



**ANNUAL REPORT 2019**

**ECONOMIC DEVELOPMENT  
AND POLICIES IN BULGARIA:  
EVALUATIONS AND  
PROSPECTS**

**Focus:  
Structural Imbalances and Risks  
to the Economy**

**Economic Research Institute at BAS**

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Economy**

**Gorex Press  
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The report analyzes the state of the Bulgarian economy in 2018 and outlines the perspectives for its development in middle term. The focus is on the structural imbalances and the risks to the economy.

Analysis and forecast evaluation are directed towards a wider circle of specialists and most of all the state institutions, employers' and workers' organizations, municipal and local authorities structures, non-government organizations, scientific community and the general public. The conclusions about the macroeconomic development and policies concern the opportunities for improvement.

The evaluations and projections are expert ones and reflect the views of the authors.

The report is discussed and approved by the Scientific Council in the Economic Research Institute at BAS.

We wish to thank the members of the Expert Council and the Scientific Council at the Economic Research Institute at BAS for their comments and recommendations.

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## **ABBREVIATIONS**

ACABG	- Association of Collection Agencies in Bulgaria
ALMP	- Active Labor Market Policy
BAS	- Bulgarian Academy Of Sciences
BNB	- Bulgarian National Bank
BU	- Banking Union
CFP	- Consolidated Fiscal Program
EA	- Euro Area
EAR	- Economic Activity Rates
EC	- European Commission
ECB	- European Central Bank
EMR II	- Exchange Rate Mechanism
EP	- European Parliament
ER	- Employment Rate
ERI	- Economic Research Institute
ESF	- European Social Fund
EU	- European Union
FED	- Federal Reserve
FDI	- Foreign Direct Investments
GDP	- Gross Domestic Product
GFC	- Global Financial Crisis
IFRS 9	- International Financial Reporting Standard
JV	- Job Vacancies
MLSP	- Ministry of Labor and Social Policy
MoF	- Ministry of Finance
MW	- Minimal Wage
NBFI	- Non-Bank Financial Institutions
NFC	- Non-Financial Corporation
NHIF	- National Health Insurance Fund
pp	- Percentage Point
UR	- Unemployment Rate

## SUMMARY

Economic Research Institute at Bulgarian Academy of Sciences presents to the scientific community, institutions and the general public the next annual report analyzing the economic development of Bulgaria and the implemented economic policies. The report examines the state and the development of the national economy in 2018 and provides forecast evaluations of the economic development in the medium term. It examines the main sectors of the economy (real, external, fiscal, monetary, banking) and analyzes the labor market. The issues of the financial decentralization and the structural changes that have occurred in the economy in the recent years have been discussed. The focus this year is on the structural imbalances and the resulting risks to the economy.

The report aims to analyze the current economic developments in Bulgaria in the previous year; to project their development in the medium term; to evaluate the implemented policies, and to draw specific conclusions and recommendations. Based on a small structural macroeconomic model, a well-grounded medium-term macroeconomic framework is proposed, reflecting different assumptions about the development of the external economic environment and the expected economic policies.

The report consists of two parts. **PART ONE** contains analytical studies of the economic environment (external and internal), as well as evaluations and short-term forecasts of the most important variables included in the macroeconomic model. The report presents the main macroeconomic parameters of Bulgaria's development and a forecast until 2021. It draws conclusions for the trends in their development and suggestions for improvement of the implemented policies. Different chapters present an analysis of the economic policy by sectors of the economy.

The **first chapter** analyzes the economic environment (internal and external), in which the economy has developed in the past year, and outlines the main prospects for the forthcoming three-year period. *Regarding the global trends*, it is noted that since the second half of 2018, international financial institutions and experts have started to revise downward the short- and medium-term forecasts for the development of the global economy and trade. There is still no satisfactory and generally acceptable answer to why this is happening. One of the most commonly outlined reasons for the slowdown of the global growth is the exhaustion of the effects of the fiscal stimuli in USA, together with a gradual tightening of the monetary policy. The stagnation in the euro area and the notable slowdown of the Chinese economy should be added to that. There are also some specific factors (the new fuel emission standards in Germany, the natural disasters in Japan) that hinder the activity of the main economies. These events have happened amid worsening financial market expectations, trade policy uncertainty and concerns about the prospects for China. It is also pointed out that the political and economic problems in the EU have been accumulated for a long time, and the region is on the verge of a recession sooner than expected, despite the ECB's refusal to change its expansionary monetary policy. The imbalances in the Chinese economy and the difficulties with the reshaping of the growth factors from mainly external to domestic ones have led to a rapid accumulation of debt in both corporate and public sector.

Attempts to manage the situation of fast-growing credit have negatively affected the financial stability, which faces serious challenges.

The **second chapter** analyzes the real sector of the economy and assesses the contribution of the main factors to the realized growth in 2018, as well as the distribution of the income in the economy through the prism of the national accounts of Bulgaria. Economic policies have been evaluated in terms of the growth prospects. The expectations for economic growth in the medium term are presented, with special attention to the planned or other possible policies that could have an impact on the growth in the short, medium and long term.

GDP growth rate declines from 3.6% in 2017 to 3.1% in 2018. Despite the slowdown, growth remains above the EU average but is one of the lowest among the new member states. Despite the generally positive economic prospects, maintaining the current economic growth rates means that getting close to the EU average income per capita remains far in the future. Increased wages and improved household expectations have a positive impact on the private consumption – household consumption increases by 6.3%, supported by continuing income growth, employment growth and increased consumer trust. Growth in public sector consumption is also stronger than in previous years, reflecting mainly the increase in costs for personnel and utilities. Investments are gradually recovering – after the drop of 6.6% in 2016, gross fixed capital formation increases by 3.2% in 2017, and accelerates to 6.5% in 2018. Net exports, which until a few years ago were a main driver of growth, have already contributed negatively to the overall growth. This is due both to the slowdown in export growth and the stronger domestic demand, reflecting import volumes, including consumer goods. The tendency of recent years to close the gap between actual and potential GDP confirms. An unfavorable finding is that the achieved growth cannot yet be described as incorporating and has no notable impact on poverty reduction and the economic and social inequalities. Rates of poverty and income inequality are the highest in the EU. The tax system based on proportional income taxation not only does not help to reduce inequality in the market incomes, but even deepens it. This is due to both the lack of redistributive effect of the proportional income tax and the relatively low level of expenditures on social protection and the lack of a mechanism for better targeting and updating of the social transfers to those in need.

The **third chapter** analyzes the dynamics and structure of budget revenues and expenditures, the changes in the budget balance and government debt, the tax trends and financial relations between the levels of government. The dependency between fiscal policy and macroeconomic activity is outlined. The implemented fiscal policy has been examined not only in terms of achieving a stable fiscal position and its impact on the aggregate demand in the short term, but also in terms of its role in long-term impact on growth. Concerning **revenues**, it is acknowledged that the unfavorable trend in the recent years of decreasing budget revenues in relative terms has stopped. An increase in all revenue items was registered in 2018. Main contributors are the tax revenues, with the increased tax revenues being the result of the increased domestic consumption, the increased activity of the economic agents and the revenue administration measures to improve revenue collection and fight smuggling. At the same time, it is noticed that the structure of tax revenues remains generally unchanged, with indirect taxes having a serious majority. Economic theory states that taxation of

profits and individual incomes has a stronger negative effect on economic growth than taxes on consumption (indirect taxes). This can be interpreted as an argument in favor of indirect taxes. As a counterpoint to this understanding, it is pointed out that the main disadvantage of the indirect taxes is their potential regression, which does not allow for bigger fairness in the distribution of the tax burden. The benefit of initiating a debate on the need for possible reforms towards increasing the proportion of direct taxes at the expense of indirect taxes and reconsideration of the proportional taxation is grounded. Concerning **expenditures**, it is noted that they are more pliable to direct managerial impacts, so the chronic lagging of the actual expenditures from the planned ones should be explained by a deliberately implemented restrictive fiscal policy that might be detrimental to economic development. Particular attention is paid to the non-rhythmical spending of budgetary resources, which is not always in line with the adopted budget rules. A critical analysis of how to absorb capital expenditures is made, concluding that they have the character of a “buffer” that ensures the achievement of the budget deficit goal. A different view on the economic meaning and the appropriateness of achieving (at all costs) and maintaining a fiscal equilibrium is argued.

The **fourth chapter** provides an overview of the development of the external sector, tracing the dynamics of the commodity structure and geographical structure of exports and imports, as well as of some of the most important commodity groups. It is reported that the economy maintains the prevailing exports of raw material, with Bulgaria being an exporter mainly of goods with low added value. Significant imports of consumer goods continues. Expectations for the impact of the foreign trade on the economic growth of Bulgaria in the short term remain conservative. Internal and external factors influence the volumes traded by Bulgarian companies. Internal factors are the uncertainty on the prospects of the transport industry and the decrease of bookings of foreign tourists for the summer season. External factors are mainly related to the impact of the international environment – the development of USA-China and USA-EU foreign trade relations, the expectations for the US economy to enter recession – have an impact on the foreign trade as a whole. Because of their significant foreign trade concentration, Bulgarian exports can be directly influenced by changes in the main partner countries. Therefore, the projections for recovery of the Turkish economy in the medium term, as well as the reports of a possible recession of leading European economies, should be taken into account.

The **fifth chapter** examines the problems of the banking sector. It points out that in the past 2018 the banking sector continued to develop in the direction already established in the recent years. The profit in the system is increasing, the concentration is rising and the credit activity remains far from the pre-crisis levels, despite the continuing decline in interest rates and the strengthening of the economic activity in the country. Monetary statistics show some increase in the nominal volume of new business for non-financial corporations. However, this volume is still lower than the one reported before the 2008 global financial crisis, and when assessing the dynamics in relative terms, the unpleasant finding is that real activity is weakening. Comparison for a longer period does not lead to more favorable findings. It is noticeable that the relatively weak activity in the corporate segment is accompanied by a slight increase in the share of long-term loans which, in addition to the somewhat increased demand for investment credits, could partly be explained also with a weakening of the activity of renegotiating and



refinancing old claims. With reserved business attitudes, maintaining of the credit policy of the commercial banks has the main contribution to the increased credit activity in the corporate segment. The aggregated results of the BNB Credit Activity Survey indicate that, except for the first quarter of 2018, for the second consecutive year most respondents keep unchanged the credit standards for crediting enterprises. In the past year, main contribution has the risk assessment (unweighted average of the assessment of the macroeconomic environment). An important regulatory moment for the past year is the introduction of the new IFRS 9. It was expected that the introduction of the standard would have a shocking effect on the capital of the commercial banks, but data show that the intensity of this shock is relatively weak, since most banks have probably benefited from the possibility of a transitional treatment and the effect of the new standard will be extended over time. Undoubtedly, the focus of 2019 and the next few years will be the accession of Bulgaria to the Banking Union (BU) and the preparations for joining the euro area (EA). There are strong arguments in support of such steps and, above all, the fact that BU is perhaps the only possible way to fill the gaps in the structure of the European project. The recent global financial crisis has unequivocally demonstrated that existing supervisory mechanisms do not provide sufficient opportunities for preventing, managing and overcoming crisis situations, as the increasing integrity and interrelation of the European financial markets far outweigh the capacity of the national supervisory mechanisms. At the same time, the EU does not have adequate commitments to cooperation, coordination, consistency and trust between the national supervisory authorities within the Union, hence sufficient capacity to prevent and overcome crises of this magnitude (at least until the beginning of the debt crisis).

The **sixth chapter** examines the labor market. The analysis shows that decreasing employment in 2018 and smaller changes in key indicators show deepening negative trends. The numbers of unemployed and inactive people also decline, with the process significantly supported by the demographic factor. The internal reserves to increase the number of employed are almost exhausted, especially through the activation of the discouraged and generally inactive people who want to work. There is a physical shortage of workforce in some areas with increased segmentation of employment. These trends are an objective result of transitions between employment, unemployment and inactivity of the population of economically active age. To some extent, domestic labor markets have limited access to unemployed and inactive people. Changes in the labor market demand and supply can be assumed, requiring changes in labor protection mechanisms and policies for activating the transitions to employment. Employers' demand decreases its activity. Employed, attracted and kept with higher salaries before, are now dismissed. The significance of wages as a motivator for employment also diminishes. The expected positive inflation in the next three years again puts the requirement of renewed social policies to protect wages and incomes of the population.

The **seventh chapter** presents the main assumptions for making the forecast, as well as the very forecast of the main macroeconomic indicators. The macroeconomic forecast developed for the purposes of this report is based on assumptions about medium-term developments in international prices and external demand, as well as on government economic policies, outlined in the State Budget Report for 2019 of the Ministry of Finance. The macroeconomic forecast of ERI is based on macroeconomic

information available on April 15<sup>th</sup>, 2019. Projected international prices and external demand expectations are based on IMF report on the world economic perspectives (World Economic Outlook) in April 2019. The other large set of forecast data to be taken into account is the one from the medium-term budget forecast for the period 2019-2021, No 195 of Council of Ministers on April 11<sup>th</sup>, 2019, which approves an updated mid-term budget forecast for 2020-2022. With the inclusion of these forecasts, we take into account the government's ability to directly influence the size of public debt and budget expenditures, assuming that the goal of the budget deficit will be achieved primarily through correction of the capital expenditures.

The ***eighth chapter*** of the report summarizes the findings and assessments of medium-term development and formulates relevant recommendations to the macroeconomic policy.

**SECOND PART** of the report examines the topic of focus: Structural imbalances and risks to the economy.

This part analyzes the state and perspectives of the Bulgarian economy in relation to the already observed slowdown of the global and European economies and the regional turbulences. The main thesis defended in the report is that structural imbalances are accumulated in the Bulgarian economy, which poses risks that increase by the strong dependence of the Bulgarian economy on the worsening external environment in 2018. The subject of this study is the identification of these structural imbalances and the tracking of the differences in the starting conditions in 2019 compared to the pre-crisis period 2007-2008. The analysis starts with tracking the trends in the economic development in a global and regional perspective and outlining the instruments available to assess the macroeconomic and structural instability. On a structural level, the Bulgarian economy is examined in two aspects – in terms of dependence on the external environment, and in particular the euro area economy, and on the basis of indicators from the real sector of the economy to establish structural sustainability. The second part of the study seeks to answer the question on what stage of the economic cycle is the Bulgarian economy now and what is its dependence on the economic situation in its main trading partners. The third part analyzes the challenges related to:

- Increasing dependence of the Bulgarian economy on the dynamics of the European economy;
- Low, instable and imbalanced growth of the country;
- Insufficient domestic and foreign investments and their priority focus on the non-tradable sector of the economy;
- Decrease of companies' profit and the available income for investment;
- Weak and risky credit activity in the non-financial sector;
- Decrease of employed people and the worsening of the branch structure of the employment;
- Accumulation significant liabilities in the state-owned enterprises, municipalities and non-reformed sectors with predominant state ownership.

The analysis of the external and internal challenges of slowing economic activity in the country shows that the worsening of the external environment would have much more structural effects than direct financial dimensions, like in the global financial and economic crisis in 2008. Globally, the financial sector is already stabilizing and no significant risks are expected that would create a new financial and consequently economic crisis, since the causes and the nature of the slowdown of the global and the European economies are different from those already observed. So the channels for transferring cyclical fluctuations are primarily related to purely economic processes with different scope and effect on the individual economies.

At the same time, there are certain structural weaknesses of the Bulgarian economy (low, unsustainable and unbalanced growth; insufficient domestic and foreign investments in their priority focus on the non-tradable sector of the economy; decrease of the companies' profits and available income for investment; accumulating significant liabilities in the state-owned enterprises, municipalities and non-reformed sectors with predominant state ownership). They are to a large extent characteristic of all countries with catching up development from Central and Eastern Europe and influence its state regardless of the influence of external factors. Limited investments – local private investment, foreign direct investment and investment credit – cannot be fully compensated by low-performing public investments, which to a large extent depend on the flow of European funds, and provide domestic economic environment, sufficiently resilient to cyclical fluctuations.

For the most part, the structure of the economy remains unchanged, despite the change in the model of economic development driven mainly from foreign investment inflow in the period 2004-2007, to export-oriented economic growth in 2010-2016, and growth driven by domestic demand after 2017. This again shows that the identified vulnerabilities of the Bulgarian economy are in essence its structural characteristics. Their manifestation does not depend on the specific phase of the economic cycle, but it is necessary to seek long-term solutions to overcome them by implementing structural reforms. Moreover, in the post-crisis recovery the Bulgarian economy reaches potential growth at much lower levels than in the pre-crisis period, indicating that the possibilities for overcoming the slowdown in the process of catching up with the European economy in the current structure of the economy are already exhausted. Not only the low rates of economic growth, but also its volatility and imbalance, are serious challenges, which addressing requires much more than the standard policies for management the demand. This is shown also by the imposed dominant role of the non-tradable sector in the country with a much lower degree of development of the promising sectors such as ICT and industrial production.

However, the extent of these structural weaknesses appears to be systematically underestimated and the focus is much more on the external factors for accelerating and slowing of the economic growth in the country. Although international institutions like EC, ECB, IMF and rating agencies focus in particular on the need for structural reforms, the economic policy at local level still remains primarily oriented towards overcoming difficulties and problems of situational character, which has the potential to further deepen the unfavorable external effects.

**PART ONE**

**ECONOMIC DEVELOPMENT AND MID-TERM  
FORECASTS**



## **1. Economic Environment in 2018 – Assessment and Short-Term Prospects**

### *1.1. Internal environment*

For another year, internal environment is relatively stable and calm from an economic point of view, but with a continuing tendency to further political tension. The year starts with a vote of no confidence to the coalition government for lack of a policy to counteract corruption. The specific in this case is that the opposition has initiated this vote at a time when Bulgaria took over the EU presidency that (in the opinion of both domestic and foreign observers) was successful. New votes follow (in June for security issues and in October for healthcare failures), as well as many scandals and protests, and resignations of ministers. There are also some positive news – according to the latest Progress Report of Bulgaria, which has come public at the end of autumn, there is a real chance that monitoring of the country will be suspended this year, provided that all recommendations are met. Another long-awaited good news is the agreement of the European partners to set the start of the country's accession to the euro area. Although Bulgaria has made a serious compromise, close to a retreat<sup>1</sup>, the start of the process is positive in itself.

With regard to economy, things seem more calm, but there are still problems. There is (though unjustified) civil discontent over high fuel prices and a general rise in price of life. Claims for a better standard of living, higher wages and pensions, though socially fair, are economically untenable at this stage. The level of productivity in Bulgaria (both labor and capital one) is seriously lagging behind the more developed European economies, which does not allow for a noticeable increase in wages, and this is the basis of the public discontent. For another year the results of the state-owned companies are disappointing, and large companies such as BDZ, Bulgarian Posts, NEC and “Maritsa Iztok 2” TPP continue to accumulate losses. Foreign direct investments are insultingly low and decrease with each passing year. Even more unfortunate, however, is that the main reasons for the declining inflow of foreign investments (lack of qualified staff; poor infrastructure; sluggish legal system; inefficient administrative services; a sense of corruption all over) turn into a sustainable feature of the economy.

There is every reason to argue that in Bulgaria there is a confusion of the goals with the means to achieve them, and the delusion that relatively good macroeconomic indicators are a sufficient condition for economic prosperity continues. If we analyze in depth, we will understand that even the dreamed high and stable economic growth is not a goal but just a means of achieving higher goals: a better standard of living and a quality of life that includes noticeable improvement in each of the areas of health, education, culture, social and legal protection, real participation in public life, etc. From this point of view, 2018 again did not bring the desired breakthrough and it cannot yet be argued that the Bulgarian economy is steadily moving in an ascending trajectory.

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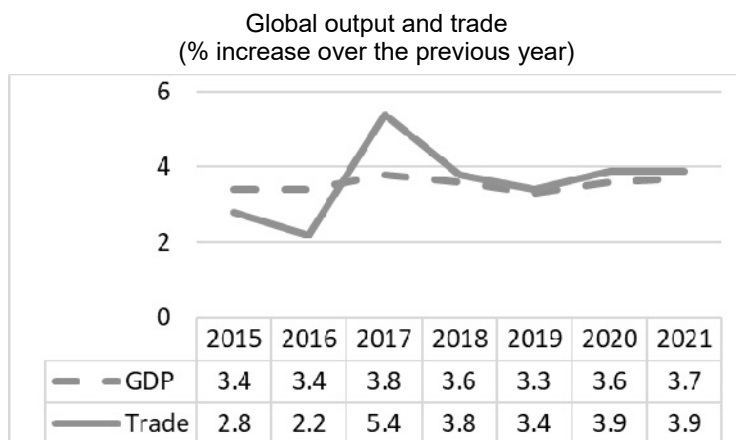
<sup>1</sup> The official position of Bulgaria was that accession to the banking union is possible and appropriate only after the country joins ERM II.

## 1.2. External environment

### 1.2.1. Economic activity

Since the second half of 2018, international financial institutions and experts have begun to revise their short- and medium-term forecasts for the global economy and trade (Figure 1). There is still no satisfactory and unified answer to why this is happening. One of the most often outlined reasons for the slowdown in global growth is the exhaustion of the effects of fiscal incentives in USA, together with a gradual tightening of the monetary policy. To that should be added the stagnation in the euro area and the noticeable slowdown of the Chinese economy. There are also some specific factors (the new fuel emission standards in Germany, the natural disasters in Japan) that hinder the activity in the large economies, but these events have happened amid worsening expectations of the financial market, trade policy uncertainty and concerns about the prospects to China.

Figure 1



Source: IMF, WEO, April 2019.

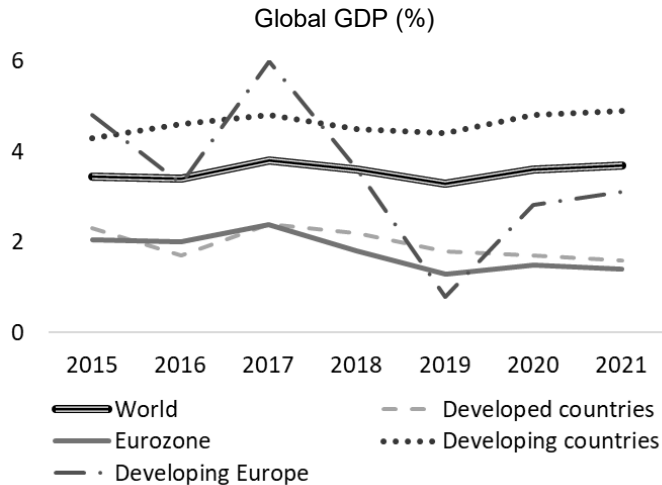
Political and economic issues in the EU have been accumulated for a long time and the region is on its way to a recession sooner than expected, as this happens despite the ECB's refusal to change its expansionary monetary policy. The imbalances in the Chinese economy and the difficulties with the re-adjustment of the growth factors from mainly external to internal ones have led to a rapid accumulation of debt in both the corporate and public sectors. The attempts to manage the situation with fast increasing credits have negatively affected the financial stability, which faces serious challenges.

There are good reasons to state that the world economy has not been able to fully recover from the global financial crisis as the three main engines of global growth China, Euro area and USA<sup>2</sup> experience difficulties, though of a different nature.

<sup>2</sup> IMF data for 2017 indicate that these three economies account for 51% of world production.

The negative trends from the second half of 2018 will continue in the coming quarters as well, with global growth expected to fall to 3.5% in 2019 and then increase slightly (Figure 2). This model of growth reflects mainly the decline in growth rates of the developed economies, the decline in growth rates in some of the emerging markets (especially Argentina and Turkey), as well as the impact of the sanctions against Russia and Iran and the impact of trade conflicts between China and USA on the Asian economies.

Figure 2



Source: IMF, WEO, April 2019.

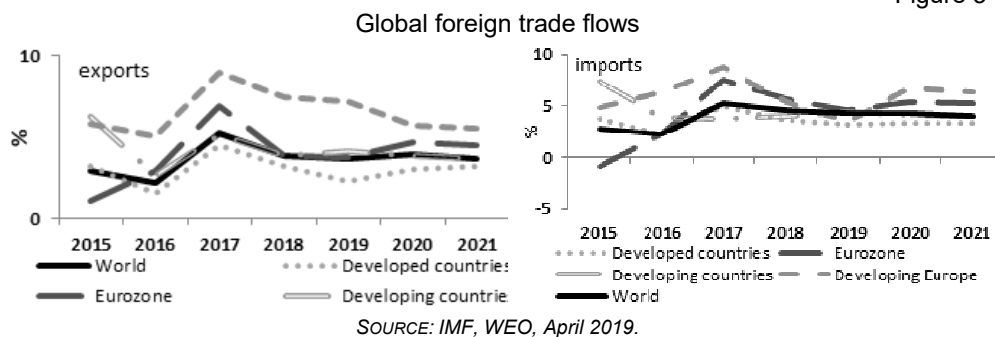
Growth in the euro area is expected to be moderate with a decreasing trend from 1.8% in 2018 to 1.6-1.7% in 2019 and the next two years. This trend is clearly defined in the more developed countries, especially Germany, and is due to a combination of lower domestic consumption, lower industrial production and smaller external demand.

### 1.2.2. Foreign trade flows

Fulfilling his pre-election commitments, President Trump's administration has begun implementing in practice a policy of a widespread protection of the American economic interests. Since the beginning of 2018, we have witnessed many actions in this direction that have greatly complicated the global trade relations. At this stage, most affected seems to be China, but problems arise also with the trade relations with the EU. The future of the tripartite North American Free Trade Agreement (NAFTA) remains uncertain and the potential for escalating the trade tensions increases. Studies of experts show a noticeable decrease in export orders of cars in Germany and Japan, which has a direct impact on all industrial production. Following the big growth in 2017, export and import growth rates have declined significantly (Figure 3).



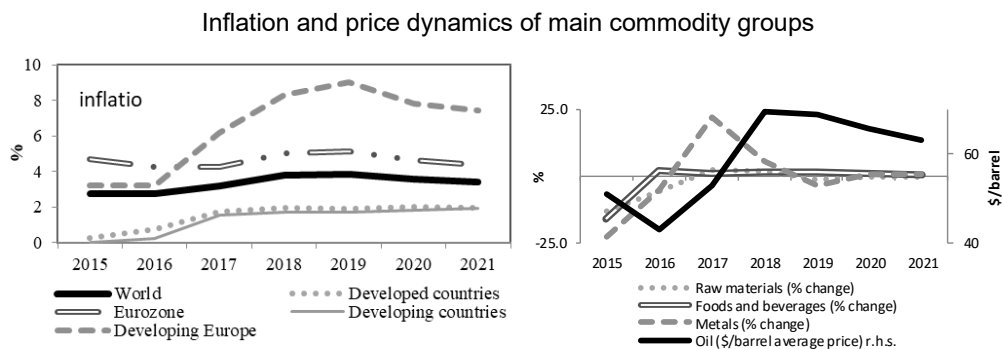
Figure 3



### 1.2.3. Inflation dynamics and prices of main commodities

In the last months of 2018, the higher energy prices raise the annual inflation in both developed and developing economies (Figure 4). However, base inflation (excluding food and energy prices) remains below the expectations and the targets set by central banks in most developed economies. In the newly emerging markets and developing economies, with the exception of the hyperinflation in Venezuelan, base inflation remains below the average in recent years, but with an upward trend.

Figure 4



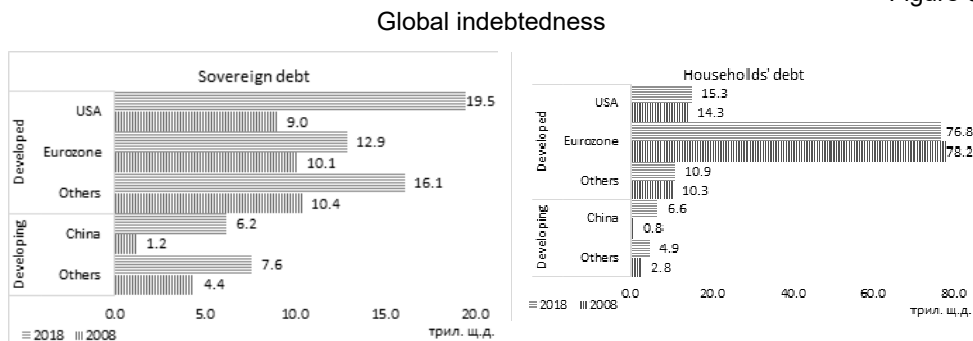
As a whole, the dynamics of the consumer prices is sustainable in the developed economies. Base inflation remains low in the euro area (around 1%) and Japan (0.3%). Real wage growth in most developed economies remains unchanged, although the labor market is activated and the economic activity is close to (in some cases even above) the potential one. For example, in USA and Japan, where unemployment rates are the lowest for decades, wages have increased only moderately, partly reflecting the weak growth in productivity.

In newly emerging and developing countries, base inflation has also maintained its dynamics. In China, where domestic demand slows down in response to the tightening of the financial regulations, base inflation is around 2%. In India, base inflation increases to around 6% as a result of higher energy prices and exchange rate devaluation. Base inflation has decreased in Brazil and Mexico (to about 2.5% and 3.5%, respectively), reflecting the slowdown in economic activity and persistent expectations of low inflation. In Russia, base inflation is also lower than the previous year, largely due to the restrictive monetary policy and the decreasing inflation expectations.

#### 1.2.4. The indebtedness issue

Global indebtedness has increased significantly over the last decade (Figure 5). In 2018, combined debt (corporate, sovereign, and household one) exceeds USD 178 trillion (230% of global GDP), an increase of nearly 50% compared to 2008 pre-crisis levels. Sovereign debt grows particularly fast (by nearly 80%!) and already exceeds USD 60 trillion. There is no doubt that such high levels of indebtedness cause alarm. It is somewhat reassuring that the increase of global indebtedness is concentrated mostly in sovereign debt and not in households, as it has been during the last global financial crisis. Another comforting factor is that the increase of corporate debt (especially in China) is at the expense of an increase of debts to domestic creditors, and a possible bankruptcy would have a smaller impact on the state of the global finances. Nevertheless, the risks of shrinking the crediting, accompanied by a decrease in the volumes of foreign trade flows and a decline in economic activity, are high and rising.

Figure 5



Source: BIS.

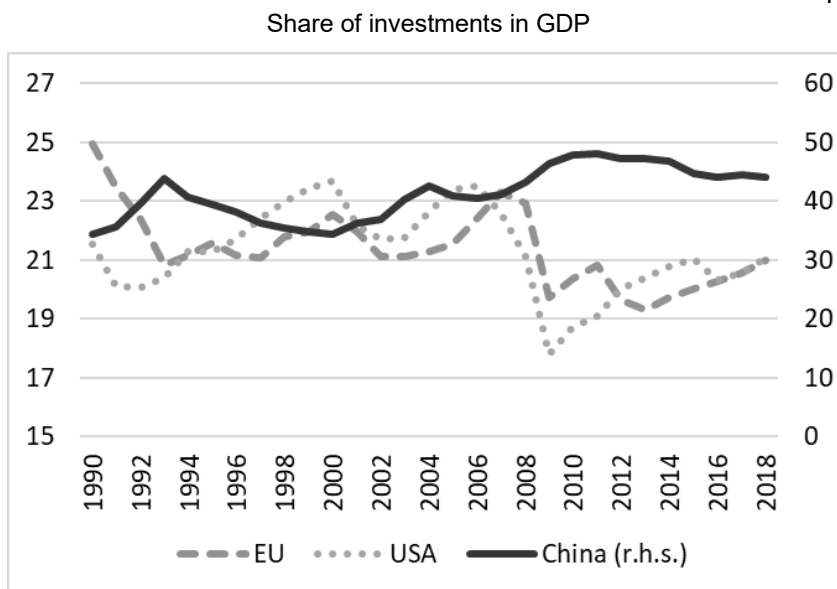
Another aggravating factor is that due to the long period of exceptionally low interest rates, investors are increasingly interested in lower securities as well as in products with a non-traditional structure of fixed income, leading to much faster increase of debt with BBB rating or lower (170% for the last decade). As a rule, the markets for these securities are of lower liquidity, high volatility and extremely susceptible to the so-called financial contagion.

### 1.2.5. Decreasing total factor productivity

It is already clear that there is a global downward trend in total factor productivity starting in 2011. In other words, technological changes do not lead to higher growth, which remains dependent only on investment volumes and labor force, i.e. global growth is extensive. Why did this happen and how sustainable is this trend?

After the GFC, measures to strengthen the global economy are almost universally undertaken in the largest economies. As a result, many insolvent banks and companies have been “rescued”, thus activating the zombification<sup>3</sup> of the global economy. Undeniable fact is that after the global crisis, investments in both Europe and USA have dropped significantly and have not yet recovered their pre-crisis levels (Figure 6). Capital formation in China maintains high rates, but the problem is that investments become more and more unproductive, thus the overall factor productivity declines. This in turn largely explains the problem of the growing indebtedness of the Chinese economy, as the revenues from the investments are clearly not enough to service the debt.

Figure 6



Source: IMF, WEO Database.

<sup>3</sup> The term “zombification” is introduced by the American economist Edward Cain and describes a financial institution that has a negative net worth but continues to operate with external support, most often provided by the state.

### 1.3. Short-term and mid-term perspectives

#### 1.3.1. External environment

- Global growth is expected to remain at around 3% this and next year. This is a slight slowdown from the beginning of the decade, and if this trend remains, there will be an increase of the risks that could potentially intensify the challenges to the development in many parts of the world. More specifically, the global economy faces merging the risks that can seriously damage the economic activity and cause significant damage to prospects for long-term development. These risks include escalation of trade disputes, sharp worsening of the global financial conditions, and intensification of climate risks.
- Although global macroeconomic indicators remain largely favorable, they do not reveal the whole picture. Behind the seemingly *normal indicators*, there is an accumulation of short-term risks that threaten the prospects for global growth. The arguments can be grouped in the following directions:
  - In many developed countries growth rates have already reached their potential, while unemployment levels have fallen to historical minimums.
  - Developing economies from East and South Asian regions remain on a relatively high growth path, increasingly driven by domestic demand. At the same time, however, data show that economic growth is very uneven in individual countries, and several large developing countries have a drop in income per capita. Even among economies with strong growth of income per capita, economic activity is often driven by the main industrial and urban regions, leaving peripheral and rural areas far back, which further intensifies the problems posed by social and economic inequality.
  - Private consumption continues to be a main driver of GDP growth for most regions. Globally, decreasing unemployment in developed countries is accompanied by increasing unemployment in some large countries with higher average income like Argentina, Brazil and South Africa.
  - Global inflation remains moderate but increases in most countries. Expectations of the price dynamics of the main groups of raw materials are based on IMF forecasts, stating that there will be a relative stabilization in this year and no dramatic changes are expected by the end of the projected period. The average Brent crude oil price is expected to fall to about 61-62 USD/barrel. If the “strong dollar” policy remains, it will not have a strong effect on fuel prices in BGN. Depending on the successful resolution of the tensions in Venezuela and Iran, in the medium term, the crude oil price may continue to gradually fall.
  - As a result of the growing trade tensions between the world’s largest economies and the tightening of the monetary policy, the dynamics of international trade flows slows down and practically equals that of the economic activity (Figure 1).

World trade growth is expected to remain below 4% per year in the medium term, well below the average trade growth observed over the past decades.

- The rise of political tensions in many parts of the world, as well as the deepening of the specific vulnerabilities in different countries, generated high financial instability in 2018, which will, most likely, continue in the next year and possibly in the medium term.

### 1.3.2. Internal environment

As a small and highly open economy, Bulgaria is strongly dependent on the development of the external factors. More specifically, Bulgaria is dependent on the economic cycle in the euro area, since the monetary policy of the ECB fastly and almost mechanically transfers in Bulgaria through our currency board mechanisms, the integration of the banking sector and the high level of trade commitment. Unfortunately, there is sufficient reason to argue that the main trading partners in the euro area (mostly Germany and Italy) are entering (or will soon enter) the negative phase of the business cycle. Until recently, growth in the euro area countries was largely due to a strong expansionary policy that favored an increase of the financial asset prices, maintaining a low cost of borrowed funds of the banks, cheaper servicing of credits already granted to households and businesses, and stronger search for new credits. This policy is coming to an end and on the agenda is the question what will be the nature and what will be the driving forces of growth in the medium and long term, given that it will not be able to rely on the effects of the monetary policy, and the problem with indebtedness not only remains unsolved but it even gets worse.

The economic prospects of Bulgaria for this and the next two years are rather positive, but risks remain relatively high. To the traditional risks with the external environment and the changes in external demand are added also the internal risks associated with the traditionally unstable political environment, which is likely to become more and more unstable (given the European elections in May and the local elections in the autumn). Estimates for the projected period can be summarized in the following directions:

- Bulgarian economy is open and highly dependent on external demand and external financing. In view of the active trade war, it may be assumed that world trade volumes are being retained or even reduced. This, together with the limited export potential of the economy and the unfavorable export structure, does not give reasons to rely on exports as a significant growth factor in the short and medium term. The negative net exports will have more and more restraining influence on the economic growth rate.
- External financing in the form of foreign direct investments will be far from the levels in the years before the global financial crisis. Main source of external financing will be the funds from the European programs, which are expected to gradually increase in the projected period. However, risks are high, as it is still unclear how Brexit will affect the EU common budget.

- Considering these two factors, it can be concluded that real GDP growth will remain at the levels of the previous years and will be very close to the potential one. There are two opposite trends that will determine the aspect and the drivers of the growth in the medium and longer term. On one hand, the decrease of the external demand, due to the business cycle of the main trading partners entering a downward phase, will have a negative effect. The shortage of labor force will also act towards limiting the potential growth. The stagnation can be added to this, even a slight decrease in the productivity dynamics. These negative trends will be counteracted by the accelerated absorption of funds from the EU Cohesion and Structural Fund; the increase of the domestic demand as a result of the higher nominal and real wages; favorable financial environment. A slight increase of the growth can be expected by the end of the projected period, but it will, anyway, remain far from what is needed for the so-called catching up development, implying a rate of minimum 5%.
- At the beginning of the new programming period, the absorption of funds from European programs is traditionally low. Over the next few years, we expect increase in the absorption, resulting in more significant increase of government investments and increase of gross fixed capital formation in both nominal and real terms.
- Expectations of price dynamics in 2019 relate to a sustained exit from the negative zone, in which it has been in the last few years. This will be supported by the increased domestic consumption and the change in the prices of energy resources. At this stage, there are no reasons to fear high inflation, which will remain at around 3% annually.
- The trade balance is expected to worsen in the coming years, due to the maintained export rates and the expected increase of imports, determined by the increased domestic demand. In the coming years net exports will probably contribute negatively to GDP growth. This trend can be counteracted only by a sharper and positive change in the “trading conditions” indicator, but such is not expected. Concerning the balance of payments, another compensating factor may be the balance of trade in services, which is expected to be positive throughout the projected period.
- The positive tendencies in the labor market development can remain, but there is no reason for much optimism in this direction. Private sector will be cautious about opening new jobs under pressure to raise the labor payment. In the next years the employment increase is likely to remain at about the same rate as in 2018. The increase of employment will be accompanied by a gradual increase of labor costs per production unit. Given the low level of wages, this will not have a noticeable impact on export competitiveness.
- Considering the realized surplus in the consolidated fiscal program over the past three years, the fiscal policy in the current year will most likely be expansionary. Expenditures in this and the following years will grow faster than revenues and the budget will again be in deficit but subject to the limitations imposed by the Law on Public Finance.

- Concerning financial sector development, expectations are optimistic. The attracted funds from the non-government sector in the banking system will continue to increase. This will be facilitated by the increased economic activity; the maintained saving rate and the increase of the external private transfers by non-residents. Interest rates on deposits will remain low but with a trend towards a gradual increase, which may also play a role (though limited) in attracting resources into the banking system. The more significant importance of restoring the role of the banking sector in terms of its intermediary functions can be expected if banks increase their credit portfolio.

#### *1.4. Risks*

##### *1.4.1. Credit slowdown*

The review of the assets of the six Bulgarian banks selected by the ECB may have a negative impact on the credit process – such a slowdown was observed in Bulgaria during the previous review, and the same trend is observed in the euro area before the introduction of the single supervisory mechanism. The reasons are in the desire of the banks to avoid taking new credit risk and to maximize their portfolios and clear some bad receivables, which negatively affects the volume of credits. Last but not least, the redirection of personnel from credit-related activities to activities directly related to the review will also have an impact. Another expected effect (though with an unclear direction) is of a different nature and affects the impartiality of the banks on the credit market. Unlike in 2016, when the BNB subjected all banks to an assets review and a stress test, only six banks will now be evaluated, which (under equal other conditions) puts them in a less favorable position compared to the other banks.

##### *1.4.2. Higher interest rates*

Historically low interest rates, maintained for a long time, imply an expected more significant increase, which will affect also the interest rate risk. The FED has already taken this path, ECB is postponing (at least for now), but it is clear that this will happen sooner rather than later.

Euro area countries are currently experiencing a slowdown in GDP growth together with increasing inflation. This favors a situation known in the economic literature as “stagflation”. Avoiding such a scenario will require a strong return to the traditional monetary policy instruments, including the rising interest rates as an element too, even with poor economic growth. In practice, this means a transformation of interest rate risk into credit risk, worsening of the credit quality, a need for more provisioning and, hence, a lower profit rate of the banks. This is the reason why BNB decided to activate the anti-cyclic capital buffer since October 1<sup>st</sup>, 2019.

### 1.4.3. ERM II and participation in the Banking Union

The participation of the national currency in ERM II is one of the five Maastricht criteria for assessing the readiness of a country to join the euro area. Bulgaria currently does not meet just this criterion. The lack of formal requirements for joining ERM II makes the process highly subjective and rather political. The lack of formal accession criteria, as well as the historical practice of all previous accessions of national currencies, do not exclude the right of Member States to add new conditions or to create new criteria. At the same time, however, in order for these new conditions and criteria to be mandatory for the new candidates, a change in the European legislation is needed but such is not yet available – participation in ERM II is based on the same rules existing for more than 20 years. In practice, we find ourselves in a situation that can be described as a combination of new requirements and unchanged rules, which creates a number of problems related to asymmetric treatment and all the resulting risks. The fact is that while the desire for euroisation of the economy was a deliberately implemented policy of different governments, the decision to join the banking union was not voluntary and therefore not accepted unambiguously by politicians and experts. There is an impression that Bulgaria has made a big compromise and according to many the compromise was unnecessary, even harmful.

The mechanism of the so-called “close cooperation” is specific to inclusion in the Single Supervisory Mechanism, intended for Member States with currency different from the euro. This mechanism has not yet been approbated and it is clear that Bulgaria’s experience will be further used as a precedent. However, there are reasons to believe that a country with “close cooperation” will face asymmetric treatment. The reasons for such a conclusion are as follows:

- The country will not participate in decision making on supervisory matters in the Executive Council of the ECB.
- Supervisory decisions of ECB generally work only in the euro area and those of them that are not legally binding outside the euro area will have to be replicated by acts of the local supervisory authority.
- Participation in the Single Supervisory Mechanism does not guarantee access to liquidity support from the ECB and will not have access to the European Stability Mechanism in case of a need for bank recapitalization.

In addition to the above considerations, the asymmetries and inequalities between the countries from the euro area and those from the non-euro area are further deepening in the Single Resolution Mechanism, in which the country joining the Single Supervisory Mechanism with “close cooperation” is automatically included. This explains why joining the banking union with “close cooperation” before euro area membership, though a step in the right direction, poses risks.



## 2. Real Sector

### 2.1. GDP dynamics

Facts:

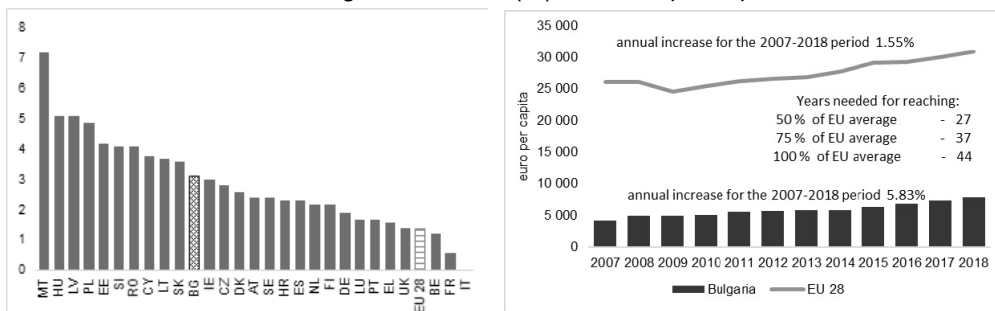
- GDP in 2018 increases in real terms by 3.1% compared to 2017 and reaches a nominal value of BGN 107.9 billion.
- Recalculated in EUR, the GDP is EUR 55.2 billion, with EUR 7829 per capita (EUR 7328 in 2017), which is around 25% of the EU average.
- Gross value added amounts to BGN 93.5 billion, the real value of the indicator being 3% higher than that the one reached in 2017.
- Industrial sector accounts for 27.4% of the value added of the economy, a decrease of 1 pp compared to 2017. Service sector accounts for 68.4%, and agrarian sector – 4.2% of value added, with 66.9 and 4.7% respectively in 2017.

Analysis:

The rate of economic growth of GDP decreases from 3.6% in 2017 to 3.1% in 2018. Despite the slowdown, growth remains above the EU average (Figure 7), but is among the lowest in the new Member States. Despite the generally positive economic prospects, maintaining the current economic growth rates means that convergence with the EU average income per capita remains far in the future.

Figure 7

Economic growth in 2018 (%) and GDP per capita

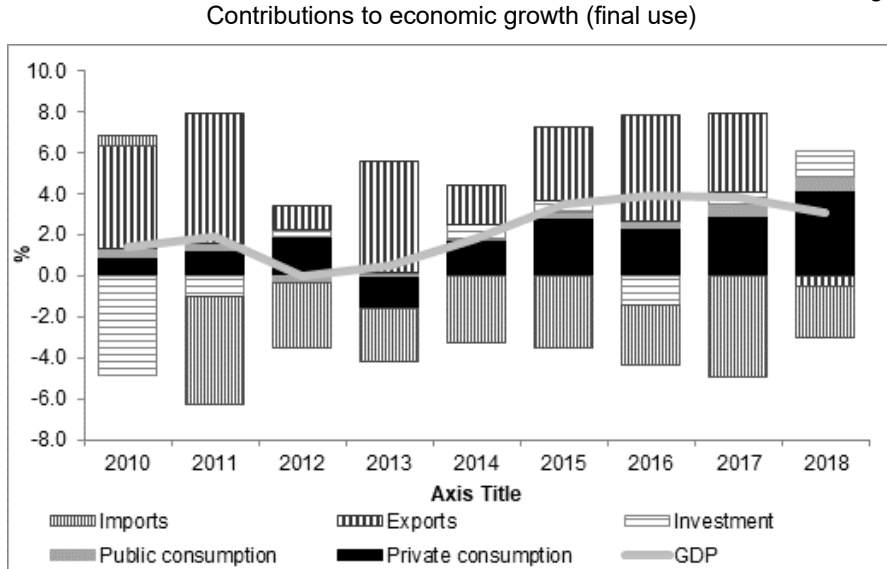


Source: NSI, Eurostat.

Increased wages and improved household expectations have had a positive impact on private consumption – household consumption increases by 6.3%, supported by continuing income growth, employment growth and consumers trust. Consumption growth in public sector is also stronger than in previous years, reflecting mainly the

increase in costs for personnel and utilities. Investments gradually recover – after a decrease of 6.6% in 2016, gross fixed capital formation grows by 3.2% in 2017, and accelerates to 6.5% last year. Net exports, which until a few years ago are a main driver of growth, have already contributed negatively to the overall growth. This is due to the slowdown in export growth and the stronger domestic demand, reflected in import volumes, including of consumer goods. The trend from recent years of closing the gap between actual and potential GDP has been confirmed.

Figure 8



Source: NSI.

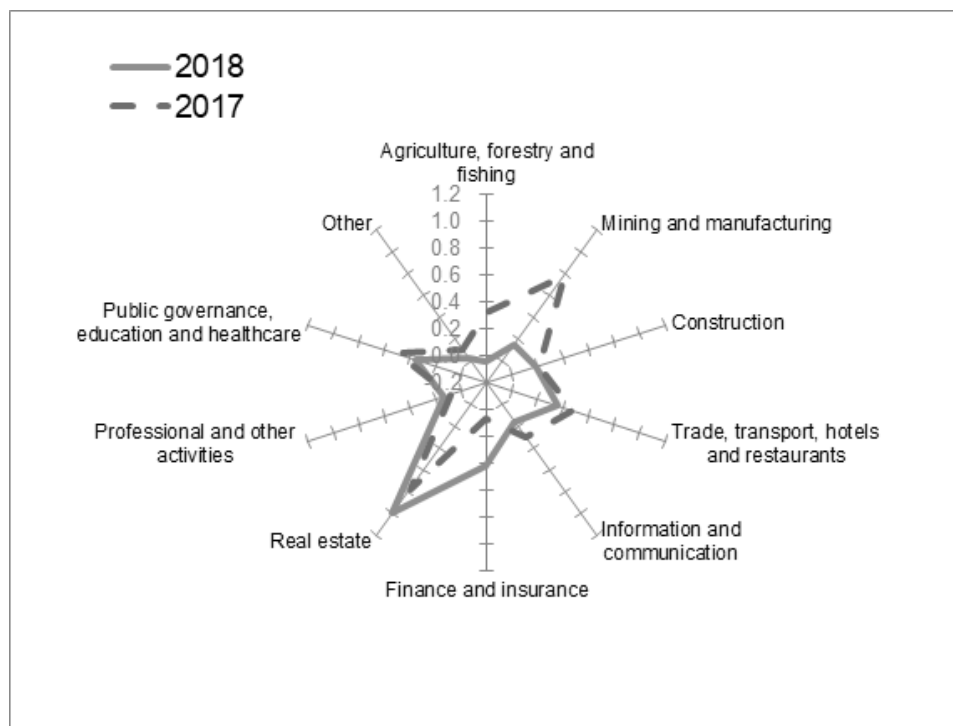
In this context, it should be pointed out that the growth of potential GDP benefits from productivity improvements but remains limited due to the low investment volume and the unfavorable demographic structure that had a severe negative impact on labor supply. Potential GDP in medium term is expected to remain at about 3-4%, which is insufficient in view of the need for catching up development and the projected growth of potential GDP for some of the countries in the region.

Another unfavorable finding is that the realized growth cannot yet be considered as inclusive and has no noticeable impact on the decrease of poverty and economic and social inequalities. Levels of poverty and income inequality are the highest in the EU. The tax system based on proportional income taxation not only does not help to reduce inequality in the market incomes, but it even helps its deepening. This is due to the lack of redistributive effect of the proportional income tax and the relatively low level of expenditures for social protection and the lack of a mechanism for better targeting and updating of the social transfers to the people in need.

By economic sectors, the growth in 2018 can be considered as more unsustainable than in the previous year (Figure 9), since the real estate sector is the highest contributor. At the same time, it is disappointing that structure-defining sectors, such as industry and information and telecommunications, have been decreasing their contribution to the overall growth for a second consecutive year.

Figure 9

Contributions to economic growth (by economic sectors)



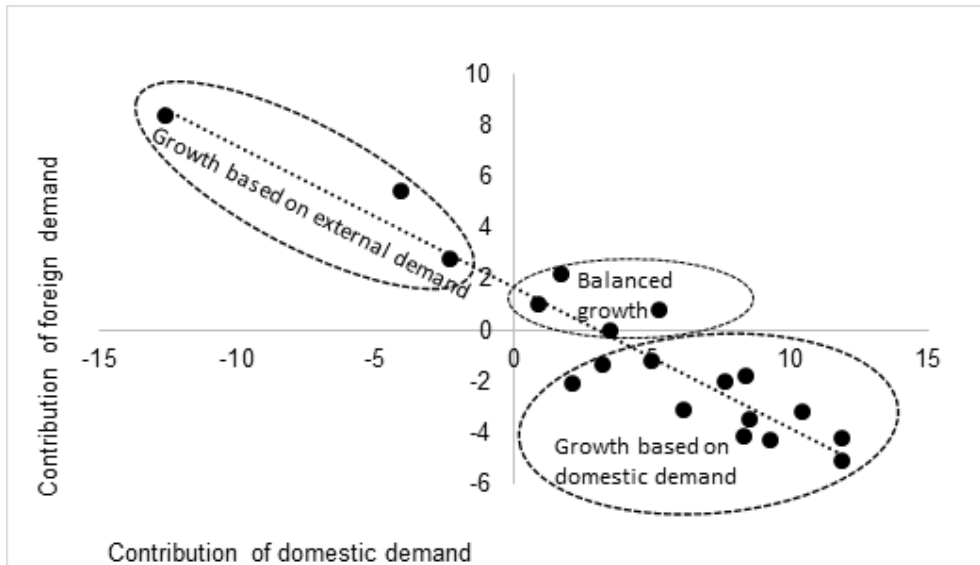
Source: NSI

## 2.2. Internal and external growth factors

The data since 2000 have undoubtedly shown (Figure 10) that domestic consumption is increasingly becoming a main growth factor. In the last few years this is largely due to the growing trust of both consumers and producers. The several good tourist seasons and the generally favorable financial environment contribute in the same direction.

Figure 10

Contributions of domestic and external demand to economic growth  
(2000-2018)



Source: NSI

The trend of predominance of internal growth factors cannot be assessed one-sidedly. As a small and open economy, Bulgaria is highly dependent on the external sector, which is traditionally considered as the main driver of economic growth. This has been repeatedly stated in a number of government programs as well as in various scientific publications, including in previous editions of the Annual Report of Economic Research Institute at the Bulgarian Academy of Sciences. Many studies have found a high correlation between exports increase of and economic growth. According to the main theoretical postulates, the advantages of export-oriented growth models are due to the following reasons:

- Internal costs of providing a foreign currency unit are lower than the costs of saving it;
- Overcoming the limitation concerning the economies of scale;
- Exposure of local producers to external competition leads (in general) to increased efficiency and reduction of costs;
- Significant increase of FDI in export-oriented economies is empirically proven;
- There is also empirical evidence concerning the opportunities of job creation that are higher at higher export volumes.

At the same time, growth models prioritizing exports have also serious weaknesses, the most important of which are:

- Dependence on the external demand of the foreign trade partners and increase of the volatility of the growth rates;
- Slowing down the rates of development of the domestic market;
- Intensifying competition among developing countries and desire for “export displacement” of competitors, leading ultimately to a worsening of trading conditions for all exporters;
- Deepening the global imbalances and a negative impact on financial stability;
- The more countries apply this model, the lower its efficiency is, due to the limitations of the global demand.

Because of these weaknesses, in recent years more popular become the arguments in favor of the view that export-led growth models have been exhausted and should be replaced with models based on the development of domestic demand. One of the main arguments is that China’s entry on the international markets has fundamentally changed the “rules of the game”. The reasons for this are rooted in the hierarchical structure of this type of models, suggesting replacing old players with new ones that offer lower cost per production unit. The supply of cheap, undemanding and relatively well-trained labor in China is practically unlimited, putting the other developing countries (both in the region and globally) at a disadvantage. There are already a number of examples (mostly in the light industry and in particular knitted items) proving the hypothesis of export displacement.<sup>4</sup>

Despite the weaknesses of the export-oriented growth, there is no doubt that developing countries (at least at a certain stage of their development) cannot do without development of export industries as long as they provide the necessary currency. The question is in what context export encouragement is considered. From this point of view, international trade should be subjected to the idea of economic development rather than looking for comparative advantages in different activities and industries at all costs, since this often leads to negative effects in the longer term. In order to be successful, models based on domestic demand should be built on the following principles:

- Optimization of the distribution of income in the economy;
- Good governance (competent and uncorrupted);
- Financial stability;

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<sup>4</sup> Palley, T. I. *Export-Led Growth: Is There Any Evidence of Crowding-Out? Structural Change and Economic Dynamics*, Elsevier 2000.

- Reasonable and affordable external financing.

These principles clearly outline the limitations of applicability of the models based on the development of domestic consumption by imposing significantly higher standards. I.e. it is not just about desires and choice, but also about opportunities. It is hardly a coincidence that the overwhelming majority of highly industrialized countries rely much more on domestic factors of economic growth rather than on external demand.

Clarifying the theoretical concepts about the possible types of economic growth and the constraints they impose is important in terms of forming a specific economic policy. The question is can Bulgaria at this stage generate sufficiently high growth, based on internal factors, so that there is no need to rely on the whims of the foreign markets? Moreover, a possible positive response to this question also requires an answer to another question – what should be the role of the government in implementing such a policy?

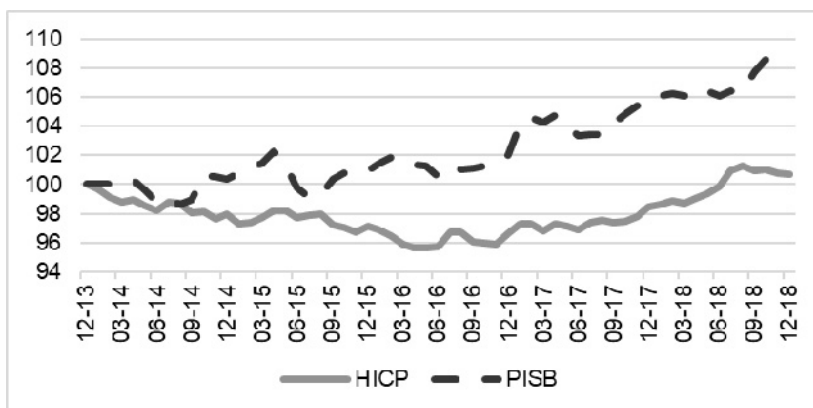
No matter how convincing the arguments of the opponents of export-led growth are, the bitter truth is that the level of income in Bulgaria continues to be low. The constraints imposed by the currency board and the impossibility (at least in the short run) of conducting an expansionary fiscal policy are additional factors in support of the conclusion that, in the foreseeable future, Bulgaria should rely mostly on exports in order to ensure economic growth based on economies of scale. From the point of view of the constraints imposed by the balance of payments, the message is clear – the increase of the economic growth is possible only by increasing the attractiveness of Bulgarian exports and/or decreasing the elasticity of imports (at best a combination of both). Otherwise, i.e. if production capacity grows faster than domestic demand (due to constraints imposed by the balance of payments), unemployment will increase, further decreasing the consumption. In other words, it is not just a matter of ensuring economic growth by more exports, but by exporting the “right” goods and services, i.e. the ones with elastic demand. To put it briefly, the tendency to overcome the majority of the internal factors can be considered as rather unfavorable. Higher growth rates, ensuring the so-called catching up development, are possible only if the contribution of the external sector to economic growth rates is positive and excels the one of the domestic demand.

### *2.3. Inflation dynamics*

Inflation in the past year (measured by the harmonized index) increased to almost 3% at the end of August 2018, then calmed down and at the end of the year it was 2.3%. After three consecutive years of deflation, consumer prices began to rise in 2017. The trend continues in 2018, with more noticeable increase of prices of the so-called “small consumer basket”, to which the population is more sensitive (Figure 11). Price pressures have increased due to a sharp increase of oil prices, secondary effects on the food prices, and increases of unprocessed food prices after a weak harvest in the summer. Regulated prices also increase significantly in 2018.

Main drivers of inflation dynamics are the prices of services (increase by 4.4%) and food (2.4%), especially bread and cereals (11.2%). Considering the high weight of **food** in the consumer basket, the dynamics in this commodity group is important for the overall index. In 2018, the increase of prices in this group has a clear acceleration trend. The main external factors influencing food prices are the increase of the international prices, particularly noticeable for cereals, and the overall increase of prices of energy resources. Among the domestic factors, the smaller supply (evidenced by the decrease of gross value added), as well as the increase in wages in “agriculture” sector, have an impact. The dynamics of the prices of **services** is also influenced by higher prices of energy resources, as well as the increased demand, particularly high in hotel business and catering, where the inflation reaches 5.6% at the end of the year. The administratively controlled prices increase by 2.4% at the end of 2018 due to rising prices of electricity, heat energy and central gas supply, as well as water and sewerage services.

Figure 11

Inflation indices<sup>5</sup>, December 2013 = 100

Source: NSI.

Despite the increasing inflation pressure, the analysis shows that there are no reasons for concerns at this stage. Base inflation increases, but remains low (2.1% at the end of 2018). Moreover, it is low compared to all new EU Member States. The increased values in the previous year relate to the increased domestic demand and the positive dynamics of a large part of the imported goods. There are no serious grounds for seeking a direct and strong connection between the increase of average wage and price dynamics. The latter reflects rather the closing output gap between potential and real GDP. Other macroeconomic indicators, such as increasing employment, increased use of production capacities, and the results of the business surveys pointing to an emerging shortage of labor, also point to this conclusion.

<sup>5</sup> Harmonized index of consumer prices (HICP), Price index of a small basket (PISB).

Concerning future expectations, there are reasons to conclude that the trend in increase of consumer prices will remain in the current year and will calm down by the end of the projected period. These conclusions are due to the current dynamics and expectations of international prices of raw materials. The projected stabilization of the international prices of energy resources will have a hindering effect on the domestic prices of energy goods.



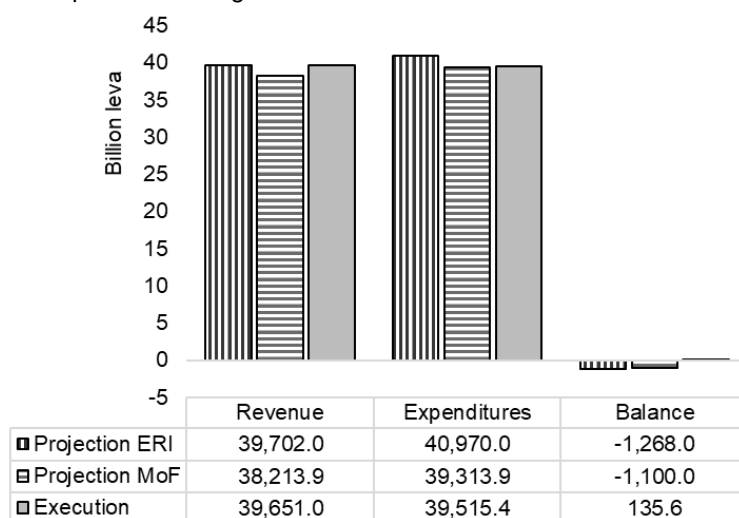
### 3. Fiscal Policy and Government Debt

#### 3.1. Evaluation of the forecast of the previous period

The fiscal projection from last year's report is relatively correct (Figure 12). In terms of revenues, our expectations are very close to the reported results (difference of 0.1%), and in terms of expenditures, the discrepancies are more significant (difference of 3.7%), but within the tolerable error. In terms of the expenditure side of the budget, the main discrepancy is due to the non-implementation of the capital expenditures.

Figure 12

Comparison of budget forecasts with actual execution for 2018



Source: Ministry of Finance

The MoF projections show the opposite trend – understated revenue side (-3.6%) and a relatively accurate projection of the expenditure side. No institution expected a positive balance at the end of the period. This has been the case for a third consecutive year, and in none of the years the CFP suggests a surplus, but a small deficit.

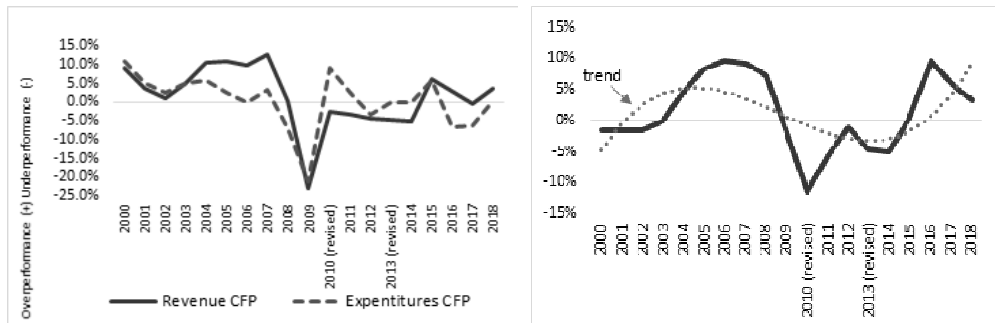
Discrepancies between forecasts and execution are common, when within reasonable limits, and particularly when the main trends are correctly projected. In this regard, it should be recalled that in the 2018 forecast we pointed out the possibility of a better outcome than the planned one in the consolidated fiscal program. We noted that a lower budget deficit can be explained by the government's stated intention to save the bigger part of the higher revenues, and the budget balance could get very close to a balanced one at the end of the year, given that the implementation of the program for public investments continues to fall short.

In fact, the more important issue here is about the role and importance of the macroeconomic forecasts, especially when they are carried out by the government. The opportunities of the budget to influence the macroeconomic development are enormous – the effects come through planning (as long as the budget signals to the private sector) and in the implementation process where becomes clear how serious and honest were the intentions of the government and to what extent they serve a political interest. From this point of view, the comparison of planned budget flows with their actual implementation is very informative.

Figure 13 clearly shows that for the past 18 years the MoF has failed to satisfactorily manage the forecast activity. For this period, the absolute value of average error in the forecasting of revenues is 6.3% (about BGN 1.5 billion per year, or about 2.2% of GDP), while for expenditures it is 5.2% (about BGN 1.3 billion per year, or about 2% of GDP). Moreover, permanent unfavorable trends can be clearly identified. Under conditions of economic progress (2003-2008), revenues are underestimated, which makes it possible to spend public funds without the sanction of the National Assembly through various mechanisms (since this is not permitted by law). In times of low economic growth (from 2009 to 2014), revenues are overestimated, which creates the opportunity to plan corresponding volumes of expenditures that would otherwise not be planned since they go beyond the constraints imposed by the compliance with the rules on the size of the budget deficit. Our previous reports confirm our expectations that we will see a systematic underestimation of the revenue side of the budget, and respectively the creation of prerequisites for extra expenditures beyond those regulated by the Law on Public Finance. It would be interesting to trace whether the reversal of the trend observed in 2018 signals for entering a new cycle.

Figure 13

#### Execution of the Consolidated Fiscal Program (CFP) and degree of credibility of fiscal projections<sup>6</sup>



Source: Ministry of Finance, authors' calculations.

<sup>6</sup> The indicator is calculated as a difference of the differences between the revenue and expenditure projections and execution. Whenever an overperformance of revenue is accompanied by reciprocal overperformance of expenditure, the fiscal position remains unchanged and the indicator will turn to zero.

### *3.2. Main events in the previous year*

#### 3.2.1. Changes in legislation and discretionary policies

There were no major changes in tax legislation during the year, at least not such that would significantly change the collection trends. Concerning the discretionary policies, the following more important events can be noted<sup>7</sup>:

- In the revenue side, the discretionary measures planned by the government are:
  - Increase of the excise rates on cigarettes;
  - Increase of wages in the budgetary area, and increase of the minimum wage;
  - Increase of the social security contribution to the “Pension” Fund of income tax by 1 pp, an increase of the minimum social security income for self-employed people and by economic activities and professions, an increase of the incomes from social security choices and from the requirement for increased social security length of service at retirement;
  - Expected one-time concession payment from a concession of “Civil airport for public use Sofia” (not implemented).
- On the expenditure side, the discretionary measures relate to:
  - Change of the pension policy parameters;
  - Increase of wages in the budgetary area;
  - Increase of the minimum wage;
  - Increase of the social security contributions and the social security income, on which health insurance contributions of certain categories of people are paid from the state budget;
  - Change of the parameters for calculating monetary compensation or cash benefits;
  - Change of the requirements for receiving unemployment cash benefits and for the social security length of service when determining the period of receiving the unemployment cash benefits.

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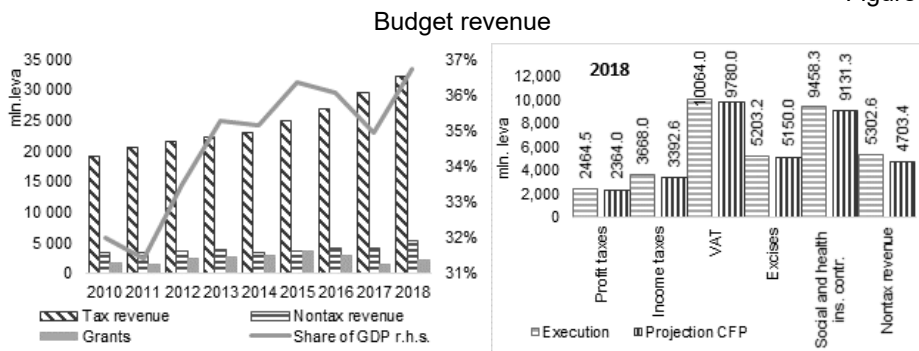
<sup>7</sup> Budget In Brief – 2018 Newsletter.

### 3.3. Dynamics of the main budgetary indicators

#### 3.3.1. Revenue

In 2018, revenues as a ratio to GDP reach 36.7%, which stops the unfavorable trend of decrease of budget revenues of the previous two years. There is an increase for all revenues, with tax revenues being the main contribution. Increased tax revenues are a result of increased domestic consumption, increased activity of the economic agents and measures of the revenue administration to improve revenue collection and fight smuggling (Figure 14).

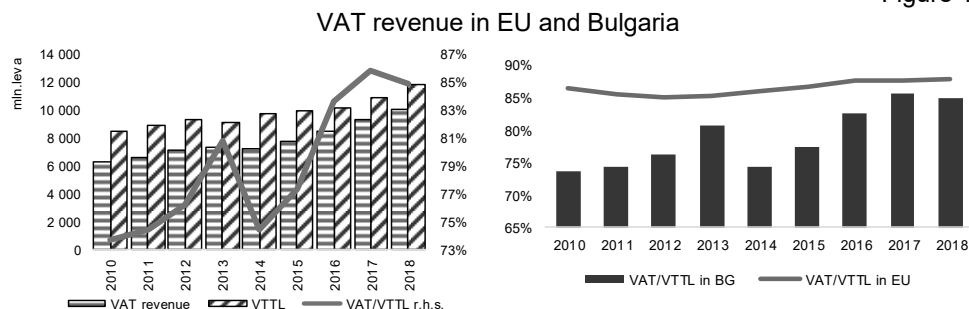
Figure 14



Source: Ministry of Finance.

The increase of revenues, especially when achieved in conditions of unchanged tax rates, is positive and the role of the tax administration (and indirectly of the entire government) should in no way be underestimated. Figure 15 convincingly illustrates the success achieved in recent years, despite the slight retreat in 2018.<sup>8</sup> The EU average indicators have not yet been reached, but the progress in the recent years is visible.

Figure 15



VTTL – VAT Total Tax Liability.  
Source: CASE<sup>9</sup>, authors' calculations.

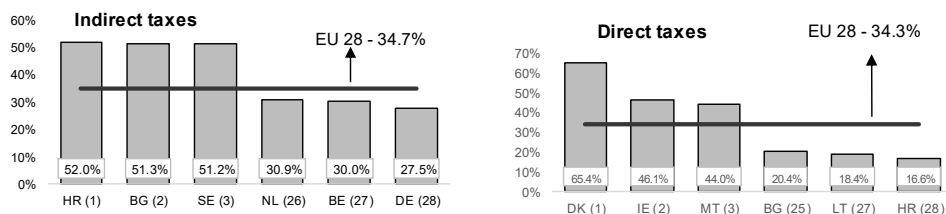
<sup>8</sup> Data for 2018 is preliminary and estimated by the authors. A more significant adjustment is possible.

<sup>9</sup> Center for Social and Economic Research, Study and Reports on VAT Gap in the EU-28: Final Report 2018.

The structure of tax revenues remains generally unchanged – there are only slight changes in the relative shares by individual groups. Economic theory postulates that the taxation of profits and individual incomes has a more pronounced negative effect on economic growth compared with taxes on consumption (indirect taxes). This can be interpreted as an argument in favor of the indirect taxes. At the same time, it should be recalled that the main disadvantage of indirect taxes is their potential regression, which does not allow for greater fairness in the distribution of the tax burden. From this point of view, it is more and more necessary to discuss possible reforms towards increasing the share of direct taxes at the expense of indirect taxes and reconsidering the proportional taxation. The comparison with the structure of tax revenues in the EU countries (Figure 16) is a strong argument in this direction – it is clear that the structure between direct and indirect expenditures in Bulgaria is very different from that in the EU countries. While the average EU tax burden is evenly distributed between direct and indirect taxes, in Bulgaria indirect taxes have a strong lead. As far as the social security contributions are regressive (given the presence of maximum social security income) and the income tax is proportional, the prevalence of indirect taxes further increases the regression of the entire tax system.

Figure 16

Direct and indirect taxes as a share of total tax revenue in the EU (2017)



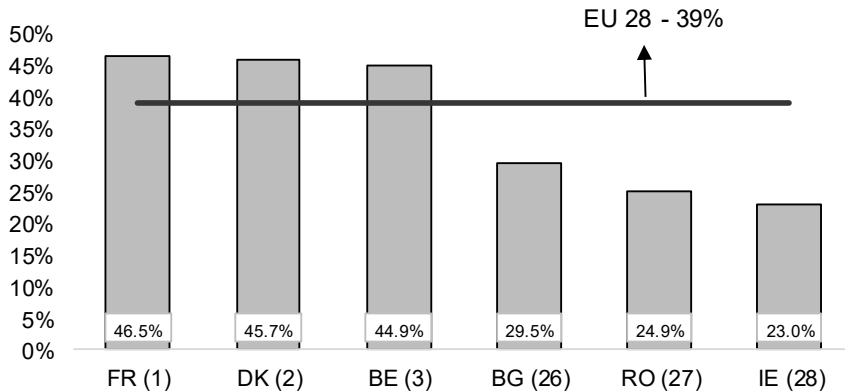
Source: Eurostat.

There are other serious problems in the tax system that have remained unsolved for many years. The low (in terms of European standards) redistribution function of the budget must be absolutely pointed out. The debate about the role and the functions of the state in today's market economy is complex and strongly influenced by the political attitudes of the ruling parties. There are serious differences of opinions in both academic and management circles. It is hardly appropriate here to address the theoretical side of the issue – it is not the goal of this report. However, the comparisons with other EU Member States concerning the ability of the state to participate actively in the economic life are important, since in an economic area with a clearly stated goal to achieve a high economic, political and financial integration, it is not possible (rather not desirable) to have significant differences in fiscal policy.

Figure 17 demonstrates the lagging behind of Bulgaria compared to the EU countries. At the current GDP levels, reaching EU average values means more than USD 10 billion of budget revenues annually. Given the improved revenue collection in the recent years, the obvious reason for the weak redistribution function of the budget (along with the additional opportunities to increase collection) is due to low tax rates.

Figure 17

## Tax revenue as a share of GDP (2017)

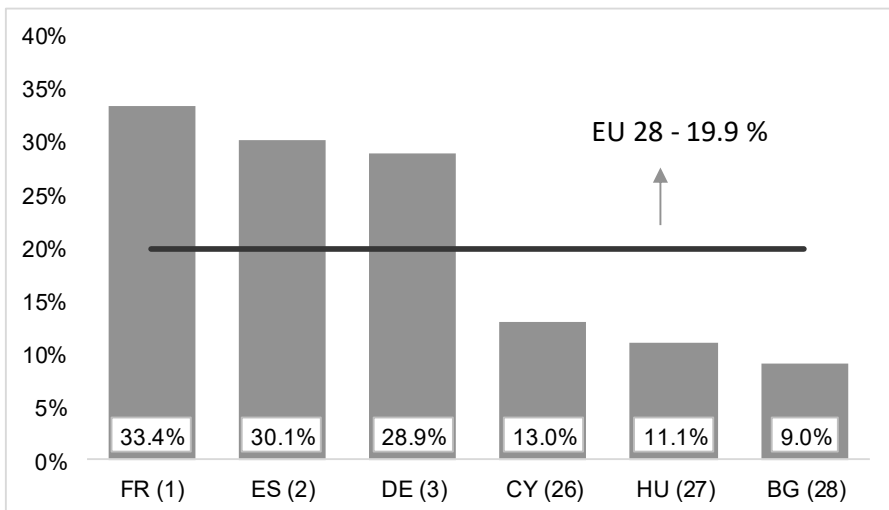


Source: Eurostat.

The effective tax rate in Bulgaria is the lowest in the EU (Figure 18) and one of the lowest in the world. This policy is adopted ten years ago in the hope that the tax benefits will attract foreign investors, which would accelerate economic growth, create new jobs and broaden the tax base, and this will compensate (at least partly) the low rates.

Figure 18

## Effective tax rates in EU (2018)



Source: Eurostat.

Unfortunately, nothing or very little of the intentions is accomplished. Economic growth may look good compared to stagnant Europe, but it is far from what is needed for so-called catching up development that will bring us closer to the average GDP per capita in the EU in the foreseeable future. Foreign direct investments have not increased, they have even decreased in recent years. Income inequality in society (measured by the Gini coefficient<sup>10</sup>) increases, and the ability of the state to influence redistribution processes becomes smaller and smaller. This economic reality is confronted with the populism growing in the society and people's expectations that the state should take more responsibility in important sectors of the economy such as healthcare, education, science, and so on. To that should be added the deepening of the demographic crisis, which creates serious tension on social security and the growing need for budget financing.

Attention deserves the EC assessment<sup>11</sup> published in the European Semester 2019 report: *"The overall tax burden in Bulgaria (29.5% of GDP in 2017) is one of the lowest in the EU. The tax structure mainly relies on consumption taxes, like Value Added Tax and excise duties, and generates relatively high revenue from environmental taxes (2.7% of GDP). This characteristic tends to result in a relatively growth-friendly tax structure. However, the Bulgarian tax and benefit system has little power to reduce inequalities and to promote policies to reduce poverty, which is the highest in the EU). This is partly a result of inefficiencies in the social benefit system and in the design of labor taxation, which is the least progressive in the EU".*

In practice, this means that society faces a serious challenge. On one hand, without doubt there is a need for more budgetary resources. They can be provided in several ways – substantially improving collection rates; expanding the tax base; and/or raising tax rates. Of course, the first option is preferable, but it is a difficult and slow process with certain limitations. Concerning the tax base, serious intentions have been stated by the EC to impose in the near future uniform and mandatory rules for its determining, which also limits the capabilities of this instrument. Concerning the tax rates, both economic theory and empirical data show a negative correlation between tax rates and economic development rates, which explains the resistance to changes in the tax system. At the same time, however, if only the new Member States are considered, it is obvious that there is no such relation (Figure 19). With the exception of Slovenia and Croatia, all new EU Member States have achieved higher economic growth rates, though the effective tax rates are significantly higher (in some cases even doubled). It is obvious that the persistently implemented policy of tax competition in itself cannot provide benefits to the economy.

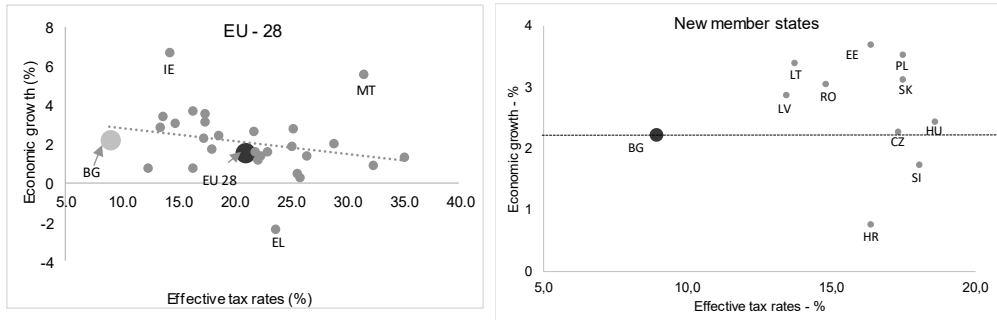
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<sup>10</sup> According to EUROSTAT – SILC Survey, Bulgaria is the country with the highest Gini coefficient in the EU in terms of available income. For 2017, the coefficient is 40.2, with an EU-28 average of 30.7. Another unpleasant point is that over the last five years, the trend has been on a continuous rise.

<sup>11</sup> Report on Bulgaria for 2019, including an in-depth review on the prevention and correction of the macroeconomic imbalances, March 2019, COM(2019) 150 final, p. 28.

Figure 19

## Effective tax rates and economic growth (2010-2017)



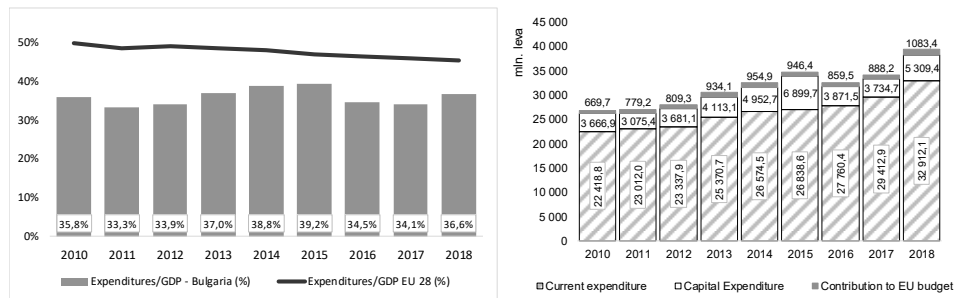
Source: Eurostat.

## 3.3.2. Expenditure

Expenditures in CFP in 2018 increase in both nominal and relative terms. Compared to EU countries, however, expenditures (as a share of GDP) are significantly behind (Figure 20).

Figure 20

## Expenditures of Consolidated fiscal program



Source: Ministry of Finance.

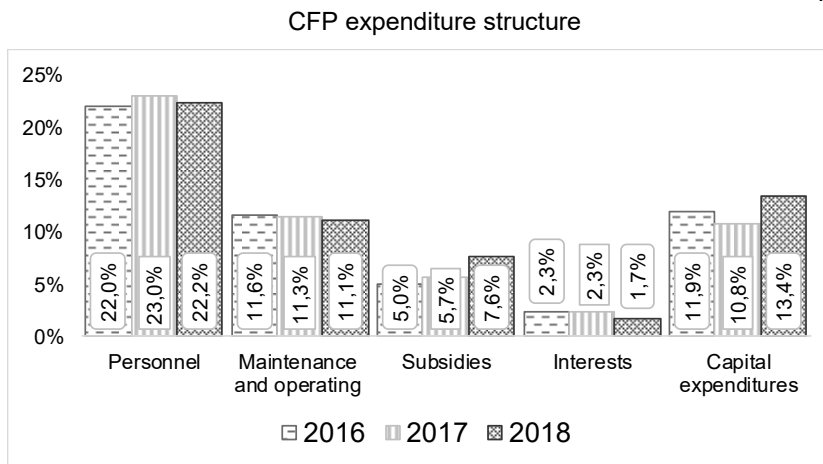
The low share of expenditures is due to the deliberately implemented policy of refusal of fiscal incentives, which in the last three years has become a policy of budget surpluses. However, the expedience of such policy raises serious doubts. The desire for a balanced budget is generally praiseworthy, but it is hardly useful when important budget sectors are underfinanced, infrastructure is obviously old, economic growth is one of the lowest among the countries we compare, on almost all social indicators we are in the



last place among EU countries. **There is a need for a debate on budgetary priorities and reconsideration of the policy of a balanced budget at all costs.**

The dynamics and structure of the expenditure side of the budget have not changed significantly compared to previous years (Figure 21). The only expenditure item with a steady growth is subsidies, and in 2018 they are 40% higher than planned.

Figure 21



Source: Ministry of Finance.

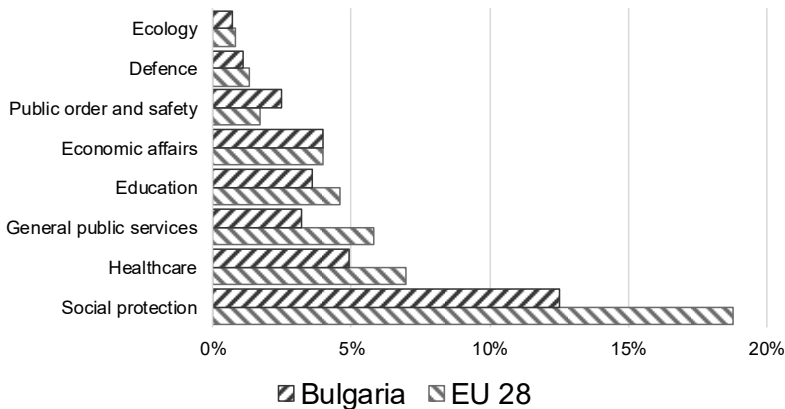
The analysis of expenditures in terms of their functional characteristics does not show favorable changes. The structure is rather frozen, and the comparison with EU countries (Figure 22) shows that in important sectors such as education, healthcare and social protection, Bulgaria is seriously lagging behind, while in sectors like order and security it has a leading position.

Planning and managing the expenditure side of CFP should be easier (compared to the revenue side), since these activities are directly dependent on management decisions. From this point of view, the chronic lagging behind and the lack of rhythm of the actual expenditures compared to the planned ones are hard to explain. Clearly outlined is the practice of deliberate retention of expenditures in the first 11 months of the year, and expenditures in the last month that are many times higher than the average monthly. This trend increases in the past three years and is particularly strong in capital expenditures (Figure 23).<sup>12</sup>

<sup>12</sup> From a purely economic point of view, capital expenditure data in 2018 should be considered with a lot of conditionality as they include 1.35 billion BGN to complete the "Hemus" highway and 0.5 billion BGN for the reconstruction of municipal dams requiring urgent repairs. These funds were placed in special budget accounts last year and were accounted as expenditures, although there were no tender procedures, no specific contractors were selected and no respective construction and assembly work was done.

Figure 22

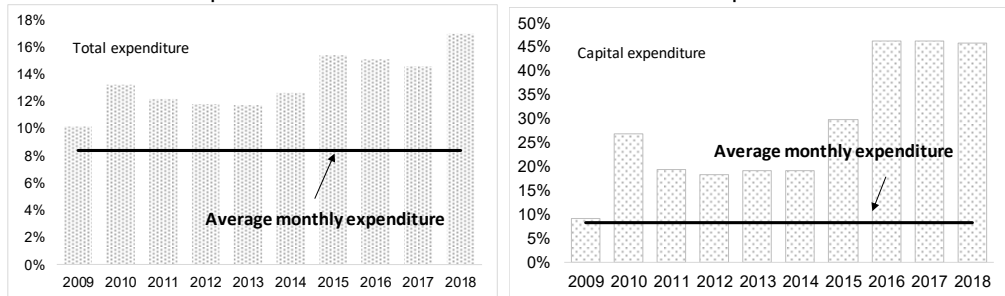
## Functional structure of CFP expenditure



Source: Eurostat.

Figure 23

## Expenditure in December as a share of annual expenditure



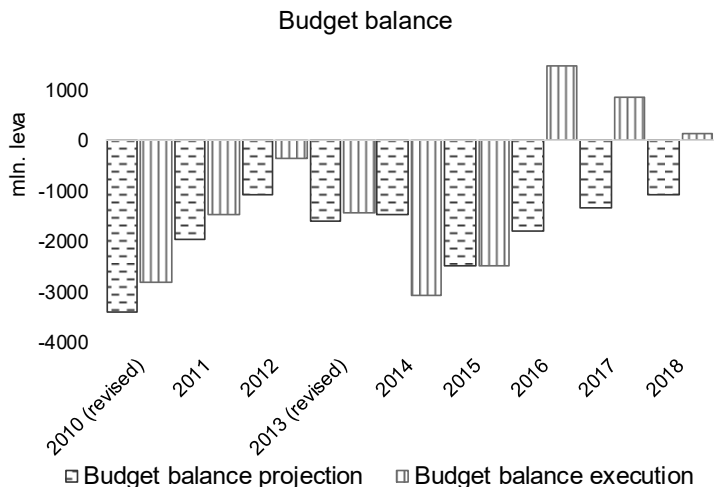
Source: Ministry of Finance.

This practice cannot be considered in any other way but a non-transparent spending of public resources, since the discretionary government decisions at the end of the year do not receive the sanction of the parliament. The formal justification is that under the Law on Public Finance, the government can reallocate funds provided this does not lead to an increase of the set fiscal result. This explains why there is a trend of underestimating the revenues in the forecasts and retention of expenditures to the last possible moment. The drastic uneven distribution of capital expenditures over the course of the year cannot be explained with the technological cycle of production and certainly poses problems for companies realizing public procurements.

### 3.3.3. Budget balance

For the third consecutive year, the budget ends the year with a surplus, while a deficit being planned in all three years. Unlike in 2016, however, when the expenditure side is not completed (resulting in a surplus of 1.6% of GDP), in the past year, the revenue side is decisively significant (realization 103.8%), while the expenditure side is almost as planned (realization 100.5%) (Figure 24).

Figure 24



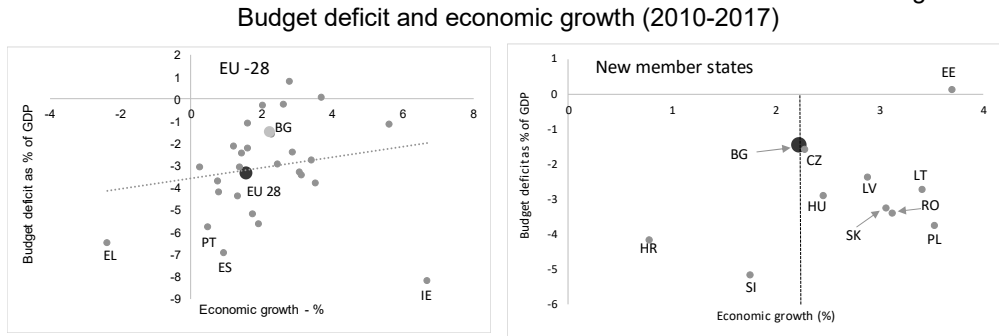
Source: Ministry of Finance.

Macroeconomic assessment of the realized budget surpluses is not one-sided. Economists from different schools cannot agree on fiscal policy recommendations. Representatives of the neoclassical liberalism are firm in their beliefs about the harmfulness of the budget deficit. At the same time, however, there should be a distinction between anti-deficit radicalism and budget conservatism. In other words, stigmatization of the budget deficit is just as damaging as the irresponsible spending of a public resource and its subsequent financing by issuing new debt. This in practice means that it is extremely important to accurately assess the so-called *fiscal space* and make management decisions from the point of view of the specific economic situation rather than following the dogma. This understanding is even more valid for Bulgaria, which has voluntarily refused to implement monetary policy. The refusal of active use of fiscal instruments will mean in practice a refusal of macroeconomic governance at all.

Figure 25 is interesting since it compares rates of economic growth and budget deficits in EU countries. It turns out that Bulgaria has not only the lowest tax rates but also maintains the best balance on the budget. This however does not help the country to increase the economic growth which remains one of the lowest compared to the other new Member States. It is no secret that many of the budget areas are chronically underfinanced and it is quite clear that they will remain such in the foreseeable future (unless a major change in budget priorities is made). It turns out that the economy has

imposed self-limitations on revenues as well as on expenditures and budget deficits, provided the country has a huge need for investments. **The model of economic development, relying on minimum state intervention and low payment of labor, obviously has failed and needs reconsideration. At the same time, any change in the tax system based on raising the effective tax rate should be undertaken only on the condition that tax collection is optimized and the necessary structural reforms are realized.**<sup>13</sup>

Figure 25



Source: Eurostat.

### 3.3.4. Government debt

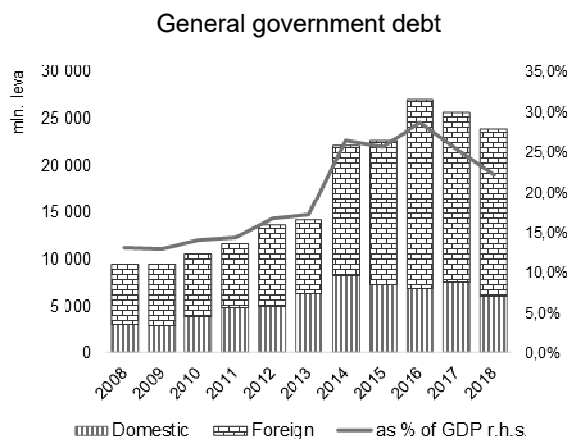
After the global financial crisis, many countries (including many of the highly developed ones) have been forced to manage the effects of the crisis by issuing new debt. Bulgaria has also experienced some problems, even at one stage it seemed that the danger of a fast accumulation of debt is quite real. However, fears turn out to be exaggerated – the achieved economic growth, together with a sound fiscal stance, have reversed the trend, and in the last two years public debt has decreased both in nominal and relative terms (Figure 26). If, until 2-3 years ago, the debate has been how dangerous the fast growth rates are (between 2010 and 2016, government debt virtually doubles – from 14% to GDP to nearly 29%), now the debate is how expedient it would be to start large infrastructure projects and what are the possibilities for them to be funded through new debts. A logical economic approach is debt to be issued when the economic dynamics is expected to be stimulated so that the economy is able to repay them as a result of higher economic results. If new debts do not lead to higher economic growth and do not provide catching up economic dynamics, then new indebtedness only leads to financial enslavement.

Figure 27 compares the dynamics (by years and cumulatively since 2009) of budget deficit, government debt and fiscal reserve. It is clear that in the first years after the financial crisis and its subsequent impact on the Bulgarian economy, the accumulated

<sup>13</sup> The question of the dilemma “structural reforms and/or fiscal incentives” is addressed in the focus part of the report.

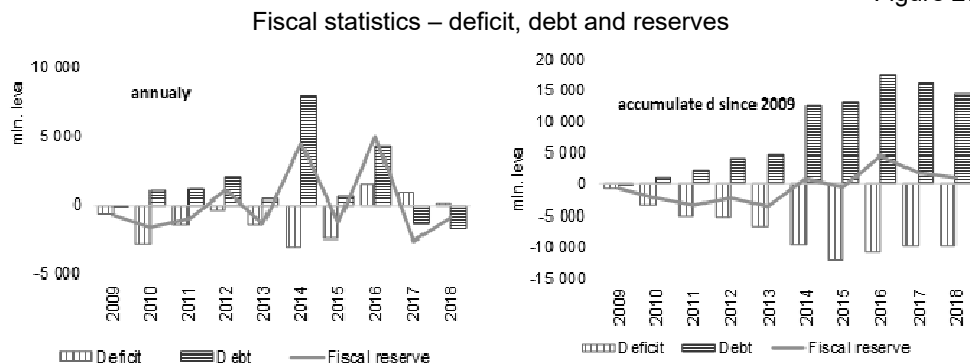
deficits are only partly covered by issuing new debt. For the period 2009-2011, the accumulated deficit is almost BGN 5 billion, while for the same period the government debt increased by only BGN 2.1 billion. This is obviously at the expense of the fiscal reserve, which decreases by BGN 3.3 billion and almost reached the “sanitary minimum”. Such type of “fiscal balancing tricks” should be avoided, they do nothing to help the economy as a whole or the business in particular, but simply try to transfer and blur the political responsibility concerning the government debt. The exhaustion of the possibilities for using the fiscal reserve to finance current deficits quickly proves the insolvency of such an approach to public finance. A change occurs in 2014 when the fiscal reserve has already reached critically low levels, and the only way out of the dangerous situation is a sharp increase of indebtedness, both in terms of financing the rising deficits and covering the fiscal reserve. After the crisis in 2014, there is a reverse trend – the cumulative fiscal surpluses for the past three years have led to an absolute decrease of government debt and have restored the usual amounts of fiscal reserve.

Figure 26



Source: Ministry of Finance.

Figure 27



Source: Ministry of Finance.

According to the updated mid-term forecast of the Ministry of Finance, debt financing of the budget (in the form of government securities) over the next three years will be in a relatively broad range – from 0.8 to 3 billion BGN per year. It is envisaged that the utilization of funds on already contracted government loans total for the period amounted to about 300 million EUR. Given the intentions of the state, there is every reason to expect that the downward trend of the public debt will continue and will settle at levels around BGN 21-22 billion (about 15-16% of GDP).

The government declares that concerning issuing new government guaranteed loans, it will continue to follow the legally regulated practice, which will ensure a gradual decrease of government guaranteed debt to about BGN 1.5 billion (or slightly above 1% of projected GDP). It is also stated that there are no plans of issuing new debt in the form of financial leasing or other forms of debt by the primary budget governance authorities.

### *3.4. Main assumptions for the 2019-2021 period*

In the current 2019, two elections are to take place – European and local one, which will certainly have an impact on public finances, especially on those under the control of the local authorities. From this point of view, more serious deviations can be expected from the forecasts regarding the consolidated fiscal program than from the state budget. To date, the fiscal forecast is based on the following more important assumptions:

- Fiscal policy will be rather expansionary in 2019, with the fiscal impulse within 2-3% of GDP. In the next two years, consolidation may be expected, the budget remaining rather balanced or with a small deficit.
- The revenue side of the budget will continue to increase, influenced by tax and social security contributions as well as the non-tax revenues and benefits.
  - The increase of minimum wage (in several steps to 610 BGN in 2021), leading to an increase of the minimum insurance thresholds, and the minimum social security benefits of the self-insured people, have biggest contribution to the expected increase of the tax-insurance incomes.
  - A discretionary measure with the biggest effect is the introduction of toll fees and electronic vignettes with a total effect of over BGN 500 million for the projected period.<sup>14</sup> In 2020, a budget effect of revenues from toll fees and electronic vignettes of BGN 263 million is projected. In 2021, the range of the paid road network will continue to expand in stages, which will lead to a further increase of the planned revenues by nearly BGN 300 million.

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<sup>14</sup> Ministry of Finance, Updated Medium-Term Forecast 2020-2022, p. 33.

- A further increase of the indirect taxes (mainly VAT) is expected related to the increase of pensions. The amount will depend on the adopted pension indexation policy and will be between 20 and 100 million BGN.
- The increase in the expenditure side is related to the reimbursement of capital expenditures and the proportional increase of almost all current non-interest expenditures.
  - The most significant effect on the level of discretionary expenditure measures is by the planned expenditures in the Defense and Security sector in relation with the acquisition of a new type of fight plane and basic combat equipment with a total amount of about BGN 3 billion for the projected period.
  - Additional effect on the expenditures has also the increase of the minimum social security income, on which health insurance contributions of certain categories of people are imported from the state budget. Just this is expected to increase expenditures by about BGN 370 million over the next three years.
- Given the surplus realized in 2018, the budget balance for the current year will probably worsen, but improvement is expected over the next two years.
- The accumulated liquidity buffers and the government's stated intentions give reasons to expect a slight decrease of the government indebtedness in the coming years.

### *3.5. Summary, conclusions and recommendations*

In medium term, fiscal policy faces serious challenges that require responsible policy decisions, many of which may be unpopular. Priority for the government should be to avoid the lack of rhythm in distribution of public funds, especially capital expenditures. The most important challenges can be summarized as follows:

- In the revenue side:
  - Low degree of redistribution of GDP by the state;
  - Maintaining an unfavorable ratio between direct and indirect taxes;
  - Refusal to introduce (or at least seriously discuss) progressive taxation;
  - Maintaining uniform and low tax rates for leading tax revenues;
  - Difficult revenue collection.
- In the expenditure side:

- Public expenditures have a steady upward trend without a clear relation to the economic and/or social efficiency;
- Discrepancy between annual changes in state expenditures and revenues;
- Expenditure side of the budget (especially the budget of municipalities) continues to be a hostage of short-term political interests.

The recommended policy in medium and long term is to preserve the fiscal stability, but at the same time it should be clearly stated that growth-enhancing public spending is investment in education (improving human capital – knowledge, understanding, skills), healthcare (improving labor productivity and healthy life expectancy) and economic infrastructure.

Another important direction of reforms for ensuring the sustainable development of the national economy will require more fair and rational tax system. These important and structure-defining reforms should be done after a careful “impact assessment”, since it is impossible to expect both a positive fiscal effect and a long-term macroeconomic effect. In some cases, it may be necessary to choose between a temporary higher deficit and long-term effects. In this respect, it is imperative that the assessment of the expected actual effects (expenditures, benefits and redistributive effects) of the proposed/acting normative acts (laws, decrees, regulations, etc.) be properly regulated and institutionalized.



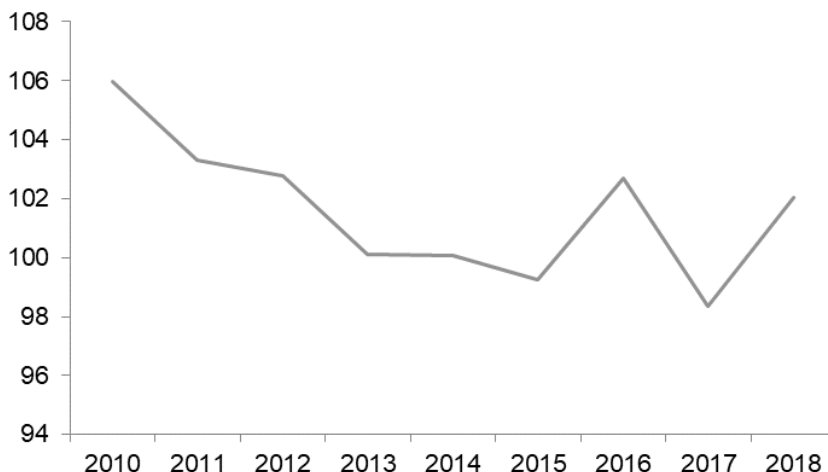
## 4. Foreign trade

The slowdown in the world trade rates and the economic problems of one of our main trading partners, Turkey, continue to have a serious negative impact on the international transactions of the Bulgarian companies. The impact of these factors turns out stronger than projected, with exports decreasing in 2018, which is the first time since the end of the global financial crisis. With this lack of exports growth, it can be assumed that the entire imports growth goes to satisfy domestic consumption.

In 2018 the export price index is 102.6 compared to the previous year. At the same time, the import price index is 100.6, and their ratio shows the “trading conditions” index of 102. It should be noted that the decrease of exports is despite the positive impact of the “trading conditions” in the past year. Figure 28 presents a comparison of the values of the indicator for the last years.

Figure 28

Values of the trading conditions indicator (2010-2018)

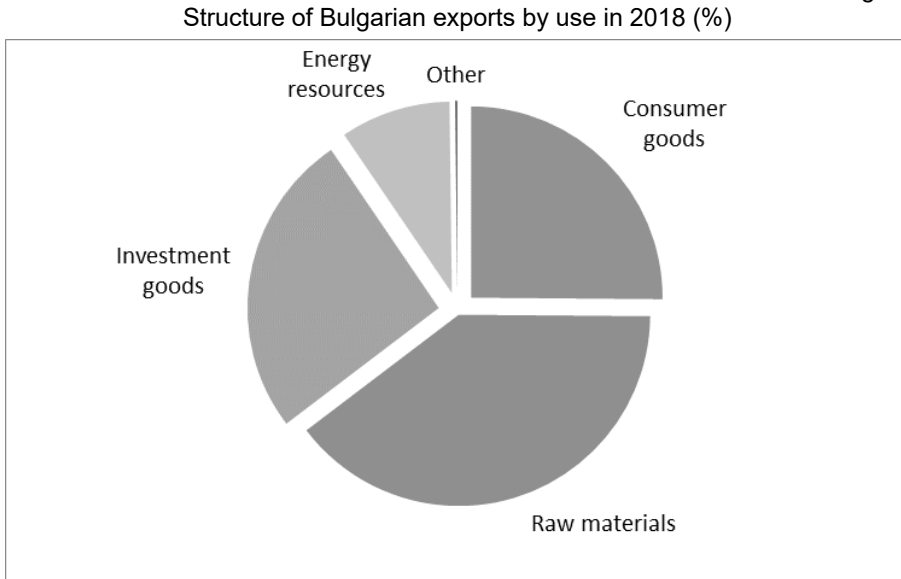


Source: using NSI data.

### 4.1. Exports

The physical volumes of exports of goods from Bulgaria in 2018 decrease by 1.9% compared to the previous year. However, there are no significant changes in the already established structure of Bulgaria's foreign trade, considered by use (Figure 29).

Figure 29



Source: BNB.

Consumer commodities have a share of 25%. Nearly 40% are formed by raw materials, 25% of the exported commodities are investment commodities and 10% are energy resources. The steady trend of exports of low-processed commodities, including raw materials, and relatively low added value, continues.

In 2018, exported commodities decrease to almost all main trading partners of Bulgaria, with the exception of Germany, but this has no impact on the structure. Despite the decrease of the traded volumes, the established trend of export concentration to the other EU countries – four of the first five export countries are from the EU, continues. The country with the biggest share in exports is Germany with 14.9%. It is followed by Italy, Romania and Turkey. Fifth place is Greece. Table 1 lists the most traded five commodities by main partner countries in 2018.

In 2018, exports to Germany continue to be dominated by unrefined copper and ores and concentrates of precious metals extracted in Bulgaria. In 2018, Bulgaria is 38<sup>th</sup> in the list of importing countries in Germany.

To Italy are exported mainly petroleum oil and shoe parts. Exported to Romania are mainly steel rods, tractors and related harvesting devices. Turkey imports from Bulgaria mainly petroleum oils, refined copper and steel pipes. Concerning Greece, exports are dominated by sunflower oil, corn and electricity.

Table 1

## Main trading partners and the commodities exported to them in 2018

Top 5 countries / commodities	Germany	Italy	Romania	Turkey	Greece
Share in the export of Bulgaria (%)	14.9	8.7	8.5	7.5	6.7
Share in the Bulgarian exports to the respective country (%)					
Wheat		3.8			3.3
Corn					3.9
Sunflower, cotton or safflower oil					4.1
Ores and concentrates of precious metals	8.1				
Petroleum oils		7.4	3.4	15	3.0
Electricity					3.6
Medications	2.4		2.7		
Shoe parts		4.0			
Steel rods			5.2		
Steel tubes				13.3	
Unrefined copper	9.7				
Refined copper		6.8		13.9	
Unprocessed lead				4.6	
Machines and devices for harvesting			3.6		
Ball, roller or needle bearings					
Boards, panels, consoles, shelves, cabinets	2.4				
Parts for electrical panels		2.2			
Wires, cables	2.4			10.5	
Tractors			4.4		

Source: using NSI data.

In 2018, Bulgaria's exports maintain the trend of concentration on a limited range of countries. The concentration of foreign trade is measured by "geographical concentration GCr of export" (Galabova, Nestorov, 2018). As a result of the calculations, it turns out that the geographic concentration of Bulgaria's exports has a balanced geographic structure – the first five countries form 46.2% of the commodities exports of the country. Compared with the previous 2017, this is an increase by 1.2 pp.

#### 4.2. Imports

The physical volume of imports of commodities in Bulgaria in 2018 increases by 3.7% compared to the previous year, while maintaining the established structure by use (Figure 30).

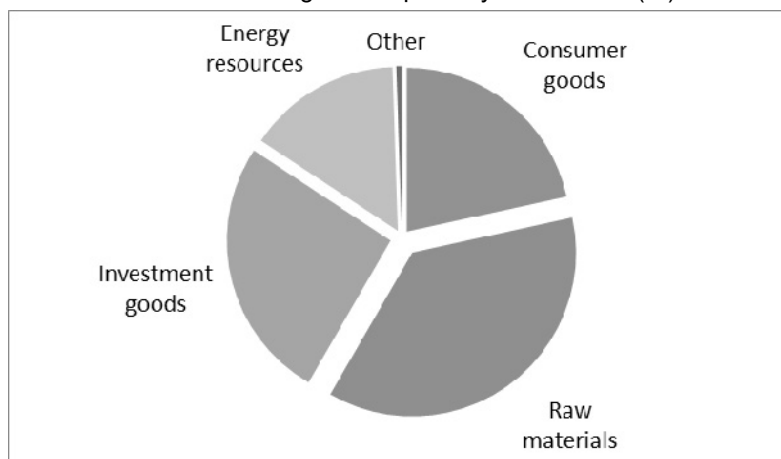
Consumer commodities account for 22%, almost 37% are formed by raw materials, 27% of imported commodities are investment commodities, and energy resources amount to 14%. The steady trend of high share of imported consumer commodities continues, testifying to the inability to meet consumer demand with domestic commodities. In the absence of exports growth, the entire increase of imports is explained by the increase of domestic consumption.

In 2018, Bulgaria's main trading partners, established in recent years, also remain. Imports from other EU countries amount to 51% of the imports of commodities. Asian countries totally have a share of 19%, and the Balkan countries – 9%. Also, Germany is

the country with the biggest share in imports with its 11%. It is followed by Russia, China, Italy, Turkey. Table 2 lists the most traded five commodities by main partner countries in 2018.

Figure 30

Structure of Bulgarian imports by use in 2018 (%)



Source: BNB.

Table 2

Main trading partners and the commodities imported from them in 2018

Countries / top 5 commodities	Germany	Russia	China	Italy	Turkey
Share of imports to Bulgaria (%)	11.2	9.4	7.9	7.3	6.3
Share of Bulgarian imports to the respective country (%)					
Citrus fruits					1.9
Copper ores and their concentrates					2.7
Crude petroleum oils		56.2			
Petroleum oils		6.3			
Petroleum gas		21.3			
Medications	3.7				
Shoe parts				1.5	
Refined copper		2.7			
Rolled products of iron or steel					4.6
Unprocessed aluminum		2.5			
Telephone and communication equipments			5.8		
Computers			2.6		
Parts for electrical panels				2.0	
Electronic integrated circuits; parts for them	1.9				
Air conditioners			2.1		
Leather				1.9	
Wool			2.0		
Wires, cables					3.2
Tractors	2.0			3.1	
Passenger cars	6.0			3.6	4.0
Transport vehicles	1.9				
Parts and accessories for vehicle			2.8		

Source: using NSI data.

In 2018, imports of commodities from Germany are dominated by passenger cars and medications. From Russia are mainly imported crude petroleum oils and petroleum gas. From China are mainly imported telecommunication equipments, parts for vehicles and air conditioners. Imports from Italy are dominated by passenger cars, tractors and parts for electrical panels. From Turkey are mainly imported rolled products of iron and steel, as well as passenger cars.

Noticeable is the concentration of Bulgaria's imports from a limited number of countries. The concentration of foreign trade is measured by "geographical concentration GCr of import" (Galabova, Nestorov, 2018). The geographic concentration of Bulgaria's imports has a balanced geographic structure. The value of the coefficient in 2018 is 0.42. This corresponds to a 42% share for the first five main trading partner countries of Bulgaria's imports, with 1.1 pp increase compared with the previous year.

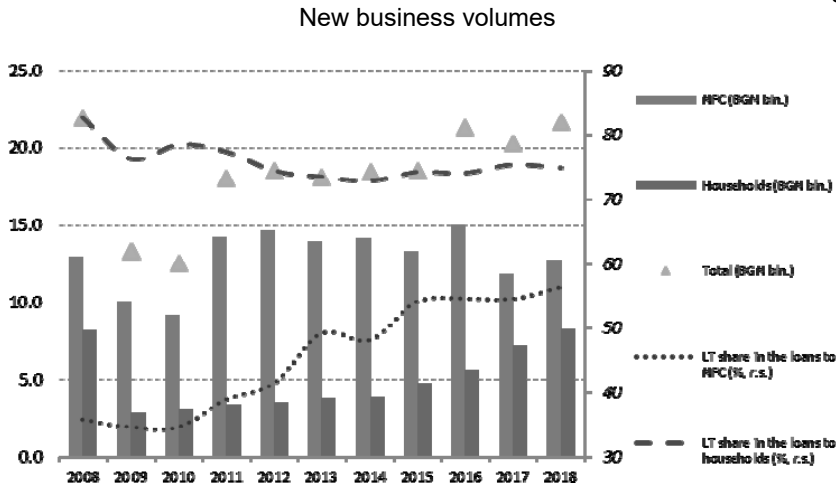
Based on the analysis, it can be concluded that Bulgarian economy maintains the established dominating exports of raw materials. Bulgaria is also considered as an exporter mainly of commodities with low added value. The significant import of consumer commodities continues.

The expectations for the impact of foreign trade on the economic growth of Bulgaria in the short term remain conservative. Internal and external factors influence the volumes traded by Bulgarian companies. Among the internal factors are the uncertainty about the prospects of the transport branch and the decrease of bookings by foreign tourists for the summer season. The external factors are mainly related to the impact of the international situation – development of USA-China and USA-EU foreign trade relations, expectations of the US economy to enter a recession. They affect the international trade as a whole. Because of their significant foreign trade concentration, Bulgarian exports can be directly influenced by changes in the main partner countries. Therefore, the projections for recovery of the Turkish economy in the medium term, as well as reports of a possible recession of leading European economies, should be taken into account.

## 5. Banking Sector

In the past 2018 the banking sector continues to develop in the direction already established in the recent years. Profit in the system increases, concentration increases, credit activity remains far from the pre-crisis levels, despite the continuing decrease of interest rates and the improving of the economic activity in the country. Indeed, data from the monetary statistics (Figure 31) show some increase of the nominal volume of new business for non-financial corporations (from BGN 20.3 billion previous year to BGN 21.7 billion in 2018). However, this volume is still lower than the one reported in 2008 (BGN 21.9 billion), and, assessing the dynamics in relative terms, the unfortunate finding is that the real activity decreases (from 24.5% of the total volume of loans and advances at the end of 2018 to 24.4% of the reported value of loans and advances at the end of this year). The comparison for a longer period does not lead to more favorable findings, since despite the 7.5% increase in the loans granted to non-financial corporations (NFC), their total volume reaches only BGN 12.8 billion, which is 1/10 lower than the levels before 2017 (average of BGN 14.2 billion per year for 2011-2016) – only BGN 12.4 billion. It is noteworthy that the relatively low activity in the corporate segment is accompanied by a slight increase of the share of long-term credits, which, apart from the somewhat increased demand of investment loans, could partly be explained by weakening actively on re-negotiating and refinancing of old receivables.

Figure 31



Source: BNB, authors' calculations.

Almost BGN 7.2 billion of the volumes of new corporate business in the corporate segment have an agreed maturity of over 5 years, thus the share of long-term loans reaches 56.3% or by 1.7 pp more than that the achieved one in 2017. However, the reported volume cannot reach the levels of 2015 and 2016, which in turn shows that, despite a certain increase of the investment activity of the enterprises, they generally keep their pessimistic attitudes in the short and medium term plan this year.

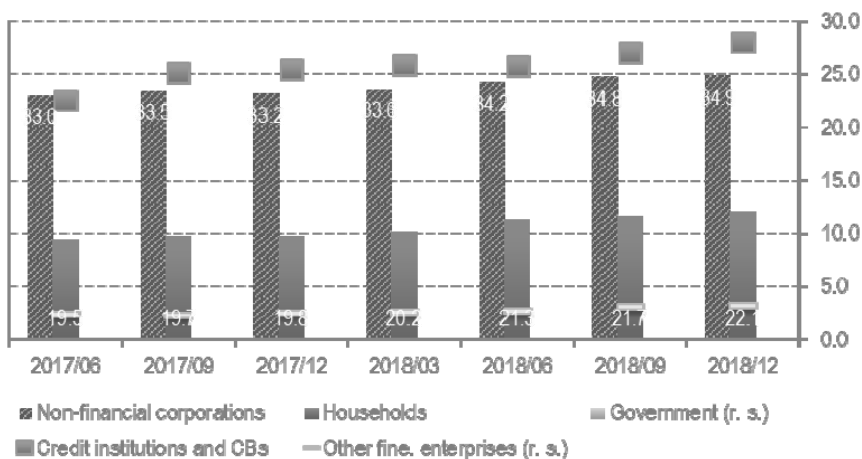
With the reserved business attitudes, maintaining the credit policy of the commercial banks remains the main contributor to the increase of the credit activity in the corporate segment – the generalized results of the credit activity survey of BNB show that, excluding the first quarter of 2018, most respondents keep the standards for crediting enterprises unchanged for the second consecutive year, for which the main contribution over the past year is the risk assessment (unweighted average of the macroeconomic assessment environment). At the same time, financial institutions seek to encourage credit activity by continuing to ease the terms of their crediting – throughout 2018 the balance of opinions on credit interest rates to non-financial corporations remains negative. In the first and fourth quarters almost 1/3 of the surveyed banks report a decrease of the interest rates on newly granted loans in the studied segment. This obviously manages to encourage some of the potential business clients, since in 2018 the number of respondents reporting increased demand for corporate loans (between 7 and 9 in the different product categories) remains bigger than the number of those reporting decrease of the demand.

The increase of gross credits in nominal terms (by BGN 1.7 billion for the past year) slightly gets ahead of the increase of the volumes on new business in the segment (BGN 897 million), despite the pressure against the increase of the gross value of the portfolio put by the high activity of the banks concerning the forced collection of receivables and the writing off of bad credits. Indicative in this regard are the data of the Association of Collection Agencies in Bulgaria (ACABG), published in April 2019, according to which the volume of debts purchased by the collector companies has increased considerably from BGN 772 million in 2017 to BGN 1.905 billion in 2018 as a result of record deals for business credits. Banking products continue to increase their share in the portfolio of non-serviced debts in the ACABG excerpt (reaching 51% of the total volume). It can be assumed that the upward increase of the gross credits to NFC is mainly due to the eased depreciation of the portfolio in this segment, which is a natural result of the continuing increase of the share of long-term credits (from 34.7% in 2010 to 54-56% for the period after 2014).

Retail crediting shows significantly more favorable trends (Figure 32). The segment shows higher activity and the total volume on new business increases for the ninth consecutive year, reaching BGN 8.3 billion for 2018, which is by BGN 975 million (or 13.4%) more than the one achieved in 2017. It should be noted that this tendency shows good sustainability over time – in practice, volumes on new business in this segment have been steadily increasing since 2010. The trend towards a change in the share of long-term credits to households is also quite sustainable. While before the start of the financial crisis this share is around 81-82% of the total volume on new business in the credits to the population, in the next six years the share of long-term credits decreases to 72.9%. Since 2015, the ratio fluctuates narrowly and generally remains high – between 74% and 76% (mostly due to the intensive activity in the mortgage segment). In 2018 there is a slight decrease (by 49 base points to 74.9%), which can be explained with the shortening of the deadlines for some of the new contracts with citizens and households, which is a natural result of the increase in incomes in the last years.

Figure 32

Gross loans before impairment at end of period (BGN billion)



Source: BNB, authors' calculations.

The increased activity in retail crediting reflects the dynamics of the absolute volume of gross credits. After the long kept decrease of negative rates of credits to citizens and households (in the years after 2010), in the summer of 2016 the rates in the segment reach positive values (0.17% on an annual base at the end of August), and since October 2017 growth rate remains steadily above 6% on an annual base. The acceleration of the dynamics indicators continue in 2018 as well, reaching two-digit values in the second half of the year and by the end of December the annual growth rate of credits to households reach 11.6%.

The intensive increase of the new business, which for the past year reaches twice the volume compared to 2013-2015 (about BGN 4 billion per year), is the main contributor to maintaining high growth rate in this segment. The anticipated increase of the gross credits to households (by BGN 2.2 billion, with a two time smaller absolute growth in volumes on new business) is due to the longer original maturity of credits granted after 2014, on one hand, and on the other, the decrease of the share of refinancing of old loans, which is indicative of the change in the dynamics of overdrafts for individuals. In the period of intensive refinancing (until the end of 2017), the annual growth rate of the segment remains negative, and some citizens and households switch to new products, with fixed redeem schedules. In 2018, this trend stops and overdrafts begin to increase, with the annual rate of change in December reaching nearly 3%.

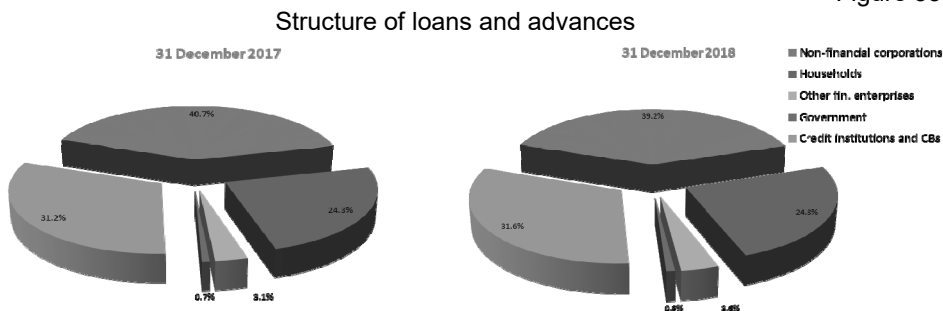
As a whole, the increase of the activity among citizens and households can be explained mostly with maintaining relatively sustainable indicators of the incomes of the population, since in the entire period from the beginning of 2018 the costs of labor payment still changes positively (6-9%), unemployment declines steadily for the seventh consecutive year (up 6.2% according to data of Employment Agency for last year), while real GDP growth is still above 3% for the fourth year.



Survey data show that the demand for consumer loans over the past year remains sustainable, and credits for purchasing home continue to increase. According to the unweighted results for the last quarter of 2018, 3 banks register an increase in the demand for consumer loans and 2 banks respectively report a decrease. Higher demand for credits for purchasing home are reported by 4 banks and only 1 bank register a decrease. It should be noted that, unlike the corporate segment, here the contribution of commercial banks' policy to encourage the demand in the segment is much smaller, since yet in the first half of the year most financial intermediaries have stopped easing the crediting conditions. The results of the regular BNB survey show that in the third quarter the balance of opinions on the changes in interest rates on consumer credits is -5, and for the fourth quarter it changes to -4. The balance of mortgage credits for 2018Q4 is -9. In comparison, in the last quarter of the previous year the balance of opinions on consumer credits is -18 and on mortgages credits it is -32 (in the first half of 2017, half of the interviewed respondents have lowered the interest rates on newly granted consumer loans, and this share is even higher for mortgage credits – 13 of the 19 respondent banks report lowered interest rates in the first quarter).

The overall impression of the monitoring of credit activity in 2018 is that, despite its partial recovery, it is below the target values of some of the banks in the country, as the growth of gross credits (excluding those for banking institutions) continues to lag behind the total growth of credits. It has increased by 8.6% on an annual base in the past year, while the total volume of loans and advances increases by 8.9%, reaching BGN 89 billion at the end of December. The convergence of the two dynamics indicators (in 2017, the difference between the reported rates is several times higher) leads to maintaining the structure of the credit portfolio, which until last year changes in favor of the low-interest and non-interest segments (credits to financial corporations, credit institutions and central banks). For the past 12 months, this share increases relatively weak (by 0.36 pp), entirely at the expense of the decrease of the share of non-financial corporations (Figure 33). In comparison, a year earlier, a much faster increase of the exposures to the low-interest and non-interest segment is reported (1.98 pp).

Figure 33



Source: BNB, authors' calculations.

Maintaining credit standards with the still unsatisfactory volumes of new business (especially in the corporate sector) shows that, as in the previous year, banks in the

country are more likely to keep the surplus of the attracted resources. They would rather accept the payment of the respective price for this in the form of negative interest rate on the excess reserves than lower their standards to decrease the share of rejected requests (thus increase the investment of their free resource), but risk realizing at a loss from possible worsening of the quality of the portfolio.

Financial intermediaries do not accept another alternative to use the resource, namely purchase securities. The balances of the commercial banks show that, excluding the first quarter, debt securities in the portfolios of the commercial banks maintain relatively stable volume over the past year (BGN 13.2-13.3 billion). This can be explained with the contradictory signals on the coming changes of the interest rates levels. This is the reason why surpluses from attracted resources are directed to exposures in central or commercial banks (in 2018 the total increase in these categories reached BGN 2.6 billion).

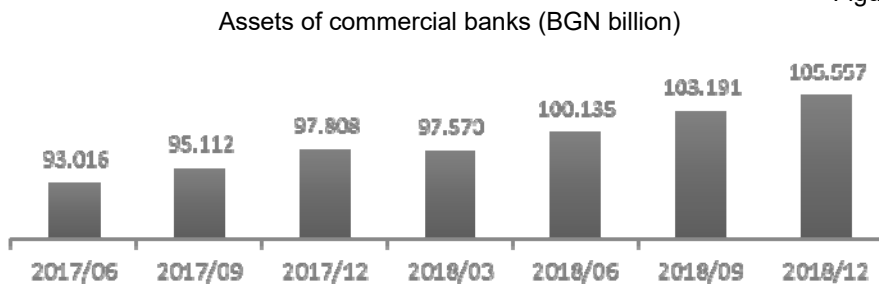
It is not surprising that banks in the country still compensate their inadequate activity by increasing the financing of non-bank financial institutions (NBFI). In the past year, the portfolio in this segment increases by 27.3% (BGN 690 million), which is more intense than in the previous year (24.9%). In this way, they partly compensate the insufficient volume of gross credits but cannot compensate for the worsened profitability of interest-bearing assets, since credits to NBFI generally have low income. Last but not least, it has to be taken into account that redirecting an increasing share of commercial banks' resources through the NBFI channels to end users somewhat distorts the picture of the portfolio quality, since the creditworthiness of the applicants for the so-called "fast credits" is generally lower than for traditional clients of the banks. This problem exists, although it can hardly be outlined in the conditions of low interest rates, relatively high employment and relatively sustainable final consumption (indicative in this respect are the data provided by ACABG about the 50% decrease of the number of non-serviced debts to be recovered – from 2 633 192 in 2017 to 1 221 227 last year).

The moderate improving of the credit activity and the maintaining of a highly liquid (and low profitable) asset structure are unavoidable with the set of factors that determine the activity of the financial intermediaries. The degree of uncertainty remains high, and the criteria for reflecting asset quality on bank profits are getting tighter, which in turn requires a cautious approach to crediting. At the same time, deposits in the banking system continue to increase at a higher than expected rate, resulting in an increase of the balance sheet number of the banks to BGN 105.6 billion in 2018 (Figure 34). The investment of the accumulated resource remains concentrated in low profitability categories (excess reserves and inter-bank deposits) instead of redirected to business and household consumption.

In an attempt to reverse this unfavorable trend, Bulgarian National Bank (BNB) maintains the negative interest rate on excess reserves throughout 2018, but the effect on the real economy remains still unconvincing. As noted, despite the negative interest rate on excess reserves, the share of the item "cash and balances with central banks" in the structure of the bank assets decreases very little during the year (from 19.9% at the end of 2017 to 19.3% at the end of 2018). This decrease is fully compensated by an

increase of the share of another class of liquid assets (receivables from credit institutions) with also negative profitability.

Figure 34



Source: BNB, authors' calculations.

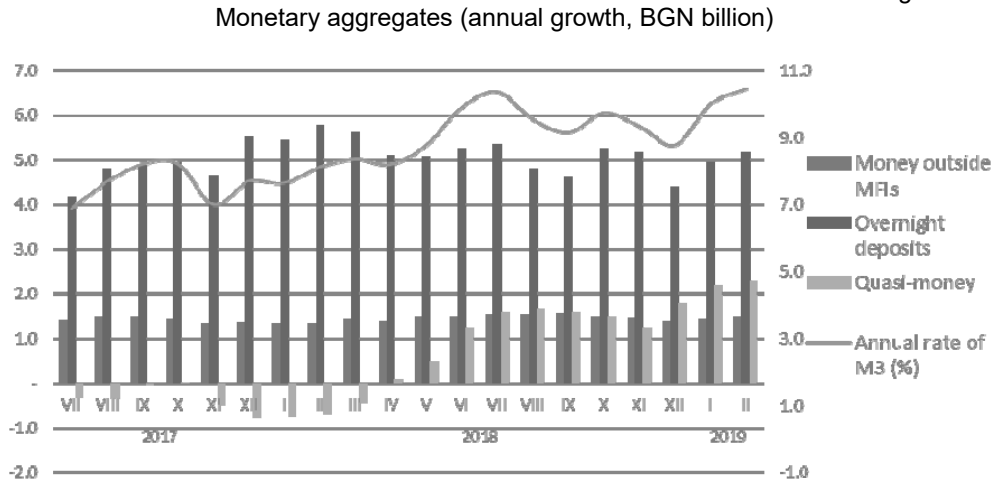
Already in the first months of 2018 it becomes clear that the effect of the last increase of the negative interest rate on excess reserves (to -0.6% as of October 4<sup>th</sup>, 2017) is more in the form of redistribution of income between financial institutions and to some extent as support for the prices of the debt securities, rather than in the form of a real crediting incentive. This is perfectly normal with the still poor trust of the business in the development of the local economy. Indicative for this are the high rates of increase of the attracted resources from NFI. Indeed, at the end of 2018, reported is a slowdown in the growth of deposits in the segment (from 11-13% on an annual base in the previous five quarters to 4.5% in the last quarter of 2018). This slowdown is most likely due to temporary factors (like changes in the tariffs of the individual bank), since in the beginning of the next year the dynamics accelerates again (to 7.3% in February). It is a fact that, despite maintaining stable economic indicators in the country, a large part of the Bulgarian enterprises still refrain from starting new projects and continue to provide their free resources to the local banks for keeping.

What is interesting here is that the increased sanction does not have a particular effect, despite the increasing households' inclination to save, which should encourage the banks to credit more actively. Data of Banking Supervision show that, in spite of the expectations for a coming increase of the interest rates on attracted resources, in 2018 deposits from citizens turn the trend of the previous year. While throughout the year 2017, they follow the trend to lag the dynamics indicators (from 6.2% on annual base for the first quarter of 2017 to 4.8% for the latter), in 2018 the trend is exactly the opposite and the annual rate of deposits of households accelerates from 5.1% in the first quarter to 7.9% in 2018Q4. This could somewhat be considered a natural result of the continuing income growth and the uncertain recovery of the attitudes to consume. However, last but not least, this shows mostly the weakening preferences of the citizens for alternative forms of preserving the value over time (mostly real estate), as well as the increase of the negative expectations in the medium term.

The dynamics of the monetary aggregates clearly shows the weight of the last factor in defining the behavior of the Bulgarian households. After a certain period (the second half of 2017 and the first half of 2018), during which economic growth remains close to

its post-crisis record of 2016Q4, and the growth of wages reaches double digits, the quasi-money (deposits with agreed maturity, or contracted for use after a notice up to 3 months) have contributed negatively to the change in money supply, but at a later stage this trend stops. Since spring 2018, households renew an increasing part of maturing term deposits (Figure 35), although the profitability curve remains still flattened, and expectations for future normalization of interest rates are rising (at least until the end of 2018).

Figure 35



Source: BNB, authors' calculations.

As a whole, in the second half of the year, households are less likely to keep their money in a form that allows them to be quickly transferred when a more favorable alternative appears (a product with a higher interest rate or an alternative savings option) and more and more often prefer products with fixed maturity. This trend increases, with the rate of quasi-money rising from 1.6% in the summer of 2018 to 2.3% in early 2019.

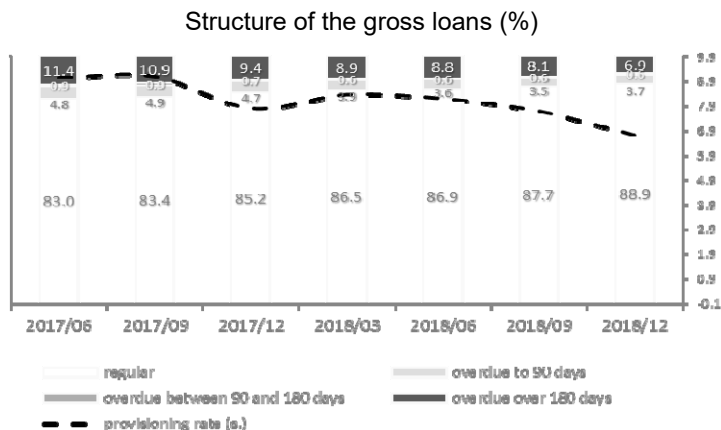
An interesting finding can be made from the comparison between the income reports for 2017 and 2018. The data show that for the past year the banks in the country have realized net total operating income of BGN 4.2 billion, which is BGN 336 million more than the reported one in 2017. To some extent this difference can be explained with some one-time effects, such as the inclusion of a new reported item in the past year – a branch of a foreign bank, which by the end of the first half of the year has been reported as a non-banking financial institution and which net profit in 2018 amounts to BGN 45 million; dividends from participation in the capital of other companies (BGN 150 million); recognition of incomes from the sale of non-interest-bearing assets (BGN 82 million), and others. In the previous year, a similar effect has also been reported (in the form of an extra revenue for the banks, amounting to BGN 186 million from the transaction between Visa Europe and Visa Inc. in June 2016), but now the contribution to the increase of the operating income from this category of effects is more noticeable.

Second is the increase of the income from fees and commission by BGN 103 million (8.9%). This is a result, on one hand, of the ongoing activity of credit refinancing, and on the other – the introduction of penalties on the current accounts from corporate customers. Next is the decrease of the costs for interests on financial liabilities, reported at depreciated value (mainly clients' deposits) by BGN 83.9 million (28.9%). At the same time, incomes from regular activity grow at a lower rate (for example, gross income from interests on credits and receivables increases by only 1.57%). In short, the distribution of the contribution of these factors is indicative of an exhaustion of the potential for improving the profitability of the banking institutions and most probably of a coming worsening of their indicators.

The main risk to bank profits in short term is the forthcoming widening of the scope of Regulation (EC) No 924/2009, which will result in the equalizing the fees on outgoing EUR transfers for all EU countries (so far the Regulation covered only all euro area countries). The planned amendments will come into force in mid-December 2019 and this will surely lead to a noticeable decrease of the incomes from fees on outgoing transfers, especially in countries like Bulgaria, where these fees are highest and vary between EUR 15 and 25. This, of course, does not exhaust the risks of worsening the results of the banking institutions in the country (and not only). A far more serious danger to the situation of the financial intermediaries is the expected economic stagnation and the resulting increase of provision costs.

As a whole, the observations made during the period since the beginning of the year confirm the expectations expressed in the previous report – moderate credit growth, continuing recovery of the quality of the credit portfolio, which remains maybe the most significant of all observed trends (Figure 36), maintaining an asset structure with poor profitability, continuing increase of the attracted resources at relatively constant prices and maintaining high liquidity ratios. Consolidation pressures will remain strong as a result of continuing administrative incentives and of stronger competition from e-money companies and payment institutions, because of which new mergers in the banking sector may be expected.

Figure 36



Source: BNB, authors' calculations.

An important regulatory focus of the past year is the introduction of the new IFRS9. Expectations have been that, coming into force on 01.01.2018, the standard will have a shocking effect on the capital of the commercial banks, but data show that the intensity of this shock is relatively weak, since most banks have probably benefited from the opportunity of a transitional treatment and the effect of the new standard will be extended over time. The sector finalizes 2018 with a significant capital surplus, respectively with ratios of capital adequacy and leverage considerably exceeding the regulatory requirements, although the ratio of CET 1 slightly decreases (from 20.4% to 18.99%).

Undoubtedly, the focus of 2019 and the next few years will be the accession of Bulgaria to the Banking Union (BU) and preparation for joining the Euro area (EA). There are strong arguments in support of such steps and, above all, the fact that BU is perhaps the only possible way to fill the gaps in the structure of the European project. The recent global financial crisis has unequivocally demonstrated that existing supervisory mechanisms do not provide sufficient opportunities for preventing, managing and overcoming crisis situations, as the increasing integrity and interrelation of the European financial markets far outweigh the capacity of the national supervisory mechanisms. At the same time, the EU does not have adequate commitments to cooperation, coordination, consistency and trust between the national supervisory authorities within the Union, hence sufficient capacity to prevent and overcome crises of this magnitude (at least until the beginning of the debt crisis). The BU is exactly such a mechanism, which foresees the creation of new supranational institutions serving these functions, namely: Single Supervisory Mechanism (in force since 2014), Single Restructuring Mechanism (in force since 2016), and European Deposit Insurance Scheme (still in creation). Single Supervision Manual has also been developed.

These structures will replace the local regulatory authorities by gradually taking their functions, which is the strategic goal of this initiative, namely the elimination of the opportunities for any autonomy in the field of the monetary policy. Although, according to the EC's official statement, most of the initiatives within the BU are aimed at liberalizing the environment and removing the "unnecessary regulatory constraints to financing the economy", it implicitly implies that the legislative acts building the regulatory framework of the BU impose stricter (harmonized) rules on the individual economies, more and more restricting the opportunities for implementing independent national policies.

Formally, individual member states maintain some area for own actions, but it is placed within strict limits, on the one hand, and is gradually being restricted, on the other. For example, before coming into force in 2014 of the so-called CRD IV package (Directive 2013/36 EU of the European Parliament and of the Council of 26 June 2013 and Regulation No 575/2013 of the European Parliament and of the Council of 26 June 2013, the provisions of which are reproduced locally by Regulation No 8 of BNB on the capital buffers of the banks), the central bank have had the entire freedom to impose its own rules, and it has pursued its policy through the so-called specific credit risk requirements, requiring the commercial banks to maintain higher levels of capital adequacy. The harmonization of the rules for all banks in the EU has introduced equal requirements – 8% total capital adequacy, 6% Tier 1 capital and 4.5% basic Tier 1

capital (CET1), and imposing additional buffers is in the authority of each national regulator. From the beginning, BNB uses two of them at their maximum allowed size – capital buffer for systemic risk (3%) and preventive capital buffer (2.5%). Since the beginning of 2018, active is also a buffer for other systemically important institutions (currently BNB has set 11 such), the maximum size of which is 2% according to the regulation. To these three buffers, on October 1<sup>st</sup>, 2019, a 0.5% anti-cyclic buffer for Bulgarian exposures of banks will be added too. In this sense, the rules are harmonized as far as the structure and management of these buffers are covered by the general regulatory framework (CRD IV package), but the decisions on their specific levels are made locally – by local institutions of prudential supervision. At the same time, the scope of action of the local regulatory authorities is limited, in the sense that they cannot change their structure or transfer the threshold set in the regulation for each of them.

In other words, the main purpose of the Banking Union is to be used as a tool for forcing the local central banks (especially those outside the EA that will join through the close cooperation mechanism) to align their policies with the fact of their belonging. This is part of the EU's main strategy, namely to impose strict coordination of the national policies in a way that primarily serves the objectives of the EU core, under the pretext of convergence, high competitiveness and sustainable growth.

So far, no country, except Bulgaria, has declared a desire to join the close cooperation regime, and this is understandable, since the inclusion in this regime means “extremely asymmetrical treatment”.<sup>15</sup> Such country will have to replicate (with acts of the local supervisory authority) the ECB's supervisory decisions that are not legally binding outside the euro area, i.e. will have all the responsibilities of BU membership but will remain excluded from the final decision-making on supervisory matters in the Executive Council of ECB and will not have access to liquidity support from the ECB, nor the European Stability Mechanism as a potential source of funds for direct and indirect recapitalization of the banks. The asymmetries and inequalities between euro area and non-euro area Member States are further deepened by the Single Restructuring Mechanism, where a country that has joined the Single Supervisory Mechanism with “close cooperation” is automatically included.

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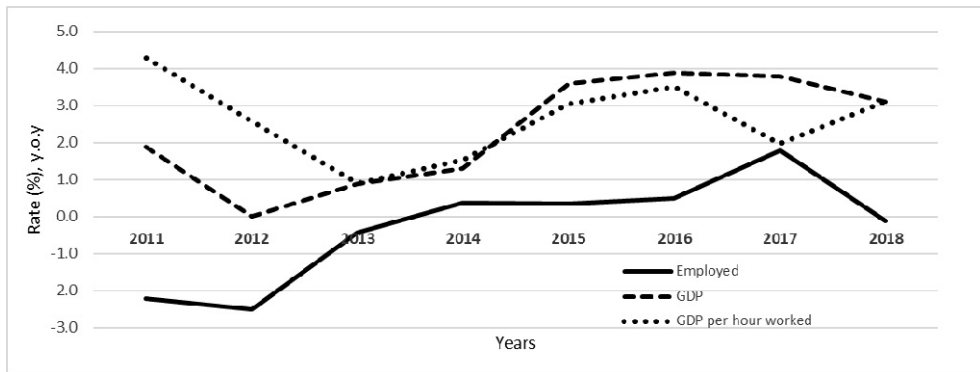
<sup>15</sup> Hristov, K. (2018). Why is the Banking Union not a reasonable option for countries outside the Euro area. – The EUROFI Magazine.

## 6. Labor Market

### 6.1. Employment, economic growth and labor productivity

The forecasted employment decrease in 2018 by rate of -0.1% (Annual Reoprt, 2018) is completely realized. In 2018 the number of employed reaches 3521.6 thousand people, according to preliminary NSI data. It slightly goes down by 3.7 thousand people compared to 2017 (increase of 1.8% in 2017); 0.5, 0.35 and 0.37% in 2016, 2015 and 2014 (Figure 37). Economic growth remains positive, but fails to pull up employment after the successful 2014-2018 period. This could have happened if GDP growth in 2018 have been over 3.5%.

Figure 37  
Dynamics of employment, GDP and labor productivity (% , on annual basis)



Source: NSI, National accounts.

The general slowdown of employment growth in 2018 is due to its slight descending in the third quarter, when a strong positive impact of the seasonal factor is traditionally expected. The number of employed then decreases by 35.2 thousand people on an annual basis. The registered drop continues in the fourth quarter and leads to a general shrinking of the labor market for the year.

The number of employed continues to increase (by 21.6% compared to 2017), which shows a still stable main segment in the employment. Specific for 2018 is the controlled short-term change of the self-employed (down by 25.3 thousand people).

In 2018 the employed in the national economy register higher labor productivity compared to 2017 (Table 3). Despite some fluctuations in the GDP per man-hour worked, the overall trend after 2013 is to increase productivity. It still remains the lowest compared to other EU-28 countries. This is an expected result, since the labor productivity in the country has the strong influence of the labor factor, but is realized in the conditions of decreasing investment activity and low rate of gross fixed capital formation. The available preliminary information does not give grounds for changing the position of the country concerning its relative labor productivity in 2019-2021.



Table 3

## Labor productivity in Bulgaria

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018
GDP per man-hour worked*	12.61	13.9	14.52	14.55	14.83	15.63	16.54	17.44	18.63
GDP per man-hour worked**	105.4	104.3	102.6	100.9	101.5	103.0	103.5	102.0	103.1
Nominal productivity per employee in Bulgaria (% of total EU-28 = 100)	41.2	42.1	43.5	42.7	43.8	44	45.3	45.5	...

\* current prices, BGN

\*\* Physical volume index, calculated at 2010 prices / previous year = 100

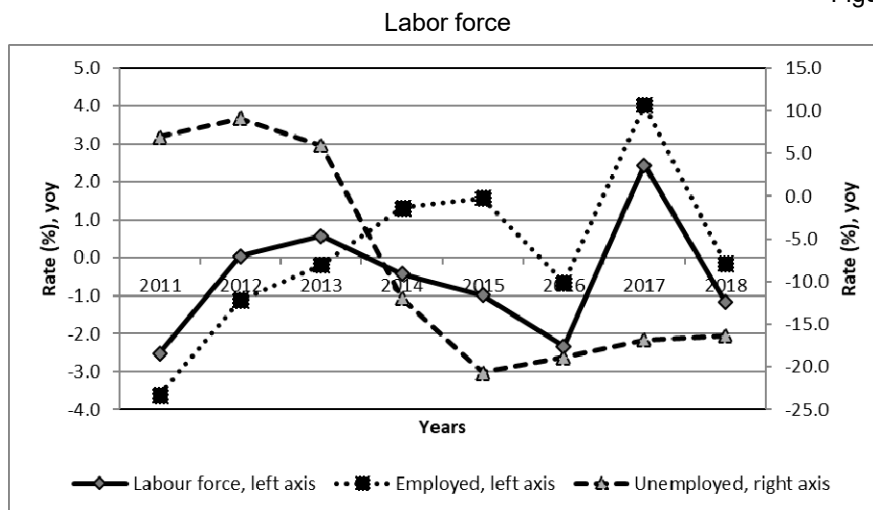
Source: NSI: Eurostat, tec00116.

## 6.2. Economically active, employed and unemployed people

## 6.2.1. Changes in 2018

According to the information in a survey of the supplied labor force (Labor Force Survey of NSI), in 2018 the *active people* aged over 15 reach 3326 thousand, and just those aged between 15 and 64 years – 3239.6 thousand. The rate of the active population in the second age group decreases by 1.2% in 2018, but not as strongly as in 2016 (by - 2.3%) (Figure 38). After 2011 (despite the increase in 2017), economically active people decline by an average of 0.5% per year.

Figure 38



In the labor force structure by age, the highest increase is for elders aged over 65 and for those aged between 55 and 64. They have a low number (and a relative share) and decisive significance to the overall dynamics of the workforce. It depends on the

changes in the number of people aged between 30 and 54. Their relative share in its structure increases strongly at the expense of young people aged 15-29.

The number of *employed* (aged 15-64) steadily increases in the period 2011-2015, then slightly decreases in 2016 and 2018.<sup>16</sup> In 2018, the employed (3068.9 thousand people) remain above the 3 million people mark according to the labor force survey as well.

In 2018, Bulgaria is the only country in the EU with a negative growth rate of employed people aged between 15 and 64.<sup>17</sup> The negative change in employment sharpens the problems of its structures. In 2018, women lose their positions more easily (a decrease of 0.4 thousand people); young people between 15-24 and 25-34 years of age also decrease, as well as those between 35 and 44 years of age. People aged over 45, including those aged 65 and over, keep stable positions. This is a small groups with "as a rule" low professional mobility and low contribution to the quality of the workforce.

In 2018, employed people with secondary education (including secondary vocational education) are the only group in their structure by education degree, which also limits its presence. The people with primary and lower education have maintained their employment (increase by 12.3 thousand) and also those with higher education (with a modest increase of 7.7 thousand). The most stable position in the structure of employed by professions keep-on the two groups of specialists and the professions, which do not require special qualification. Professions necessary for the trade and service of the population and the security also keep their positive growth.

The number of employed decreases in 23 of all 28 statistical districts. In 2018, the process of strengthening the degree of interrelated functioning of regional industrial centers and thus opening new employment opportunities did not develop further adding new ones. The segmentation of the regional labor markets requires a serious review of the growth and employment policies for the lagging behind regions.

Unemployed are steadily decreasing, reaching 170.8 thousand people in 2018 (33.3 thousand less than in the previous year). This is a historical minimum since 2002, even lower than the registered 198.5 thousand people in 2008. The reduction rates in the number of the unemployed change from -20.7% in 2015, to -18.9% in 2016, -16.8% in 2017, and -16.3% in 2018, indicating a gradual reduction in the intensity of the process. Each percentage of decrease in 2015 corresponds to a 4.3 people reduction in the number of unemployed, while in 2018 only to 2.5 people.

Unemployed for more than 12 months keep high shares in their structure by duration of the loss of work. In 2018, they are 101.6 thousand people or 58.6% of their total. Their share slightly changes compared to the maximum values in 2003 and 2005 (65.4%) and does not reach the minimum 43.4% registered in 2009.

Under conditions of a demographic crisis, labour market supply has to rely on an inflow of labor force reserves from the group of the inactive people. However, they also

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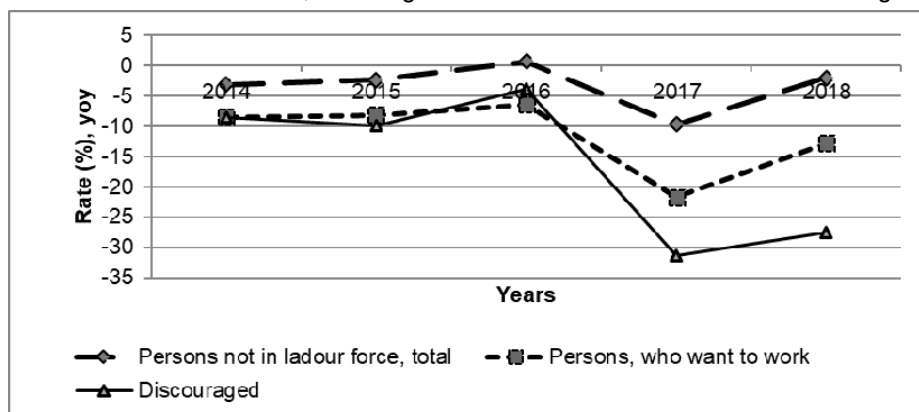
<sup>16</sup> Further on are considered indicators mainly for the 15-64 age group, unless otherwise indicated.

<sup>17</sup> In the last 4 years, only Romania has registered a decrease (-1.1%) in 2016.

decrease after 2016, and the changes in the discouraged are strong (Figure 39). For this group, like for the unemployed, it can be argued that there is a greatly reduced capacity to contribute to employment after 2016.

Figure 39

Persons not in labor force, including those who want to work and the discouraged



Source: NSI.

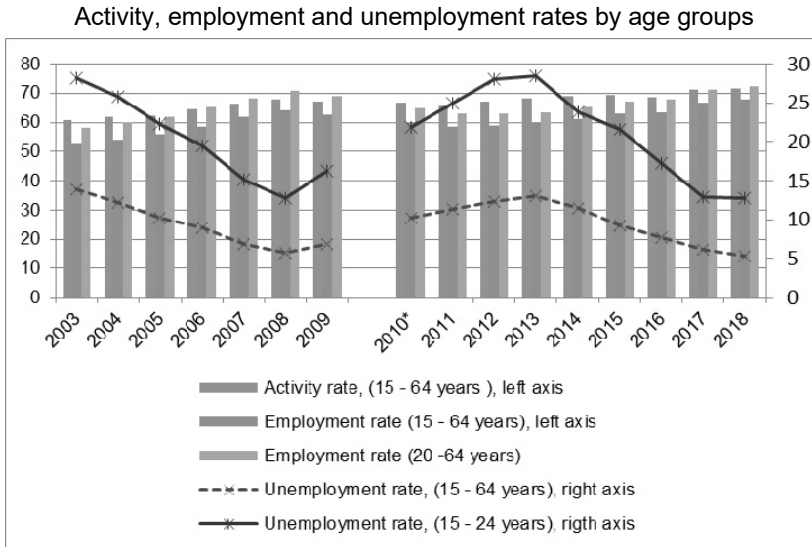
The studied changes in the structure of the labor force and the inactive people, as well as specifically for employment and unemployment, point to an assumption of an already realized “peak” on the labor market in 2015. The decreasing employment in 2018 and the weaker changes in other key indicators labor market testify to the start of weak, but still negative changes. Reduction of both the labor force contingents and the internal opportunities for its possible increase is a main and deepening problem.

#### 6.2.2. Economic activity, employment and unemployment rates

The relative indicators of economic activity, employment and unemployment continue their positive change (Figure 40). However, they are substantially facilitated by the demographic factor. Employment rates (ER) of people aged 20-64 steadily go up to 72.4%, but unfortunately it is difficult to assume that they will reach the target of 76% by the end of 2020. The lagging in this indicator puts Bulgaria in the group of the 19 countries in the EU that fail to meet their 2020 targets. Successful examples are Ireland, which in 2017 already realized ER 73% of GDP with a national goal of 69%, and the Czech Republic – 78.5% with a goal of 75%.<sup>18</sup>

<sup>18</sup> Eurostat, Code: t2020\_10.

Figure 40



Source: NSI. 2010\* - revised data.

Good results have been achieved with regard to unemployment rate (UR) and, in particular, the youth unemployment rate. In 2018, the first reaches 5.3%, compared to 5.7% in 2008. The youth UR is 12.7% in 2018, thus reaching its 2008 level. The economic activity rates (EAR) accumulate the changes in the respective employment and unemployment rates. They have a development close to the employment rates of people aged between 20 and 64, which is an expected result.

### 6.2.3. Transitions between employment, unemployment and inactivity

In 2018, the transitions of employed, unemployed and inactive people continue some positive changes since 2017. However, they run with much more moderate dynamics. The activation of inactive people continues, but they move harder to employment than in 2017 and 2016. However, their attitude to seeking for a direct transition to employment rather than being granted unemployment status maintains. It can be assumed that in 2018 these people have a lower motivation than in the previous years for inclusion in the labor market and that they are more oriented to remaining in the group of inactive.

The number of employed with unchanging status slightly changes (1.65% increase for the first nine months of 2018 compared to the same period in 2017), but with a small increase of the number of unemployed and inactive. Unemployed people reduce their number and 1/3 of them find new employment (Eurostat). The activation of inactive people continues, but they are less likely to move to employment than in 2017 and 2016.

#### 6.2.4. Employment reserves

Employment reserves can be grouped in two main flows. The first includes domestic reserves<sup>19</sup> coming from the population of economically active age. These are part of the employed people who want to change employment; people unemployed for a long period; economically inactive people who want to work. The second flow is the external reserves of labor “import” from other countries, the inflow of emigrants and other. Due to the low interest in labor emigration to Bulgaria<sup>20</sup>, the national (domestic) reserves of active age population have main significance. Its decrease due to demographic reasons increases the interest of the use of the internal reserves. Here are presented the main groups that can be included in the employment or be more fully realized in it. It should be noted in advance that these are potential sources of additional labor force.

- Reserves from part-time employed or those recruited on temporary employment contracts

The interest in part-time and temporary employment in the country is traditionally low, among employers as well as people seeking employment. According to latest Eurostat data, in 2017, 57 thousand people work part-time, and in 2016 – 66 thousand people. In the period 2008-2017, an average of 2/3 of these people (per year) want to change their employment to full-time. In 2018, they are likely to be between 33-34 thousand people (preliminary estimates). Data on Table 4 show that the interest in transition to full-time employment is highest in the period 2012-2014 when demand for labor is high.

Table 4  
Part-time employed (part-time employment) and temporary employed (thousands)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Part-time employed looking for a full-time job	33.6	35.7	35.5	36.2	43.0	44.5	45.5	39.5	34.5	39.4	-
Temporary employed	144	129	118	104	114	143	135	115	107	120	110

Source: Eurostat.

The number of those recruited on temporary contracts also changes in line with the general changes in employment (Table 4). Temporary employment in Bulgaria is associated mostly with seasonally repeating activities. This character is well-proved by the fluctuations in quarters and the maximums reached in the third quarters. Providing off-season employment is not a new problem in the country, but is still unsolved. The decrease of the opportunities for subsidized temporary employment in budgetary programs reduces further the opportunities for its combinations with seasonal activities. At the same time, the offered higher payment for seasonal activities in other countries

<sup>19</sup> Internal reserves are considered available, with demographic problems (fertility and emigration) not being examined in detail.

<sup>20</sup> Import of labor force is one of the possible alternatives but must be sufficiently effective. It can make sense if the costs of learning Bulgarian language and acquiring key competencies and profession by these persons are lower than the ones for activating the internal employment reserves. In this connection is the task of attracting educated people to contribute to improving the quality and structures of the workforce. So far the results are modest and ambiguous in terms of secondary emigration from Bulgaria to other European countries. Internal employment reserves keep their main significance. For details, see: Report on the Implementation of the Employment Agency's Plan in 2018.

stimulates emigration. This becomes a problem for the development of agriculture, tourism, hotel business, restaurant business and some other groups of activities that are important to the economy.

- Employed people in high age groups who want to continue work after retirement age

For these people, a specific requirement for employment stability is most often laid down in the last years of their work experience, in order to facilitate the transition to retirement. However, with the demographic situation in the country, it is necessary to support the labor longevity of those who want and can work. This needs integrated approach towards updating the professional training to remain in employment after the age of 50 or 55 (for some professions it can start at an earlier stage); directing to appropriate work of older workers; provision of services to ease their transition to work for these of above-retirement age, who want and can work. The pension reform and the gradual increase of retirement age also require attention to the elders in terms of maintaining their status as employed in the last years of their work life.

- Potential workforce from inactive people

Inactive people who want to work, but do not seek employment (aged 15-64) are 160.6 thousand in 2018, compared to almost 300 thousand in 2013 (NSI). It is difficult to determine what part of their reduction has entered the national employment and how many have emigrated to other countries. In this group, however, there are mainly people with secondary and higher education, who can be a valuable additional resource in the employment.

- Inactive youth who are not in education, training or employment

In 2017, the share of these inactive youth aged 15-24 is 12.2% totally in their age group. Again, as in previous years, this is one of the highest shares compared to other EU-28 countries. The incomplete use of an important strategic resource for employment in Bulgaria continues despite the substantial decrease of the youth unemployment rate (aged 15-24).

- People with disabilities who can and want to work

This is one of the risk groups on the labor market, the information for which is incomplete. People with disabilities still does not get the necessary attention and care for assiting their realization in labor.<sup>21</sup> Although we do not have data after 2011, it can hardly be assumed that the employment of people with disabilities has improved. The introduction of the quota principle for hiring disabled people can improve their situation on the labor market in 2019 and later.

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<sup>21</sup> In 2011, included is a survey module for the content of the individuals aged between 15 and 64 who have at least one lasting health problem, as well as people with at least one lasting difficulty in executing their daily activities. The employment rate for people in the first group is 42%, and in the second group – 31%. For the same year, the total employment rate for people aged 15-64 is 58.4%, respectively. The comparison between the inclusion of disabled people in employment and the general rate outlines the seriousness of the problem (NSI).

The mentioned groups of employment reserves do not exhaust all opportunities. Reserves are a dynamic contingent and the periodic observations of their state are of increasing importance. The activation of these groups and their inclusion in labor must be considered as one of the national priorities concerning the labor market. It should start its realization by examining who are these people in the potential workforce; who are the employers who have conditions for hiring them; what is the integrated package of needs of both sides and what incentives can be transformed into mutual interests in favor of employment.

### *6.3. Labor demand*

#### *6.3.1. Level and dynamics*

In 2018, labor demand increases from 2017, but remains almost unchanged from 2016. 20 781 job vacancies (JV, annual average number) are offered, while in 2016 and 2017 they are respectively 20 042 and 19 539.<sup>22</sup> The JV rate<sup>23</sup> in 2018 is 0.9 and slightly changes upward from previous years. The announced job vacancies decrease throughout the year, starting with 23.5 thousand in the first quarter, 20.8 thousand in the second, and reaching 19.3 thousand and 19.5 thousand in the third and fourth quarter.

Traditional graphical illustration of the intensity of jobs supply and their consistency with the demand through the Beveridge curve shows a stable movement to the left due to decreasing unemployment (Figure 41). In 2018, however, the labor market situation of 2008 is not reached due to lower activity of the demand.

Holding back of the employers' activity in offering jobs in 2018 is the result of their expectations for the business environment. Changes in the total business climate indicator<sup>24</sup> in 2018 are positive until August, when it declines to its levels in the same period in 2017. At the end of December, business expectations of respondents in industry decline, while optimism among the managers in the others sectors remains. In March 2019, total business climate indicator keeps its level from the beginning of the year, with improvement registered only in retail. The weak changes of the business climate indicator, starting in 2019, do not yet allow for a significant increase in employment this year.

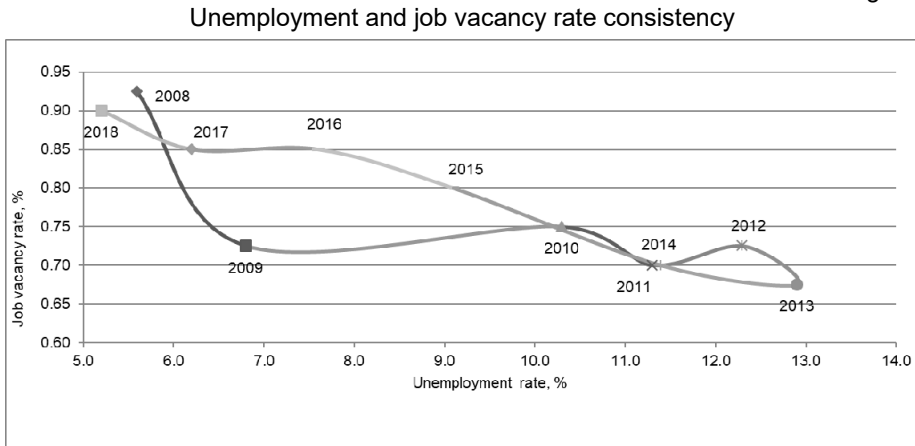
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<sup>22</sup> According to NSI data and additional calculations. Data for 2018 and 2017 are preliminary.

<sup>23</sup> Ratio between job vacancies and the sum of the employed people and job vacancies. This coefficient presents the degree of "non-employment" and the nature of the discrepancies between demand and supply of labor in periods of expansion or contraction of the economy.

<sup>24</sup> NSI, Business Surveys in 2017.

Figure 41



Source: NSI.

Managers in industry, construction, trade and services continue to state lack of appropriate personnel as one of the major issues in their work. Obviously, they give high evaluation to the labor factor, they seek and cannot find the needed personnel. The problem, however, is not unambiguous, since employers release qualified workers and total employment shrinks. Along with this, there is already a physical shortage of labor force and uneven distribution on the territory of the country.

In 2018 the labor force demand, registered in previous years, continues without the well-defined structural priorities (Table 5). Typical examples are the fluctuations of the leaders by number of employees in the group “Wholesale and retail trade; repair of motor vehicles and motorcycles” and “Manufacturing”. Their increased number in agriculture in 2017 is significantly reduced due to various reasons related to the unsustainable economic position of the Bulgarian farmers. Tourism and agriculture have failed to take advantage of the seasonal factor and are a reason for the reduction in total employment in the second half of 2018. One of the already mentioned reasons is the emigration to other countries with higher payment of seasonal employment.

Construction, education and administration have the highest contribution to the increase of employment in 2018. Construction manages to keep the momentum from the last year. Education compensates for the deficits in the number of employed and provides the necessary staff for the reform carried out in it. Administration continues to be a main employer in small settlements and of the young people there, in the absence of other opportunities.

The mentioned main changes in employment by groups of economic activities well illustrate employers' demand, which corresponds to development of the economy with insufficient active priorities. The situation of the labor market demand is more a consequence, and in this connection – an element of the economic environment, rather than a factor for development and changes in it.



Table 5

Changes in the number of employed people by economic activity (thousand, compared to the previous year)

	2013- 2012	2014- 2013	2015- 2014	2016- 2015	2017- 2016	2018 - 2017
Total	0.9	46.5	50.5	-15.1	133.5	2.4
Agriculture, forestry and fishing	6.5	13.4	-1.0	-4.2	17.3	-13.6
Mining and quarrying	0.0	0.4	-0.7	0.3	5.8	0.0
Manufacturing	-27.1	8.1	13.2	-8.8	12.9	-1.6
Electricity, gas, steam and air conditioning supply	-4.3	-2.8	2.3	0.7	-0.6	-0.2
Water supply, sewerage, waste management and remediation activities	-2.5	-2.3	-4.8	-0.6	5.5	-2.6
Construction	0.9	8.5	-1.4	0.8	19.5	11.8
Wholesale and retail trade; repair of motor vehicles and motorcycles	-1.4	-7.0	1.5	-4.2	26.6	-3.7
Transportation and storage	4.5	-3.2	7.0	11.6	14.4	-4.5
Accommodation and food service activities	-6.6	9.0	3.2	-0.5	11.7	-1.5
Information and communication	6.4	-2.1	14.5	0.7	3.5	6.6
Financial and insurance activities	-1.1	8.9	1.8	-3.7	5.1	1.7
Real estate activities	1.9	1.5	0.4	-1.7	1.4	1.2
Professional, scientific and technical activities	6.1	8.6	9.8	8.2	-0.3	-5.7
Administrative and support service activities	12.6	-6.5	-1.4	-1.5	2.1	8.5
Public administration and defence; compulsory social security	-1.8	-5.3	1.1	-4.0	-1.4	3.5
Education	-3.4	3.7	-2.9	-12.8	-1.2	11.4
Human health and social work activities	8.4	9.9	-0.7	-1.3	3.5	-1.6
Arts, entertainment and recreation	1.1	1.3	1.0	5.1	1.6	-1.0
Other service activities	0.6	2.3	7.7	0.9	6.0	-6.3

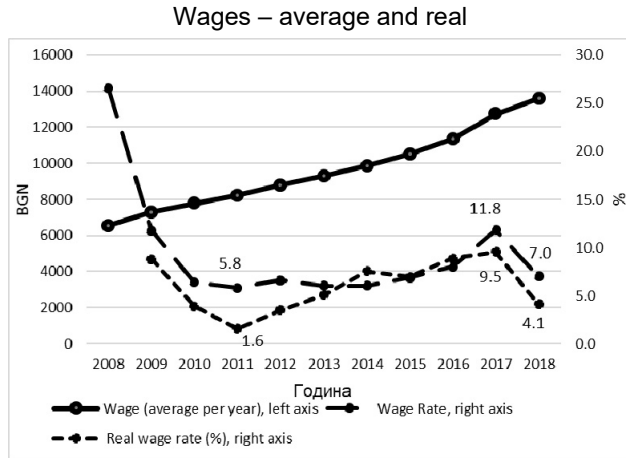
Source: NSI.

### 6.3.2. Wages

In 2018, wages continue to rise in nominal, but not in real terms. According to NSI preliminary data, the average annual wage in 2018 reaches BGN 13 621 (EUR 6 949) and increases by 7%, while in 2017 it is BGN 12 725 (EUR 6,949), a growth of 11.8%. This is a dynamics that is slightly approaching the one in 2008 and 2009 (26.5 and 11.8%, respectively) (Figure 42). In 2017 and 2018, the dynamics of the nominal wage anticipates that of the real one in terms of rising inflation. The expected higher inflation over the next three years sets again the requirement for renewed social policies to protect the incomes of the population.

There are no major changes in the relative structures of the nominal wage by economic activity. The highest contribution to the total increase have the wages in the economic activities "Creation and dissemination of information and creative products; telecommunications" (2.4 times higher wages than their average level). The wages in seven economic groups are higher than their national level (as in 2017).

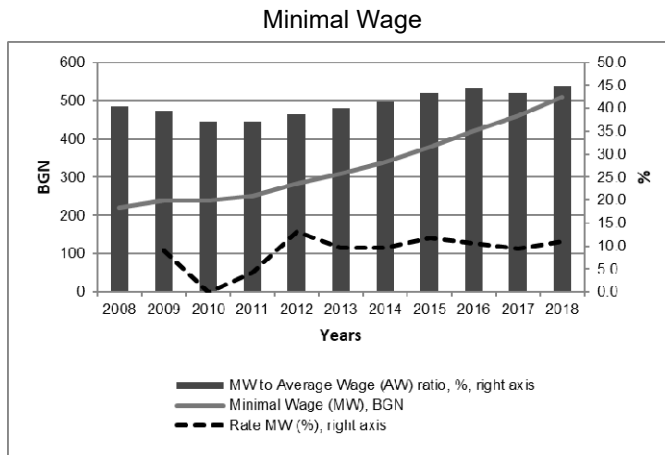
Figure 42



The *minimal wage* (MW) in 2018 reaches BGN 510 (EUR 260) according to the relevant administrative decisions. This year it is higher by BGN 50 (which relates to the expectations for higher inflation as well), while in the previous three years – by BGN 40 (EUR 20.4) every year.

In nominal terms, MW has a high increase index – 231.8% in the period 2008-2018, which exceeds that of the nominal one – 208.3%. The formed ratio between them in 2018 is 44.9%, and it has the highest value in the period 2008-2018 (Figure 43). It testifies to the administratively imposed high values of MW and to the generally low level of the average wages in Bulgaria.

Figure 43



Increases of the minimal wage and its ratios to the average one have different economic and social explanation. In terms of employers' interests, exactly this ratio in 2018 might be one of the reasons for reducing the employment in relation to their labor costs and achieving better price competitiveness. The unsatisfied demand for a qualified workforce may be the reason for the offered low payment. From the positions of those receiving minimal or slightly higher wages, updating their size is a pressing necessity. The realization of this role, however, is not complete since the slight changes of the participation of employed in the distributive relations remain. The total indicator of employees' compensation in GDP in Bulgaria increases, but in 2018 it is at its 2012 level and is lower than the 2009 one. The indicator remains lower than its EU-28 levels, but the trend is to reduce the difference between them. In 2018 it is 4.6%, while in 2009 – 13%.<sup>25</sup>

As a result of the established conditions for determining wages and social securities due by employers for the employees, their total labor costs continue to increase in 2018 as well. Compared to 2012, they are 52% higher.<sup>26</sup> Formal reason is their low starting base. These costs are an essential preliminary argument for deciding how many and what new workers to be hired. They can be endured by the employers if they can reduce the high energy intensity and material intensity of the relevant products as a result of new technologies and restructured productions. Since this is not yet a massive outcome, there is no reason in the near future to expect a strong change of the share of labor costs in the newly created value and generally in the significance of the labor factor. This will make employers to continue to save labor costs through low wages and reduced number of employees. Ultimately, ensuring decent payment requires parallel processes to increase productivity, investments in real sector, and intensification of productions towards smart growth.

In conclusion, the examined main indicators of demand and supply on the labor market show a worsening of its state. A more serious situation on the labor market can be expected in the course of this change in the second half of 2019, as well as in the repetition of employment reductions in this period.

### 6.3.3. Active labor market policies

In 2018, the implemented active labor market policies (ALMP) continue to realize national strategies and plans, as well as the specified by EC specific recommendations to the national labor market for the 2018 and 2019.<sup>27</sup>

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<sup>25</sup> Eurostat, [nama\_10\_gdp].

<sup>26</sup> Based on 2012 = 100, total labor cost index for employers per hired person is 119 in 2015; 127.3 in 2016; 142 in 2017 and 152.3 in 2018 (calendar-adjusted data). The 2018 index is based on quarterly information.

<sup>27</sup> The specific recommendations made by the EC to Bulgaria are to improve the employability of people in disadvantaged groups and to strengthen the activation measures; to introduce a regular, transparent and revised minimal income scheme and to improve their range and adequacy. Recommendation of the Council on 13.07.2018 on the National Reform Program of Bulgaria for 2018 and included opinion of the Council on the Convergence Program of Bulgaria for 2018.

#### 6.3.4. Results

In 2018, 22 programs and traditional measures are financed from the State Budget under the Law on Employment Promotion (LEP). The programs do not change their nomenclature, except for those implemented by the social partners.

European Social Fund (ESF) co-finances 23 procedures under the first axis of HRD OP.<sup>28</sup> Two new program procedures are implemented: “Work” (for long-term unemployed and inactive) and “Future of the labor market” (in the conditions of digitization of the economy and structural changes in employment). The newly announced procedure “Skills” for preparation of staff for specific jobs according to the needs of employers is also interesting. Within the framework of HRD OP, activities innovative for the Bulgarian practice continue to be implemented in support of the employment, as well as such that are important for risk groups and inactive people.

In 2018 the labor administration has provided an inclusion in ALMP of a fewer number of people than in the past (Table 6).

Table 6

Activated people on the labor market

Year	2015	2016	2017	2018
1. Included in employment and training on programs and measures	35069	33650	39189	31830
Employment (subsidized)	24357	22386	28264	21297
Training	10712	11264	10925	10533
2. Participants in employment schemes of HRD OP (first axis)	9600	33984	27029	17918
Employment	4800	26675	20527	12206
Training (without vouchers for employees)	4800	7309	6502	5712
Total activated, including:	44669	67634	66218	49748
Total in employment	29157	49061	48791	33503
Total in training	15512	18573	17427	16245
Share of total included people to average annual number of registered unemployed (%)	13.5	23.8	28.0	24.5

*Source: NSI, Employment Agency and other information received from MLSP.*

The programs and measures under the Law on Employment Promotion maintain main significance with decreasing coverage in the program procedures under HRD OP (some are in process of completion). These procedures provide a higher scope of training mainly due to the applied voucher system.

The importance of the training is smaller than the subsidized employment. The adult education system, applied by the Employment Agency for registered unemployed, still remains badly reformed.

<sup>28</sup> This group does not include procedures that have been announced in December 2018 and will be launched or finalized in 2019. These are the procedures “Skills of Training Employees”; “Joint actions of the social partners” to develop and introduce new practices and instruments of adapting businesses in selected areas and to extend the scope of social dialogue; “Development and implementation of quality standards in the provision of youth services in Bulgaria” to develop and implement objective measures for the efficiency and effectiveness of services for young people on the labor market.

The positive general results of the labor market, for which the implemented active policies have main importance, include most of all a decrease of the number of registered unemployed, maintenance of certain levels of access and coverage of these persons by the active policies, including adult education<sup>29</sup>, activating part of the inactive people who want to work. The share of unemployed people entering non-subsidized jobs increases (compared to the total registered). Share of unemployed and employed, included in trainings, as well as unemployed who make fast transitions to employment or training, also increases.

*In 2018*, changes leading to improved organization of customer service at the Labor Offices continue. The changes in the quality of the provided service by the labor administration, realized in 2018, are the basis for changes in the “technology” of servicing the “clients” on the labor market by using internet platforms and online links (including surveys of employers and unemployed); expanding the nomenclature of intermediary services, improving their personalization and focus on the people who actual need them; use of mobile teams to work with key employers. The analytical work concerning the labor market has become routine on important topics such as the state of the net effects of programs and measures, and the development of forecasts for labor force supply and demand. The results of these and other surveys (including online questionnaires) may be significant to improving the content of policies and their focus on the groups of people in need.

Compared to other EU-28 countries, Bulgaria realizes some of the low levels of activation of the unemployed people and those who want to work, according to latest Eurostat data. By indicator of activation of unemployed, we are close to Slovenia, Germany and the Czech Republic, and behind us is only Lithuania. The additional calculations for 2017 and 2018 show a possible improvement of our position. However, we are unlikely to come close to countries like Sweden (42.3%) and Hungary (44.3%), which provide activation through budget ALMPs to almost half of the registered unemployed. The issue, however, is not only about levels of financing and the relevant range of unemployed. In countries with developed social policy exactly in the years of crisis it is not allowed (except for the drop in 2009) to limit the care for the unemployed, as opposed to the restrictions in our country.

Consideration of the activation in Bulgaria compared to other countries should take into account existing differences in the social policy models<sup>30</sup>; opportunities (power) of employers' demand; demographic indicators; the initial base for changes. Despite these different initial conditions, the other countries have managed to find the right solutions to offer transitions to employment and to attract the active population in them.

The activation of people seeking job has reciprocal results to the ones for the unemployed, since in Bulgaria they have a main presence in this group of activated

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<sup>29</sup> Here, and further on, the term adult education means a training organized outside the systems of the secondary and higher education.

<sup>30</sup> Sweden, for example, is an emblematic example of a country that applies the Scandinavian model of welfare, incomparable to the social policy of Bulgaria. One of its main features is high taxes and high share of redistribution for social purposes. The results achieved in this country (despite the registered crises in the model during the crisis and in relation with the refugee wave to this country) can be considered as one of the best examples of care for people who want to work.

people. The implemented specialized programs for activation of the inactive people are financed from the budget and from the European Social Fund. The first axis of HRD OP provides extended nomenclature services for inactive, employed people and their employers and for long-term unemployed.

After 2008, unfortunately, in Bulgaria there are still more stated intentions, but not real results when activating the inactive people. The lack of complete care for the active population is precisely a reason for emigration of part of it. The realization of measures for activation of unemployed people is important but insufficient in the current situation on the labor market. The problem is common to other EU countries as well. In Bulgaria, there is a high need to place a priority on the creation of an integrated package of employment policies (and their above-administration management), implemented by several interested ministries and other administrations in favor of anyone who can and wants to work.

#### 6.3.5. Financing

The budget funds planned for 2018 (BGN 69.9 million/ EURO 35.7) for active policies are almost fully absorbed (99.4%) (Employment Agency). For active policies in Bulgaria are put aside small amounts, which decrease as a share of GDP after the start of the crisis. They are among the lowest – 0.119% of GDP in 2016 (according to latest Eurostat data) and close to those in Cyprus (0.106%) and higher than those in Romania (0.024%). Countries with lavish social policies which spend high labor cost are Hungary and Sweden (0.9%).<sup>31</sup> These are the highest results in the activation of the working population in these countries. Preliminary calculations for these shares in 2017 and 2018 do not show any significant changes in these costs in Bulgaria, which implies maintaining our position compared to the other European countries.

The implemented organization of budget financing corresponds mainly to number of registered unemployed people, minimal wage, low expenditure rates for education and other services. The activation of inactive people is mainly through subsidizing jobs for specialists to work with them at municipalities and labor offices (program “Activation of Inactive People”), as well as assigning certain functions to external organizations; to organize information events and job fairs, for vocational guidance and counseling.

A well-regulated administrative mechanism, almost completely isolated from market principles and regulations, applies to budget funding. It has no proactive character. The opportunities of a fund organization besides that of the national social security are not used. Vouchers for education of employed and unemployed are already a good example. They can be used for a wider range of employment services (including budget-funded) to employ unemployed people and employed inactive people. Another opportunity for improved efficiency of the financed funds is the extension of the practice of assigning specialized servicing to external organizations or individual experts, which is being implemented in the activation of inactive young people.

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<sup>31</sup> [https://webgate.ec.europa.eu/empl/redisstat/databrowser/view/LMP\\_EXPSUMM/default/table?category=Imp\\_expend](https://webgate.ec.europa.eu/empl/redisstat/databrowser/view/LMP_EXPSUMM/default/table?category=Imp_expend).

In the 2014-2018 period, 77.2% of the available funds are contracted for the first axis of HRD OP “Improving Access to Employment and Quality of Jobs”, while actually paid are 42.1%.<sup>32</sup> In the 2014-2018 period, the funds actually paid just for program procedures significant to employment amount to a total of BGN 340.5 million (EURO 173.7).<sup>33</sup> These are total amounts (from ESF and national funding) to implement procedures for programme scheme “Youth employment”; “Active”; “New job 2015”; “Training and employment of young people”; “Employees vouchers”; “Flexible opportunities for employment and training in enterprises with varied activity intensity”; “Adult education”; “Work”; and “Parents in employment”.<sup>34</sup>

The funds, which State Budget has financed just for programs and measures under the Law on Employment Promotion for the period 2014-2018, amount to a total of BGN 341.9 million (EURO 174.4 million).<sup>35</sup> The comparison of the two amounts proves almost the same importance of the two main sources of funds for ALMP. Better budget funding will support the development of specialized activities and services to activate the employment demand, but also the structural changes in these policies.

#### 6.3.6. Labor income policies

The implemented labor income policy in 2018 affects the development of incomes in the public sector (funded by the budget) and the determination of minimal wage, as in the past years. With the introduction of payment reforms in public administration in 2012, by 2016 wages of employees grow in a balanced way. The number of people employed in public administration systematically decreases in order to optimize and improve service efficiency. As in previous years, it is expected to achieve main goals such as limiting the budget expenditures for wages for regulating the budget deficits.

In the period 2009-2017, the average wage in the private sector exceeds that in the public sector (Figure 44). In 2018, however, the wage in the private sector slightly drops and is lower than the one in the public sector. Growth of wages in the public and private sectors converges towards the end of 2018. A similar situation is observed in 2013, which implies optimization of labor costs in both sectors, but above all of the wages in the public sector.

The mentioned discharging of specialists and technicians with secondary general and secondary vocational education, as well as the corresponding savings from their wages, shows that employers do not seek to keep the qualified employees by offering higher salaries in 2018. Another reason for salary cuts in the private sector may be the lack of specialists who can make a real contribution to production results. This situation will not change within the next year. Most probably the salaries in the public and private sectors will keep similar dynamics, but with tendency of anticipated growth of those in the private sector in 2021.

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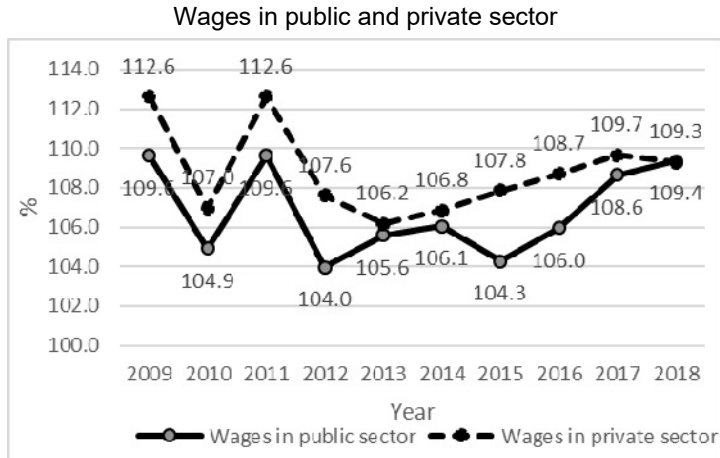
<sup>32</sup> EUMIS. <https://eumis2020.government.bg/>.

<sup>33</sup> EUMIS and additional calculations.

<sup>34</sup> EUMIS and additional calculations.

<sup>35</sup> Employment Agency Reports with Appendix 1; additional calculations.

Figure 44



Source: NSI.

In 2018, the policy of administrative increase of the minimal wage, started in mid-2011, continues. The government has proposed a mechanism for this wage that has not been accepted by the social partners. The important prerequisite for the development of an acceptable mechanism for determining the minimal wage level concerning the ILO Convention 131 ratified by Parliament, has not yet been implemented. Foreseen is that it should be already in force on March 20<sup>th</sup>, 2019.<sup>36</sup>

Systems for negotiating wages at the high and low levels still work on the principle of opposing the social partners rather than seeking the best ways to implement a national concept of employment and labor costs. Traditionally, trade unions advocate an increase in the minimal wage and in general the labor payment in Bulgaria. In response to these requirements the employers' traditional arguments is that it should not have higher rate than the one of the productivity, in order to maintain competitiveness. This requirement is realized in 2018, when the dynamics of real wages and productivity considerably converge (Figure 45). This may have a positive impact on some economic results in 2019 and, possibly, on employment (under equal other conditions). At the same time, the correlation between changes in real wages – productivity is quite mediated (Figure 46). The relevant correlation coefficient (-0.41) is a statistical estimate for the lack of such a relation. This result should again be related to the state of contractual relations in Bulgaria resulting in the respective proportions of wages.

<sup>36</sup> [www.ilo.org/budapest/whats-new/WCMS\\_631168/lang--en/index.htm](http://www.ilo.org/budapest/whats-new/WCMS_631168/lang--en/index.htm).



Figure 45

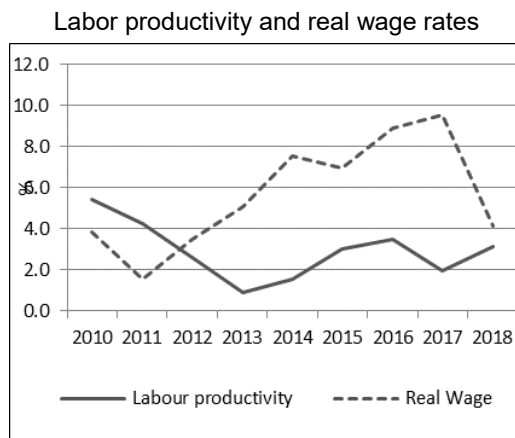
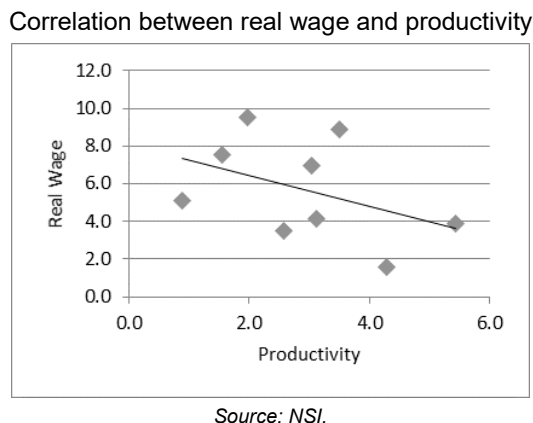


Figure 46



#### 6.4. Summary and forecast

The decrease in employment in 2018 and the weaker changes in key indicators show a deepening of the negative changes of the labor market. Unemployed and inactive people decrease, and the process is supported by the demographic factor as well. Internal reserves to increase the number of employed are almost exhausted, especially through activation of discouraged and generally inactive people who want to work. There is a physical shortage of labor force and increased territorial segmentation of employment.

The slight drop in employment in 2018 is an objective result of transitions between employment, unemployment and inactivity of the population at economically active age. To a certain extent, domestic labor markets have limited the access of unemployed and

inactive people to them. The reduced number of those who shift to employment is in this connection.

Employers' demand declines. Employed people who in previous periods have been attracted and kept with higher wages, are dismissed.

The importance of wages as a motivator for labor realization in Bulgaria greatly decreases. The expected positive inflation in the next three years again puts the requirement of renewed social policies to protect labor payments and incomes of the population. Changes in demand and supply on the labor market can be assumed, which require changes in labor protection mechanisms and policies for activating the transitions to employment.

The ALMP in 2018 does not provide substantial changes to its content. There is rather a routine of the performed functions and the realization of the planned results. The work on activating the unemployed and those who seek jobs continues, and the results are still modest compared to the achieved in other European countries.

In the period 2012-2017, explicitly stated are opportunities for a positive impact of the labor market on domestic consumption based on wage growth and increase of the number of employed and its solvent demand. The worsening of the parameters for this market in 2018 should now be considered as a consequence of the lack of structural restructuring of the economy. The labor market may start to hinder economic growth if these changes are not at least stabilized.

There are opportunities the process of limiting the employment to be controlled in the presence of favorable economic conditions. In 2019, employment<sup>37</sup> will most probably not change, and in 2020 and 2021 it will regain its growth to 0.4 and 0.9%.

The number of unemployed will continue to decrease, but not as fast as in previous years, due to the smaller employers' demand and demographic constraints. In addition, inactive people who want to work prefer transitions directly to employment. The contribution of unemployed and inactive will not be enough to increase the number of employed and the total economically active people.

Expectations are for an increased impact of the demographic factor on the supply of labor force, and in this respect also on the employment and economic activity rates (Table 7). The goals of the Europe 2020 Strategy will not be fulfilled in their part concerning employment.

Table 7

Relative labor market indicators, estimated values (%)

Year	2019	2020	2021
Employment rate	68.8	70.0	71.5
Unemployment rate	5.1	4.8	4.6
Economic activity rate	72.5	73.5	75.0

<sup>37</sup> Here and further on, the comments relate to indicators for the 15-64 age group, unless otherwise indicated.

Wages will continue to rise in nominal terms. The projections are for an average wage of BGN 1244 (EURO 634.7) at the end of 2019, BGN 1355 (EURO 691.3) in 2020, and BGN 1478 (EURO 754.0) in 2021. Due to inflation increase, the dynamics of real wages will lag behind the one of the nominal ones over the next three years.

There is still no significant relation between real wages and labor productivity. In 2018, their dynamics are converging. When inflation expectations come true in the next three years, and labor productivity increases with decreased number of employed, the ratio between these dynamics may change in favor of productivity over the next three years.

Employers' labor costs are high and increasing until 2018. The started stabilization of their changes will continue over the next three years. Together with the employers' bad expectations for the business climate in 2019, they can be one of the factors for keeping the employment.

## 7. Macroeconomic Indicators for the Development of Bulgaria until 2021

### 7.1. Evaluation of the forecast from previous year

The mid-term forecast we have proposed last year is largely justified. What is important in such forecast is not to “hit” the exact numbers, but to find the trends. From this point of view, there are no serious grounds for dissatisfaction. The ERI forecast has been the only one to state that the slowdown of the economic growth will continue in 2018. Expectations concerning the dynamics of global trade have also been justified (Table 8).

Table 8

Comparison of the forecast with the actually achieved results

Indicator	2018	
	Reported	Forecast
<b>Assumptions</b>		
Crude oil international price (index, 2005=100)	124.8	116.8
Industrial and food products international price (index, 2005=100)	133.4	150.0
Metals international price (index, 2005=100)	126.5	165.4
EU GDP real growth (index, 2005=100)	119.1	119.8
World trade volume (index, 2005=100)	163.7	164.1
<b>Key macroeconomic indicators</b>		
GDP (current prices, BGN million)	107 925	105 653
GDP (real growth, %)	3.1	3.3
GDP deflator	3.6	3.7
Private consumption (real growth, %)	6.4	4.6
Public consumption (real growth, %)	4.8	4.1
Gross fixed capital formation (real growth, %)	6.5	8.7
Export of goods and services (real growth, %)	-0.8	4.4
Import of goods and services (real growth, %)	3.7	7.3
Average annual HICP inflation (%)	2.6	2.0
Employment rate (population aged 15-64, %)	5.3	5.7
Budget balance (% of GDP)	0.1	-1.2
Current account (% of GDP)	4.6	3.9
Monetary aggregate M3 (growth, %)	8.8	7.7
Credit to non-financial enterprises and households (growth, %)	8.9	5.1

Concerning the key macroeconomic indicators, in most of the cases the trends have been recognized (e.g. decrease of the economic growth rate; weakening external demand as a growth factor; increasing inflation pressure; positive trends on the labor market). The more significant discrepancies are as follows:

- Serious underestimation of the impact of the crisis in Turkey, which has led to a significant drop in export volumes particularly to this economy and in general;
- Underestimation of the rate of recovery of private consumption;
- Higher optimism concerning credits to the real sector and the related investments;
- Overestimation of the expenditure side of the consolidated budget, which is explained by the higher expectations of the state's capital expenditures.

## 7.2. Key assumptions for the forecast period (2019-2021)

The macroeconomic forecast developed for the purpose of this report is based on assumptions about medium-term development (up to 2021) concerning international prices and external demand, as well as the government economic policies outlined in the Law on State Budget for 2019. The macroeconomic forecast of ERI is prepared on the basis of macroeconomic information available to April 12<sup>th</sup>, 2019.

Projected international prices and expectations for external demand are based on the IMF report World Economic Outlook published in April 2019.

Table 9

### Key assumptions in the macroeconomic forecast

Indicator	Source of information	Reported data			Preliminary data	Forecast data		
		2015	2016	2017	2018	2019	2020	2021
Crude oil international price (index, 2005=100)	IMF, WEO	95.2	80.5	94.9	124.8	123.7	118.2	113.5
Industrial and food products international price (index, 2005=100)	IMF, WEO	133.9	130.2	131.4	133.4	135.1	135.9	136.6
Metals international price (index, 2005=100)	IMF, WEO	126.2	116.6	118.7	126.5	127.2	127.6	128.2
EU GDP real growth (index, 2005=100)	IMF, WEO	111.7	114.0	116.7	119.1	121.4	123.8	126.6
World trade volume (index, 2005=100)	IMF, WEO	148.4	151.7	157.4	163.7	170.3	177.1	185.5
Current expenditure (BGN, million)	MoF, mid-term budget forecast, as of April 2019, ERI-BAS	26838.6	27400.4	29412.8	32912.1	35066	36939	38946
EU budget contribution (BGN, million)		946.4	859.5	888.2	1083.4	1280	1420	1620
Budget balance (% of GDP)		-2.8	1.6	0.8	0.1	-0.3	-0.2	-0.2
Domestic public debt (EUR, million)		7283.3	6860.3	7626.2	6108.8	5515	5437	5281
External public debt (EUR, million)		7889.7	10273.7	9198.3	9093.9	8530	8480	8400

- In the presented forecast the key assumptions for the real sector relate to the deepening of the slowdown of the global economic activity, and this process will be observed in both developed and developing countries. Factors with the biggest influence are:

- Exhaustion of the effects of the expansionary policy;
- Worsening of the trade relations between the main economic powers;
- Financial instability in the developing countries due to large volumes of debt; political and military confrontations in many regions of the world;

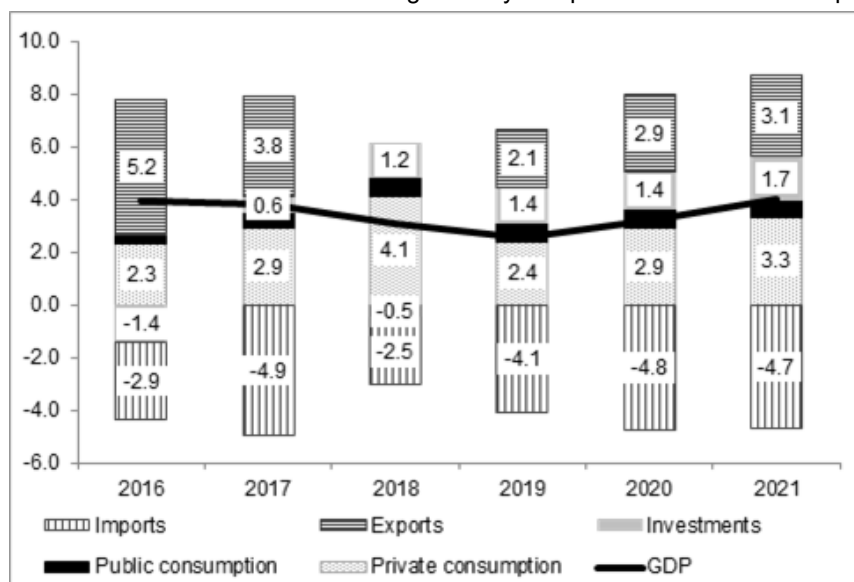
- Unstable political and economic situation in Turkey is likely to continue in the short run, which will negatively affect Bulgarian exports.
- Dynamics of the European and American economies will slow down in 2019. In 2020, economic activity in the EU will accelerate slightly, driven by growth in the euro area countries.
- Gradual increasing of consumers' trust and improving the business climate in the country as a result of accelerating the economic growth rates.
- Increase of the rate of absorption of European funds under Operational Programs.
- Certain recovery of the financial flows to the country besides those under operational programs.
- Lack of significant impacts on the Bulgarian economy from the UK's exit from the EU.
- Maintaining the parameters and policies set in the medium-term fiscal framework, in particular for:
  - Lack of significant changes in the tax system;
  - Loosening the fiscal policy, in regards to the European Parliament elections and local elections.

### *7.3. Dynamics of the key indicators in the forecast period*

- Taking into account the NSI's economic indicators and the worsening of the external environment, it can be assumed that the decrease of the economic growth rates will continue in the current year, but will accelerate over the next two years.
- The relatively high rate of increase of domestic demand will remain in the current year, and we even expect a slight acceleration by the end of the forecast period. The dynamics of the consumption will be driven by wage growth, moderate employment increase, and moderate but still positive growth of credit activity in the country. Investments will be mainly influenced by the rates of absorption of the EU funds, as well as the higher domestic and external demand. The contribution of net exports, however, will be significantly decreased, mainly due to the higher imports related to domestic demand growth.
- In the medium term, economic growth in Bulgaria will remain at the annual rate of 3-4%. Investment growth will be mainly determined by the progress of the 2014-2020 program period and the expectations for an accelerated absorption of European funds in Bulgaria, as well as by the improvement of the international and domestic business environment. With the increase of incomes in the country, an accelerated growth in household consumption is also expected.

Figure 47

Contributions to forecasted economic growth by components of final consumption



Source: NSI, authors' calculations.

- The gradual acceleration of domestic demand will lead to an average annual inflation rate of 3-4%. There will be an impact of the change in administratively regulated prices, especially of electricity and heat energy, which will inevitably rise. The increase of the prices of all goods and services from the small consumer basket can be expected as a secondary effect.
- The values of employment and unemployment forecasts will lead to a stabilization and possibly an improvement of the economic activity rate of the population. There are reserves to increase the economically active people with appropriate social policies, a stable economic environment, targeted support for specific employers to open sustainable jobs. In addition to the immediate employment factors, as in previous years, reliance will be placed on the budget funds for active policies for professional qualification and services for the registered unemployed people; use of ESF funds through HRD OP and other donor funds.
- Despite the negative demographic expectations, in quantitative terms, we should be able to fulfill our commitment to the Europe 2020 Program for 75% employment of the population. However, the issue is not just quantified calculations but rather hiring well-trained workforce. If employers in Bulgaria continue to consider it unavailable, they will be forced to import the personnel they need. Again, considered are the problems of education and professional qualifications, which must be in line with employers' expectations. In this regard, the negative expectations are supply of new jobs to continue to decrease; structural discrepancy between demand and supply of

labor to deepen; regional disproportions in the distribution of the workforce to expand. When realizing these negative assumptions, it will be necessary to import labor force to help increase productivity and opportunities to support people outside the labor force.

Table 10

Projections of Bulgaria's macroeconomic development until 2021

Indicators		Reported data			Preliminary data	Forecast data		
		2015	2016	2017	2018	2019	2020	2021
Real sector								
GDP in current prices	BGN million	88575	94130	101043	107925	114577	122807	132426
GDP	%	3.5	3.9	3.8	3.1	2.6	3.2	4.0
Private consumption	%	4.5	3.5	4.5	6.4	3.6	4.3	4.9
Public consumption	%	1.4	2.2	3.7	4.8	4.5	4.7	3.8
Gross fixed capital formation	%	2.7	-6.6	3.2	6.5	6.9	6.7	7.9
Export of goods and services	%	5.7	8.1	5.8	-0.8	3.3	4.5	4.7
Import of goods and services	%	5.4	4.5	7.5	3.7	5.9	6.7	6.4
Prices								
Average annual HICP inflation	%	-1.1	-1.3	1.2	2.6	3.9	2.9	2.9
End-of-period HICP inflation	%	-0.9	-0.5	1.8	2.3	3.9	3.1	3.1
GDP deflator	%	2.2	2.2	3.4	3.6	3.5	3.9	3.7
Labor market								
Employment rate (population aged 15-64)	%	62.9	63.4	66.9	67.9	68.8	70.0	71.5
Unemployment rate (population aged 15-64)	%	9.2	7.7	6.2	5.3	5.1	4.8	4.6
Employment, annual growth rate	%	1.6	-0.6	4.0	-0.1	0.0	0.4	0.9
Average monthly wage	BGN	878	948	1037	1135	1244	1355	1478
Average monthly wage, annual growth rate	%	6.8	8.0	9.4	9.4	9.6	8.9	9.1
External sector								
Current account	EUR million	-15	1244	3368	2539	1159	1192	1331
Trade balance	EUR million	-2622	-984	-766	-2248	-3522	-3459	-3293
Capital account	EUR million	1422	1071	530	778	789	822	845
Financial account	EUR million	3080	4135	2161	2330	1947	2014	2176
Foreign direct investments in the country	EUR million	2342	1390	1896	1935	1955	1974	1994
Gross external debt	EUR million	33493	34221	33397	33476	33519	33967	34921
Current account	% GDP	0.0	2.6	6.5	4.6	2.0	1.9	2.0
Trade balance	% GDP	-5.8	-2.0	-1.5	-4.1	-6.0	-5.5	-4.9
Capital account	% GDP	3.1	2.2	1.0	1.4	1.3	1.3	1.2
Financial account	% GDP	6.8	8.6	4.2	4.2	3.3	3.2	3.2
Foreign direct investments in the country	% GDP	5.2	2.9	3.7	3.5	3.3	3.1	2.9
Gross external debt	% GDP	74.0	71.1	64.6	60.7	57.2	54.1	51.6
Financial sector								
Monetary aggregate M3	BGN million	73961	79581	85727	93256	100903	110313	121390
Credit to non-financial enterprises and households	BGN million	50773	51676	54025	58858	63044	65795	68491
Monetary aggregate M3	%	8.8	7.6	7.7	8.8	8.2	9.3	10.0
Credit to non-financial enterprises and households	%	-1.6	1.8	4.5	8.9	7.1	4.4	4.1
Foreign currency reserves	EUR million	20285	23899	23662	25072	26899	29481	33183
Coverage of the imports of goods and non-factor services with foreign currency reserves	months	8.5	10.0	8.7	8.6	8.4	8.4	8.7
Budget sector								
Budget revenues	BGN million	32200	33959	35317	39651	42236	44534	47217
Budget expenditure	BGN million	34685	32491	34471	39515	42540	44736	47435
Budget balance	BGN million	-2485	1468	846	136	-304	-202	-217
Budget balance	% GDP	-2.8	1.6	0.8	0.1	-0.3	-0.2	-0.2



- The 10% wage increase in the public sector, in effect from the beginning of 2019, will also have an impact on the private sector, since the limited labor resources have decreased significantly in recent years. This, together with lower prices of primary energy resources, should provide support for incomes and consumption of the households at a time when job creation slows down under the pressure of a decreasing and aging population.
- Given the nominal drop in export volumes in 2018, this year (at least part of) these volumes may be expected to recover, which in practice will lead to real growth, but it is rather statistical, since it is recovery, not real growth. In the longer term, remains the finding that the country's export potential has been reached and the external sector should not be expected to make a significant contribution to GDP growth. This is further reinforced by the fact that increasing purchasing power will also lead to higher imports or respectively negative net exports.
- The recovery of the domestic demand will determine the positive but decreasing balance of the current account in the period till 2021. The progress in the implementation of EU operational programs will be decisive to the dynamics of the capital account, and the developments of the financial account will depend on government's debt policy and mainly by the gradual increase of FDI in the country and the rebalancing of the state of excess liquidity in the banking system into an increase of the credit activity.
- With the gradual increase of the economic activity in the country is expected also an increase of broad money by 8-10% annually and gradual acceleration of the growth of credit to non-financial enterprises and households.
- Budget revenues and expenditures are expected to increase at rates lower than the ones of the nominal GDP, which confirms the tendency to reduce the role of the state in redistributive processes. The assessment of this trend is presented in the section on the fiscal sector.
- External and internal restraints:
  - External environment will remain rather unfavorable with the risk of further worsening if trade disputes between USA and China continue, and an organized exit of UK from the EU cannot be found. The crisis in Turkey and the expected recession in the euro area (especially Germany and Italy) will work in the same direction. The slowdown of the growth in the euro area may have certain positive effect, since the increase of the interest rates by the ECB will be postponed and will not worsen the financial conditions.
  - The economy has practically achieved (or is very close to) full employment, which means that job creation will drastically decrease its impact on the rates of economic growth. Any open new job will be at the expense of reducing the unemployed people and increasing the employment rate in the group of population at retiring age, but this process has natural limits that are almost

reached. Possible are decisions with attraction of workforce from outside, but the political situation in the country and the configuration of the coalition government will hardly allow such a move.

- Domestic demand, which in the past two or three years has become a main growth factor, will hardly be able to grow steadily at the same rate as in 2018. The increase of the purchasing power will be limited by the slower growth of new jobs. This, in part, but not entirely, will be compensated with the higher payment of labor, since the government's medium-term forecast from April 2019 foresees new increases in the minimal wage and payment of labor in the budget sector.

## 8. Recommendations to Economic Policy

Many of the economic policy recommendations can be found in our previous reports. We repeat them deliberately and we will continue to do so, because we believe they are good-intended and benefit the whole society.

Economic growth reported in the last three years may seem high, compared to the average in the EU countries, but is still far from the desired levels needed to ensure catching up development. It turns out that the economy is highly dependent on foreign investments and cannot itself generate high and sustainable growth. It is more than clear that the most important thing for the Bulgarian economy is to achieve long-term and lasting economic growth of **at least 5% annually**. Only this would ensure more noticeable growth of incomes and welfare, which would lead to a decrease of the social tension accumulated for years. The issue is what should be the role of the state and, in particular, of the fiscal policy to ensure such growth.

It has to be recognized that the model, based on the demand for economic advantages through tax competition and focus on indirect taxes, is exhausted. Proportional taxation exhausts even the small advantages it has compared with the progressive taxation, adopted in all (without exception!) highly developed countries. Obviously, in this form, the tax system does not fully realize its main functions. More and more imposed is the impression that the only reason this model is not re-examined is the fear of the political parties (no matter which one is in power at the moment) of losing the electorate. The conclusion is clear – **there should be an academic debate about the role of the tax system with the participation of experts from all areas of public life**. The question is not only about proportional tax, but generally about tax system; about effective tax rates; the extent to which the different strata of society are fairly taxed; where the focus of the tax structure should be placed on; how to use the various tax incentives in the best way. The continued postponement of this debate is undoubtedly due to the unsustainable political configuration in the last years, but its further delay may have serious economic consequences. The economic policy has suffered such a fiasco with the delusion that low payment of labor will increase the comparative advantages of the economy and will provide sustainable export-oriented growth. As a result, we are now seeing a decrease of the power of the net exports as a factor of economic growth, reducing the export potential, increasing the migration processes to economies with higher payment of labor, discouragement and apathy of large population groups. ***Changes in the tax system cannot solve all accumulated problems in the economy, but can help to redistribute the burden to the levels with higher tax capacity.***

Macroeconomic governance should realize that the process of planning and implementing the state budget has an impact on investors' behavior. The influence of the type and nature of the public investments is significant. A possible different approach would, for example, be the arrangement of investment tasks of the government with clearly outlined performance parameters. The current practice is to declare the most common investment intentions that cannot be directly related to assumed clear and unambiguous responsibilities, subject to independent control. A

possible improved option is to declare in the next draft of the state budget the putting aside of an exact capital expenditure for a particular investment project, to be controlled in the budget implementation report in the end of the year.

There are reasons, however, to believe that the main reason for poor investment and economic activity is the poorly functioning institutions. The problems in the national economy cannot be solved through elementary quantitative change of numerical management economic parameters. It is necessary to cultivate and maintain a predictable sustainable socio-economic environment that will naturally “raise” initiative economic agents. The poor predictability of the measures at macroeconomic governance level undermines investors’ trust, which is a main prerequisite for positive economic decisions with perspective significance.

Based on the analysis, the assessments and the identified risks to economic development, the following recommendations to the economic policy can be formulated:

- Maintaining sustained rates of economic growth depends on many external and internal factors: accelerating the credit activity in the country, improving the international environment, assimilating the EU funds for Bulgaria in the 2014-2020 programming period. In this regard, there is unanimity that the role of the government is mainly related to maintaining macroeconomic and financial stability and accelerating the rates of absorption of European funds. However, this is perceived only as a necessary but not sufficient condition for accelerating the growth.
- Measures foreseen in the updated medium-term framework of the government for 2020-2022 are expected to have a moderate social effect and a short-term impact on the economic growth by creating bigger demand. This type of measures includes mainly increase of the pensions and the minimal wage. However, these measures could also have a negative impact on the demand for labor and the share of the informal economy in the country.
- We recommend restructuring of public (current and investment) expenditures and radical changes in several main directions:
  - education (with focus on school education);
  - healthcare (development of primary outpatient medical care and optimization of the hospital network);
  - denial of NHIF monopoly;
  - pension reform corresponding to the demographic structure, with a view to strengthening the role of the second and third pillars and reducing transfers from the state budget;

- economic infrastructure – waters (water supply, sewerage, purification and irrigation), electric power transmission system and transport (republican road network, railway infrastructure, ports and airports);
- more fair and rational tax system – bold reforms are needed in the legislation of taxation, which, in the medium term, will lead to:
  - gradual increase of the burden of income taxation and reconsideration of the benefits of the proportional taxation;
  - reduction of the burden of indirect taxes on consumption (options are possible also by introducing a differentiated VAT rate and a balanced excise policy);
  - increase of the importance of property taxation (by expanding the tax base, progressive taxation and reduced tax concessions).
- The described important and structure-defining reforms have to be implemented after a careful “impact assessment”, since there might be a need to choose between temporary higher deficit and long-term effects. In this respect, it would be very useful if the assessment of the expected actual effects (costs, benefits and redistributive effects) of the proposed/acting normative acts (laws, decrees, regulations, etc.) is properly regulated and institutionalized. This will ensure:
  - better, more responsible and more transparent policy decisions;
  - fewer, clearer and better-quality normative acts;
  - decent (and nationally responsible) participation in the law-making process at EU level.
- In a more specific plan (and relatively faster) steps can be taken which have a positive fiscal effect and will not negatively affect the economic activity. Some of the more important such steps are:
  - improvement of the technology of budget forecasting and planning;
  - active management of public property and analysis of the activity of the state participation in the economic activity with a view to its minimization;
  - looking for opportunities to reduce current expenditures (for wages and current utilities) in the public sector. In practice, this applies to all administrative departments, but with a higher weight in the Ministry of Defense and the Ministry of Interior, where the costs are unjustifiably high;
  - activating the process of fiscal decentralization.

- An activated policy for attracting foreign direct investment, without being specifically oriented to the monetary sector, would further stabilize the monetary system.
- Main path of achieving sustainable economic growth is to achieve a high growth of productivity of the used production factors, including labor resource. With the outlined lasting imbalances in labor supply and demand in certain professions and economic activities, only high growth of labor productivity will compensate the increase in average wages in the coming years.
- A priority in government policy should be to increase the effective use of the labor resources rather than reduce the level of unemployment in the country (if these two goals are alternative in some cases).
- Bulgaria does not have a long-term vision and strategy on migration. It is necessary to clearly highlight the priority policies and mechanisms for reducing the emigration attitudes among the Bulgarian population and for the lasting labor integration of the immigrants.
- Creating better conditions for labor realization at regional level by reducing existing regional imbalances is a step towards keeping the labor force in the country.



## **PART TWO**

**FOCUS: STRUCTURAL IMBALANCES AND RISKS  
TO THE ECONOMY**





## **1. Introduction**

The goal of this part of the report is to analyze the state and prospects of the Bulgarian economy concerning the already observed slowdown in the global and European economy and the regional turbulences. The main thesis is that Bulgarian economy has structural imbalances, which pose risks, and their materialization is increased by the strong dependence of the Bulgarian economy on the worsening external environment in 2018. Subject of the study is the identification of these structural imbalances and the tracking of the differences in the initial conditions in 2019 compared to the pre-crisis period 2007-2008. The analysis begins with tracking the trends in the economic development in a global and regional aspect, and highlighting the available instruments to assess the macroeconomic and structural instability. In a structural plan, Bulgarian economy is examined in two aspects – in terms of the dependence on the external environment, in particular the euro area economy, and based on indicators from the real sector of the economy for establishing structural sustainability. Further, the study seeks an answer to the question at what stage of the economic cycle is the Bulgarian economy now and what is its dependence on the economic situation in its main trading partners. Then we analyze the challenges associated with:

- increasing dependence of the Bulgarian economy on the dynamics of the European economy;
- low, unsustainable and unbalanced growth in the country;
- insufficient domestic and foreign investments and their priority focus on the non-tradable sector of the economy;
- decrease of the companies' profits and available income for investment;
- weak and risky credit activity in the non-financial sector;
- reduction of the employed and the worsening of the sectoral employment structure;
- accumulation of significant liabilities in the state-owned enterprises, municipalities and non-reformed sectors with predominant state ownership.

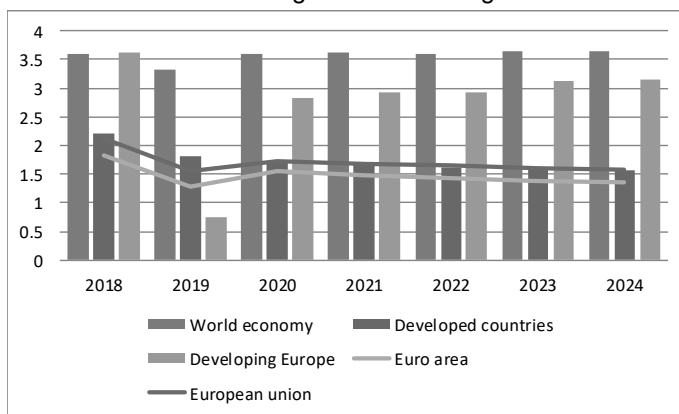
It is thus possible to trace the main external and internal risks to the Bulgarian economy, which are challenges to its development in reversing the economic cycle. On this basis, we look for an answer of how the country's economic policy can counteract the identified threats and how the implementation of structural reforms and preceding the provision of fiscal incentives can be conceptualized and prioritized. This debate is particularly significant in view of the preparation for accession to ERM II and meeting the commitments made in this regard. In conclusion, some of the main results of the analysis, which outline the specifics of the Bulgarian economy and would support the implementation of the macroeconomic policy in the country, are presented.

## 2. Macroeconomic Imbalances and Global Slowdown in Economic Growth

According to estimates of the international institutions (IMF, OECD, EC, etc.), the peak of the upward trend of the global economy, after the 2007-2008 global financial and economic crisis, is in 2017. After that, in 2018, and particularly in 2019, the **slowdown of the economic growth and the gradual entering into descending phase of the economic cycle** will continue. The main premises for these processes are the weaker global demand for goods and services due to uncertainties with the trade conflicts and the policy of trade protectionism, volatile oil prices, already started gradual rise of interest rates in USA, still high government debts of the developed countries, shocks on the stock exchanges in some of them, and even environmental risks. According to IMF, the world economy has entered a “synchronized slowdown” (Figure 48) within the global economic cycle, for which there are more and more signals both globally and regionally.

Figure 48

Forecasts for global economic growth

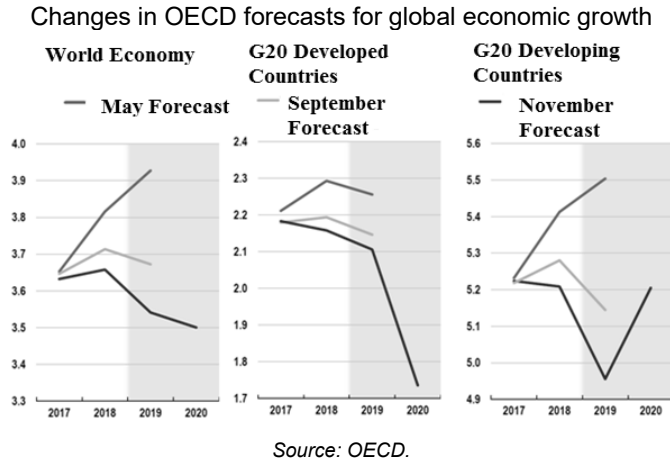


Source: IMF.

The specific forecasts of the international institutions indicate also a certain synchronism in the expectations for slowing down of the economic activity. In April 2019, for the third consecutive time since the end of 2018, IMF lowered its forecast for the global economic growth to 3.3%, with expected 3.5% in January 2019 and 3.7% in October 2019. The forecasts of The World Bank are for economic growth of 2.9%. The European Commission has also revised several times its forecasts for the economic activity in the EU and the euro area, predicting economic growth of 1.3% in the euro area and 1.5% in the EU in February 2019, with expected 1.9% for both regions in November 2018. The risks to the EU as a whole are explained by **the existence of a global economic cycle in the foreign trade and financial relations**, while internally the emphasis is on the improvement of the labor market conditions, the favorable conditions of financing and the slightly expanding fiscal policy for the European economy as a whole (EC Winter 2018 Economic Forecast).

Despite the general trend of predicted economic slowdown globally and regionally, the frequent changes in the forecasts of the international institutions are an indicator of the **high uncertainty and unpredictability of the world economy in the context of an increasing interdependence between the countries**. OECD data (Figure 49) on the revisions of the economic forecasts show that the most significant deviations are observed in developed countries, which become less and less predictable exactly because of the overlapping of a number of policy factors affecting the economic development.

Figure 49



So, the question of how effective and reliable are the developed instruments for identifying economic fluctuations after the global financial and economic crisis of 2008, both globally and regionally, becomes current. Yet at the meeting of the Group of world most developed countries – G20 in Pittsburgh on 24-25 September 2009, a Framework for Strong, Sustainable, and Balanced Growth has been developed. The main emphasis is placed on the coordination of economic policies conducted through the Mutual Assessment Process. The essence of this process is to trace the economic compliance between the national and regional goals of the economic policies of the 20 leading economies through a set of indicators to identify and assess possible imbalances in their economic development. Thus, although the issue of macroeconomic imbalances has not been sufficiently explored in the economic theory, the global financial and economic crisis of 2007-2008 has placed exactly the **macroeconomic imbalances at the center of the political debates**.

The same approach has been adopted at European Union level with the accepted in 2011 package of six legislative acts in the field of the economic governance. Thus, at European level a scoreboard of economic indicators identifying macroeconomic imbalances has been developed, on the basis of which the EC can suggest to the countries where imbalances are considered excessive to be subject to a specific monitoring or even sanctions, if they are part of the euro area. In this way, the scoreboard of indicators related to internal imbalances (indebtedness of public and

private sector, changes in real estate prices, changes in financial sector liabilities and unemployment) and external imbalances (affecting the state of the current account of the balance of payment and the net investment position, real effective exchange rates, shares of export market and labor costs), has become an influential policy instrument with a central role in the EU framework for economic governance.

At the same time, the principles of such policy instrument for assessing the economic stability of the EU Member States are very much criticized. In its 2018 report, the European Court of Auditors states that: "although the macroeconomic imbalance procedure is generally well designed, the Commission is not implementing it in a way that would ensure effective prevention and correction of imbalances. The classification of Member States with imbalances lacks transparency" (European Court of Auditors, 2018). Relying on an indicator summarizing the performance of the entire financial sector is often questioned due to the complexity of the processes in the sector and not sufficiently taking into account of the different levels of development of the financial sectors in the individual EU Member States. On the other hand, adding labor market indicators in 2015 to the scoreboard has been strongly supported by the European Parliament, according to which economic stability is directly related and depends on the state of the social sector and the labor market (EP, 2014). However, the European Council criticized these proposals and it was decided with a compromise that the extension of the set of indicators to the social dimension indicators would not have legal consequences and would not be used as a basis for further steps in the macroeconomic imbalances procedure (EU, 2015). Such debates and compromises clearly show that the scoreboard of indicators is above all a political concept, not a comprehensive economic philosophy for assessing the economic stability, where the doubts about its reliability and effectiveness come from (Bobeva, Zlatinov, 2016).

The European Banking Authority and the European Systemic Risk Board also use risk dashboards (EBA Risk Dashboard; ESRB Risk Dashboard) as part of the early warning system, which mainly focuses on the risks in the financial system. "EARLINESS – European early warning system" is being developed to identify and signal economic weaknesses for their prevention and neutralization at an early stage.

Obviously, however, the effectiveness of these forecasting instruments and mechanisms for early warning in conditions of high uncertainty and dependence on the political and global economic cycle may be questioned. On one hand, exactly in the developed countries there is a decreasing coordination of economic policies and actions, and, on the other, because of purely objective reasons due to delayed manifestation and opportunities to identify the economic processes and lags in the economy. The main reason, however, is the underestimation of the structural factors in the economy and the accumulation of structural imbalances. The Alert Mechanism Report of the European Commission in November 2018, which is based entirely on 2017 data, states that there is a correction of macroeconomic imbalances in the EU and the risks are fully transferred to the international environment because of the trade relations between USA and China, and the geopolitical tensions in the world. For another year, in macroeconomic plan vulnerable are considered countries like Bulgaria (3.1% economic growth in 2018), Croatia (2.7%), Cyprus (3.9%) and Slovenia (4.4%). German economy is commented mainly concerning the current account surpluses and

the international investment position with improving price competitiveness. Regarding Italy, stated is the decline in the share of nonperforming loans and the growing current account surplus with high levels of government debt. This is also true for France, which is reported in the EC Report with decreasing unemployment and improving competitiveness of the economy. At the same time, by November 2018, the first signals of a decrease of the economic activity in Germany since 2015 have appeared due to the depressed domestic demand, the negative effects of the new environmental standards on the automobile sector and the slowdown in the export growth. Since the end of 2018, Italian economy is officially in recession and the economic growth in France is only 0.3% in the last quarter of 2018. Altogether, the three countries (Germany, France and Italy) account for approximately 50% of the EU's GDP in 2018. The risks to their economic development are much affecting the stability of the European economy, including the strong trade and financial relations with the other mentioned countries (Bulgaria, Croatia, Cyprus and Slovenia), which total GDP amounts to about 1% of the European one in 2018. This reveals also another weakness of the systems for identification of imbalances, which is poor reporting of the bilateral commitment between the countries and the failure to consider ***economic shocks in the developed countries as a factor of macroeconomic instability in the developing countries as well***, especially in the strong commitment within the euro area.

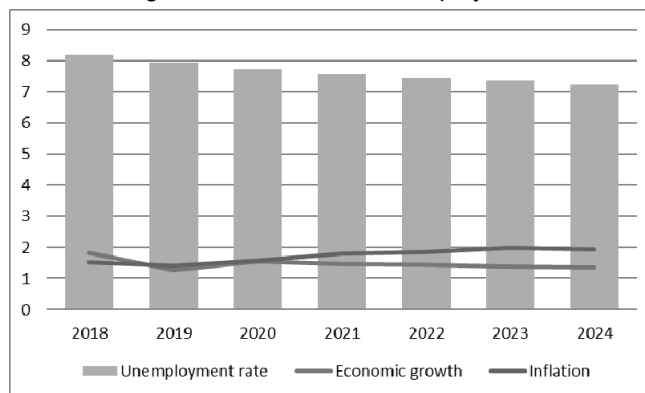
Through the active relations between the countries, both globally and regionally, the risks that lead to a slowdown in the global economy can be assessed. For the euro area, in particular, the causes can be found in the unsustainable nature of the post-crisis recovery, which is largely artificially encouraged by monetary and, to a lesser extent, fiscal incentives leading to a rapidly reached potential of economic development, and with their gradual withdrawal also to transition to a descending phase of the economic cycle. The experience of the euro area shows that ***underestimating the structural factors and reforms cannot be compensated with expansionary fiscal and monetary policies***.

It is at sectoral level, as the processes in the German economy show, that certain premises appear, leading to a reverse of the economic cycle. Thus, the decrease in the automobile industry in Germany in the second half of 2018 is largely due also to the new carbon dioxide emission standards and the ban on diesel engines in some regions of the country, as well as the possibility of imposing customs restrictions by the USA and the United Kingdom (in case of exit from the EU). The importance of the automobile industry, especially in foreign trade aspect, is great, since the exports in this sector are 18% of total exports of Germany, constitutes for over 36% of total exports of cars in the EU, and approximately 18% of world exports. This makes Germany nearly twice as big exporter as the next largest car exporter Japan. Since 2015, the European Commission makes proposals, which have already largely been transformed into Community legislation, and concern the European market carbon emissions, the establishment and management of the Energy Union and the creation of a new model of the electricity market. Their negative effects in the short term are already noticeable in the German economy. As part of the 2016 Clean Energy Package, an agreement is reached by 2030 to reduce greenhouse gas emissions in the EU by 40% compared to 1990 with a binding EU target of a 32% share of renewable energy, which is an additional risk to the short-term development of the European economy as a whole. The instability of the

German banking system also adds uncertainty to the economic growth as a whole, which also affects investment plans not only in Germany but also in the euro area, with over 30% share of Germany in the economic activity in the euro area. The **drop in investments in the EU and the euro area continues to be a leading factor for the economic slowdown**, while sustainable growth of wages maintains a relatively high level of domestic demand, which so far manages to protect the EU and the euro area from recession. Inflation is still kept at acceptable levels, but the risks for its growth increase with the steady increase of remunerations and the volatility in oil and resources prices.

Figure 50

Forecasts for economic growth, inflation and unemployment in the euro area (%)<sup>38</sup>



Source: IMF.

Although IMF forecasts do not currently show signs of recession in the euro area in the coming years, whether this will happen depends, on one hand, on the development of the factors leading to the economic slowdown in 2018, and, on the other, on their multiplication due to structural weaknesses. As the President of the ECB Mario Draghi (Draghi, 2019) stated, since 1970 in EU there have been 50 cases of slowdowns in the economic growth in a high economic activity environment (soft patch), but only 4 recessions. At the same time, although the specific reasons for the slowdown of the European economy in 2018 appear to be one-time effects, the **materialization of other structural risks indicates that the slowdown will continue, and the risk of recession will remain** which is further increased by the global and regional economy.

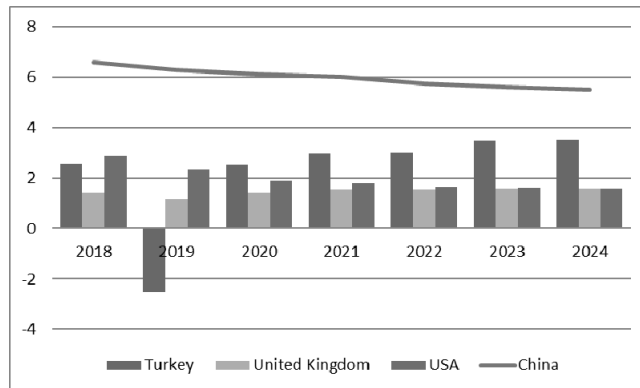
In turn, the slowdown in China's economy forms a significant part of the global trends, with a contribution to this by the introduction of stricter environmental standards in some sectors and the lower exports of goods and services. Like with the German economy, creating a new economic model that places much emphasis on **sustainable development** rather than the traditional goal of accelerating the economic growth creates certain challenges both in the short and long term, which at the moment appear **as a factor in slowing down the global economy**. Theoretically, these effects are fully

<sup>38</sup> Data from the IMF's updated forecast as of April 9<sup>th</sup>, 2019 is used, since at the time of writing the Report the EC Spring Forecast is still not officially published.

anticipated and confirmed by the environmental Kuznets curve (1955) and the studies of other economists such as Kenneth Arrow (Arrow et al., 1995), showing that when an economy has a catching up economic development, there is an increase in the environmental damage, and in a contemporary aspect their reporting and the efforts to reduce them are reflected in a lower economic growth. Neutralizing these factors involves changes in China's legislation and the liberalization of foreign investments and trade, which would have a positive impact not only on the Chinese but also on the global economy and can be considered a prerequisite for preserving its stability and a positive growth trajectory. Risks in this direction, however, come from the US economy, which, despite its upward development in 2018 with 2.9% economic growth and 3.9% unemployment, is projected to slow down its growth rate in 2019 to 2.3%. Specific factors for this are the trade relations with China, the political confrontation and uncertainty in the country. We can also add the political instability in the United Kingdom and the still unclear circumstances around exiting the EU, which increase the expectations of coming economic fluctuations in the global economy as a whole.

Figure 51

Forecast for economic growth in leading trading partners of the euro area (%)



Source: IMF.

From a regional point of view, the economy of the euro area, where Bulgaria realizes over 2/3 of its exports of goods and services and financial relations, faces new challenges also with the **crisis in the Turkish economy, the instability of the Greek economy and the political instability on the Balkans** as a whole. Turkey's economic growth of 7.44% in 2017 decreases to 2.57% in 2018, with an average annual inflation of over 16% and a deepening budget deficit of -3.6% of GDP in 2018. There are slight signals that the sharp depreciation of the TRY in 2018 has led to an acceleration of exports of goods and services, in view of the deepening current account deficit. According to the IMF's April forecast, in 2019 the Turkish economy is expected to drop by 2.6% with rising inflation and unemployment, which in essence means that it will be in a period of stagflation. At the same time, the impact of the Greek economy on the euro area has significantly decreased since the 2011-2012 turbulence is overcome, but the impact continues to be realized in regard to mutual investments, trade and



migration. The Greek economy has left the programs of the so-called “troika”, but the post-crisis recovery is still unsustainable.

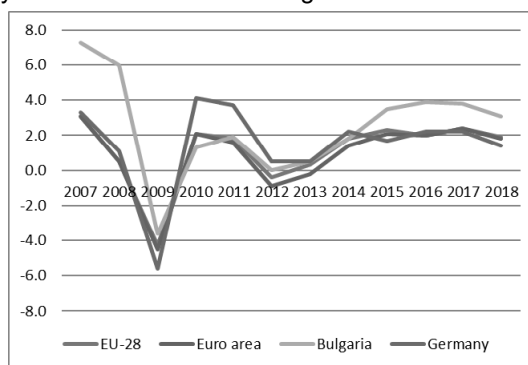
Summing up the presented expectations and factors that could influence the development of the global, European and regional economy, we can point out that at the moment the leading international institutions predict a **slowdown, but not a recession**, as the risks to both scenarios of economic development are rather balanced. This is also influenced by the plans of a number of governments to implement new policies and measures to promote economic growth, and in particular the German government has initiated a package of fiscal stimuli. The low cost of financial resources in recent years and at present creates opportunities for more ambitious fiscal programs to maintain the upward economic growth.

### 3. Cyclical Development of Bulgarian Economy and Dependence on External Environment

The observed global processes, as well as the recent financial and economic crisis of 2008, showed a high degree of **synchronization of the cyclical effects**, where in a natural way the slowing of the global economy transfers to the Bulgarian one too. Thus, given the high degree of financial and commercial integration of Bulgaria to EU, and in particular to the euro area, **one of the most significant challenges to the Bulgarian economy is now its strong dependence on the external environment**.

Figure 52

Synergy in the dynamics of real GDP in Bulgaria and its main trading partners (%)



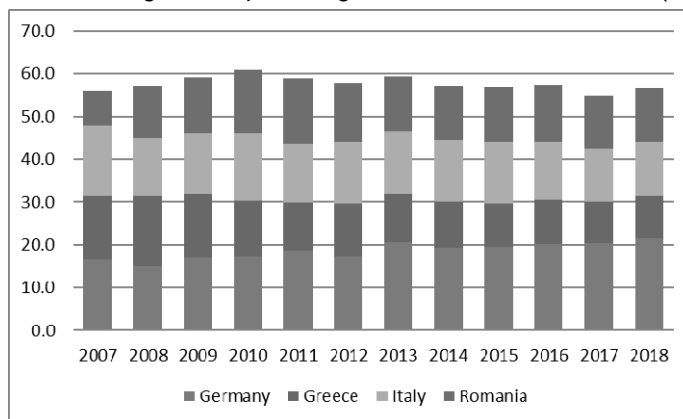
Source: Eurostat.

In order to assess this dependence on the European economy, the dependence between the production gap in Bulgaria and its main trading partners in the export of goods from EU – Germany, Italy, Romania and Greece – is studied. According to BNB data, by 2018 exports of goods to these 4 countries forms more than 56% of total Bulgarian exports to EU. Average for the period after the accession to the EU (2007-

2018), Germany has a share of 19.1%, Italy – 14%, Romania – 12.8% and Greece – 11.5%.

Figure 53

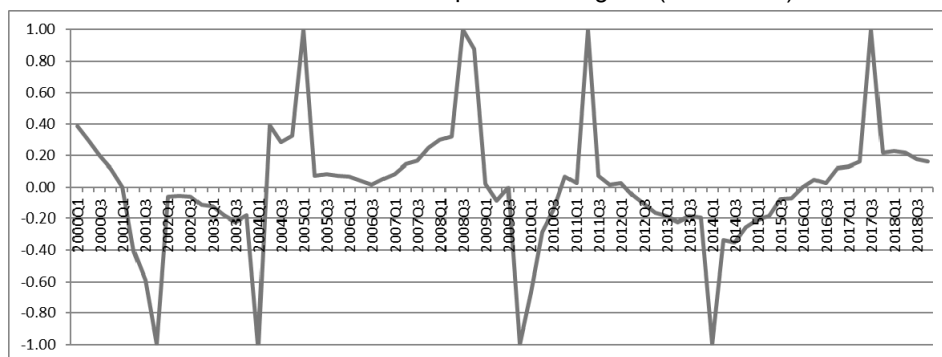
Share of Bulgarian exports of goods to EU Member States (%)



Source: NSI.

Calculations show that **approximately 1 pp change in the output gap in Germany would reflected in 0.58 pp change in the output gap in Bulgaria**. The effect of the state of the German economy on the Bulgarian one, besides in the exports, is also realized through the German investments, which for the period 2014-2018 amount to an average of 7% of the total capital inflows to Bulgaria according to BNB data; the leading place of German companies in the 100 largest enterprises in the country; and the substantial share of imports of German investment goods for the Bulgarian production.

Figure 54

Phases of economic development in Bulgaria (2000-2018)<sup>39</sup>

Source: authors' calculations.

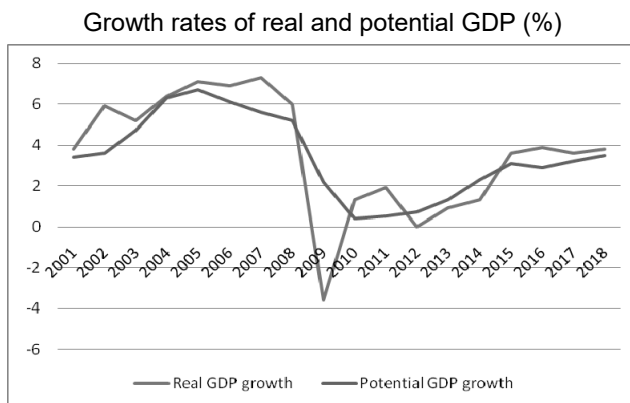
<sup>39</sup> Values on the figure show cyclical fluctuations in the economy in the following order: 1 is the economic boost and the highest point of an economic cycle; -1 is depression and the lowest point of an economic cycle; values between 0 and 1 show an upward economic development, and values between 0 and -1 reflect declines in the economy.

Thus, the slowdown of the German economy due to all the examined prerequisites is already a significant external factor for observing cyclical fluctuations in Bulgaria too, which specific manifestation, however, depends on the particular phase of the Bulgarian economy.

Thus, we can outline the following periods in the development of the Bulgarian economy:

- From the fourth quarter of 2001 to the fourth quarter of 2004 – Bulgarian economy went through an economic cycle below its potential and a quarterly average economic growth of 1.47% and average growth of the potential GDP of 1.55%;
- From the first quarter of 2005 to the third quarter of 2008 – Bulgarian economy increased by an average of 1.66% on a quarterly basis, with a growth of the potential GDP of 1.2%, which explained the entering into positive territory. The effect of the global financial and economic crisis was reflected in the registered slowdown of the economic growth in the fourth quarter of 2008, the final drop in the second quarter of 2009, and the lowest depression phase of the economic cycle reached in the fourth quarter of 2009;
- From the fourth quarter of 2009 to the first quarter of 2014 – again, the economy functioned below its potential, with the exception of the period from fourth quarter of 2010 to the first quarter of 2012, when the average growth rate of the quarterly real GDP was 0.32%, with an average growth rate of potential GDP of 0.2%;
- After the second quarter of 2014 – the economy started to develop upwards with the peak reached in the third quarter of 2017, after which began a gradual slowdown in the value of the positive output gap, especially visible in early 2018 with almost equal average growth rates of quarterly real and potential GDP – 0.8 and 0.82%, respectively.

Figure 55



*Source: authors' calculations based on NSI data.*

Towards the end of 2018, there are no clear signals for a final reverse of the phase of the economic cycle and the Bulgarian economy entering a decline, but there is a slowdown in the rates of economic growth. There is also a gradual slowdown in the growth rates of the potential GDP, which shows that currently there are no prerequisites for the Bulgarian economy to achieve higher growth than currently observed, which is necessary for catching up and real convergence to EU. Factors in this direction can be found in the nearly achieved full employment rate of 5.3% in 2018, the slowdown in the growth rate of foreign direct investments<sup>40</sup> even compared to the first years of the global financial and economic crisis of 2008 (4.9% of FDI growth in the country in 2010, with 1.1% growth in 2018) and emigration of nearly 2% of the population for the period after 2007, according to official OECD data. Thus, it is clear that not only changes in the external environment would have a negative effect on the Bulgarian economy, but there are also internal factors that lead to the reverse of phase of the economic cycle. This is evidenced by the observed convergence between real and potential GDP growth rates in 2018, similar to 2008, but the difference is that then there have been much higher growth rates of the real GDP (7.3% in 2017 and 6% in 2008), and the potential GDP (respectively 5.6 and 5.2%), clearly demonstrating the overheating of the economy, signals that are currently definitely missing.

Calculations of the output gap are based on EC data (Cyclical Adjustment of Budget Balance, Autumn 2018), with the following equation estimated econometrically:

$$Y_{BG_t} = \beta_0 + \beta_1 Y_{DE_t} + \beta_2 Y_{IT_t} + \beta_3 Y_{RO_t} + \beta_4 Y_{GR_t} + \epsilon_t$$

where:

$Y_{BG_t}$  is output gap (difference between real and potential GDP) in Bulgaria;

$Y_{DE_t}$  - output gap in Germany;

$Y_{IT_t}$  - output gap in Italy;

$Y_{RO_t}$  - output gap in Romania;

$Y_{GR_t}$  - output gap in Greece.

Calculations are made with annual data in the period 2001-2018, the econometric estimate being:

$$Y_{BG_t} = \frac{0.500}{(0.132)} + \frac{0.579 Y_{DE_t}}{(0.008)} - \frac{0.044 Y_{IT_t}}{(0.835)} + \frac{0.172 Y_{RO_t}}{(0.050122)} + \frac{0.059 Y_{GR_t}}{(0.438)} + \epsilon_t$$

Adjusted R-squared: 0.828512

To determine the phases of cyclical development in Bulgaria is used Bry-Boschan algorithm (Bry, Boschan, 1971), adapted by Dungey and Pagan (Dungey, Pagan, 2000). It allows us to identify the moment when the trend of economic development is

<sup>40</sup> For the link between the inflow of foreign capitals, the total factor productivity and the growth of potential GDP, see: Atanasov, I. (2017). Imperfections in International Technology Flows. Bulgarian Economic Papers, ISSN 2367-7082.

reversed, i.e. two-phase structure of the economic cycle with highest (economic boom) and lowest (depression) phase. The specific phase of the business cycle ( $BCI_t$ ) is determined by the difference between the reported real GDP growth ( $y_t$ ) and the potential GDP growth ( $y^*_t$ ):

$$BCI_t = y_t - y^*_t$$

by the following rule:

- Depression in period  $t$  exists if

$(BCI_{t-p}, \dots, BCI_{t-1} > BCI_t < BCI_{t+1}, \dots, BCI_{t+q})$ ,  $BCI_t < 0$  for  $t \in [-p, \dots, q]$ , which for the purpose of the graphical representation we mark by -1.

- Economic boom in period  $t$  exists if

$(BCI_{t-p}, \dots, BCI_{t-1} < BCI_t > BCI_{t+1}, \dots, BCI_{t+q})$ ,  $BCI_t > 0$  for  $t \in [-p, \dots, q]$ , which for the purpose of the graphical representation we mark by 1.

We also assume that  $p = q = 3$ , which allows us to cover the economic development within one year, in accordance with the received reliable results for a reversibility period of the phase of the business cycle from Reijer's studies (Reijer, 2002). Since data on the economic development of Bulgaria now do not suggest that the economy is in economic "boom" or economic "bottom", we adapt that algorithm to the 4-phase approach of Burns and Mitchell (Burns, Mitchell, 1946) based on the value of output gap by quarters. Potential GDP is calculated by a statistical method for the period from the first quarter of 2000 to the fourth quarter of 2018 with the Hodrick-Prescott filter with adjusted quarterly GDP data by 2010 prices from NSI. We consider the value of the parameter  $\lambda$  for adjusting the trend component to be 1600, which is the benchmark for most countries of the Organization for Economic Cooperation and Development (Marcet, Ravn, 2003).

Despite all the mentioned disadvantages of the European mechanism for identifying macroeconomic imbalances, it still allows, on one hand, to make a connection between the external and internal premises for economic instability, and, on the other, to take them into account in dynamics by the comparison between the crisis 2008 and 2018. In a macroeconomic aspect, using this mechanism to assess imbalances (it should serve as an early warning system), it is found that compared to 2008, in 2018 imbalances have decreased in terms of the number of indicators for which the data for Bulgaria deviate from the thresholds and by the scope of this deviation.

Table 11

Calculations of indicators from the Macroeconomic Imbalances Procedure Scoreboard for 2008 and 2018<sup>41</sup>

Indicator	Threshold	2008	2018
Internal imbalances			
Three year backward moving average of the current account balance	+6% of GDP / -4% of GDP	<b>-21.0</b>	3.4
Net international investment position	-35% of GDP	<b>-93.9</b>	<b>-36.8</b>
Five years percentage change of export market shares measured in values	-6%	35.1	Q3'2018: 13.7
Three years percentage change in nominal unit labor cost	+9% for euro area countries and +12% for non-euro-area countries	<b>25.5</b>	<b>13.5</b>
3 years percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 42 other industrial countries	-/+5% for euro-area countries and - /+11% for non-euro-area countries	<b>18.5</b>	4.2
External imbalances			
Private sector debt	133% of GDP	131.4	Q3'2018: 103.5
Private sector credit flow	14% of GDP	<b>33.3</b>	Q3'2018: 17.1
Year-on-year changes in house prices relative to a Eurostat consumption deflator	6%	<b>17.6</b>	<b>6.6</b>
general government sector debt	60% of GDP	13.0	22.1
Three year backward moving average of unemployment rate	10%	7.2	6.4
Year-on-year changes in total financial sector liabilities	16.5%	-0.8	7.9
Three year change of the activity rate	-0.2 pp	5.7	4.1
Three year change of the long-term unemployment rate	-0.5 pp	-3.1	Q3'2018: -3.0
Three year change in pp of the youth unemployment rate	+2%	-9.1	-8.3

Source: Eurostat, BNB and NSI.

At the same time, maintaining the imbalances on most indicators both in 2008 and 2018 shows the structural problems of the Bulgarian economy, which according to the European mechanisms are considered a prerequisite for macroeconomic instability. There is a correction of the macroeconomic imbalances in 2018 compared to 2008 in terms of the external environment – the balance of current account and the change in the real effective exchange rate. The improvement of the current account is due to a decrease in the negative trade balance with almost double increase compared to 2008 of the export and import of goods, decrease of the negative primary income balance mainly due to a reduction of the outgoing investment income from the country, as well as the increasing cash transfers from the EU. With the fixed exchange rate to EUR in Bulgaria, the changes in the real effective exchange rate largely reflect the inflation differential between the country and its main trading partners, especially the euro area. There we see that keeping higher the inflation in the country (the inflation in the euro area is almost the same in both examined years – 1.58% and 1.52% respectively, with 7.2% inflation in Bulgaria at the end of 2008 and 2.3% in 2018) is a factor that leads to

<sup>41</sup> In bold are the values of indicators that exceed the specified thresholds of deviation.

less real devaluation of the national currency. At the same time, the net international investment position and the change in nominal labor costs continue to be above the set thresholds, but with a significant correction of the deviations – almost 3 times decrease of the negative net international investment position as a percentage of the GDP in 2018, while the change of the nominal labor costs is 2 times above the 2008 threshold. However, the dynamics of both indicators reflects the catching up of the country, which essentially is more a structural feature of the Bulgarian economy than a signal of macroeconomic instability. Similarly, in the internal imbalances, the change in consolidated private debt and real estate prices still exceed but significantly reduce their deviations from the thresholds compared to 2008. However, the debt of the government sector, although far from the set threshold of 60% of GDP, almost doubles in 2018 compared to 2008, largely due to the effects of the crisis since 2008 and the support provided to the banking sector in 2014.

***The scoreboard of indicators does not signal for significant imbalances in 2018,*** but there are still signs that the Bulgarian economy is slowing down. The data also do not show serious macroeconomic risks that could lead to recession and crisis in the short run. However, the stable macroframe can be considered as a necessary but not sufficient condition for preventing cyclical declines and crises in the economy, all the more so that there are already cases when the scoreboard has not adequately signaled about the risk of drop or recession for countries that have experienced such periods in their economic development. Thus we come to the next conclusion that the instrument of mechanic identification of macroeconomic imbalances may show ***“fraudulent” macroeconomic stability*** or instability that does not correspond to the specific economic situation of the Member States which are non-homogeneous economies.

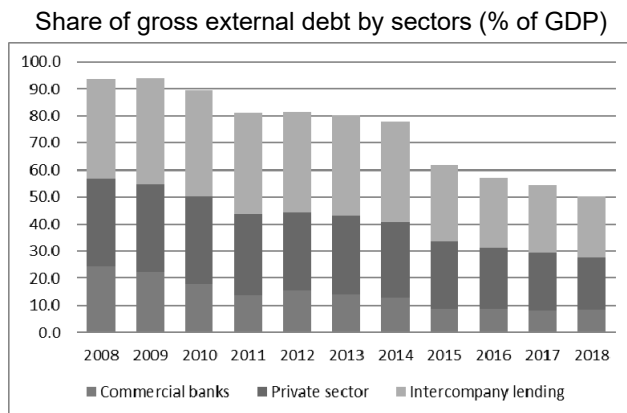
At the same time, the ***transmission channels for external instability change after 2008***, and this should also be taken into account. The analysis of the effects of the previous crisis has shown that the channels, where the external shocks can transfer to the Bulgarian economy, can generally be summarized to the following:

- ***Decrease of external demand***, which still holds a risk to maintaining the upward economic development of the country, ***not only as a result of the slowdown in the euro area but also of the region as a whole***. The turbulence in the Turkish economy has led to a 13% drop in exports of goods in 2018. In the same year the exports of goods to Russia decreases almost in half (EUR 381 million, compared to EUR 741 million in 2017). Outsourcing from the country also responds to the external demand mainly by reducing the orders for Bulgarian companies. Its growth has a positive impact on the post-crisis recovery, with Bulgaria ranked 15<sup>th</sup> among the most attractive outsourcing destinations in the world, according to A.T. Kearney Global Service Location Index. At the same time, however, ***outsourcing makes the Bulgarian economy even more vulnerable to external instability***.
- A specific channel for transferring external fluctuations, as a consequence of the slowdown of the global growth, is the activity of the global companies in Bulgaria, which form more than 45% of GDP. While in the previous crisis the external shocks are transferred mainly through financial transmission mechanisms, the current slowdown in the global, European and regional economy runs also through the value

chains, in which Bulgarian economy is increasingly active. According to World Trade Organization 2016 data, cited by Panusheff et al. (2018), Bulgaria is among the countries with highest share of external value added and the exchange of goods is strongly related to their participation in the value chains.

- Decrease of the external investment flows, which continues to be a sustainable feature of post-crisis economic development in the country. The inflow of foreign direct investments in Bulgaria in absolute terms has decreased 3 times after 2008, declining even by 9.3% on an annual basis in 2018, and reaching 2.1% of GDP compared to 28% of GDP in 2007. The reinvested profits of foreign investors in the country also decrease which just in 2018 drops 2.7 times on annual basis.
- Decrease of the tourism revenues in the country and of the international transport services with declining volumes of international trade (Yotzov, 2014). As of 2018, international transport services from the country show an increasing growth rate (6.7%, against 6.1% in 2017), but risks come from the changes in the EU legislation and the so-called legislative package “Mobility”. The growth rate of the travels in the country begins to slow down as early as 2017. By 2018, however, the highest value of EUR 3.8 billion of travel revenues since 2007 is registered.

Figure 56



Source: BNB.

The analysis of the current state of the external transmission channels for economic fluctuations shows that the importance of the financial inflows to the country, as one of the prerequisites for the transfer of the 2008 global financial and economic crisis to the Bulgarian economy, decreases with the observed reduction of foreign investments. However, the persistent necessity for external financing of a significant share of the local economy, mainly from the euro area Member States, increases the risks of economic growth decline, notably through external financing. Another specific risk, which is also visible from the scoreboard, are some structural features of the Bulgarian economy, direct consequence of the specificities of its development, the reporting of



which allows for a fuller coverage of the factors of change in the cyclical phase of the economy, which besides externally predetermined, have an internal character as well.

#### 4. Structural Specificities of Bulgarian Economy Determining the Vulnerability to Cyclical Fluctuations

In the last ten years, Bulgarian economy has remained relatively sustainable, but this sustainability creates also certain vulnerabilities, which, in unfavorable external environments, can multiply the impact of the external shocks. Their identification and timely reporting would allow for appropriate measures to be taken to prevent the economy from entering the downward phase of the economic cycle, from becoming a subsequent recession and crisis. At the same time, the analysis here focuses primarily on the supply side as a direct prerequisite for generating long-run economic growth, while the demand side, much more often a subject of analysis, is commented in the direction of production-related aspects.

##### 4.1. Low, unsustainable and unbalanced economic growth

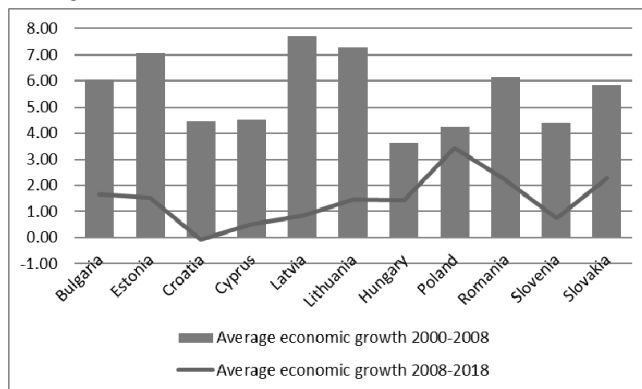
The last two quarters of 2018 show signals of a slowdown in the economic growth in the Bulgaria, which, apart for the euro area, is also true for most of the EU Member States from Central and Eastern Europe. Before the 2008 global financial and economic crisis, the 6% average growth of the real GDP by quarters in Bulgaria ranks the country 5<sup>th</sup> among the new EU Member States, right after the three Baltic countries (Latvia – 7.7%, Lithuania – 7.3% and Estonia – 7.1%), which are already members of the euro area, and Romania (6.10%), with an average EU economic growth rate of 2.4% (Figure 57). Thus, the Bulgarian economy grew by an average of 2.5 times faster than the EU average, and after the crisis this growth rate slowed down to 1.9 times with average economic growth on a quarterly basis in the period 2008-2018 of 1.7% in Bulgaria and 0.9% in the EU. Although **post-crisis economic growth can be defined as low**, especially in terms of achieving a catching up of the country and accelerating the real convergence, by growth rates the country maintains its position among the other member states from Central and Eastern Europe. Higher economic growth in this period is observed only in Poland (3.4%), Slovakia (2.3%) and again Romania (1.7%). This shows that, **besides low, economic growth is also unsustainable**. This is also typical for most transition economies such as the Baltic Countries.

The determinants of economic growth in the post-crisis period create additional risks to its sustainability. The final consumption and exports of goods and services are leading factors for economic growth after 2011. This is with a marked drop of the private investments until 2017 and their replacement by public ones in the form of European programs for funding the transport and technical infrastructure, achieving energy efficiency and a better urban environment. They contribute to an increase of the potential GDP of more than 0.6 pp in 2014, according to evaluation in the Annual Report 2015 of the Economic Research Institute at the Bulgarian Academy of Sciences (Vasileva, 2015). Administrative factors in this direction are also the systemic increase

of the minimal wage in Bulgaria, as well as the increase of public sector wages, which is a factor for stimulating private consumption. Such a structure of economic growth, driven mostly by public incentives and a favorable external environment for exports, shows an **imbalance between the different growth factors**. It also shows vulnerability that would be particularly evident when the economy enters a downward phase of the economic cycle due to worsened external environment and restriction of the fiscal incentives, including in the form of European funds and programs, which payments for now are postponed until 2020/2021.

Figure 57

Average economic growth in EU Member States from Central and Eastern Europe (%)



Source: Eurostat.

**The imbalance of the economy is also demonstrated by the structure of the gross value added**, where trade, transport, financial sector and real estate operations continue to drive the economic growth. Meanwhile, enterprises in the IT sector and manufacturing industry, as high value added sectors, report a low share of total production in Bulgaria, with a particularly noticeable slowdown in the three-month growth rate of the gross value added in industry (excluding construction) to 0.08% in the last quarter of 2018. Thus, industry stagnation and the drop in agriculture at the end of 2018 are partly compensated by the growth in the gross value added in construction (6.6% in the last quarter of 2018 compared to the same period in 2017) and in financial and real estate sectors (10.9% and 9.7% respectively). This shows that Bulgarian production is mostly concentrated in **the non-tradable sector, which, though initially hit hardest by the crisis in 2008, is rapidly recovering and continues to determine the dynamics of the Bulgarian economy**. Thus, enterprises with biggest contribution to the productive activity even after the 2008 crisis still remain the ones, which rely mainly on extensive expansion of their activity. They are small in volume and, except for financial sector and high technologies, have average wage below the country's average, and these are productions highly dependent on foreign financing. Regarding employment structure particularly, comparative sustainability is demonstrated, with cyclic fluctuations being most strongly reflected in industry and agriculture. Besides in trade and transport, there is employment growth also in culture, sports and leisure, and professional and administrative activities, with reducing the total number of employed

people in the period 2008-2018 by approximately 8%. Largely, such structure of the economy is observed also in the Baltic Countries, and it becomes a ***model of development for the countries of Central and Eastern Europe, which rely on employment, investments and lending mainly in the non-tradable sector.***

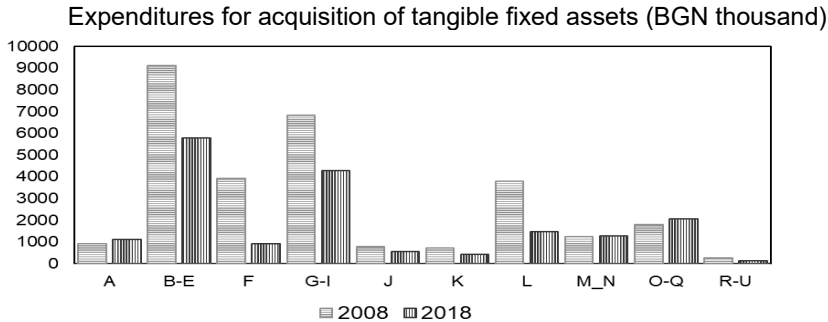
Besides the external environment, additional risks to the development of the structure-defining non-tradable sector in Bulgaria relate also to ***constraints of the credit growth as part of the macro-prudential powers of BNB***, exactly due to concerns about the excessive expansion of this sector. If the measures are effective, this will lead to a slowdown of the growth in gross value added and will further lead to a decline in economic growth when reducing external orders for industrial production. Measures for reducing lending are largely directed also to the real estate market, which in the last years shows trends of recovery, but still far below the pre-crisis dynamics. The number of transactions increases by 0.09% in 2018 compared to the previous year, house mortgage loans – by 3%, and their volume – by 9% at historically lowest interest rates globally.

#### *4.2. Low investment activity of the private sector with reducing inflow of foreign investments*

The other significant weakness of the Bulgarian economy is the ***insufficient domestic and foreign investments and the worsening of their structure.*** The size of investments in physical capital (acquired tangible fixed assets) alarmingly decreases from around BGN 29.4 billion in 2008 to BGN 18 billion in 2018. The most significant drop is in construction (-76.5%), real estate operations (-61.5%), and industry, where investments in 2018 are 36% lower than in 2008. On the other hand, the most significant increase of the cost of acquiring tangible fixed assets is in the agriculture sector, but with low absolute values of the investment activity.

However, structurally, the share of investments in industry remains almost unchanged at approximately 31% in both 2008 and 2018. This is valid also for the share of trade, transport and tourism – 23%. The most significant progress in structural terms have the costs for acquisition of tangible fixed assets in the agriculture sector, which are 6.2% in 2018 compared to 3.2% in 2008. The same is valid for the state governance, education and healthcare, their share in total investments increasing to 11.5% compared to 6.1% in 2008. ***There is a slight change in the investment structure of the sector of information and communication and professional activities and research, which are most significant for establishing high-technological and competitive economy,*** and, last but not least, also directly affect the dynamics of the economic growth in the digital era.

Figure 58

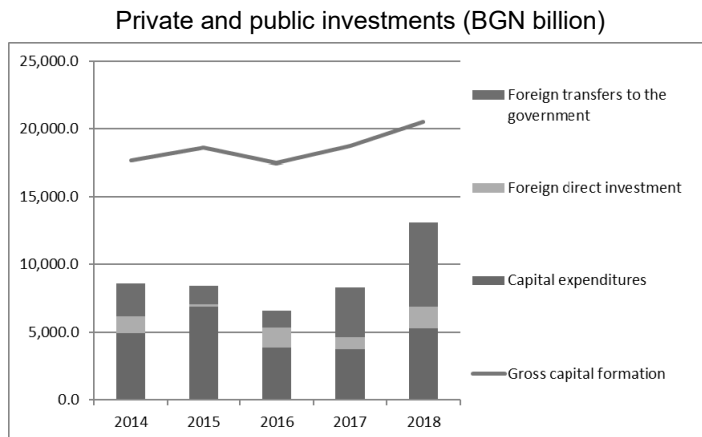


Note: The mentioned NACE activities are as follows: A – Agriculture, forestry and fishing; B-E – Industry (except construction); F – Construction; G-I – Wholesale and retail trade, transport, accommodation and food service activities; J – Information and communication; K – Financial and insurance activities; L – Real estate activities; M\_N – Professional, scientific and technical activities; administrative and support service activities; O-Q – Public administration, defence, education, human health and social work activities; R-U Arts, entertainment and recreation; other service activities; activities of household and extra-territorial organizations and bodies.

Source: NSI.

In general, the decrease of the investments may also be a signal of a push effect in the Bulgarian economy, when the uncertainty during the crisis period and refraining from private initiative, an indicator of which is the average annual credit growth of 0.6% for the period 2009-2017, the **increase of the government capital expenditures and the absorption of funds from European programs lead to significant public investments, almost comparable to the private ones**. In 2017 and 2018, the current government transfers received through the international cooperation almost double, which essentially reflect the inflow of funds under the European programs and reach BGN 6.2 billion with BGN 5.3 billion government capital expenditures.

Figure 59



Source: NSI, MoF and BNB.

The sustainably low flow of foreign direct investments since 2008 has also significant contribution to the decrease of the private investments in the country. Although the post-crisis recovery of the Bulgarian economy is realized exactly in such conditions, ***the economy of Bulgaria still shows a strong dependence on the inflow of foreign investments due to the serious presence of multinational companies.*** At the same time, however, not only the absolute levels, but also the sectors, to which foreign investments are directed, are important. ***The FDI concentration in the non-tradable sector before the crisis did not help to form a stable economy with sustainable growth, contributing to the establishment of a branch structure with low value added.***

Foreign investments have changed significantly since the start of the crisis in 2008, namely not only a significant drop but also a very unfavorable structure. Their exceptional volatility has a significant impact on the instability of the economy and especially the leading industries in it. After the pre-crisis boom and the associated effects on the economy, FDI in the manufacturing industry register the most significant drop. This trend will deepen the problems of the manufacturing industry and will have an unfavorable effect on the contribution of the sector to the economic growth, which in turn has mostly low value added. However, foreign interest in the mining industry, mainly processing imported rather than domestic raw materials that are largely exported, is sustainable to cyclic and crisis fluctuations. This is a serious structural problem.

After the initial collapse of the foreign investments in the financial sector as a result of the crisis, they remain at a stable low level. The weak foreign interest in the financial sector in Bulgaria relates to the general EU trends and the regulatory pressure and suspicions of increased risk in the sector. In conditions of significant risks to the European banking system, to which Bulgarian banking system closely relates, as well as growing need to strengthen the capital structure of the banks, the decrease of foreign investments in the sector will delay the consolidation and the further capitalization of the system with all the resulting risks.

FDI in construction and the real estate market lose their attractiveness from the pre-crisis boom, and in most periods after the crisis mark significant declines. At the same time, however, construction and real estate operations show a high degree of dependence on the dynamics of FDI input, and the boom in the attracted foreign investments in 2006-2008 is largely due to investments exactly in these sectors. Their relative share in the FDI structure over some quarters in 2006-2008 exceeds 35% and more than the capital inflows into the industry. However, since 2014, the share of investments in this sector remains constant around 23-25% of total net foreign direct investments, while capital inflows into the sectors, most promising in creating high value added, such as information and telecommunications, is between 1% and 2% of total FDI after 2014. On the other hand, FDI in tourism follows their own dynamics, increasing significantly for a short period after the crisis, surpassing the pre-2008 levels, though in the last years they decrease significantly again.

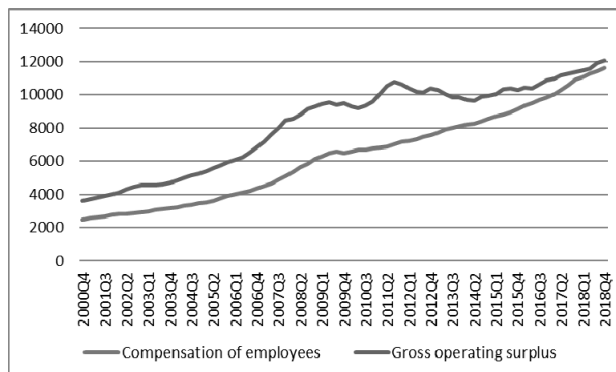
Thus, in structural terms, there are unfavorable FDI trends – apart from the fact that their inflow steadily decreases, they are directed to sectors that do not have the

potential to develop a high-income economy, thus hindering the fostering of a sufficiently strong local economic environment that can resist cyclical fluctuations from outside, as demonstrated, for example, by the Polish economy in the last crisis of 2008. Thus, the risk of attracting foreign investors, who much more exploit the advantages on the local market than consider it a long-term perspective, is another weakness of the Bulgarian economy, which does not ensure sufficiently high and sustainable rates of economic growth.

## 5. Challenges at Sectoral Level and Their Impact on Economic Activity in Bulgaria

A specific and internally determined factor of sectoral instability is the **slowdown in the growth rates of the gross operating surplus** (a measure of company profits), which significantly grows in the pre-crisis period with an average annual growth of 13%, then stagnating during the crisis and even in 2013 has a negative growth rate of -5.2%, to recover after that but with a weak growth – an average of about 4%. Construction industry, which has the most significant decrease of the cost of acquiring tangible fixed assets, marks a nearly double decrease of corporate profits in 2018 compared to 2008. To a lesser extent this happens in the IT and telecommunications (-15%). At the same time, **the decrease of company profits is related to the increase of remunerations in the country**, driven mainly by the increasingly sharp deficit on the labor market and the increase of wages in the public sector. When using seasonally adjusted data for the period 2000-2018, there is a correlation between wages and corporate profits of 0.94, and by 2018 the levels of the two indicators for the economy as a whole get almost even, unlike in the pre-crisis period when the difference between them is significant.

Figure 60  
Dynamics of the compensation of employees and gross operating surplus  
(seasonally adjusted quarterly data)



Source: NSI.

Although the increase of the total labor costs in Bulgaria has a positive macroeconomic effect in terms of encouraging domestic demand, it also leads to a decrease of company profits, which in turn affects negatively the level of private investments. Moreover, it is a

prerequisite for a low economic growth in long term, whose compensation by the demand-side of the economy has mostly unclear and above all just short-term dimensions. The problem increases also by the huge difference in payment levels in the various sectors of the economy: the average wage of the employed in financial sector and utilities is nearly twice higher than the average wages in tourism, administrative and supportive service activities and the agriculture sector.

An important challenge to the economy when reversing the economic cycle is the **low credit growth for the non-financial sector** even at the historically lowest prices of financial resource. After the first quarter of 2018, lending slows down, and in the third and fourth quarters of the year it is even negative. This is also one of the main challenges to the economy, but also to the financial sector itself, in terms of worsened external environment and reversing of the economic cycle.

At the same time, in the structure of lending the non-financial corporations, the leading role of trade, transport and tourism sectors, which account for about 1/3 of the total non-financial sector credit, remains. On the other hand, credits to industry slightly increase in the post-crisis period, reaching BGN 9.5 billion by the end of 2018, with a significant **reduction in credit funds for the mining and quarrying**, a slight increase in the credit to the manufacturing sector, and almost doubling the funds for the utilities sector, including energy. On the other hand, exactly the exports of raw materials continue to be leading in the export list of the country, which with reduced external demand will have an unfavorable impact on the export-oriented companies in the sector. The decrease of the domestic credit will further worsen its state and will have a negative impact on the economic growth, because of the substantial share of the mining and quarrying in the gross value added and employment. As a whole, in the uncertain external environment for the country's traditional trading partners in entering the downward phase of the economic cycle, **the export-oriented Bulgarian companies will be at risk**. Without diversification of the markets and the search for new markets and better use of the trade agreements of the EU with third countries, the risks to the economic growth will become real. As of February 2019, there are already signals that exactly such foreign trade scenario is being realized.

At the same time, credit growth for **unreformed and highly indebted sectors such as electricity** represents a significant risk to the banking sector and the economy as a whole. Trends of replacing fossil fuels with biofuels would result in a significant change in the country's energy mix, an increase of unemployment and restructuring of the energy sector employment, as well as increase of electricity prices and a direct impact on energy poverty in the country, which in Bulgaria is the highest among the EU Member States, according to Eurostat.

The total **credit exposure to the real estate market** is also a source of instability, although the Bulgarian banking system is the least concentrated in this sector compared to the other countries (3<sup>rd</sup> place in the EU with lowest relative share), covering 10.8% credit exposure compared to 25.8% average for the EU. However, the nonperforming loans in the sector are 33.9% of total ones. Only in Greece the value of this ratio is higher, with 4.5% average in the EU. The relative share of exposures to the construction sector is 7.3% of all exposures to non-financial corporations (with an EU average of

6.3%), and the share of nonperforming loans in this sector is also high – 27.8%, with 16.3% average for the EU.

Another important challenge to the fiscal stability and the economy as a whole is the **accumulation of liabilities of municipalities** that continue to grow in 2018. The number of those in need of financial recovery also increases. The average share of revenues in the total revenues for the country decreases to 36.65%, compared to 38.39%, according to the latest data available at the end of 2017 by the Ministry of Finance. By the end of 2018, only 38 municipalities report a revenue share of total revenues that is higher than the average for the country. The average for the country share of coverage of local activity expenditures with revenues drops to 82.38% compared to 88.39% in 2017. Above the country average result is achieved by 57 municipalities (at the end of 2017 they are 49). The average for the country level of debt as a percentage of the planned revenues, an equalized subsidy and other transfers to local activities from the central budget, is 50.25% (against 48.08% in 2017). The 2017 data also show that the municipalities' liabilities exceed 10% of GDP, which gives reason to expect that with economic drop their financial state will worsen.

The **accumulation of liabilities of state-owned enterprises** is also one of the main problems of the Bulgarian economy, which will deepen when reversing the economic cycle. Relative to GDP, these liabilities fluctuate between 13.07% in 2016 and 10.4% of GDP in 2017. At the same time, the economic recovery is not used for structural reforms in the sector of state-owned enterprises, for restructuring and reduction of their debt, which BAS mentions for some time.

Table 12

Liabilities of state-owned enterprises (share of GDP)

	2013	2014	2015	2016	2017
Total	12.5	13.4	12.1	13.1	10.4
Central government	10.2	10.8	9.8	10.9	8.2
Local government	2.3	2.5	2.3	2.2	2.3

Source: Ministry of Finance.

The **lack of reforms in the healthcare sector** leads to the accumulation of significant liabilities, which financing will be more difficult with the decline of the economic growth. The effects of unperformed reforms multiply also by the worsening of the quality of health services, directly affecting the health status of the population and the workforce in the country, leading to significant economic and demographic problems. Even in the favorable environment of the post-crisis recovery, public expenditures on healthcare remain as a share of GDP around 4%, with an average of 8-12% for the EU Member States. At the same time, the transfer of the financial burden of the health services to the population leads to the increase of poverty and the worsening of the health status of large population groups (Bulgarian Industrial Association, 2018).



## 6. Structural Reforms and/or Fiscal Growth Incentives?

The analysis of the external and internal factors for the Bulgarian economy entering an upward phase of its cyclical development shows that **external challenges create the basis for a significant slowdown, and the high vulnerability of the economy due to the accumulation of internal structural imbalances further increases the risks of slowing down the growth**. The identified significant structural problems of the Bulgarian economy will increase in the conditions of worsening external environment, but **even if the external shock is quickly overcome, there are internally determined conditions for slowing and decreasing of the economic activity in the country and slowing down of the real convergence**. Thus, both circumstances – external and internal – provoke necessity for reforms to allow the economy to face better prepared the challenges of the global and the European economic slowdown and a possible recession. At the same time, the economic activity during the short period of the post-crisis recovery, with the highest economic growth of 3.9% in 2016, is mainly driven by the external demand and the public investments from European programs with low private investments, and essentially refusal to implement substantial structural reforms to improve the efficiency in the public sector. Thus, the question arises: **What should be the macroeconomic strategy for reducing the negative effects of the economic slowdown and preventing its growing into a recession – structural reforms and/or fiscal incentives?**

The commitments to implement reforms related to the accession of the national currency to the ERM II have to contribute to the bigger sustainability of the economy to the unfavorable factors. In essence, Bulgaria is committed to join the Banking Union with all the resulting obligations for the financial sector; to improve the supervision over the non-banking financial sector; to address the gaps in the legal framework on insolvency and money laundering; to improve the governance of the state-owned companies and the institutional framework in the country<sup>42</sup>; to implement the reforms recommended by the EC in the justice system and the fight against corruption and organized crime in the country. Currently, only some legislative changes are made, while the commitment to structural reforms remains in the background.

The real results for the state of Bulgarian banking sector are expected at the end of July 2019, when the asset quality review and the stress test of some Bulgarian banks will be completed. In its Bulgaria In-Depth Review concerning the prevention and correction of macroeconomic imbalances in March 2019, EC continues to consider the high inter-company indebtedness, the still high levels of nonperforming loans and problems related to the insurance market, as serious challenges in the financial area. These circumstances create an **additional risk, with unfavorable assessment of the readiness of the country to join the Banking Union and ERM II, to multiply the internal factors that could lead to further slowdown of the economic growth, and, in the worst case scenario, also to the use of fiscal instruments for supporting financial institutions**.

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<sup>42</sup> The 2018 Convergence Report of ECB also underlines that: “The sustainability of convergence and economic resilience would benefit from wide-ranging structural reforms to enhance structural resilience, the business environment, financial stability, institutional quality and governance.”, p. 57.

At the same time, the mentioned commitments regarding accession to ERM II, which to a large extent Bulgaria has put itself in the official letter sent by the Bulgarian authorities at the end of June 2018, are supplemented by the EC recommendations within the European Semester. The main recommendations, systematically repeated for several years, are directed to:

- improving corporate governance framework for state-owned enterprises and improving revenue collection, efficiency of public expenditures and reducing the size of the informal economy;
- strengthening the supervision of the financial sector and completing the reform of the bankruptcy legislation, and improving the processes of assessment and audit of bank assets and securities, and promoting the development of the secondary market for nonperforming loans;
- public and financial sector and improving the quality of the national education system, improving the access to health services and increasing the employability of disadvantaged groups.

***EC, IMF and the leading rating agencies associate the possible positive trends and the favorable prospect for the economic development, mainly with joining ERM II, thus setting the priorities at local level, namely in the area of structural reforms.*** In this sense, one of the most important challenges to the Bulgarian economy is the result and the decision of the EC, ECB and the euro area on the accession to ERM II. Rating agencies are also expected to react and thus to raise or lower the credit rating of the country, depending on this outcome, which is considered an important signal to investors.

According to Fitch Ratings, the factors that individually or together would lead to an increase of the country's credit rating are the improving of the external and fiscal balances and the progress in accessing the euro area, which would lead to a faster convergence of the income levels with the average European ones and is one of the main challenges in terms of slowing the economy. At the same time, the worsening of the external competitiveness, as well as the sharp increase of the government debt due to fiscal loosening or materializing of relative liabilities in the country's balance sheet are estimated as factors that would lead to a decrease of the country's credit rating and essentially limit the fiscal incentives perimeter. The conclusions of the last IMF Review under Art. 4 are that the low income per capita and the unfavorable demographic trends in the country are important issues, which overcoming should be addressed by achieving sustainable and inclusive economic growth while preserving the fiscal and financial stability in the country.

Undoubtedly, in the case of a categorical and immediate accession to ERM II, the Bulgarian economy will be positively influenced, and, despite the accumulated internal and external problems, will be able to move more smoothly and without significant slowdown through the global and European unfavorable development scenarios. However, in the event of postponement or setting additional conditions, the economy

will be negatively affected and the identified imbalances will increase, which could lead to a significant slowdown and a possible recession.

The economic development in 2018 and the increasing challenges to the economy of external and internal nature call for conceptualization of a comprehensive program with structural reform. However, in view of the expected slowdown in the economy, it is important to set additional fiscal buffers to meet the unfavorable economic cycle. Appropriate measures in this direction are the more cautious spending of public funds now, when the economy still has a positive progress, as well as more active use of the European funds and programs, which, as already observed, can play the role of an instrument for anti-cyclical macroeconomic policy.

**At the same time, however, having fiscal incentives without structural reforms will lead to further deepening of the structural imbalances and will increase the risks to an economic crisis.** Thus, the macroeconomic stability and the better starting position of the economy compared to the 2007-2008 crisis period should not lead to underestimation of the fundamentally important structural factors for the stability and growth of the economy. The macroeconomic strategy to overcome cyclical fluctuations should be based on a set of structural and fiscal measures directly contributing to increasing the sustainability of the Bulgarian economy.<sup>43</sup> This is necessary also in the light of the international commitments and expectations from the country, the failure of which is in itself a significant risk to the internal stability.

## **7. Conclusion**

The analysis of the external and internal challenges of slowing the economic activity in Bulgaria shows that the worsening of the external environment would have much more structural effects than the direct financial dimension, as in the 2008 global financial and economic crisis. Globally the financial sector already stabilizes and no significant risks are expected that would provoke a new financial and subsequently economic crisis, since the reasons and the nature of the slowdown of the global and European economy are different from the already observed. Therefore the channels of transferring cyclical fluctuations are mostly related to purely economic processes, with different scope and effect on the individual economies.

At the same time, there are certain structural weaknesses of the Bulgarian economy (low, unsustainable and unbalanced growth; insufficient domestic and foreign investments in their priority focus on the non-tradable sector of the economy; decrease of the company profits and the available income for investment; accumulation of significant liabilities in the state-owned enterprises, municipalities and non-reformed sectors with predominant state ownership), which to a large extent are characteristic of all countries with catching up development from Central and Eastern Europe and have an impact on their macroeconomic environment, regardless of the influence of the

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<sup>43</sup> Similar opinion is also stated in Collective. (2015). *Economic Growth: Incentives and Limitations*. Sofia: GorexPress, ISBN 978-954-616-258-8.

external factors. The subdued investments – local private investments, foreign direct investments and bank lending – cannot be fully compensated by the low-effective public investments, which largely depend on the inflow of European funds, and provide a domestic economic environment that is sufficiently sustainable to cyclical fluctuations.

For the most part, the structure of the economy remains unchanged, despite the change in the model of economic development driven mainly by the foreign investment inflow in the period 2004-2007, to the export-oriented economic growth in 2010-2016, and to the growth driven by domestic demand after 2017. This again shows that the identified vulnerabilities of the Bulgarian economy are in essence its structural characteristics, which manifestation does not depend on the specific phase of the economic cycle. Long-term solutions for their overcoming by implementing structural reforms should be sought. Moreover, in the post-crisis recovery, the Bulgarian economy reaches potential growth at much lower levels than the pre-crisis period, indicating that the possibilities for overcoming the slowdown in the process of catching up with the European economy in the current structure of the economy are already exhausted. Not only the low rates of economic growth, but also its volatility and imbalance, are serious challenges, which addressing requires much more than standard policies for managing the demand, as shown by the dominant role of the non-tradable sector in the country at a much lower degree of development of the perspective sectors such as ICT and industrial production.

However, the extent of these structural weaknesses appears to be systematically underestimated, much more emphasizing on the external factors for accelerating and slowing of the economic growth in the country. Although the international institutions like the European Commission, ECB, IMF and the rating agencies focus exactly on the need for structural reforms, the economic policy at local level still remains mostly oriented towards overcoming the difficulties and problems of a short-term nature, which has the potential to further deepen the unfavorable external effects.



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