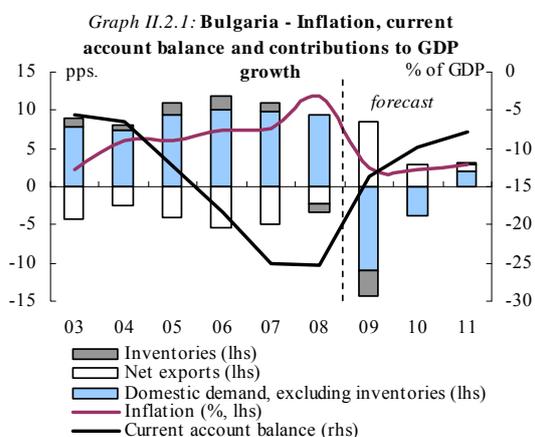


2. BULGARIA

From recession to a more balanced growth pattern

The unfolding financial crisis has reinforced the need for adjustment

Over the past five years, buoyant FDI inflows and strong domestic demand-driven real GDP growth of above 6% on average have been accompanied by widening external deficits and high inflation. The financial crisis and its consequences - tighter financing conditions and increased uncertainty - have brought investment-led growth to an end, making the adjustment to a more balanced growth even more urgent. The Bulgarian economy was hit hard by the global crisis and economic growth figures moved into negative territory in the first half of 2009, when real GDP fell by 4¼%. The deterioration stemmed from the sharp contraction in both external demand and foreign investment inflows. Reflecting the fall in investment and private consumption, domestic demand is expected to decline even further by the end of 2009. For the year as a whole, gross fixed capital formation is expected to contract by more than 21%, while private consumption should fall by approximately 5¾%.



At the same time, some of the imbalances have started to unwind. Inflation decelerated in the first half of the year and is expected to remain subdued over the forecast horizon. The large pre-crisis savings-investment gap has started to narrow, leading to a welcome adjustment in external imbalances. As imports have been declining faster than exports, the contribution of net exports to growth is set to turn positive in 2009 and the current account deficit has been decreasing. The downturn has taken its toll on public finances: after the first half of 2009, the budgetary surplus

vanished as revenues decreased while expenditures rose. Reliance on public finances to cushion the negative impact of the crisis has been limited by the need to maintain a sound budgetary position in order to underpin macroeconomic stability. To mitigate the adverse effects of the crisis, the authorities have introduced a number of measures aimed at strengthening the economy's resilience, expenditure restraint and improving revenue and tax collection. The direct influence of the financial crisis on the Bulgarian banking sector has been limited; accordingly, no support measures have been implemented by the government.

Turnaround expected in 2010 and recovery in 2011

After the projected contraction of slightly less than 6% in 2009, real GDP is expected to continue to decline in 2010, albeit at a decelerating pace of around 1%. The economy is expected to start to recover, under the impact of the international cycle, in the second half of 2010; real GDP should grow by around 3% in 2011. While the magnitude of the recovery might be higher than in other EU countries, growth in 2011 should remain well below the pre-crisis average over the past five years, thus temporarily slowing the catching-up process. Stronger economic prospects, accompanied by improved lending conditions and credit easing, are expected to lead to a smaller decline in both gross fixed capital formation and private consumption in 2010 and to bring about positive growth rates in 2011. The increase in infrastructure investment, mainly due to the absorption of EU funds, is expected to have 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. The envisaged government infrastructure projects should contribute to the rebound of fixed investment in 2011. The projected increase in private consumption is expected to be supported by improving economic prospects and higher employment.

Looking ahead, the pattern of growth is expected to partially shift from domestic demand to the external side. The growth contribution of net exports is projected to remain positive even in 2011 when domestic demand should pick up again. This rebalancing should result in a partial

unwinding of the external imbalances, as imports fall faster than exports during the downturn. In line with the positive developments in external demand, exports are expected to start to pick up in 2010, ahead of imports. As real GDP growth resumes in 2011 and imports start to rise again, projected gains in price competitiveness stemming from the adjustment in nominal wages should lead to a further narrowing of the trade deficit.

Risks to this baseline scenario are tilted to the upside. Foreign capital inflows may turn out to be larger than expected, either through a partial recovery in FDI, or through higher absorption of EU funds, which would support domestic demand and mitigate the strong fall in investment still in 2010. Following the marked run-down in 2009, a rebound of inventories could offer an additional boost to growth as the economy starts to recover. In addition, the commitment by foreign parent banks to support their local subsidiaries might translate in some credit easing. A faster-than-projected adjustment in nominal wages could bring unit labour costs further down and lead to an improvement in price competitiveness. On the negative side, despite the relative resilience of the labour market in the first half of 2009, unemployment could increase faster should the slowdown turn out to be more protracted, thus putting further pressure on private consumption. In addition, within the context of credit restraint, the servicing of the economy's high external 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.

Correcting domestic and external imbalances

With the lowest GDP-per-capita level in the EU, the main challenge for Bulgaria is to ensure sustained and quick catching-up process while preserving macroeconomic stability. 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.

With domestic demand contracting in 2009 and 2010 and recovering only partially towards the end

of the forecast horizon, a significant correction of the external deficit by 2011 is projected. After reaching a level of around 25% of GDP at the end of 2008, the current account deficit has been adjusting rapidly in 2009 and is expected to more than halve by the end of 2010 and to fall further to around 8% of GDP thereafter - but to still remain at high levels. The sustainability of the current account adjustment would depend crucially on the supply-side response. With the external imbalances correcting, the economy's net borrowing vis-à-vis the rest of the world is expected to undergo a significant downward adjustment. However, given the competitiveness challenges in recent years, it remains to be seen how sustainable these adjustments will be and how far they will go.

Due to tight labour market conditions, nominal wage growth in the boom years has by far exceeded productivity growth, raising nominal unit labour costs and fuelling inflation. As a result, 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.

After peaking at 12% on average last year, HICP inflation has been on a fast downward path and is projected to remain low over the forecast horizon. However, when the global recovery gains momentum, the prices of oil and other commodities in international markets could again become sources of inflationary pressures. In addition, core inflation is set to slightly exceed 3% over the forecast horizon, remaining well above headline inflation and reflecting a certain degree of price rigidity in product markets. At the same time, nominal wage adjustment appears to be much more sluggish. These trends have persisted in 2009, which could result in high real wage growth.

The labour market has remained relatively resilient, although the downturn led to a fall in employment and an increase in unemployment, mainly affecting the labour-intensive sectors, in particular construction. Total employment is expected to decline by 2% in 2009 and should start to increase only in 2011. The decline is due to a decrease in the number of employees; the number of self-employed will increase over the whole forecast period. As a result of the significant fall in output, far in excess of the decline in employment, productivity growth should be negative in 2009, impacting adversely on price competitiveness. Only towards the end of the forecast horizon is the

adjustment in the competitiveness determinants expected to gather momentum, with productivity increases exceeding real wage growth.

Maintaining a sound budgetary position

The economic downturn, which is adversely affecting the tax intensity of the economy and leading to higher spending pressures, has already resulted in the accumulation of a small deficit amounting to around ¾% of GDP in the first eight months of 2009. The new government has started to implement a number of revenue-raising measures targeted at increasing tax compliance and combating fraud, as well as expenditure cuts, which would limit the general government deficit to around ¾% of GDP this year. Under a no-policy-change assumption, the budgetary outcome should yield a deficit of around 1¼% of GDP in 2010 and less than ½% in 2011. There are risks that the budgetary deficit might turn out to be higher. 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 might have a smaller-than-estimated and/or only temporary impact on compliance in the context of the sharp downturn. On the expenditure side, as the effect of the crisis on the labour market unfolds, social spending

should increase. As regards the envisaged expenditure cuts, while these are essential for keeping total expenditure under control, across-the-board downsizing in items such as capital expenditure could affect the economy's potential and the growth prospects in the medium term.

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 | 1.3 | 6.3 | 6.2 | 6.0 | -5.9 | -1.1 | 3.1 | |
| Private consumption | 45.5 | 68.2 | 1.9 | 9.5 | 5.3 | 4.8 | -5.7 | -2.1 | 2.0 | |
| Public consumption | 10.9 | 16.3 | -2.8 | -1.3 | 3.1 | 0.0 | -0.2 | -0.1 | 0.2 | |
| Gross fixed capital formation | 22.3 | 33.4 | - | 14.7 | 21.7 | 20.4 | -21.1 | -8.7 | 3.1 | |
| of which : equipment | - | - | - | - | - | - | - | - | - | - |
| Exports (goods and services) | 40.4 | 60.5 | - | 8.7 | 5.2 | 2.9 | -13.3 | 2.3 | 4.5 | |
| Imports (goods and services) | 55.6 | 83.3 | - | 14.0 | 9.9 | 4.9 | -19.9 | -2.8 | 2.3 | |
| GNI (GDP deflator) | 64.1 | 96.1 | - | 2.7 | 7.6 | 5.7 | -5.4 | -0.8 | 3.5 | |
| Contribution to GDP growth : | | | | | | | | | | |
| Domestic demand | | | - | 10.0 | 9.9 | 9.4 | -11.0 | -3.8 | 2.1 | |
| Stockbuilding | | | - | 1.8 | 1.2 | -1.1 | -3.4 | -0.1 | 0.1 | |
| Foreign balance | | | - | -5.4 | -4.9 | -2.3 | 8.5 | 2.8 | 0.9 | |
| Employment | | | -0.1 | 3.3 | 2.8 | 3.3 | -2.0 | -1.3 | 0.8 | |
| Unemployment rate (a) | | | 14.8 | 9.0 | 6.9 | 5.6 | 7.0 | 8.0 | 7.2 | |
| Compensation of employees/head | | | - | 7.4 | 17.9 | 19.3 | 7.8 | 2.5 | 5.1 | |
| Unit labour costs whole economy | | | - | 4.4 | 14.2 | 16.2 | 12.2 | 2.2 | 2.8 | |
| Real unit labour costs | | | - | -3.8 | 5.9 | 4.3 | 7.9 | 0.3 | 0.2 | |
| Savings rate of households (b) | | | - | - | - | - | - | - | - | |
| GDP deflator | | | 48.9 | 8.5 | 7.9 | 11.4 | 4.0 | 1.9 | 2.5 | |
| Harmonised index of consumer prices | | | - | 7.4 | 7.6 | 12.0 | 2.4 | 2.3 | 2.9 | |
| Terms of trade of goods | | | - | 5.1 | -1.4 | -2.5 | 0.8 | 1.2 | 1.1 | |
| Trade balance (c) | | | -7.2 | -22.0 | -25.5 | -25.8 | -15.7 | -12.9 | -11.7 | |
| Current account balance (c) | | | -4.4 | -18.6 | -22.5 | -22.9 | -13.7 | -9.8 | -7.9 | |
| Net lending(+) or borrowing(-) vis-à-vis ROW (c) | | | -4.3 | -17.9 | -21.3 | -22.1 | -12.8 | -8.7 | -6.7 | |
| General government balance (c) | | | - | 3.0 | 0.1 | 1.8 | -0.8 | -1.2 | -0.4 | |
| Cyclically-adjusted budget balance (c) | | | - | 1.4 | -1.8 | -0.3 | 0.3 | 1.0 | 1.5 | |
| Structural budget balance (c) | | | - | 1.5 | -1.8 | -0.3 | 0.3 | 1.0 | 1.5 | |
| General government gross debt (c) | | | - | 22.7 | 18.2 | 14.1 | 15.1 | 16.2 | 15.7 | |

(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.