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Macroeconomic Imbalances

Bulgaria 2014

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Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Bulgaria continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, the protracted adjustment of the labour market warrants policy actions, while the correction of the external position and corporate deleveraging are progressing well.

More specifically, Bulgaria experienced a period of very rapid accumulation of imbalances during the boom phase that coincided with accession to the EU. High foreign capital inflows contributed to the overheating of the economy and sustained increases of fixed asset prices. The current account reversed since 2009 but the stock of external liabilities, though a large share is FDI, remains high. The adjustment appears to be mostly non-cyclical, but a further reduction in external liabilities depends on sustaining external competitiveness and a strong export performance. The ongoing deleveraging of non-financial corporations could limit investments and growth in some sectors in the short and medium term. Also the weak non-inclusive labour market limits the adjustment capacity of the economy and is one of the reasons that holds back potential growth. Unemployment has increased sharply, as the contraction in employment during the crisis has been more pronounced than suggested by the contraction of output. The low-skilled and young workers have been most affected by labour shedding. Despite relatively low wage costs, after strong increases in recent years, wage floors may risk pricing the most vulnerable out of the labour market. At the same time, active labour market policies and the educational system have not been effective in facilitating the adjustment process so far and hamper a broad-based accumulation of human capital.

Excerpt of country-specific findings on Bulgaria, COM(2014) 150 final, 5.3.2014

Executive Summary and Conclusions	9
1. Introduction	11
2. Macroeconomic Developments	13
3. Imbalances and Risks	19
3.1. External imbalances	19
3.1.1. External cost competitiveness	19
3.1.2. Sustainability of the external position	19
3.1.3. Current account cyclicity	21
3.1.4. Saving-investment balance	22
3.1.5. FDI and the road ahead	23
3.2. Labour market and social developments	25
3.2.1. Overview and recent developments	25
3.2.2. Social consequences of unemployment	28
3.2.3. Labour market policies and education	33
4. Policy Challenges	37
References	39

LIST OF TABLES

2.1. Key economic, financial and social indicators - Bulgaria	18
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LIST OF GRAPHS

2.1. Real GDP growth by demand components	13
2.2. Key labour market data	13
2.3. Components of potential growth	13
2.4. CA gross components	14
2.5. Private sector debt decomposition	14
2.6. Net assets by sector, non-consolidated	15
2.7. NFC deleveraging	15
2.8. House price cycle	16
2.9. House price ratios	16
3.1. Export market shares	19

3.2.	Decomposition of ULC growth by sector over 2008-2012, annualised	19
3.3.	External financing needs	20
3.4.	Gross external debt by currency	20
3.5.	Gross external debt structure	20
3.6.	Gross external debt by maturity	20
3.7.	NIIP stabilizing CA	21
3.8.	Underlying current account	22
3.9.	Saving - investment balance	22
3.10.	NFC profit margins	22
3.11.	Net investment by sector	23
3.12.	NFC saving - investment	23
3.13.	Net inward FDI stock	23
3.14.	Inward FDI stock by industry	24
3.15.	FDI inflows 2009-2013	24
3.16.	FDI inflows 2010-2013	24
3.17.	Employment rate	25
3.18.	Unemployment rate by duration	26
3.19.	Employment rate by education in 2012	26
3.20.	Unemployment rate by education level	26
3.21.	Average wage growth by educational attainment (02-10)	26
3.22.	Minimum and average wages (leva)	27
3.23.	Ratio of minimum wage to average earnings (2012)	27
3.24.	Ratio of minimum to average wage differentiated by education in 2010	27
3.25.	Number of sectors with minimum wage as the MSST	28
3.26.	AROPSE	29
3.27.	Severe material deprivation	29
3.28.	Deprivation by number of items (economic strain dimension)	29
3.29.	In-work AROP	30
3.30.	AROP by employment status	30
3.31.	Regional poverty (2008-12 avg)	30
3.32.	Regional unemployment	30
3.33.	Reduction in the risk of poverty after social transfers	30
3.34.	Non means-tested benefits	31
3.35.	Means-tested benefits	33
3.36.	Labour market policies by category (LMP expenditure)	33
3.37.	Lifelong learning (age 25-64)	33
3.38.	Labour market policies	34
3.39.	Expenditure on education and early school leavers	34

LIST OF BOXES

3.1. Roma participation on the labour market

32

EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that Bulgaria was experiencing macroeconomic imbalances, in particular relating to the high stock of external liabilities, the economic impact of deleveraging in the corporate sector as well as the protracted adjustment of the labour market. In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the persistence of imbalances or their unwinding. To this end, this In-Depth Review (IDR) provides an economic analysis of the Bulgarian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **A sustained current account adjustment has helped reduce the country's external financing needs, but the stock of liabilities remains high.** High foreign capital inflows contributed to the overheating of the economy and the accumulation of external liabilities before the crisis. From peak deficits in 2007-08, Bulgaria's current account has rapidly improved during the crisis and turned into a surplus in 2013. The adjustment appears to be mostly non-cyclical: it has been driven by a decrease in imports brought about by the crisis but also by a strong export performance, as reflected in Bulgaria's steady gains in world market shares. Thanks to this adjustment, the net international investment position has improved and external financing needs have decreased. Furthermore, the structure of external liabilities does not suggest immediate risks, as it is mostly composed of long-term euro-denominated intra-company loans, which also imply low foreign exchange risk. However, the stock of liabilities remains high. Further unwinding of this vulnerability will depend on strengthening further external competitiveness and a strong export performance.
- **Foreign direct investment remains a key source of funding future growth.** Ample foreign investment inflows before the crisis have benefitted some economic sectors but may have also inflated fixed asset prices. Since then, the country's saving-investment balance has improved, helping deleveraging. Continuing to attract foreign capital, and its efficient allocation, remains crucial for speeding-up growth and accelerating convergence.
- **Corporate indebtedness remains high and deleveraging pressures could limit growth in some sectors, but immediate risks for the economy appear contained.** The debt stock of non-financial corporations has been decreasing since 2010 but remains high as a share of GDP. As a response to deleveraging pressures, companies have increased profitability and saving, mostly through cost-cutting, including labour shedding. Going forward, still high indebtedness and the build-up of large other accounts payable (consisting of payments due to suppliers of goods and services, including arrears) could threaten the viability of some firms, or deter investment and growth. However, since most of the debt of non-financial corporations is in the form of intra-company loans, potential spillovers to the financial and public sectors appear limited as already underlined in the second IDR for Bulgaria.
- **The stability of the banking sector has been preserved and consolidation seems to be under way.** As described in the two previous IDRs, the banking sector has weathered the crisis well and continues to have strong overall capital buffers. Non-performing loans have stabilised and remain well-provisioned. Credit growth has resumed in some tradable sectors. Domestically-owned banks are expanding their portfolio faster compared to subsidiaries of foreign banks, which is likely a sign of higher risk appetite. The systemic importance of local entities has increased following their gains in market share, including two acquisitions of foreign-owned banks in the country in the last twelve months.
- **An underperforming labour market limits the adjustment capacity of the economy and holds back its growth potential.** During the crisis, the contraction of employment has been more pronounced than the contraction in GDP. Since 2008, unemployment has more than doubled, reaching 13% in 2013, and the number of young and long-term unemployed has increased drastically. The

employment rate remains low and a large section of the population faces major challenges to participate in the labour market, which exposes them to the risk of poverty. The fact that unemployment is the major driver of poverty in Bulgaria underscores the importance of a broad-based labour market recovery.

- **Increased wage floors risk pricing the low skilled out of the labour market.** Wage floors, in the form of minimum wages and in particular minimum thresholds for social security contributions, have increased substantially in recent years, endangering the employment prospects of low-skilled workers.
- **Active labour market policies have not been effective in facilitating adjustment, while weaknesses in the educational system hamper a broad-based accumulation of human capital.** Two groups, the low-skilled and young workers, have been hardest hit by labour shedding. So far, active labour market policies, including training, have not succeeded in reintegrating even the more experienced workers, thus contributing to skills mismatches and a high level of structural unemployment. Looking forward, weaknesses in the educational system, including poor outcomes and a high share of early school leavers, are a key concern for the employability of future workers.

The IDR also discusses the policy challenges stemming from the analysis and what could be possible avenues for the way forward. A number of elements can be considered:

- Concerning the challenge of ensuring a smooth deleveraging of the corporate sector, optimisation of the insolvency framework as well as strict implementation of the rules on late payments could be explored.
- As regards the challenge of sustaining the adjustment of the external position, maintaining fiscal stability would be beneficial for improving the business climate. Improved business environment would help attracting foreign capital and innovations into productive sectors, which in turn would help preserving competitiveness and safeguarding the strong export performance. Ensuring effective and increased EU funds absorption would help potential growth.
- Concerning the complex challenges facing the labour market, several policy avenues could be considered. Improving the effectiveness and increasing the efficiency of active labour market policies seems warranted. Ensuring that increased wage floors do not price the low skilled out of work would facilitate labour market adjustment. Addressing the challenge of reducing skills mismatches through advances in training and education could be beneficial for growth in the medium and long term.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

This is the third IDR for Bulgaria. The previous IDR was published on April 10, 2013 on the basis of which the Commission concluded that Bulgaria was experiencing macroeconomic imbalances, in particular involving the impact of deleveraging in the corporate sector as well as the continuous adjustment of external positions, competitiveness and labour market. Overall, in the AMR the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the persistence of imbalances or their unwinding. To this end this IDR takes a broad view of the Bulgarian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

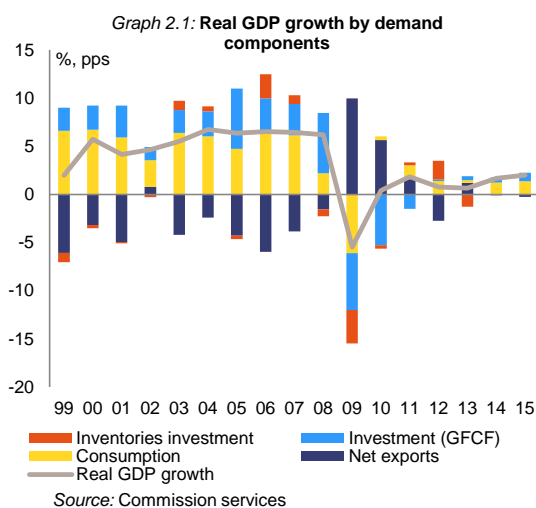
Against this background, Section 2 overviews the general macroeconomic developments and section 3 looks more in detail into the main imbalances and risks. Section 4 discusses policy considerations.

2. MACROECONOMIC DEVELOPMENTS

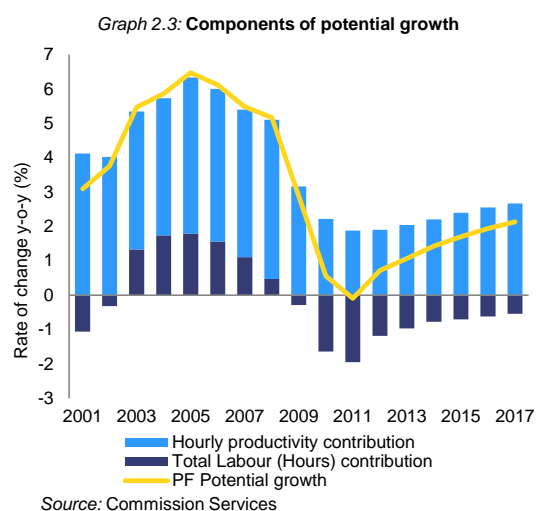
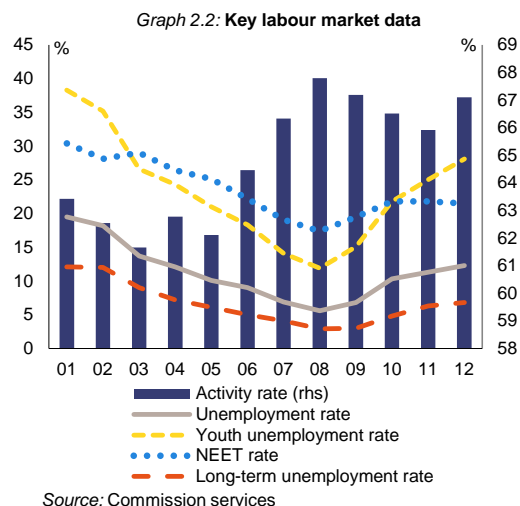
Growth remains low on the back of a weak labour market

The recovery in Bulgaria has been slow and the economy continues to operate considerably below potential. After a moderate rebound in 2011, growth has remained under 1% over 2012-13 and is projected to pick up only slowly over 2014-15 (EC forecast, 2014). In 2013 the output gap widened compared to 2011-12. The economy is forecast to remain below its potential over the forecast horizon, with the recovery depending on improvement of the labour market situation (See Graphs 2.1 and 2.3).

Inflation has decelerated sharply in 2013 and is projected to remain low. The low-growth environment and decreases in the administratively-set energy prices in 2013 have kept the average annual rate of HICP inflation at a very modest 0.4%. The expected moderate increase in economic activity over 2014-15 is projected to lift inflation somewhat (EC forecast, 2014).



The labour market remains in distress. Employment has been significantly affected by the crisis and has been declining since 2008 (see Graph 2.2). First signs of stabilisation were seen only in the second half of 2013. Unemployment has increased above the EU average, with significant differences across regions and educational levels. Going forward, the labour market is projected to stabilise and improve only gradually in the coming years (see section 3.2. for a detailed analysis of the labour market situation).



Fiscal stance remains stable

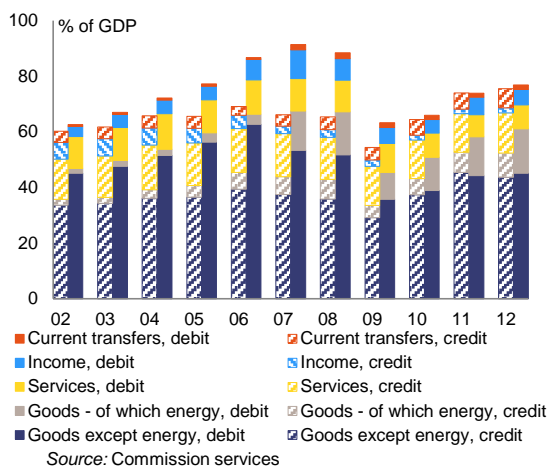
The fiscal position has stayed overall strong, despite an increase in the budget deficit in 2013-14. After a period of strong consolidation over 2010-12, the deficit has reverted to around 2% of GDP in 2013 due to a combination of revenue shortfalls and a fiscal stimulus, including social spending and some current expenditure. While increasing, the public debt level remains one of the lowest in the EU and financing conditions have remained favourable.

Strong export performance supports current account adjustment

The current account (CA) correction has improved Bulgaria's external position.

Following deficits of over 20% of GDP over 2007-08, the CA has returned to balance in 2010-13. Growing exports and current transfers, together with a decrease in imports, have contributed to the correction. Strong export growth has led to a positive CA in 2013. The export of goods has performed especially well and helped improve the traditionally negative trade balance in goods. The CA is forecast to turn to remain balanced over 2014-15, with the recovery of domestic demand and the associated increase in imports offsetting the growth in exports (EC forecast, 2014). The trade deficit in goods, excluding energy, has decreased since 2010 (see Graph 2.4). The deficit in energy trade remains present, although it has been reduced to an average of 6% of GDP over 2009-12, from 14% over 2005-08. Thus, balancing the CA is expected to depend on the export performance as well as the recently increasing current transfers, mostly due to higher remittances. Capital transfers, linked to EU funds absorption have also contributed positively to the overall external position and will remain important in the coming years. The structure of the CA and its implications for Bulgaria's external position are further discussed in section 3.1.

Graph 2.4: CA gross components



Private sector deleveraging continues

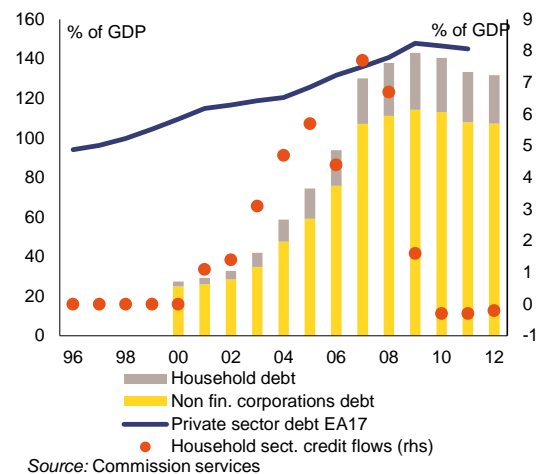
The high level of leverage in the private sector, more specifically of non-financial corporations

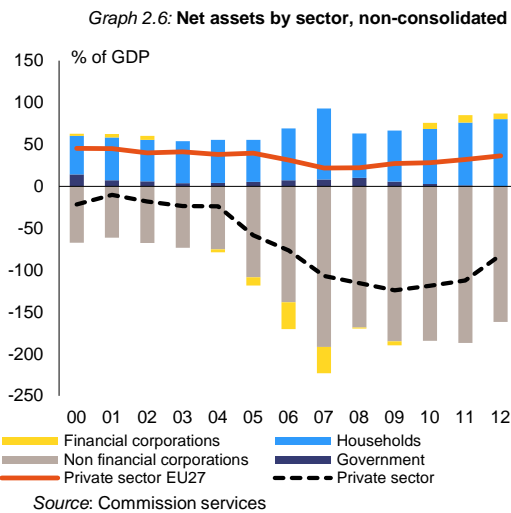
(NFC), was identified as a potential risk factor for the economy last year (IDR 2013). This section examines the latest developments in the sector and their risk implications for the overall economy.

Deleveraging of NFC is under way and could limit growth in the short term.

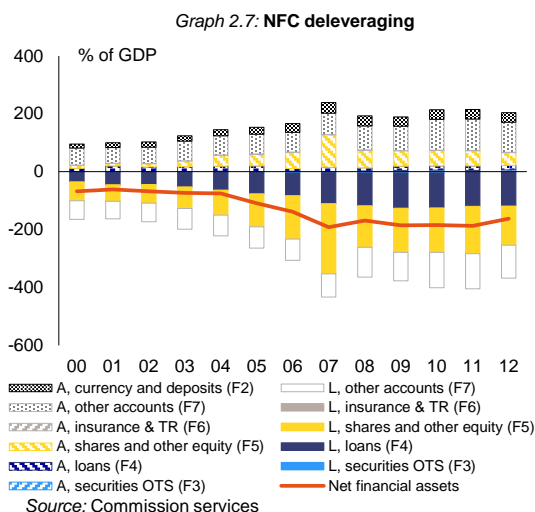
Private sector debt in Bulgaria is mainly concentrated in the non-financial corporate sector and is somewhat higher in comparison to the levels in peer European countries. However, a large share of the liabilities is in the form of cross-border intra-company loans, implying a lower-risk profile. In addition, deleveraging has been on-going since 2009, resulting in a correction by 7pps. in consolidated debt as well as an improvement of close to 30pps. in net financial assets by 2012 (both as share of GDP, see Graphs 2.6 and 2.5).

Graph 2.5: Private sector debt decomposition





Overall, indebtedness within the NFC sector remains high. On a non-consolidated basis, the sector continues to display a high level of overall indebtedness, including a large 'other payables' account (consisting of payments due to suppliers, rent on buildings and arrears, see Graph 2.7). The growth of this balance sheet item during the crisis years suggests an increase in arrears, which could raise the uncertainty between market participants.



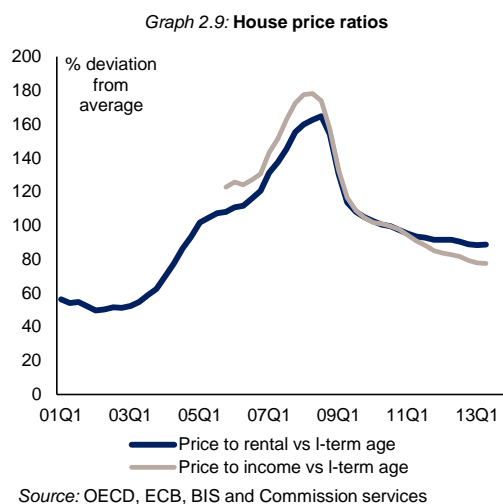
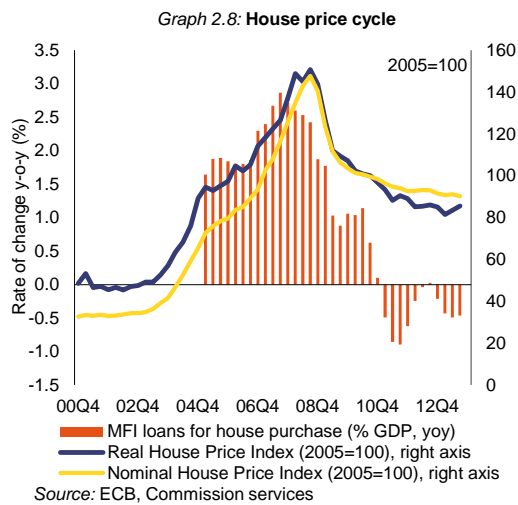
Newly introduced rules on late payments and revised bankruptcy procedures should facilitate the deleveraging process. In 2013, the government introduced stricter rules on late payments into national legislation, in line with EU requirements. Strict implementation of those rules would ensure a smooth settlement process. The

same is valid for the updated bankruptcy procedures, which have limited the possibility to 'backdate' insolvency during court proceedings. Data on the effects of those measures will only become available in the coming years.

High NFC indebtedness does not suggest significant spill-over effects to the banking sector. Most of the debt of NFC is in the form of cross-border intra-company lending, which is also reflected in the high foreign direct investment (FDI) stock. As a result, a relatively smaller share of capital has been channelled through the financial sector, which implies a lower risk of negative spill-overs from the NFC's deleveraging to the banks, than suggested by the high level of non-consolidated debt.

The indebtedness of households remains relatively low and decreasing. Households' debt has decreased by 4.2pps. as a share of GDP since the 2009 peak, reaching 24.5% of GDP in 2012, while their net financial assets have increased by 19pps. in the same period. The improvement is largely explained by the accumulation of deposits and other financial instruments, the latter most likely through the pension funds system.

The drop in house prices has decreased households' wealth. House prices have undergone a correction of over 40% since the peak in 2008, with a negative impact on household's wealth. However, prices appear to have stabilised in 2013 (see Graph 2.8). House price ratios suggest a possible undervaluation compared to historical averages (see Graph 2.9). However, those averages should be viewed critically, as the available time series mostly cover the period of peaking prices.



In conclusion, private sector indebtedness does not entail significant risks for the overall economy through spill-overs but could threaten the viability of some firms and be a limiting factor to investment and growth in the short and medium term.

Financial sector maintains stability

The banking sector has maintained macro-financial stability and witnessed some consolidation. The banking sector has weathered the crisis well due to strong banking supervision, conservative provisioning and a build-up of capital buffers. At the aggregate level, the banking system's capitalisation was little changed relative to a year ago. The regulatory capital adequacy ratio reached 16.9% in Q3 2013, marginally up

from 16.6% in Q3 2012. The average quality of banks' loan portfolio also remained broadly unchanged, with the non-performing loans (NPLs) ratio standing at 17.2% in Q3 2013. NPLs remain well-provisioned for with the coverage ratio of all buffers in the banking system reaching 99.8% of gross NPLs. ⁽¹⁾ The second part of 2013 has been marked by a significant deceleration of credit growth, which fell down to 0.5% y-o-y in Q3 2013. As a result, the system's credit to GDP ratio decreased slightly from 70% in Q3 2012 to 68.7% in Q3 2013. The sector is undergoing a process of consolidation. Two acquisitions of foreign banks' subsidiaries by domestically-owned banks were announced in the past year. According to the regulator, the consolidation is a welcomed step, which further strengthens the capital base and does not affect competition.

Banks' aggregate balance sheet shows a moderate overall expansion during the year prior to November 2013. The expansion consisted in the acquisition of foreign assets, funded by a continued rapid increase in domestically-collected resources. Total assets expanded by 4.5%. Domestic assets remained almost unchanged, given that the expansion in fixed assets by almost 16% more than offset the decline in banks' claims on the economy. On the liabilities side domestic deposits, included in the money supply, grew by 9.4%. Longer-term liabilities and other liabilities increased by 15.6% and 7.3% respectively. Banks' capital position and retained reserves continued to grow, even though by a moderate 2.8% y-o-y in November 2013. Given that the aggregate balance sheet expanded by less than the increase in the domestically attracted resources, banks' foreign liabilities declined by a non-negligible EUR 1.1 billion, or more than 15%.

The aggregate developments at the level of the system hide major differences at individual level, notably with respect to business development strategies and the underlying risk appetite. Foreign-owned banks continued their deleveraging process, which resulted in a notable decline in their market shares. At the same time, institutions owned by Bulgarian capital pursued an active expansionary policy, especially in the

⁽¹⁾ See IDR 2013 for details on the specific provisions used by the regulator.

segment of corporate clients. Thus, the market share of domestic banks reached 27.3% in June 2013, up from 15.7% prior to the 2008 crisis and 25% in June 2012. As a result, an increasing number of domestically-owned institutions could be considered systemically important now. On the one hand, this marked expansion might suggest that the local institutions are showing higher flexibility in their credit decisions by seizing the opportunity to develop when others are leaving the market. The positive implication thereof is that the supply of credit to the economy is not restrained and future growth prospects could be supported financially. On the other hand, however, this segmented credit expansion might be strongly influenced by business decisions at a broader group or shareholder level, without necessarily paying due attention to long-term viability implications of credit decisions.

In conclusion, the banking sector has managed to preserve its stability and no financial sector-related imbalance could be identified. Nevertheless, credit expansion by a limited number of domestically owned institutions warrants close monitoring by the regulator, which has so far proved to be a conservative one, in order to identify risks and take corrective measures early enough, should risks begin to materialise.

Table 2.1:

Key economic, financial and social indicators - Bulgaria	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (yoy)	6.4	6.2	-5.5	0.4	1.8	0.8	0.6	1.7	2.0
Private consumption (yoy)	9.0	3.4	-7.6	0.1	1.5	2.6	-0.4	1.4	1.7
Public consumption (yoy)	0.3	-1.0	-6.5	1.9	1.6	-1.4	3.1	2.2	2.3
Gross fixed capital formation (yoy)	11.8	21.9	-17.6	-18.3	-6.5	0.8	1.7	2.4	4.2
Exports of goods and services (yoy)	6.1	3.0	-11.2	14.7	12.3	-0.4	8.2	5.6	6.4
Imports of goods and services (yoy)	9.6	4.2	-21.0	2.4	8.8	3.7	5.0	5.5	6.8
Output gap	5.7	6.6	-1.8	-2.4	-1.4	-1.5	-1.9	-1.7	-1.5
Contribution to GDP growth:									
Domestic demand (yoy)	9.4	8.5	-12.0	-4.9	-0.3	1.6	0.6	1.7	2.3
Inventories (yoy)	0.9	-0.7	-3.4	-0.4	0.3	1.9	-1.9	0.0	0.0
Net exports (yoy)	-3.8	-1.5	10.0	5.6	1.8	-2.7	1.9	0.0	-0.3
Current account balance BoP (% of GDP)	-25.2	-23.1	-8.9	-1.5	0.1	-1.3	.	.	.
Trade balance (% of GDP), BoP	-19.7	-20.6	-8.2	-2.5	0.4	-2.9	.	.	.
Terms of trade of goods and services (yoy)	-0.1	-0.4	1.5	2.5	0.1	-1.3	0.9	-0.4	-0.3
Net international investment position (% of GDP)	-81.1	-98.4	-101.8	-95.4	-85.9	-79.7	.	.	.
Net external debt (% of GDP)	32.7	48.9	49.6	43.6	35.2	28.8	.	.	.
Gross external debt (% of GDP)	94.3	105.1	108.3	102.7	94.3	94.9	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	-21.9	-9.6	-4.4	-5.5	-4.3	-7.0	.	.	.
Private credit flow (consolidated, % of GDP)	43.4	34.7	5.1	3.3	1.7	2.5	.	.	.
Private sector debt, consolidated (% of GDP)	130.1	137.9	143.0	140.5	133.4	131.8	.	.	.
Deflated house price index (yoy)	.	.	-21.6	-12.3	-9.7	-5.3	.	.	.
Residential investment (% of GDP)	5.3	6.1	5.3	2.8	2.4	.	.	.	.
Total Financial Sector Liabilities, non-consolidated, (% of GDP)	29.3	-0.8	1.3	-1.7	4.9	10.1	.	.	.
Tier 1 ratio (1)	11.6	13.0	17.5	16.5	14.9	14.6	.	.	.
Overall solvency ratio (2)	13.9	14.9	17.0	17.4	17.6	16.6	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	3.3	4.8	11.5	17.9	19.7	19.8	.	.	.
Employment, persons (yoy)	3.2	2.6	-2.6	-4.7	-3.4	-4.3	-0.2	0.2	0.4
Unemployment rate	6.9	5.6	6.8	10.3	11.3	12.3	12.9	12.7	12.1
Long-term unemployment rate (% of active population)	4.1	2.9	3.0	4.8	6.3	6.8	.	.	.
Youth unemployment rate (% of active population in the same age group)	14.1	11.9	15.1	21.8	25.0	28.1	28.6	.	.
Activity rate (15-64 years)	66.3	67.8	67.2	66.5	65.9	67.1	.	.	.
Young people not in employment, education or training (% of total population)	19.1	17.4	19.5	21.8	21.8	21.5	.	.	.
People at-risk poverty or social exclusion (% total population)	60.7	44.8	46.2	49.2	49.1	49.3	.	.	.
At-risk poverty rate (% of total population)	22.0	21.4	21.8	20.7	22.2	21.2	.	.	.
Severe material deprivation rate (% of total population)	57.6	41.2	41.9	45.7	43.6	44.1	.	.	.
Persons living in households with very low work intensity (% of total population)	16.0	8.1	6.9	8.0	11.0	12.5	.	.	.
GDP deflator (yoy)	9.2	8.4	4.3	2.8	4.9	2.2	2.2	0.9	2.0
Harmonised index of consumer prices (yoy)	7.6	12.0	2.5	3.0	3.4	2.4	0.4	0.5	1.8
Compensation of employees/head (yoy)	12.7	16.8	8.1	9.9	6.8	2.9	4.4	3.5	3.6
Labour Productivity (real, person employed, yoy)	3.2	3.7	-3.8	4.4	4.1	3.4	.	.	.
Unit labour costs (whole economy, yoy)	9.3	12.6	12.4	5.2	2.5	-0.5	3.6	1.9	1.9
Real unit labour costs (yoy)	0.1	3.8	7.7	2.4	-2.2	-2.6	1.4	1.0	0.0
REER (ULC, yoy)	7.1	9.0	10.2	3.2	4.1	-3.8	4.4	2.8	0.3
REER (HICP, yoy)	4.7	8.6	4.0	-2.9	1.0	-2.0	0.1	1.1	-0.5
General government balance (% of GDP)	1.2	1.7	-4.3	-3.1	-2.0	-0.8	-1.9	-1.9	-1.7
Structural budget balance (% of GDP)	-0.7	-0.5	-3.8	-2.2	-1.5	-0.3	-1.3	-1.4	-1.2
General government gross debt (% of GDP)	17.2	13.7	14.6	16.2	16.3	18.5	19.4	22.7	24.1

(1) domestic banking groups and stand-alone banks.

(2) domestic banking groups and stand-alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

Source: Eurostat, ECB, AMECO.

3. IMBALANCES AND RISKS

3.1. EXTERNAL IMBALANCES

Bulgaria's external position is highly negative and can be considered a possible imbalance, largely formed during the 2005-09 period. This section analyses Bulgaria's external position in terms of its net international investment position (NIIP) and gross external debt in order to evaluate the extent of the imbalance and the risks it poses to the economy going forward. Contributing factors like the CA developments are examined to evaluate external sustainability and the role played by the business cycle in the observed outcomes. Finally, recent FDI developments are summarised and identified as a key component for funding future growth.

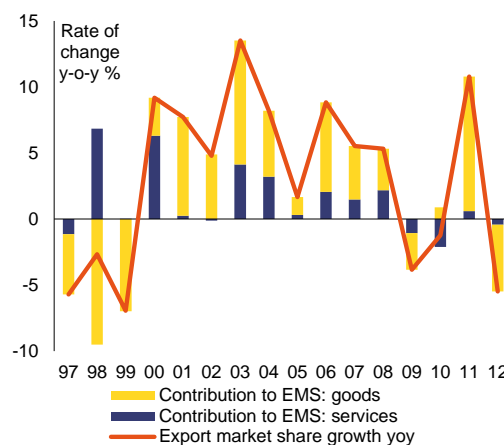
3.1.1. External cost competitiveness

The export performance currently does not seem to be harmed by competitiveness issues. Bulgaria has consistently gained export market shares since 2000, with the exception of the crisis years 2009-10 (see Graph 3.1). After a one-year dip in 2012, the country is set to continue gaining world market shares in 2013 and 2014.

Unit labour cost (ULC) growth has moderated but wage growth continues to outpace gains in productivity. Labour cost and unit labour cost (ULC) growth has slowed down considerably in the last years, especially in the tradable sector (see Graph 3.2). Nevertheless, wage growth remains somewhat higher than productivity advances, most notably in the services sector. This higher growth may be harmful for cost competitiveness going forward, particularly as wage pressure in the non-tradable sector can be transmitted to the tradable sector and increase overall price levels or squeeze profit margins. ULC growth is projected to remain moderate until 2015 (EC forecast, 2014). Non-cost factors have been shown to reconcile the observed gains in market shares and the losses in cost competitiveness. ⁽²⁾

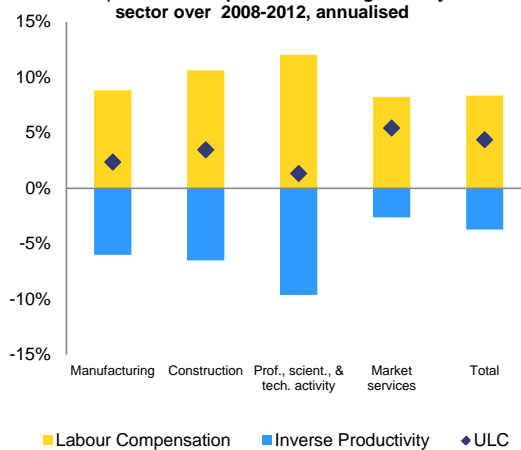
⁽²⁾ See IDR 2013 as well as Benkovskis and Wörz, 2012 and Di Comite, 2012 for more details.

Graph 3.1: Export market shares



Source: Commission services

Graph 3.2: Decomposition of ULC growth by sector over 2008-2012, annualised

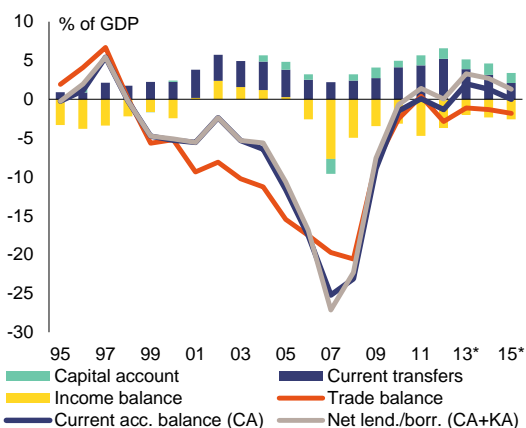


Source: Commission services

3.1.2. Sustainability of the external position

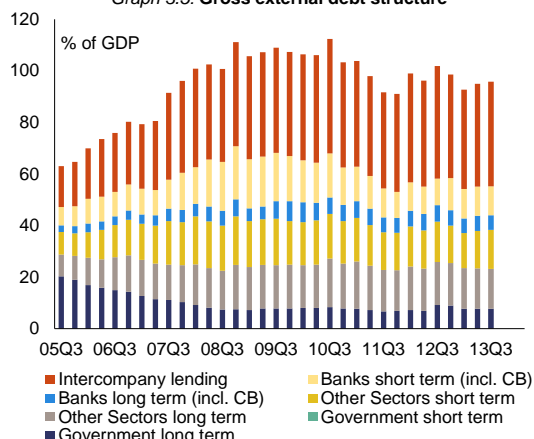
External financing needs have decreased since 2009. The balancing of the CA after the crisis has helped reduce the country's net borrowing needs and consequently its NIIP (see Graph 3.3). The NIIP has undergone a stable improvement of over 20 pps. of GDP in the 2009-12 period. The improvement is mainly driven by the reduction of net external debt (also by over 20 pps. of GDP). Furthermore, a large portion of the NIIP is FDI stock, which has built-up during the boom years and has remained stable since then.

Graph 3.3: External financing needs



Source: Commission services

Graph 3.5: Gross external debt structure

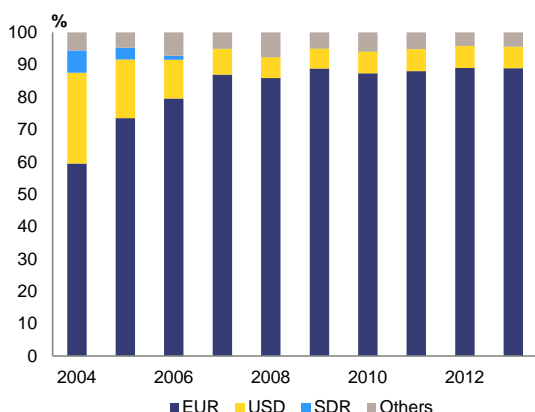


Source: Commission services

The gross external debt is mostly euro-denominated, implying low foreign exchange risk (see Graphs 3.4 and 3.5). At the sectoral level, the same holds for government, corporate and banking debt alike. The share is expected to increase even further in 2015, when a relatively large US dollar-denominated government bond issue matures. The authorities have indicated plans to refinance the bond in euro (National Reform Programme, 2013). The currency-board regime in the country, under which the Bulgarian lev is pegged to the euro, is stable and supported by sufficient currency reserves.

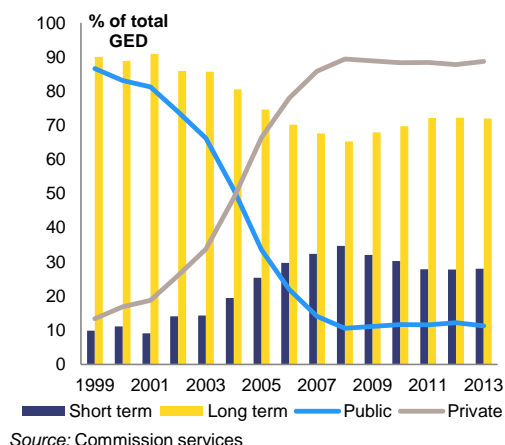
No short-term refinancing concerns are observed. Short-term debt has decreased recently, after peaking at close to 35% of the total in 2008 (see Graph 3.6). It is roughly equally distributed between the financial and non-financial corporate sectors. The government's external debt is entirely long-term. After a drastic reduction over 1999-2008, both in absolute and relative terms, it has stabilised around 11.5% of the total GED over 2008-12.

Graph 3.4: Gross external debt by currency



Source: Commission services

Graph 3.6: Gross external debt by maturity



Source: Commission services

The net external position is mostly influenced by liabilities developments but assets are gaining importance. Bulgaria still holds a relatively small stock of assets abroad and its NIIP is mostly affected by changes on the liabilities side. Nevertheless, assets are gaining importance since 2008 and will deserve more attention going

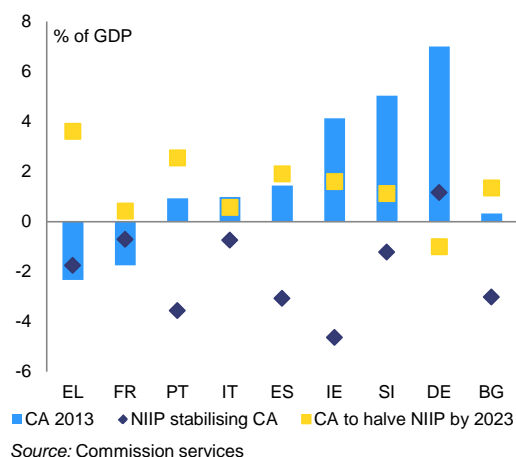
forward. Notably, holdings, other than the reserves held by the central bank, are increasing their share in the asset mix mostly due to growing portfolio investments and some FDI. Domestic banks and pension funds have been increasingly buying foreign assets, mostly government bonds. With the development of the financial market and growth of the pension funds, those investments will play a larger role in shaping the country's NIIP.

Currently, the implied yield is higher on liabilities than on assets. The implied yield on foreign-owned domestic equity is almost three times higher than the return on foreign equity. The yield on domestic debt is somewhat lower than on foreign, which could be linked to the large amount of cross-border intra-company loans, which are used by foreign investors to finance local operations. As assets held abroad increase, a higher yield on those could benefit the income balance of the current account.

NIIP improvement is expected to continue in the short term. The in-house model, used to forecast the development of the NIIP⁽³⁾, indicates a continued improvement of the external position over the forecast horizon. Stabilising the NIIP as a share of GDP at its 2012 level would require a CA deficit of at most 3% of GDP (see Graph 3.7). This translates into a non-interest CA (trade balance + current transfers) surplus of 1.5%. Reducing the NIIP as share of GDP in half over the next ten years requires an average CA surplus of 1.3%, equivalent to a non-interest CA surplus of 4.8% per year. Thus, the average forecast CA balance of -0.1% of GDP until 2015 implies only a gradual improvement in the NIIP.

⁽³⁾ The model has been developed by the European Commission's Directorate General for Economic and Financial Affairs. The baseline scenario assumptions for GDP growth, inflation and external yield are based on the Financial Sustainability Report 2012.

Graph 3.7: NIIP stabilizing CA



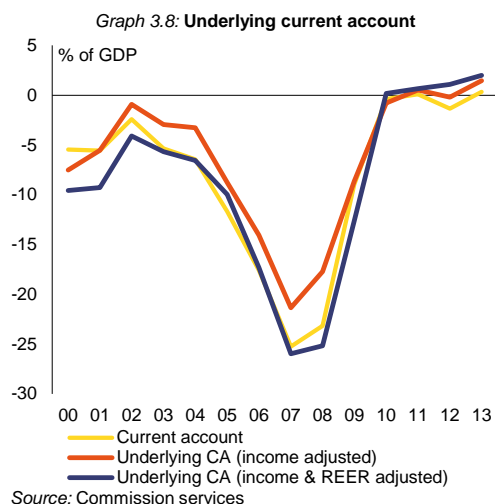
FDI is expected to remain a key component of funding future growth in the medium and long term. As discussed below (section 3.1.5.), the current increase in saving is mostly a response to deleveraging pressures and is not expected to be sufficient for fully financing growth going forward. The observed recent improvements in the NIIP, which are forecast to continue in the short term, could be reversed in the medium term. This once again highlights the importance of FDI and improved EU funds absorption for increasing potential growth and improving the NIIP through reducing net borrowing.

3.1.3. Current account cyclicity

CA balance correction over 2007-2013 appears mostly non-cyclical. The economic cycle can only partly explain the large pre-crisis CA deficits. The average positive output gap over 2004-08 is estimated at 4.4% of potential GDP, peaking at over 6% in 2008. At the same time, the CA deficit was exceptionally high only in 2007 and 2008. The rapid correction that followed does suggest a larger cyclical component. Thus, non-cyclical drivers seem to have played the major role in the post-crisis CA improvement. This conclusion is also supported by data from an in-house model for adjusting the CA for the output gap and REER movements (see Graph 3.8).⁽⁴⁾ According to the model, the majority of the CA correction observed over 2007-13 has been non-cyclical. This observation is supported by the gains in world

⁽⁴⁾ Graph produced using a horizontal model for calculating underlying CA.

market shares seen over the past decade, and concentrated mostly in tourism, agricultural goods, metals and mineral products.

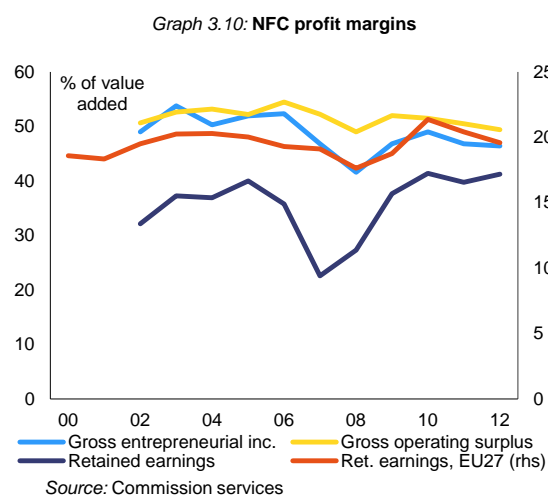
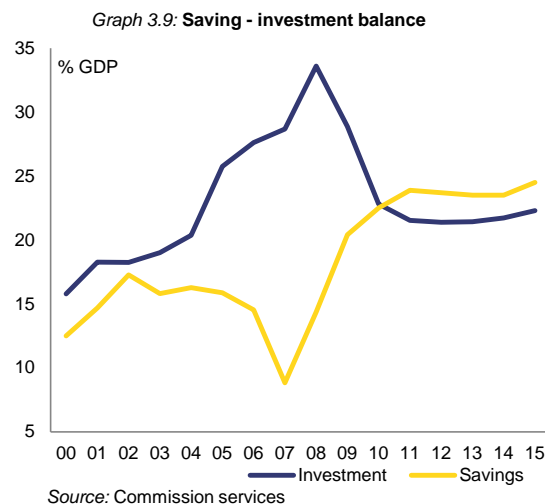


CA deficits during the boom years can be considered as a one-off event. For the Bulgarian economy, the 2005-08 period was characterised by a remarkable combination of global economic growth, financial markets deepening and positive confidence effects in the build-up to the country's EU accession. The large current account deficits were financed by FDI inflows and, to a large extent, driven by those foreign investments requiring imports of goods and services, like manufacturing and real estate. A repetition of this or a similar combination of economic conditions seems unlikely. The current economic climate is characterised by higher risk perception, resulting in more cautious investment decisions and only modest capital inflows.

3.1.4. Saving-investment balance

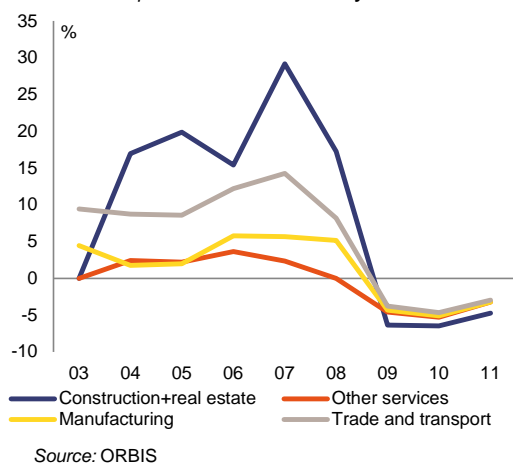
Saving has increased in response to deleveraging pressures. The saving-investment balance of the total economy has stabilised since 2010, with saving moderately outpacing investment (see Graph 3.9). This balance can be explained by the rapid increase in leverage in the pre-crisis period, which resulted from the high investment and low saving rates. With the economy slowing down, NFC faced deleveraging pressures in order to remain viable. Investment has been reduced and NFC profitability has increased markedly (see Graph 3.10). Despite those efforts,

deleveraging has only been moderate, implying a continued period of increased saving may still be needed.



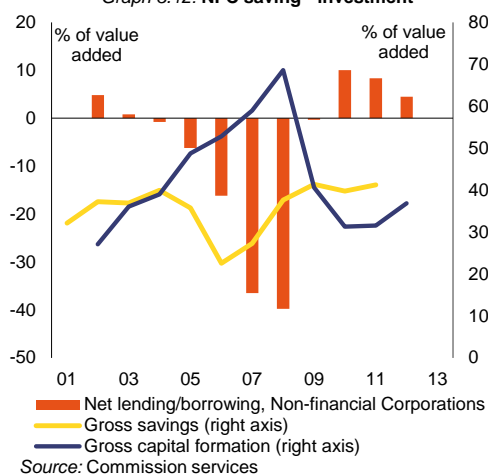
Investment contracted sharply and is recovering only gradually. Investment peaked in 2008 and seems to have bottomed out over the following two years. The largest contraction was in the construction and real estate sectors. Nevertheless, net investment (excluding estimated depreciation) has been negative in all sectors since 2009 (see Graph 3.11). At the same time, capacity utilisation in industry has recovered somewhat but remains below the peak levels of 2007 and 2008. Funding investments is unlikely to be secured by domestic saving alone, highlighting the importance of FDI going forward (also discussed later in this section).

Graph 3.11: Net investment by sector



Source: ORBIS

Graph 3.12: NFC saving - investment



Source: Commission services

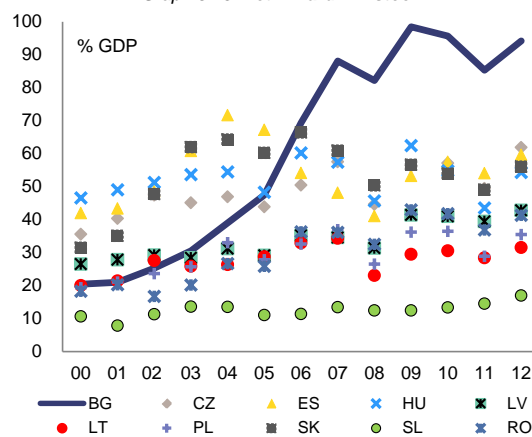
Corporate deleveraging pressures created the need for increased profitability and may partly explain the steep drop in employment. The high leverage resulted from a considerable saving-investment imbalance both for non-financial corporations and the economy as a whole (see Graph 3.12). Deleveraging pressures created the need to increase saving through improved profitability and also seem to have impacted employment negatively. The drop in employment in Bulgaria observed since 2008 was higher than in other countries with similar drop in output. A possible explanation relates to the rapid accumulation of corporate debt in the pre-crisis years and the currently on-going balance sheet repair (Bakker and Zeng, 2013). Adjustment seems to have relied on labour shedding and not on wage adjustment. The labour productivity increased and firms' competitiveness may have been preserved

and even improved. ⁽⁵⁾ The strong current export performance supports this observation.

3.1.5. FDI and the road ahead

Bulgaria's net inward FDI stock is high and likely to increase. The relatively large FDI stock compared to other EU-10 countries has mostly been accumulated during the 2005-07 period through strong inflows in the manufacturing, construction and real estate sectors (see Graphs 3.13 and 3.14). This result can be explained by the potential of high returns, given the country's low labour costs and excellent tourism potential and lower risk perception associated with the country's EU accession. The high FDI stock, including a high share of parent company lending, decreased the risk of swift capital outflows during the crisis, often associated with portfolio investments and third-party lending. Cross-border intra-company lending also limited the negative spill-over effects to the financial sector. As a small converging economy, Bulgaria's future growth is likely to require further FDI inflows.

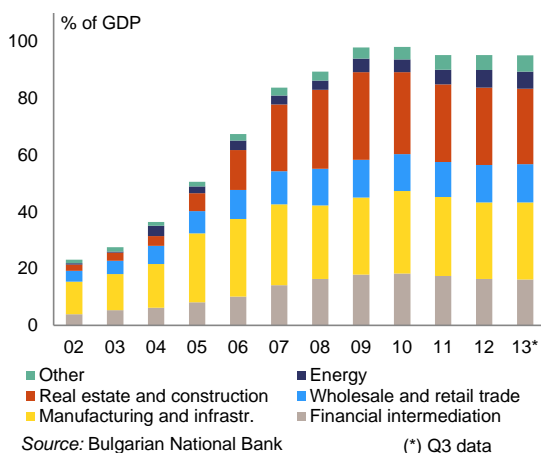
Graph 3.13: Net inward FDI stock



Source: UNCTAD

⁽⁵⁾ This is more likely the case for the tradable sector. Job losses in construction have been matched by a reduction in the number of active companies.

Graph 3.14: Inward FDI stock by industry



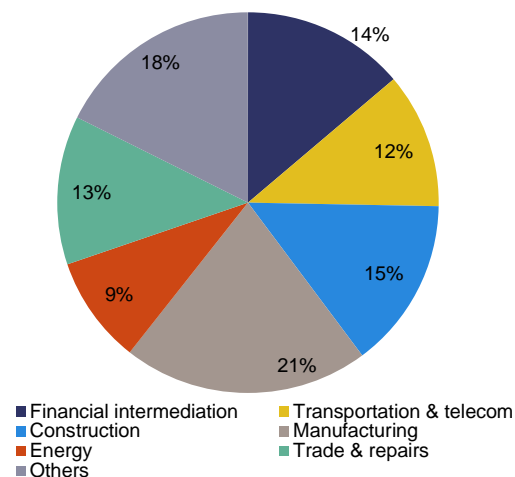
FDI appears to have benefitted parts of the manufacturing and tourism sectors.

Investments in manufacturing have improved the sector's competitiveness and boosted the county's export performance, which has been the only driver of growth after the crisis. Capital flows in construction and real estate have increased Bulgaria's tourism potential and the country has gained world market shares in travel services. On the negative side, the rapid build-up of FDI has resulted in an overheating with inflated fixed asset prices in the abovementioned sectors. Corresponding corrections became necessary when FDI flows dried up. Economic sectors which have not attracted significant FDI, including education and healthcare, are among those most in need of transformation.

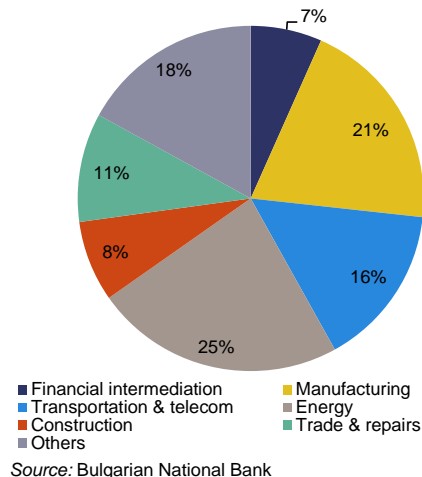
Foreign investors have shifted their sectoral focus in the post-crisis period.

Statistics on recent FDI flows show a shift in the interests of foreign investors. The energy sector, including renewable energy sources, has attracted the most attention (see Graph 3.15 and 3.16). The FDI stock in energy has doubled over 2010-13. Manufacturing has attracted 21% of the investment flows. Transportation, telecom and financial services have more or less maintained constant inflows. Construction investments have also continued but are likely linked to infrastructure developments, given the sharp reduction in real estate activity. The last strong inflow in real estate was in 2009, when the sector attracted over 20% of the total. The sector has witnessed an outflow of investments amounting to 6% of the total FDI flows since then.

Graph 3.15: FDI inflows 2009-2013



Graph 3.16: FDI inflows 2010-2013



Attracting FDI in the tradable sector remains crucial.

As mentioned before, foreign investments in the tradable sector have improved competitiveness and increased exports. Broadening the range of business activities that attract FDI within the tradable sector would provide a strong base for continued exports growth. Recent examples of increased activity include the automotive, pharmaceutical and metal manufacturing industries. Thus, improving the business environment and ensuring a well-functioning labour market remain vital for the attractiveness of the country as an investment destination.

Attracting FDI in some non-tradable sectors overlooked until now may also be beneficial.

Strong FDI in telecommunications, financial and other business services (e.g. advertising, marketing), which are key intermediary inputs have played an indirect role in improving external competitiveness and strengthening the tradable sector's export capacity. Sectors like education and healthcare, which have received very little attention from foreign investors so far, could also be beneficial for competitiveness and the overall development of the country.

In conclusion, the previously-identified risks related to the country's negative external position appear to be decreasing. The CA balance adjustment has been sustained over the last five years and is forecast to remain broadly balanced over the forecast horizon (EC forecast, 2014). However, the stock of liabilities remains high and further unwinding would depend on sustaining external competitiveness and a strong export performance.

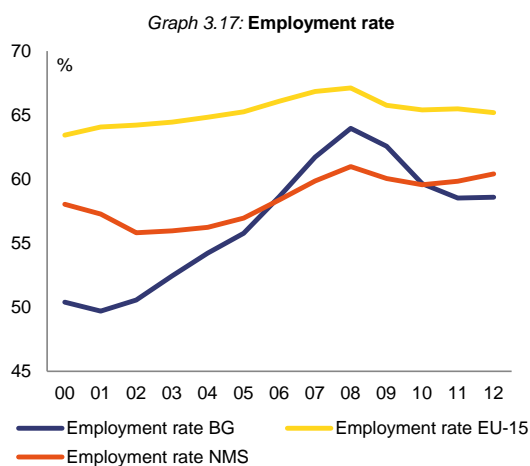
3.2. LABOUR MARKET AND SOCIAL DEVELOPMENTS

Rising unemployment in Bulgaria and the overall weakness of the labour market, discussed below, limits the adjustment capacity of the economy in the short term and restricts growth in the medium and long term. This section presents the main difficulties facing the Bulgarian labour market as well as some underlying structural problems in the formation and skill composition of the labour force. The possible impact of minimum wage and social security threshold setting is explored. Also, the role played by labour market and education policies in facilitating labour market adjustment and addressing labour market exclusion is explored. The significance these developments have for social outcomes is analysed.

3.2.1. Overview and recent developments

The labour market has remained weak over an extended period, with first signs of stabilisation visible only in the second half of 2013. Part of the employment weakness can be attributed to the strong decline in Bulgaria's working-age population by about 1.5% per year due to negative demographic trends (low birth rate, ageing population, emigration). However, even if corrected for the population decline, the

employment rate, as a share of the working-age population, has declined strongly in Bulgaria by over 5 pps. from the peak in 2008 to 2012 (see Graph 3.17). The unemployment rate has also more than doubled from about 5% of the labour force in 2008 to about 13% in 2013. After the first signs of stabilisation in 2013, the recovery in the labour market is forecast to remain modest also in 2014-15 (EC forecast, 2014).

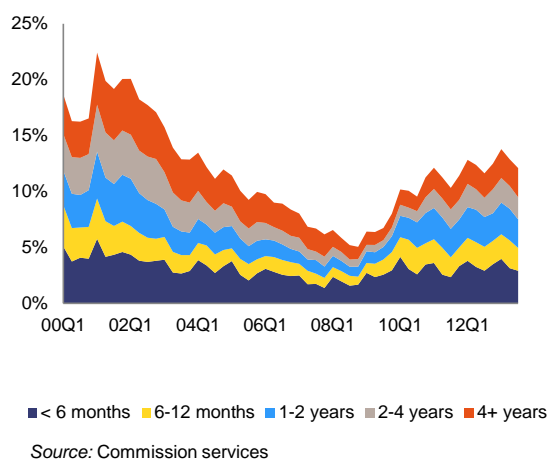


Long-term unemployment has increased markedly since 2008 and risks becoming structural. The average unemployment duration grew between 2009 and 2013. Notably the share of people out of job for more than four years increased from around 14% to over 20% of all unemployed between 2010 and 2013 (see Graph 3.18). This increases the risks of unemployment becoming structural as the skills of the jobless are eroded or become irrelevant with the changing demands of the labour market. High structural unemployment would lower the economy's growth potential and its adjustment capabilities.

The crisis has affected the lowest-skilled and the young the most. As identified in previous studies (Maiväli and Stierle, 2013; IDR 2012 and 2013), the unemployment rate is especially high and increased the most over the crisis for the following labour market groups: people with low educational attainment, the young and the country's Roma population. In terms of sectors, the largest job losses have been in construction and manufacturing. Large regional disparities in unemployment existed already before the crisis and have remained prominent.

Employment status depends strongly on the level of educational attainment. Many of the lowest educated are not active in the labour market. Only about 15% of the lowest educated population group are employed, compared with 63% of the population with upper secondary education and over 81% with university degree (see Graph 3.19). Similarly, the unemployment rate of those with primary or lower education is significantly higher and increased the most during the crisis (see Graph 3.20). The weaker standing of lower-educated people in the labour market is reflected in lower wages and also in lower wage growth over the past decade (see Graph 3.21).

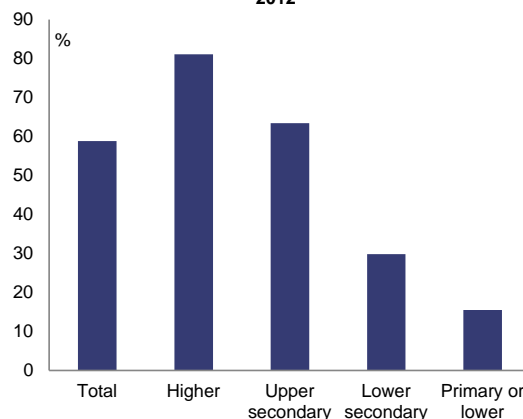
Graph 3.18: Unemployment rate by duration



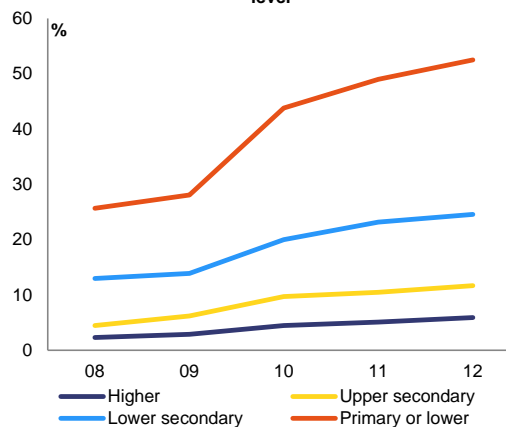
The crisis has also affected some 'core' groups of workers that are typically not excluded from the labour market. As discussed, relatively large shares of the low-educated workers have become or remained jobless following the crisis. However, this group forms a small share of the working age population, while workers with upper-secondary or higher education account for close to 78%. ⁽⁶⁾ It is thus this latter group that defines the aggregate labour market outcomes, making it the more problematic that also experienced middle-skilled workers lost their jobs. A statistical profiling of the out-of-work population reveals that a relatively large out-of-work group can be characterised as middle-aged rural population with ample previous work experience and medium educational attainment level (World Bank, 2014).

⁽⁶⁾ Data source: Commission services.

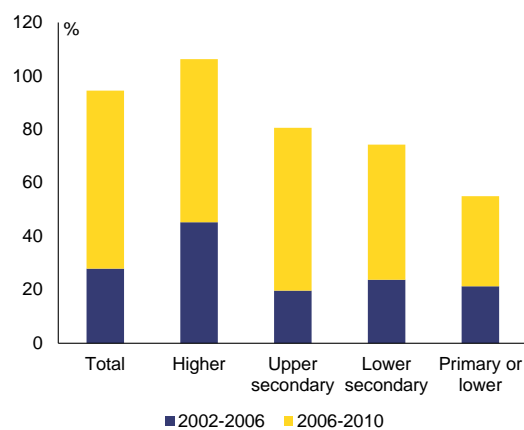
Graph 3.19: Employment rate by education in 2012



Graph 3.20: Unemployment rate by education level



Graph 3.21: Average wage growth by educational attainment (02-10)

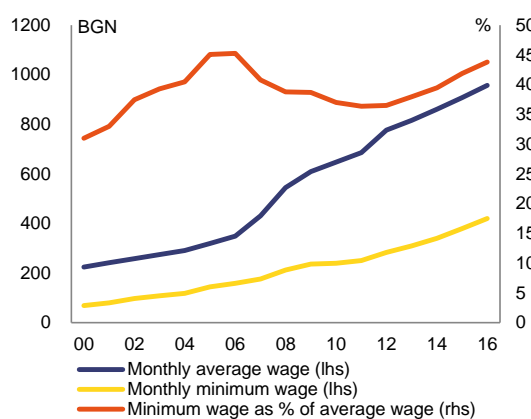


The existence of wage floors, through the minimum wage and social security thresholds (MSST),⁽⁷⁾ and their increase in recent years, risks pricing the low-skilled out of the labour market and limiting labour market adjustment.

While the aim of a wage floor is to support the incomes of low paid, low productivity workers, it also raises the cost of labour for them and might reduce their employment opportunities. Given the weak standing of the low-skilled in the Bulgarian labour market, the impact of such floors can be particularly important. In particular, wage floors may limit downward wage flexibility in the face of a crisis and could potentially explain some of the strong employment decline concentrated among the least skilled (and lowest paid) worker groups.

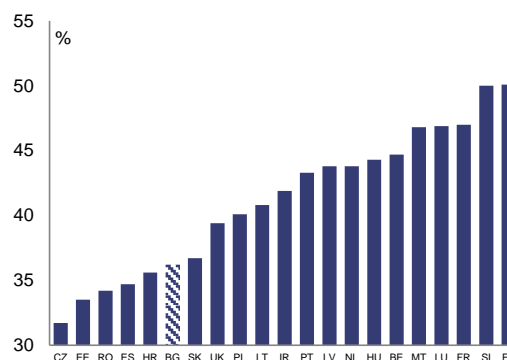
Minimum wages have been raised strongly since 2011. Over recent years, the Bulgarian authorities seem to have changed their previously cautious policies on the minimum wage and have raised it strongly (see Graph 3.22). Cumulative increases from 2011 to 1 January 2014 amount to about 40%. In spite of the recent strong increases, in absolute levels the Bulgarian minimum wage per month remains the lowest in the EU, even when taking into account price level differences. The ratio of the minimum wage to average earnings is still relatively low compared to most other EU Member States (see Graph 3.23), but is higher for the low skilled. Already in 2010, i.e. before the strong increases, the ratio of the minimum wage to the average wage approached 70% for the least educated workers (see Graph 3.24).

Graph 3.22: Minimum and average wages (leva)



Source: NSI and Ministry of Finance

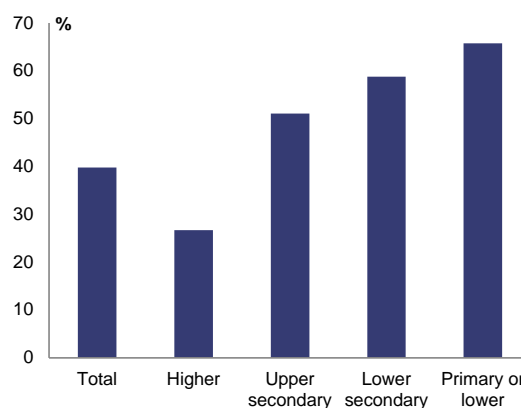
Graph 3.23: Ratio of minimum wage to average earnings (2012)



Due to differences in the data source, these ratios are not comparable with the Bulgarian Statistics Office data

Source: Commission services

Graph 3.24: Ratio of minimum to average wage differentiated by education in 2010



Source: NSI

Minimum wage policy is intertwined with the MSST. This system was introduced by the government in 2003 with a view to combating the shadow economy and improving tax collection and sets over 700 different minimum-income thresholds across about 85 sectors and 9 occupations for the calculation of social security contributions. MSST has a strong impact on the lower end of the wage distribution and can explain the low coverage of the minimum wage. While the MSST are typically set higher than the national minimum wage, after the strong increases in the minimum wage this does not hold anymore for many unskilled and low-skilled occupations. In addition, the MSST could have an impact on wage demand throughout the wage scale, given that they are also set by occupation.

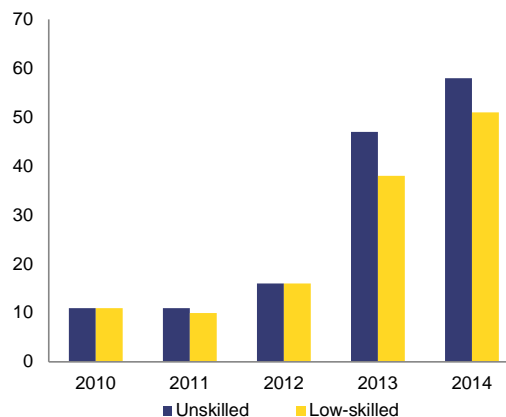
⁽⁷⁾ See IDR 2013 for a full overview of the MSST.

The thresholds are considered by social partners as indicative minimum wages by sector and occupation. Employee organisations have an incentive to ask for higher thresholds as this indirectly leads to higher wages. The government also has some incentives for increasing thresholds as this directly adds to tax revenues and reduces the shadow economy. At the same time, the potential adverse impacts on employment might be overlooked since these effects are less immediately evident. Most of the thresholds were increased substantially also during the crisis.

The growth of MSST has been differentiated according to sectoral and occupational economic conditions but remains strong for the low-skilled. The minimum thresholds are agreed between social partners or, in case an agreement is not reached for some groups, these thresholds were administratively set by the government. As of 2013, contrasting to previous years, the government decided to keep the limits for those professions unchanged where the employers and employees were unable to reach an agreement. This has also resulted in a lower average increase of the thresholds. However, the recently strongly increased minimum wage has pushed up the lowest MSST, even though the average growth rate of the MSST has subsided since 2011. Notably for unskilled and low-skilled the minimum wage has become the MSST in most economic sectors (see Graph 3.25). Thus, increases in the minimum wage since late 2011 administratively have raised the MSST for the unskilled and low-skilled at a higher rate than the average MSST growth.) MSST may also have resulted in a compressed wage distribution. The declared wage of over one quarter of all employees is just above their respective minimum threshold (within 10% of the threshold). ⁽⁸⁾

⁽⁸⁾ Own calculations based on unpublished data.

Graph 3.25: Number of sectors with minimum wage as the MSST



Source: Ministry of Labour and Commission services

The government has taken some action to analyse the impact of MSST increases but policy implications remain unclear. In 2013, the Ministry of Finance completed a study on the employment effects of the MSST, focusing on the low-skilled in several services sectors. A second study is under way in 2014, examining the possible effects of MSST growth on employment by region and firm size. Preliminary results point to possible negative effects for small and micro firms but not necessarily on regional level. The government has not specified the possible policy implications of the results of those studies.

3.2.2. Social consequences of unemployment

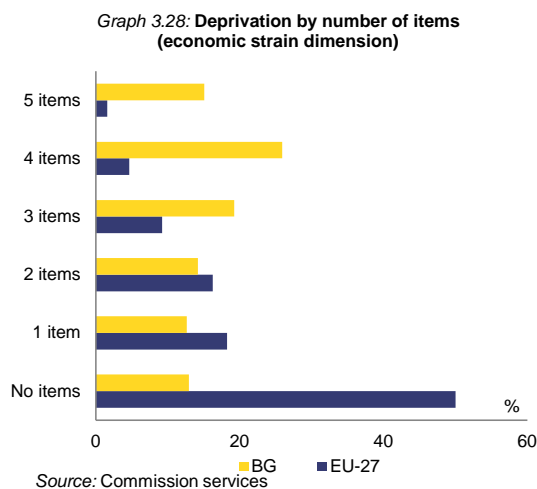
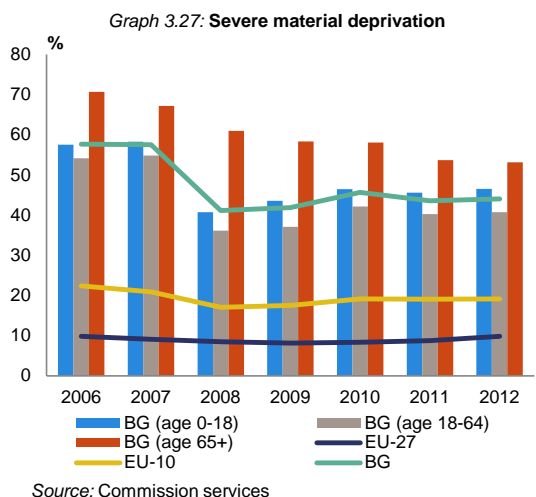
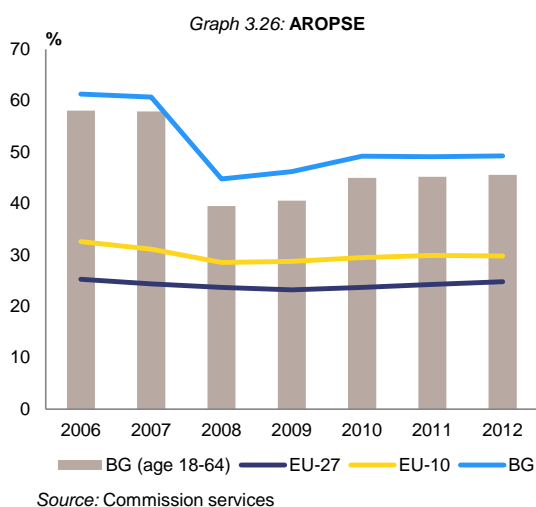
As suggested in previously published analysis, poor labour market outcomes and a non-inclusive labour market have negative social consequences, through increased poverty and material deprivation (Maiväli and Stierle, 2013, IDR 2013) Below we look at the main social indicators for Bulgaria.

Nearly half the population is at risk of poverty or social exclusion. The composite indicator, AROPSE ⁽⁹⁾ is close to 50% in Bulgaria (see Graph 3.26). The high level is mostly due to the high share of people living in severe material deprivation. The share of people living in severe material deprivation ⁽¹⁰⁾ in Bulgaria is more than

⁽⁹⁾ AROPSE – At risk of poverty or social exclusion.

⁽¹⁰⁾ Living conditions severely constrained by a lack of resources, they experience at least 4 out of 9 following deprivations items: cannot afford i) to pay rent or utility bills, ii) keep home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every

double the EU-10 average and more than 4 times higher than the EU average (see Graph 3.27). This can partly be explained by the differences in GDP per capita, as the indicator includes many tradable goods. Nevertheless, the share of people constrained by their economic situation is considerable (see Graph 3.28).

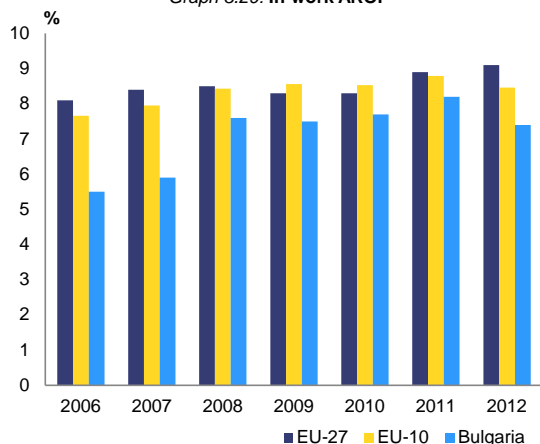


Employment income appears key for reducing the risk of poverty, while the unemployed face the greatest risk of poverty. While overall the risk of poverty is much higher in Bulgaria than in all other EU countries, for the employed it's even lower in Bulgaria than in the EU on average (see Graph 3.29). This underscores the importance of a labour market recovery in Bulgaria and the importance of effective active labour market policies (ALMP) in facilitating labour market adjustment. By contrast, close to half of the unemployed are at risk of poverty, compared to around a quarter of the retired and other inactive persons (see Graph 3.30).

The link between unemployment and poverty is also confirmed at the regional level. As can be expected, regions with higher unemployment and lower GDP per capita also have a higher share of their population at risk of poverty (see Graphs 3.31 and 3.32). The regional differences between the capital region and the rest are significant. Differences between the five regions (excl. the capital) are smaller.

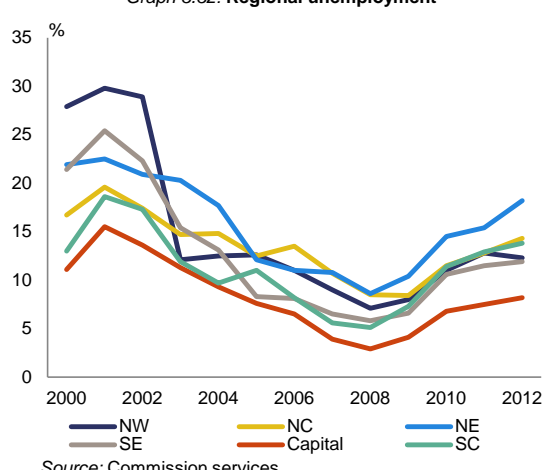
second day, v) a week holiday away from home, vi) a car, vii) a washing machine, viii) a colour TV, or ix) a telephone.

Graph 3.29: In-work AROP



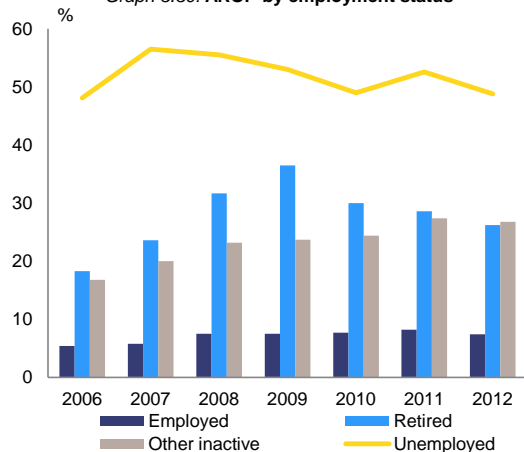
Source: Commission services

Graph 3.32: Regional unemployment



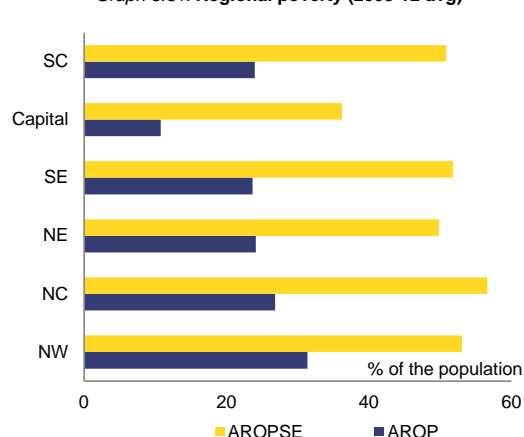
Source: Commission services

Graph 3.30: AROP by employment status



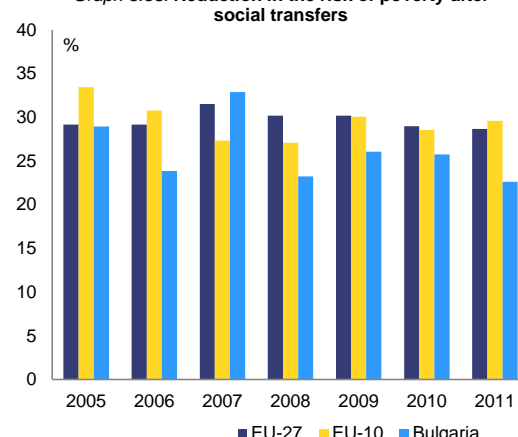
Source: Commission services

Graph 3.31: Regional poverty (2008-12 avg)



Source: Commission services

Graph 3.33: Reduction in the risk of poverty after social transfers



Source: Commission services

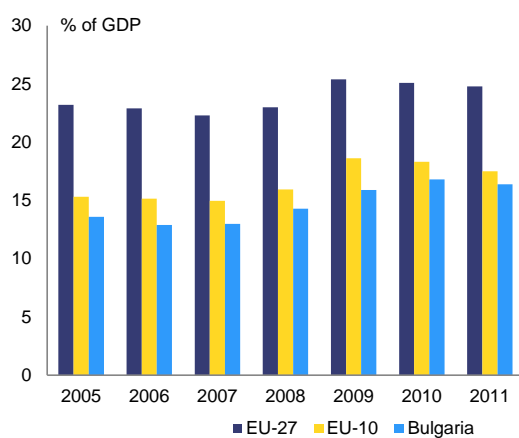
Social spending has not been sufficiently effective in reducing poverty (see Graph 3.33).⁽¹⁾ Means-tested benefits have not increased noticeably since the crisis, unlike non-means tested ones. Both types of benefits are lower than the EU averages as share of GDP, with means-tested considerably lower (see Graphs 3.34 and 3.35). Recent research also suggests that although means-tested benefits are well-targeted, their coverage is low (IMF Country Report, 2014). Possible explanations include the strict eligibility thresholds and the lack of indexation rules for those thresholds. Improving the provision of means-tested benefits would also depend on developing sufficient administrative capacity to manage them.

⁽¹⁾ Pensions are considered as part of the income before transfers.

Consecutive governments have implemented social stimuli in 2013.

A number of measures, targeted at low-income households and disadvantaged social groups were implemented by the caretaker and post-election governments in 2013. The total spending on those measures remained below 0.1% of GDP. Additionally, pensions were increased by close to 10%. The effectiveness of those measures remains to be seen.

Graph 3.34: Non means-tested benefits



Source: Commission services

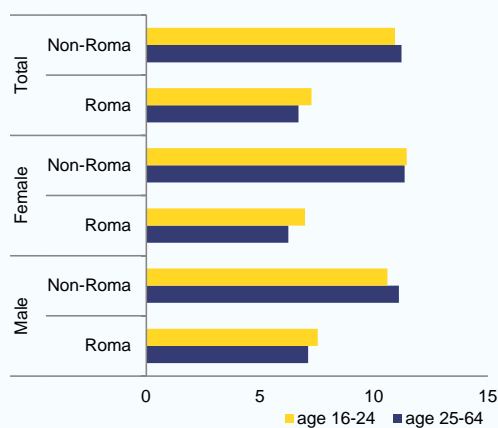
Box 3.1: Roma participation on the labour market

The Roma represent a considerable and socially vulnerable part of the population. The share of Roma population in the country is estimated at around 10%, with an expansive age pyramid. The Roma are characterised by lower education levels, translating in poorer labour market integration and consequently higher risk of poverty or social exclusion than the rest of the population.

Lack of education limits the chances of labour market participation for the Roma. On average, the Roma receive four and a half years less education than the rest of the population (see Graph 1a). In turn, the lower education decreases their chances on the labour market and translates into much higher inactivity and unemployment rates (see Graph 1b). Roma citizens are employed predominantly in the low-skilled, low-paid segment of the labour market, including agriculture, construction and public utilities.

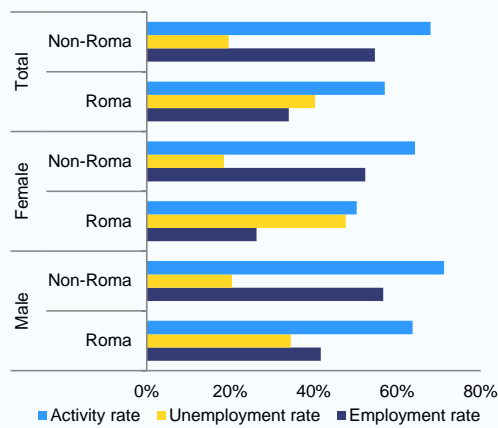
Government programmes have not yet achieved sufficient progress. Several governments have shown awareness of the problem and have developed a National Programme “Activation of the Inactive Persons” and a National Roma Integration Strategy. However, the effectiveness of those programmes has not been demonstrated so far. In an EU context, country-specific recommendations have asked the country to take measures to improve Roma integration. So far, those programs have not shown satisfactory results, as assessed in the framework of the European Semester.

Graph 1a: Roma education



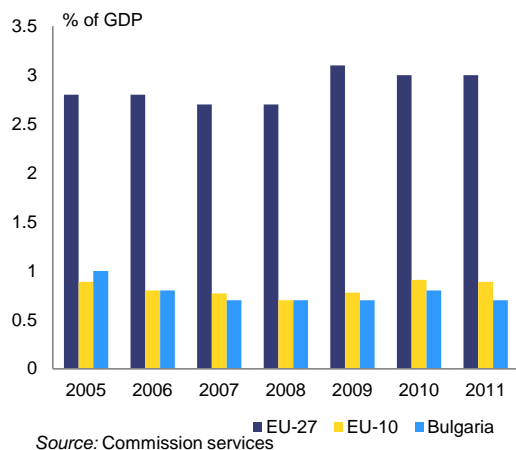
Source: UNPD/WB/EC Regional Roma Survey, 2011

Graph 1b: Roma employment statistics



Source: UNPD/WB/EC Regional Roma Survey, 2011

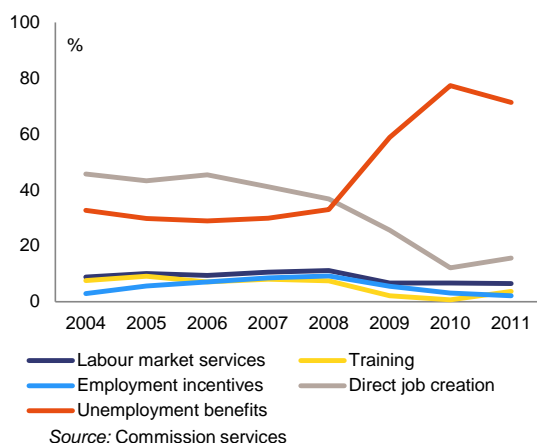
Graph 3.35: Means-tested benefits



3.2.3. Labour market policies and education

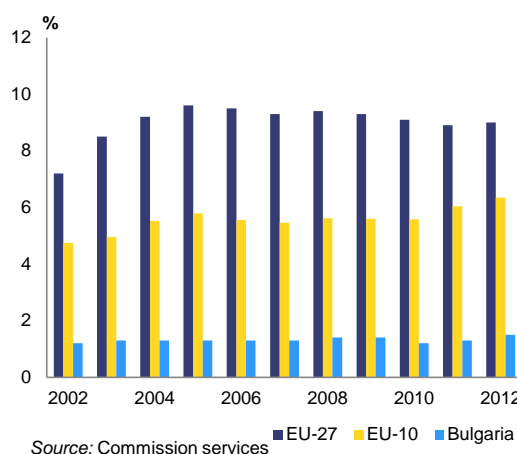
Overall labour market policy (LMP) expenditure has increased mainly due to unemployment benefits. Unemployment benefits in Bulgaria are somewhat higher than the EU-10 average both in terms of generosity (i.e., replacement rates) and duration. As unemployment increased, unemployment benefit expenditure has increased and acted as an automatic stabiliser with the deterioration of the labour market after 2008. In turn, expenditure on active labour market policies (ALMP) remained broadly stable and their share in total LMP expenditure has decreased from 67% in 2004 to below 30% in 2011 (see Graph 3.36). Thus, the balance between active and passive measures has been distorted since the start of the crisis.

Graph 3.36: Labour market policies by category (LMP expenditure)



Active labour market policies appear insufficient. The government expenditure on ALMP has declined over 2004-10. Despite a small increase in 2011, its share of GDP is still considerably lower than in the pre-crisis years and has remained flat in nominal terms until 2014, with the exception of a social stimulus following the budget revision in 2013. In contrast, ALMP spending has increased in peer EU-10 countries post-2008 (see Graph 3.38). In Bulgaria, this translates into a decreased coverage of the ALMP caused by the strong increases in minimum wages since 2011, as less people can benefit from subsidised employment. The share of employed on temporary contracts is among the lowest in the EU and has remained unchanged since the crisis (DG Employment, 2014). Programmes funded by the European Social Funds (ESF) have increased in importance, given the limited national funding. Funds absorption has increased over 2011-2013 and would continue to depend on maintaining sufficient administrative capacity and ensuring smooth public procurement procedures. Indeed, a preliminary assessment of the impact of ESF funding over 2007-2012 indicates a net increase in employment of 1.5% and decrease in the unemployment rate of 1 pp. over the period. Clearly, the ESF will continue to play an important role for ALMP going forward.

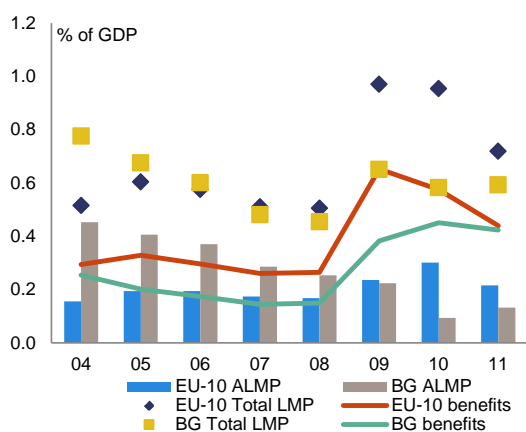
Graph 3.37: Lifelong learning (age 25-64)



Lifelong learning practices in the country are considerably less developed than in peer countries. The share of population over 25 years old participating in education and training has consistently been drastically lower than the EU average (1.5% vs. 9% in 2012). In contrast with the improvements seen in peer countries over the

past decade, the number of participating adults in Bulgaria has remained unchanged (see Graph 3.37). Lifelong learning is indispensable for reducing skill mismatches, which have been identified as a problem in a number of studies (Berkhout et al., 2012; Maiväli and Stierle, 2013). Excess supply in construction and services and excess demand in the public sector have been found to increase sectoral mismatches (Labour Market Developments, 2013). A strategy on lifelong learning has been drawn up in fulfilment of the 2014-2020 Structural Funds ex-ante conditionality, with a target to reach 7% participation by 2020.

Graph 3.38: Labour market policies



Source: Commission services

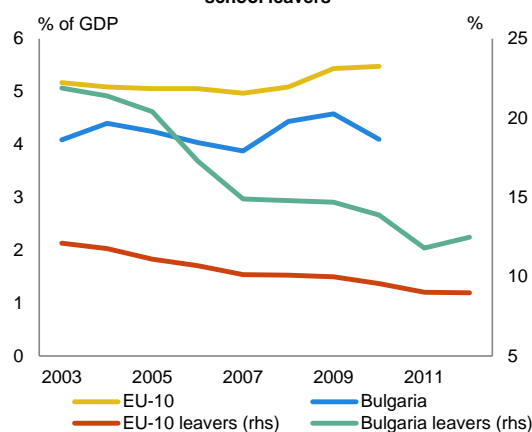
The quality of schooling is low as measured in international studies. According to the latest PISA study results (OECD, 2013), 15-year-old students in Bulgaria had the lowest scores in the EU in reading and mathematics and were among the worst performers in science. Despite modest improvements compared to the 2009 study, 39.4% of students do not possess the necessary skills in reading and 43.8% those in mathematics. Another international study, focused on reading ability, found that reading skills among 10-year-olds in the country have declined over the last decade (PIRLS, 2011).

The share of early school leavers has decreased but remains high. The share of early leavers from education and training has been reduced significantly, from over 22% in 2003 to 12.5% in 2012 (just below the EU average). The share of early leavers remains higher in comparison with other EU-10 countries and increased by 12% in

2012 compared to 2011 (see Graph 3.39). Moreover, the absence of life-long learning practices means those who drop out early have little chance to improve their qualifications in the future. Overall expenditure on education has been somewhat lower than the EU and EU-10 averages. Total education expenditure is lower by about 1pp. of GDP. Both the quantity and quality of spending remain vital for improving the educational system.

The existence of an important disparity between higher education outcomes and labour market demand worsens structural unemployment and limits the adjustment capacity of the economy. Higher education faces persisting challenges in responding better to labour market needs. Employment of young graduates was only 67.3% in 2012. The lack of sufficiently-trained employees hampers the development of high-value added, innovative sectors, most prominently the ICT sector. A strategy on higher education has been published for public consultation in November 2013 and could be adopted in 2014. An immediate challenge is the identification of the professions and qualifications which will be demanded by the labour market over the next few years.

Graph 3.39: Expenditure on education and early school leavers



Source: Commission services

In conclusion, the reasons for the protracted labour market adjustment appear deeply rooted. While it is fuelled by the economic slowdown, institutional factors and policies pushing labour costs up, the lacking related activating policy responses as well as longer-term structural deficiencies of the labour force play a key role. The adjustment process is thus likely to be protracted and presents policy challenges in the

labour market itself as well as in education and training practices.

4. POLICY CHALLENGES

The analysis in sections 2 and 3 indicates that macroeconomic developments in the areas of corporate deleveraging, external indebtedness and especially distressed labour market are the main challenges in Bulgaria. Deleveraging in the economy is on-going and could pose some limits to growth in the short-term but is necessary for preserving competitiveness and growth potential in the future. The external position has further improved compared to last year and the analysis does not suggest significant risks of repeating the imbalances that were accumulated through large CA deficits during the economic boom years 2005-08. In turn, improving the situation in the labour market, including reducing unemployment and increasing participation, stands out as the most pressing current challenge.

It should be recalled that these challenges were already identified under the MIP in the first and second IDRs and relevant policy responses were reflected and integrated into the country-specific recommendations issued for Bulgaria in July 2012 and in July 2013. The assessment of progress in the implementation of those recommendations will take place in the context of the assessment of the National Reform Programme and Stability Programme under the European Semester. Against this background, this section discusses different avenues that could be envisaged to address the above challenges.

Concerning the challenge of ensuring a smooth corporate deleveraging process, a number of avenues can be explored:

Continuing the efforts for strict enforcement of rules related to late payments would facilitate deleveraging. Timely monitoring of strict implementation and impact of the newly-introduced regulations on late payments, in line with EU Directive 2011/7/EU, can be beneficial for the business relations between the government and the private sector as well as within the corporate sector.

Enhancing the insolvency framework remains important for smoothing the deleveraging process and increasing market transparency. Evaluating the effectiveness of recently introduced measures, including the removal of the possibility for insolvency backdating, could be useful. Out-of-

court settlements remain an area which could be explored as an alternative source of dispute resolution.⁽¹²⁾ Developing guidelines for out-of-court negotiations and speeding up court proceedings has proven beneficial in other countries facing similar challenges.

Concerning the challenge of sustaining the adjustment of the external position, while continuing to attract productive foreign capital, the following measures may be discussed:

Improving the business climate, through facilitating business operations and ensuring a level playing field is crucial. This challenge has already been identified in the 2013 CSR on the business environment. Fighting corruption more effectively and ensuring the independence of the judicial system are important and could be useful for reducing uncertainty and increasing the attractiveness of the country as an investment destination. Increasing the coverage of e-services offered by the government and further reducing administrative costs could be explored. Assessing the impact of recent administrative reforms in this regards could be useful for the way forward.

Further increasing EU funds absorption in an effective way could help potential growth. The challenge of accelerating EU cohesion, structural and agriculture funds absorption is part of the 2013 CSRs and an improvement in this area in the last three years is recognised. Ensuring the effectiveness of EU-funded investments, including assessing the impact of policies implemented, could be beneficial for better targeting of future programs and ultimately increasing the country's growth potential. In this context, strengthening the public procurement environment, introducing e-procurement tools and ensuring sufficient administrative capacity for all sectors funded could have a positive effect.

⁽¹²⁾ This has also been mentioned by the IMF Article IV consultation – staff report.

Concerning the complex challenges faced by the labour market, including rising unemployment, job losses concentrated in the low-skilled segment and skill mismatches, the following actions could be considered:

A major challenge relates to improving the efficiency and effectiveness of active labour market policies. This challenge has already been identified in the 2013 CSR related to enhancing active labour market policies. It involves targeting measures to those most in need of activation and whose employability is highest. In this regard, the inactive young and the long-term unemployed low-skilled people with work experience as well as other vulnerable social groups identified in this report could be considered. Specific measures for the young could include programs aimed at increasing the educational attainment and improving their qualifications through targeted training. Reintegration measures for the long-term unemployed with work experience may include effectively linking social benefits to participation in training and subsidised employment. Programs relying on the social responsibility of businesses could also be examined.

Assessing the impact of existing ALMP as well as introducing new measures could be useful. Actions taken by the government, including the preparation of an Employment Action Plan as well as the ALMP assessments planned for 2014 are recognised. Further steps could include linking the outcomes of the evaluation to future policy in a clear and concrete way. Regularly documenting the results of different initiatives in a consistent way and prioritising policies which have a proven track record could increase the efficiency of the policy measures. Adopting successful practices from other countries could also be explored.

Finding the right balance between active and passive measures is another important challenge. As demonstrated in the report, employment is a key ingredient for addressing the problem of poverty. Thus, effective active policies could prove beneficial for improving the social situation and reducing poverty in the country. At the same time, increasing the effectiveness of social transfers would be important to ensure adequate living standards for their recipients.

Reviewing policy on the minimum wage and the minimum thresholds for social security contributions to ensure it has no adverse side-effects for the labour market remains important. This challenge has already been identified in the 2012 and 2013 CSR related to labour market policies. Initially introduced as a measure to combat the shadow economy, the thresholds for social security contributions have increased significantly, including during the economic downturn, and have come very close to the average wage in some sectors and occupations. This is especially the case for the unskilled and low-skilled workers, which were also hardest hit by the rise in unemployment. The government's action, including limiting administrative increases of thresholds and the reviews of the system undertaken in 2013 and 2014 are recognised. Nevertheless, the recent strong minimum wage growth has further increased the thresholds for the lowest-paid workers and could potentially distort the labour market. Those policies may also have a bearing on the coverage of ALMP as it increases the spending needed for subsidised employment programs.

Improving education and training practices appears important for the labour market. The challenge of ensuring access to education has already been identified in the 2013 CSR on education. In addition, policies related to achieving sufficient participation, translated into higher educational attainment could be examined. Developing training and lifelong learning practices targeted at specific skills, which are or would be in demand on the labour market could be useful to address the existing skills mismatches in some sectors of the economy. Those practices could also increase the ability of the economy to adjust and ensure that the labour market does not limit its growth potential.

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