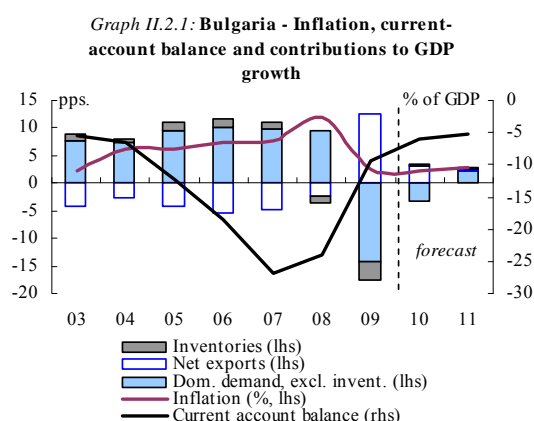


## 2. BULGARIA

### Correcting imbalances in a difficult environment

#### Weak domestic demand weighs on the economy in 2009

The global economic downturn had a severe effect on the economy of Bulgaria. In the fourth quarter of 2009 the decline of real GDP was still accelerating to a preliminary 6.2% from 5.4% in the previous quarter and reached 5% on average as a whole. The growth contribution of domestic demand was negative as all of its components contracted sharply. Gross fixed capital formation registered the highest decline, collapsing by 27%. Private and government consumption expenditures were lower as well, declining by 6% and 5.5% respectively. Tight credit market conditions, declining FDI inflows, balance-sheet adjustments and lacklustre medium-term economic prospects were some of the main factors behind the negative dynamics of domestic demand.



At the same time the economic crisis brought about a welcome adjustment in some of the imbalances which started to unwind. Inflation decelerated substantially from 12% in 2008 to 2.5% and is expected to remain subdued over the forecast horizon, while the current-account deficit improved sharply from 25.5% in 2008 to 9.6% in 2009. However, whereas in 2009 the decline of the current-account deficit was driven by the fall in FDI inflows and imports decreasing faster than exports, in the medium term the correction is expected to be the result of exports picking up faster and earlier than imports.

As a result of the downturn the budgetary balance swung from a surplus of 1.8% of GDP at the end of 2008 to a deficit of 3.9% of GDP, as the

implemented measures to curb expenditures and improve tax compliance were not enough to offset the significant revenue shortfall. However, the undertaken fiscal consolidation measures helped to stabilise the fiscal position and avoid the accumulation of a much larger general government budget deficit. Reliance on public finances to cushion the negative impact of the crisis has been restricted by the need to maintain sound budgetary position in order to underpin macroeconomic stability.

#### Stagnation in 2010 before recovery in 2011

Under the impact of the continuing weakness of domestic demand, the economy is likely to start to recover towards the end of 2010 under the impact of the international cycle. Initially, the main driver of the economic recovery is expected to be net exports, while in 2011 it would shift again to domestic demand. Although the growth rate might be slightly higher than in other EU countries, in 2011 it should remain well below the pre-crisis average, thus temporarily slowing the catching-up process.

Stronger economic prospects, accompanied by improved lending conditions and credit easing, are expected to slow the decline in both gross fixed capital formation and private consumption in 2010 and to result in a positive growth rate in 2011. The increase in infrastructure investment, mainly due to the absorption of EU funds, is expected to play a stabilising role at the beginning of the forecast period, but this may not be sufficient to compensate for the slowdown in corporate investment and construction. Fixed investment is expected to continue to decline in 2010, albeit at a slower pace, and to rebound in 2011 when the balance-sheet adjustments of the corporate and households sectors are at a more advanced stage. The brighter economic prospects, milder lending conditions and higher employment towards the end of the forecast period are also expected to support an increase in private consumption expenditure.

Driven by improving external demand, the contribution of net exports is projected to remain positive until 2011 when domestic demand is set to pick up again, thus providing an impulse to imports. This pattern is likely to result in further unwinding of the external imbalances as exports

would be rising faster and earlier than imports. Projected gains in price competitiveness stemming from the adjustment in nominal wages are expected to prevent the trade deficit from growing in spite of the predicted stronger import demand. The current-account deficit is expected to shrink from 9½% of GDP in 2009, to 6% and slightly above 5% of GDP in 2010 and 2011 respectively. Given the monetary regime in place, the sustainability of its adjustment depends crucially on the supply-side response and the ability of the economy to shift from the non-tradable to the tradable sector.

Risks to this baseline scenario are broadly balanced. Foreign capital inflows may turn out to be larger than expected, either through a partial recovery in FDI, or through higher EU funds absorption, which would support domestic demand and mitigate the strong fall in investment. Following the marked drop in 2009, a rebound of inventories could offer an additional boost to growth as the economy starts to recover. A faster-than-projected adjustment in nominal wages could bring unit labour costs lower and lead to improved price competitiveness. On the negative side, the trend of rising unemployment could continue unabated, should the slowdown turn out to be more protracted. A continuing decline in housing prices may involve negative wealth-effects for households and worsen the decline of the construction sector. This could put further pressure on private consumption and fixed investment. At the same time, a weaker-than-expected pick-up in external demand would result in a delayed and less pronounced rebound of economic activity. In addition, within the context of tight credit-market conditions, the servicing of the economy's high foreign debt might crowd out domestic investment and spending. In the event that external financing conditions become even tighter, the external imbalance could narrow more rapidly, but at the expense of a slower economic recovery.

### Setback to catching up

With the lowest per-capita GDP in the EU, the main challenge for Bulgaria is to ensure a sustained and quick catching-up process. Given the projected lower contribution of FDI-driven investment to economic activity, the adjustment of the economy is expected to involve a shift to a more export-oriented growth pattern, which would depend to a large extent on a recovery in external demand. In addition, real convergence

could be enhanced by improved competitiveness and structural reforms to boost potential growth, such as reforms in the sectors of health care, education, pensions and public administration.

As a result of the lower current-account deficit the downward adjustment of the economy's net borrowing vis-à-vis the rest of the world is expected to continue. However, given the competitiveness challenges in recent years, it remains to be seen how sustainable these adjustments will be. Additionally, the country's gross external debt at above 110% of GDP remains high, but is mitigated by the fact that the current-account deficit has been fully financed through FDI.

The labour market worsened considerably as the downturn led to a fall in employment by 2.9% in 2009 and an increase in unemployment mainly affecting the labour-intensive sectors, in particular construction. Total employment is projected to continue to decline in 2010 and to start increasing slightly only in 2011. Wage growth is set to decelerate further both in 2010 and 2011.

Over the past few years, high unit labour costs have led to a strong appreciation of the real effective exchange rate, worsening the economy's price competitiveness vis-à-vis the EU average. As a result of the significant fall in output, far in excess of the decline in employment, as well as some labour hoarding, productivity declined in 2009. It is expected to re-enter positive territory in 2010 and to gain momentum in 2011. The adjustment in the competitiveness determinants is expected to gather momentum in 2010-11, with productivity increases slightly exceeding real wage growth.

HICP inflation is projected to remain low over the forecast horizon at around 2.5% on average. However, once the global recovery picks up, the prices of oil and other commodities in international markets could be a source of pressure. In addition, core inflation is set to remain above the euro area average over the forecast horizon, reflecting a certain degree of price rigidity in product markets.

### Shrinking the budgetary deficit

The economic downturn, which is adversely affecting the tax intensity of the economy, resulted in the accumulation of a deficit of almost 4% of

GDP in 2009 on accrual basis. It led also to a significant shortfall of revenue, particularly from indirect taxes, in the first months of 2010. To avoid a further deterioration of the fiscal position and to set the budget deficit on a declining path in 2010, the government adopted an anti-crisis and fiscal consolidation package. It contains a broad range of further measures both on the expenditure and on the revenue side, in addition to those already envisaged in the 2010 budget. Under the no-policy-change assumption and a prudent assessment of the budgetary impact of the recently announced measures, the general government deficit would reach around 2¾% of GDP in 2010. The small difference of ¾ pp. compared with the authorities' latest projection is mainly due to a more conservative growth scenario. For 2011, the general government deficit is projected to be 2¼% of GDP while government gross debt is set to increase to 18¾% of GDP.

Some of the budgetary components are subject to uncertainties. On the expenditure side, social spending could exceed the funding allocated in the budget for 2010 in case of unfavourable labour-market developments. Downsizing in items such as capital expenditure could affect the economy's potential and growth prospects in the medium term even though they are important for keeping government spending under control.

Additionally, freezing salaries, intermediate consumption and pensions could affect negatively the already weak domestic demand in 2010 and trigger further decline in indirect tax revenue.

On the revenue side, Bulgaria could face a protracted period of significantly less tax-intensive growth composition, as the economy shifts to a more export-oriented pattern. At the same time, the envisaged measures to improve tax compliance and collection might have a smaller-than-estimated and/or only temporary impact in the context of the strong downturn. The decline of social contribution rates by 2 pps. is only partially compensated by an increase in the minimum mandatory insurable income.

However, the risks to the budgetary projections are mitigated by the relatively good track record of the authorities in achieving their fiscal targets and the strong commitment to maintaining strict fiscal discipline. Additionally, the government stands ready to implement further discretionary fiscal consolidation measures in case of materialisation of some downside risks.

Table II.2.1:

**Main features of country forecast - BULGARIA**

	2008			Annual percentage change						
	bn BGN	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	66.7	100.0	1.2	1.2	6.3	6.2	6.0	-5.0	0.0	2.7
Private consumption	45.5	68.2	1.9	1.9	9.5	5.3	4.8	-6.3	-2.3	2.1
Public consumption	10.9	16.3	-2.8	-2.8	-1.3	3.1	0.1	-5.5	-1.6	0.6
Gross fixed capital formation	22.3	33.4	-	-	14.7	21.7	20.4	-26.9	-6.3	3.2
of which : equipment	-	-	-	-	-	-	-	-	-	-
Exports (goods and services)	40.4	60.5	-	-	8.7	5.2	2.9	-9.8	4.2	5.2
Imports (goods and services)	55.6	83.3	-	-	14.0	9.9	4.9	-22.3	-2.0	4.3
GNI (GDP deflator)	63.3	94.8	-	-	2.7	7.6	5.7	-4.5	0.1	3.0
Contribution to GDP growth :										
Domestic demand					10.0	9.9	9.4	-14.2	-3.3	2.2
Inventories					1.8	1.2	-1.1	-3.5	0.1	0.2
Net exports					-5.4	-4.9	-2.3	12.6	3.3	0.3
Employment				-0.1	3.3	2.8	3.3	-2.9	-1.2	0.6
Unemployment rate (a)				14.4	9.0	6.9	5.6	6.8	7.9	7.3
Compensation of employees/head				-	7.4	17.9	19.3	8.7	4.7	4.0
Unit labour costs whole economy				-	4.4	14.2	16.2	11.1	3.5	1.9
Real unit labour costs				-	-3.8	5.9	4.3	6.2	2.0	-0.2
Savings rate of households (b)				-	-	-	-	-	-	-
GDP deflator				49.0	8.5	7.9	11.4	4.6	1.5	2.1
Harmonised index of consumer prices				-	7.4	7.6	12.0	2.5	2.3	2.7
Terms of trade of goods				-	5.1	-1.4	-2.5	0.6	0.3	0.1
Trade balance (c)				-7.2	-22.0	-25.5	-25.8	-12.1	-9.5	-9.3
Current account balance (c)				-4.4	-18.6	-22.5	-22.9	-9.6	-6.0	-5.2
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-4.3	-17.9	-21.3	-22.1	-8.2	-4.3	-3.5
General government balance (c)				-	3.0	0.1	1.8	-3.9	-2.8	-2.2
Cyclically-adjusted budget balance (c)				-	1.7	-1.5	0.0	-2.8	-1.1	-0.8
Structural budget balance (c)				-	1.8	-1.5	0.0	-2.8	-1.1	-0.8
General government gross debt (c)				-	22.7	18.2	14.1	14.8	17.4	18.8

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

Note : Contributions to GDP growth may not add up due to statistical discrepancies.