

**Economic Research Institute at BAS**

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**ECONOMIC DEVELOPMENT AND  
POLICY IN BULGARIA:  
EVALUATIONS AND  
EXPECTATIONS**

**Special focus:**

**“Competitiveness of Bulgarian Economy”**

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## **MAIN CONCLUSIONS REGARDING BULGARIAN ECONOMIC DEVELOPMENT AND POLICY AND EXPECTATIONS FOR FUTURE DEVELOPMENT**

### **1. Main conclusions**

#### *External environment*

- There are significant structural obstacles in the external environment, especially in the developed European countries, that are expected to delay the restoration of the global economy in middle-term plan. In countries with newly emerged markets, including Bulgaria, the delay of growth lately will help ease the pressure from overheating the economies immediately before the global financial crisis.

#### *Real sector*

- Economic growth in Bulgaria in the years of such growth (especially in 2006-2008) has been based mostly on unstable high increase of investments volume. Large shares of these investments are directed towards construction (mostly housing), or services – real estate operations, trade, etc. These are investments that as a whole cannot substantially reflect on the long-term economic growth. The sharp decrease of such type of investments automatically leads to negative effects concerning economic growth, but also indicates that the growth model should be reconsidered.

#### *External sector*

- Dynamics of the foreign trade in the last couple of years has been giving hope that the export can draw the whole economy out of the crisis. The goods structure of the export, however, remains typical of a developing economy with dominating share of low and average technological products and services – resources and materials (especially metals), i.e. production with low degree of processing and respectively low share of added value. In long-term plan such type of structure cannot generate a sustainable economic growth, since it is strongly dependable on price changes, which are typically strongly pro-cyclic factor.
- Competitiveness of Bulgarian export by tradition is based on the low payment of labour, but such strategy cannot win in a longer plan.
- Dynamics of payment balance shows that in conditions of open economy and low levels of national savings, maintaining high rates of economic growth requires the use of foreign investments, which means increasing deficit on current account.

#### *Fiscal sector*

- Fiscal conservatism in the beginning of the crisis has helped maintaining chances of fast restoration of the economy – immediately after returning to growth of the main trade partners (mainly EU countries). The delay of this growth, however, decreases the positive effect of the fiscal conservatism.
- Main sectors like health care, education and science, security, state administration, public infrastructure, municipal sector, are ineffective users of provided funds due to their unfinished reforming.

#### *Financial sector*

- In 2011 the monetary aggregates report a positive growth rate, which reaches 12.2%. In itself reaching such level can be considered a positive sign of restoring the economy. In

parallel, the fast increase of high liquidity component M1 is notable, exceeding the consumer prices index, reaching 14.4% annual growth in 2011. In 2012 this will most probably reflect like an increase of inflation pressure.

- With expected slow rates of restoring manufacturing in the next years, the share of bad credits will grow and will reach significantly higher values, before it stabilizes.
- Crediting the enterprises registers low rates of growth, and it is mainly directed towards energy and extracting sectors, real estate and long-distance communication, i.e. in the real sector there are still no signs of restructuring and directing investments towards projects with high added value.
- Bank sector in Bulgaria faces a specific challenge. Its fast growth in the years before the financial crisis has many positive effects on the local economy (like increase of consumption). At the same time this growth has led to some unfavorable changes of parameters of the macroeconomic environment (increase of import, prices and wages, etc.), which can be generalized as loss of competitive advantages. These changes limit the potential of restoring the economy, particularly the bank system, since an uncertainly functioning manufacturing cannot be a source of profit to its creditor but only of a worsening portfolio and the connected with it provision costs.

#### *Employment and incomes*

- When economic conditions get worse and inflation is low, entrepreneurs can easiest correct their labour costs through optimization of the number of working places. That is why in the first periods of restoration, when the rate is still low and unstable, firms do not rush to restore employment from the time before the crisis as an insurance against possible new decrease of incomes from sales and the newly created income.
- Firms change average labour payment as a reaction to the crisis only 12-18 months after its start. This happens because in conditions of low inflation they cannot use a delayed indexation of nominal wages as a mean of adjusting their real labour costs against the real (deflated) income of the firm. Also, the demand for labour in 2007 and 2008 has been quite high and has contributed to increase of the nominal wages. Obviously the decrease of the nominal wages is harder and thus rarer decision for entrepreneurs than decrease of working places.
- Unlike employment, nominal average payment restores its annual growths faster, which is due to the signs of improving the business conditions, as well as certain measures of the government. The increase of the minimal insurance thresholds has contributed to the increase of the average nominal payment per employee in the first quarter of 2010. This measure is repeated in the beginning of 2011. Additional increase of the growth of the nominal wage in the first quarter of 2011 is probably due also to the actualization of the minimal wage in the country.
- Together with the decrease of the number of working places in the economy in the period 2009-2011, there is a constant process of increase of unemployment level. The decrease of working places does not transform completely into an increased number of unemployed people. About half of the people who have lost their jobs have become unemployed, or have left the working power due to discouragement or other reasons. The other half of the cut working places has been occupied by people who have been retired.
- Due to the fast decrease of employment, which rate exceeds the rate of GDP decrease, in 2010 and 2011 Bulgarian economy has exceeded its labour productivity and has improved its competitive position from point of view of using the labour resource.

- Consumption structure shows pro-cyclic changes, which are specific of the development stage of the economy. Households react to the decreasing incomes by reducing their costs for furniture and long-term items of consumption, costs for leisure time and cultural events, for transport, clothes and shoes. The costs for home farming, as well as other costs outside the consumption ones, have also decreased.

#### *Regional development*

- In 2010-2011 in regional aspect development does not follow the declared direction, namely the goal of decreasing inter-regional and intra-regional differences.
- Regional development in this period has an increasing irregularity. By many of the studied indicators, and to a great extent by the integral/general evaluation, the country is divided to South Western region and the other regions. The discrepancy “Sofia – the other country” is reproduced at regional level – Plovdiv, Varna, Ruse and the other part of the region, as well as at the district level. Even in the most lagging district (Razgrad) differences between Razgrad and the other municipalities/settlements are not less than the already mentioned.
- Center – periphery is the main model of regional development in the country. Though in a more limited form, there is another model too – a bipolar one. At district level examples are Kjustendil – Dupnitsa, Lovech – Troian, Stara Zagora – Kazanlak, Gabrovo – Sevlievo, etc. At regional level type 2 this model is followed by North Western region (Vratsa – Pleven) and South Eastern region (Burgas – Stara Zagora). At national level in the last years Varna forms as a second center.

#### *Business environment*

- In 2011 the institutional business environment gets worse. Bulgaria loses positions in the international rankings by competitiveness and business conditions. Most problem areas of competitiveness are innovations, infrastructure, institutions, business development, technological responsibility and market size. Concerning business conditions, most serious problems are regarding conditions of acquiring construction permissions, international trade, contract execution and solving insolvent manufacturing. According to Bulgarian managers, biggest limitations to the business are access to financial resources, disloyal practices of informal sector, political instability, size of tax stakes, not well trained working force and corruption.
- Studying business trends does not show improvement in 2011 either. The uncertain economic environment is the most important and strongly dominating factor in the industry. It is followed by insufficient domestic and foreign demand, financial problems of enterprises and economic legislation. Labour provision as an indicator of the business environment decreases its limiting impact. Shortage of materials and/or equipment shows most substantial increase as a hindering factor to the enterprises.
- As a result of the crisis the profitability of the enterprises by sales drops to the interval of 54-85% for enterprises of different sizes. The indebtedness of the real sector quickly increases, including the inter-firm one. In 2010 and 2011 it reaches respectively to 157.6 and 104.2 billion BGN.
- Business structure by enterprise size in the last years is stable and without substantial changes. Highest share (about 90%) in it have the micro enterprises with personnel up to 9 people.
- Till 2009 there is a good level of entrepreneurial activity, measured by creating new enterprises. The trend is toward increasing the number of small enterprises on account of the large ones.

## 2. Evaluations and recommendations to the policy

- Unstable high rates of increase of the economy before the crisis are due to the carried out government policies for encouraging demand instead of supply – policies of decreasing direct taxes (like tax on the incomes of physical entities, corporate tax, social and health insurances), which have led to excessive growth of the bank credit, unbalanced indebtedness of the households and extremely high inflation.
- Concerning the entire state of macroeconomic environment, many actions of the government can be considered as with a negative impact. The decision for holding the payments to private companies, to whom the state owes money on contracts, has led first to problems with liquidity of these companies. Due to the horizontal and vertical blindness and mutual indebtedness of the business representatives, the liquidity problems have multiplied in chain. On one hand, this has led to discomfiting of planned investments, and on the other hand – to inability to pay the employed people in these companies.
- As a whole these actions have led to general reduction of the consumption expenditures and investments, and at the same time have provoked a process of reducing the employment in order to adapt the expenditure structure to much decreased incomes.
- The whole drop of trust, which raised the sense of risk in the economy as well, is a substantial negative effect, a direct result of the actions of the government. It is known that returning the trust once lost is a slow and hard process, which in macroeconomic plan means slow overcoming of the effects of the economic crisis.
- The quality of the budget and macroeconomic forecasting should be increased so there will be no substantial risks for the execution of the approved budgets. The efficiency of the budget expenditures requires a balanced approach to strategic planning – from defining strategic goals, through planning concrete policies, measures and actions, to effective control of the efficiency of the public expenditures.
- A key factor is the increase of productivity and competitiveness through introduction of modern technologies and innovations. Besides the traditional instruments (foreign investments, transfer of technologies and know-hoe), the state should play a decisive role in encouraging R&D. Final goal of such policy is overcoming the long practice of labour-intensive goods with low added value in favour of capital-intensive production, which has a dominant share in the EU foreign trade.
- Softened and followed overcoming of the problem of low competitiveness of the Bulgarian products, especially agricultural ones. Reaching this goal will require gradual but stable increase of the assimilated European funds and implementing a purposeful policy for developing rural regions.
- Easing the access of Bulgarian firms to the EU common market through increased participation in the system of mutual acknowledgement of certificates and certification procedures. This will significantly decrease the costs of export, especially in milk processing, meat production and meat processing industries, which have well-known huge potential.
- Identifying firms with potential for presence and competitive behavior on the common European market. These firms should be supported through target programmes and projects, including establishing partnership relations with leading foreign firms. After closing the Small and Medium-Sized Enterprises Agency these functions should be transferred to the Ministry of Economy and partly to the Foreign Investment Agency.

- Because of fears of new global financial crisis, the government has taken a conservative position concerning incomes in the country. It uses very scarcely its two instruments directly influencing the average wage in the country – minimal wage and payments in the budget sector.
- The conservative behavior of the government towards the dynamics of normative determining of levels of wages and pensions in the country has been an additional sign to the real sector for limiting the income dynamics, which is one of the main factors for the drop of the individual consumption in the country.
- Determining an economically justified level of minimal wage is not a question only of “fair” payment of labour, but concerns problems like territorial mobility of labour force, growth potential, “working poor people”, higher stimuli for participation on the labour market, etc. We have to note that according to Eurostat the share of working poor people has increased from 5.4% in 2006 to 7.7% in 2010. With the ratio between minimal wage and average wage the government can influence on the income dispersion in the economy.
- By determining minimal wage the government makes a choice between two alternative goals – higher labour productivity or higher unemployment. If the goal is to achieve higher labour productivity in the economy, then the government is ready to pay the price of higher unemployment. It sets higher threshold to the working places opened in the economy. Those that cannot generate high enough added value are practically not interesting and the state engages to pay social benefits to the people who will possibly occupy them at lower normative minimal wage.
- In 2011 data show that the government has increased the employment in the budget sector (refusal from the intentions to reduce the personnel) and has frozen the level of average wage. Thus, on one hand, there was certain easing on the domestic labour market, which in the last year was characterized by increase of the number of people let go of work and low labour demand. On the other hand, the increase of the labour costs remained considerably low not to threaten the execution of the budget.
- In 2009 and 2010 Bulgaria managed to catch up with some of the difference in the labour productivity and labour payment in EU-27 because it managed to overcome the effects of the crisis without registering a drop in both indicators in none of the years since the period of the crisis on account of relatively high employment reduction. Although the catching up in the average payment is bigger than the one in the labour productivity, the convergence in the wages still lags compared to one in the labour productivity. In order for the gross wage per employed person to be in the same relation to the European one as the relation between the Bulgarian and European labour productivity, the gross wage should be about 25% higher.
- Eurostat presents data on minimal wage in 20 EU countries. In 2009-2011 most of them have updated their minimal wage two or three times. The end results are countries like Estonia, Lithuania and Ireland, where there is no change at all. On the other end is The Netherland, where this level has been updated every quarter. The more frequent consideration of minimal wage allows its updating to happen in smaller steps, which will let the economy easier absorb the effects of the change.
- The dynamics of the employment and wages in the budget sector is an instrument of the government for a direct influence on the labour market. As a whole the government managed to fulfill this intention, to a great extent forced by the necessity to consolidate the state finances. In 2010 the number of employed people in the budget sector has decreased by 4.5%, and paid wages – by 1.2%. In 2011 the number of budget employees (in health care, education and state governance) starts again to increase (by 2.3%), as well as the expenditures for wages (by 2.9%). Although the state budget continues to suffer a deficit, such increase of the expenditures for wages is justified: the total incomes

increase nominally by higher rate (6%), the goal for budget deficit was reached, and its value is lower than the one in 2009; the increase of the expenditures for wages of employed people in the budget sector is slower than its increase in the whole economy (7.8%).

- The regional policy requires decrease of the dependency of the municipalities on the government transfers. More active role of the municipalities in determining the size of the local fees, local taxes and frames of the limits from the Law on local taxes and fees. Emitting bond by the municipalities is an instrument, which for now is not fully used to increase their incomes.
- Stimulating the initiative and pro-active behavior of the Bulgarian firms for finding suitable contractors, their inclusion in high-technological sub-contractor changes in establishing and functioning of industrial clusters and entrepreneurship networks.
- Structural reforms of the sectors of the public sector, which block the growth.
- Establishing regional management organs as deconcentrated territorial structures. Regional development councils remain structures fitting national and local interest. Establishing operative programmes on regional principle is not a part of the adopted policy of financial support.
- Formulating priorities and measures in the operative programmes directed towards the development of the regions for purposeful impact.
- Purposeful financial supporting of poor municipalities through the system of state financial transfers to the municipalities.

### **3. Expectations for future development**

- In 2012 a substantial improvement of the domestic demand is not expected. It is not expected external factors to compensate in short-term plan the unfavorable impact of the internal circumstances.
- The forecast for the growth of the real GDP in the Eurozone by the Central European Bank from December 2011 annually is in the interval from -0.4 to 1% in 2012 and from 0.3 to 2.3% in 2013.
- Economic perspectives for Bulgaria in 2012 and the next two years are moderately unfavorable. As a whole it is expected the rate of restoring to be slow.
- Conceptually there are two main options concerning the post-crisis development of the Bulgarian economy:
  - a) Returning of the model of economic growth before 2009, characterized by a strong inflow of foreign financing, extensive growth of branches like real estate, trade, etc., unbalanced investing for a short-term profit and improvident taking of duties by the households and firms. This option means fast but unstable increase of GDP and increasing the vulnerability of the Bulgarian economy from unfavorable developments in the global economy.
  - b) Continuing the processes of restructuring of the economy towards balancing the shares of the components of demand to the values, observed in the developed industrial economies. This option, however, means slow and painful economic restoring for large part of the population, where the increase of the prosperity will be almost unnoticeable in short-term plan. Such type of restoring is referred to relatively

higher unemployment, respectively holding the increase of consumption and investments and delaying the whole process of convergence.

- Since the Bulgarian economy continues to have shortage of capitals, foreign financing by necessity will continue to play an important role. The form of this financing is the question – whether the focus will be on restoring FDI flows, or export should be enforced, thus ensuring the necessary financial resources for investments in real assets, leading to a sustainable economic growth.
- In foreseeable future Bulgaria should rely mostly on the export to ensure economic growth, based on economy of scale. From point of view of the limitations set by the payment balance, the message is for increase of the attractiveness of the Bulgarian export and/or decrease of the import elasticity (in best case a combination of both). Otherwise, i.e. if the production capacity increases faster than the domestic demand (due to limitations by the payment balance), unemployment will increase, which will additionally shrink the consumption. In other words, it is not a matter only of ensuring economic growth through more export, but through export of the right goods and services, i.e. the ones for which the demand is elastic.
- Since years back Bulgaria maintains a good macroeconomic stability (even in the heat of the crisis), but the feeling of economic stagnation is tactile. It is obvious that only maintaining healthy economic bases is not enough. If we assume that following export-oriented model of growth (with all its weaknesses) in the next years is inevitable. However, the question is how to ensure an optimal diversification of the trade flows. Data in the last few years show that there is a clear trend towards decrease of the diversification of the Bulgarian export, as well as towards increase of the concentration (though not very clear). For overcoming this trend the use of instruments for public-private partnership, when realizing projects financed by EU funds, should be encouraged.
- In the next few years is expected the tendency towards a negative budget balance as a result of a weak growth of the economy, informal institutions for delivery of public services (including pensions, health, education and administrative system) and servicing an increased domestic and foreign state debt, to continue. Working for the deficit to be limited to about 1-2% of GDP because of the membership of Bulgaria in the European Fiscal Compact and the necessity of high credit rating of the country in regards to future emissions of foreign debt. The deficit will be financed through raising the state debt (mainly foreign) in 2013 and 2014, and after that keeping it at the 2010/2011 level. The incomes from indirect taxes are expected to stabilize with a tendency of a slight increase due to expected growth of the import and consumption in the next years. This tendency will be probably followed on the direct taxes due to the expected slight growth of GDP. The state expenditures will follow the tendency of slight and smooth increase, since significant reforms in the public institutions and services are not expected.
- Current and financial account of the payment balance will be almost balanced, and a pressure on the financial stability of the country is not expected from them. The redistribution through the budget will remain close to the 2011 levels. The fiscal reserve will be at around the 2011 level with a tendency of an insignificant increase.
- The increase of the deposits due to high saving norm leads to increase of the bank reserves in BNB by 6.3% at the end of 2011. In the next year a slowing down of this tendency is expected. At the same time the necessity of restoring the consumption on account of savings increases, as a result of the slowed restoring of the real income and the followed decrease of the household's intention to save.
- We can expect that the redistribution of the bank sector will continue in the same direction – the increased necessity of ensuring resource for recapitalization of the mother-banks (to which striking off the foreign debt of Greece has also significant contribution).



At the same time the increasing price of financing, especially for the banks in the periphery of the Eurozone, will most probably determine a continuing activity of withdrawing foreign capitals from Bulgaria in the next 12-18 months.

- The inflation factor will also have an unfavorable impact on the financial results of the banks. The increasing dynamics of the price index will deprive the financial institutions of the opportunity to take next steps towards decrease of the interests on deposits (for improving the spread indicators). To a certain extent it will be compensated by the slowed dynamics of the bad and restructured credits, which will lead to decrease of the devaluation costs.
- If in 2012-2013 the GDP growth remains in the interval of 1-2%, the employment will most probably stabilize at the reached so far level. The adopted model of growth is also of significance. If the service sector restores in fast pace, it is possible to observe even certain increase of the employed people and decrease of the unemployment level.
- The employment dynamics in 2012 and 2013 to a great extent will depend on the speed of restoring the Bulgarian economy, as well as on the type of growth. Our expectations are the restoration of the Bulgarian economy to remain fragile and inconsistent, the growth to remain low (about 1% in real) and the employers will remain cautious in restoring the working places. The optimization of the employment will continue and it is expected that in 2012 the unemployment level will continue to increase.
- Only in 2013, when the growth of the Bulgarian economy is expected to increase and the restoration will at last become constant irreversible process, the level of unemployment will start to decrease, and the employment and level of economic activity will increase.
- The results of the regional policy analysis show that the formed interregional and intraregional differences give reasons to carry out two types of regional policy: decrease of the regional differences and development of the growth centers.
  - a) The policy for decreasing the differences can be achieved if financial resources are redirected towards the territorial entities with lowest level of development. This will decrease their differences with the more developed ones and to a greatest extent will contribute to achieving the goal.
  - b) The policy of developing growth centers has the idea that they will facilitate the development of the whole region. In this case the region concentrates its resources on one place for achieving a development, comparable to the national or European parameters. Later this is expected to have a secondary favorable impact on the whole region through developing supporting productions.
- One of the main reasons for the inter-firm indebtedness is the shortage of liquidity. Solving the problem needs taking measures for diversifying the sources of financing the firms (for example through developing stock exchange, increasing the assimilation rate of the European funds, risk capital funds, public-private partnerships), as well as decreasing the interest rates on the credit resource. Fast reimbursing the VAT and paying the debts of the state and municipalities to the firms will have a favorable impact on reducing the inter-firm debts.
- Reflecting the revised Directive 2011/7/EC of 16.02.2011 into the Bulgarian legislation for the fight with delaying the payments on the trade deals should be accelerated. It will introduce tighter regime for delayed payments by the state organs to the firms. For this purpose there can be determined a payment deadline of the invoices on trade deals for delivery of goods or providing services in the frames of 30 days, and only if there is an objective reason – a maximum deadline of 60 days can be allowed.

- Often the reason of passiveness by the creditors in collecting the delayed debts is the fear of losing clients, especially when they have a significant share in their sales incomes. For overcoming this problem, as well as for saving time and costs for the firms, suitable is a wider implementing of the out-court approaches for solving trade disputes like mediation and arbitration, which allow maintaining good trade relations.
- Increasing the competitiveness of the enterprises is also a premise, which would lead to improving their market positions and would give opportunity for negotiating payment conditions on the trade deals, protecting the interests of the firm creditors to a higher extent.