8	10938.4	13876.1	17372.7	3725.7	4322.1	20000	22500
annual growth rate in %	6.0	14.5	20.3	26.9	25.2	33.0	16.0	15	13
Exports of services, BOP, EUR mn	2455.0	2728.7	3262.1	3564.1	3990.2	551.1	651.5	4400	4800
annual growth rate in %	1.1	11.1	19.5	9.3	12.0	4.5	18.2	10	9
Imports of services, BOP, EUR mn	1949.6	2176.0	2605.8	2745.2	3270.1	728.0	779.7	3600	4000
annual growth rate in %	-7.1	11.6	19.8	5.3	19.1	29.0	7.1	10	11
Average exchange rate BGN/USD	2.077	1.733	1.575	1.574	1.559	1.627	1.493	.	.
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	0.582	0.555	0.574	0.588	0.613	.	.	.	.
Purchasing power parity BGN/EUR	0.675	0.655	0.681	0.701	0.729	.	.	.	.

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

1) Preliminary. - 2) Different methodology for quarterly data. - 3) According to ESA'95. excessive deficit procedure.

Source: wiiw Database incorporating national statistics; wiiw forecasts.