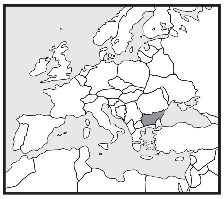
Social unrest



Bulgaria, the poorest country in the European Union, has been enjoying some economic benefits from joining the EU. However, Government assurances that the economy is solid notwithstanding, investment and exports are dropping and the GDP will soon contract. Government measures to mitigate the impact of the global crisis will probably not be sufficient. NGOs are demanding that both employers and the Government adopt emergency measures to rein in inflation, agree to wage settlements that increase real income and assess the impact of the crisis on the most vulnerable sectors of society.

Bulgarian Gender Research Foundation and Bulgarian-European Partnership Association

Although Bulgaria, the poorest EU country, has yet to feel the full impact of the global economic crisis, social protests have already erupted in response to the European Commission's decision to cut the country's pre-accession funding due to rampant corruption. Bulgarians demonstrated in front of the Parliament building in January 2009 to demand economic reforms, calling on the Government to act or step down. In the same month, farmers demonstrated throughout the country and blocked the only bridge to Romania, demanding that the Government set a minimum price for milk and stop imports of cheap foreign dairy products. Police officers, banned by law from striking, have been holding "silent" protests since December to obtain a 50% pay hike and better working conditions.

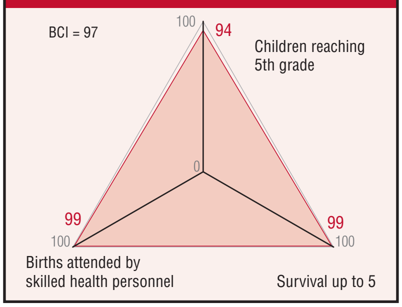
Despite this social unrest, as well as a global financial crisis that has inspired a re-examination of current economic policies all over the world, widespread questioning of the neo-liberal model and calls for stricter government regulation, the neo-liberal model remains fashionable in Bulgaria. Prime Minister Sergey Stanishev acknowledges that Bulgaria is experiencing its first economic crisis as a capitalist country and is not immune to the difficulties facing its economic partners. However, he continues to insist that the country's problems are less severe than those of other European Union members.

Boom and crunch

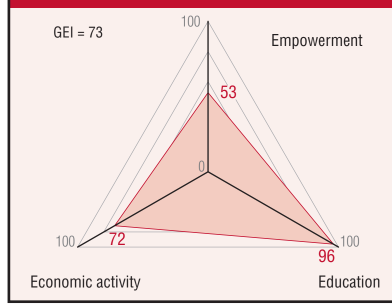
A currency board was introduced in 1997 after a severe crisis in the national bank system led to hyperinflation, bank closures, acute political crisis and mass impoverishment. Since then every government, whatever its political orientation, has favoured retaining it in order to avoid another massive crisis. The currency board's strategy has been to stabilize the macroeconomic environment while barring any increases in pay, even though Bulgaria has the lowest wages in the EU.

Since 2004, when agreement was reached on accession to the EU, Bulgaria has experienced a surge in capital inflows and a credit boom. The influx of capital was stimulated by expectations of rapid convergence with the EU, and further boosted by the presence of the currency board and a strong fiscal policy. The ratio of credit to GDP exploded from 36% in 2004 to 67% in 2007. By 2008, inflows made up about 30% of GDP.[1]

Basic Capabilities Index (BCI)



Gender Equity Index (GEI)



The surge in outside capital generated strong GDP growth, but sharply widened external and internal imbalances. GDP grew by more than 6% annually, one of the fastest rates in Europe.[2] Growth remained a strong 6.25% in 2008. However, the growth of domestic demand outpaced GDP growth, widening the current account deficit from 5% of GDP in 2003 to over 24% in 2008. This gap was accentuated by the concentration of growth in construction, real estate, and financial services according to the National Statistics Institute.

As unemployment dropped and the labour market tightened, wage growth accelerated to 24% in June 2008. The overheating of the economy, together with rising food and oil prices, accelerated inflation to a peak of 14.7% in June 2008, with food prices soaring more than 25%. Escalating prices of natural gas, electricity, central heating, road and railroad transport, water, and so on will push the cost of living up around 17% on an annual basis, while inflation for the full year will probably surpass 12%. The inflation forecast for 2009 is around 4%.[3] However, Centre for Economic Development experts are warning that the real danger ahead is deflation, not inflation.

Global financial turmoil and risk aversion by investors are likely to reduce capital flows to Central and Eastern Europe, including Bulgaria. Local bank subsidiaries are unlikely to continue receiving the large capital transfers from their parent banks that have funded credit growth. Without this financing, enterprises will reduce their production and services or shut down entirely, causing an increase in unemployment. Metallurgy and construction have already shrunk. In January 2009 industrial production plunged 19% from the previous month, according to the official Statistical Institute.

At the same time, shrinking foreign demand and declining commodity prices might lead to a drop in Bulgarian exports and a decline in tourism. The latest IMF projections show a contraction of more than 0.5% in G-7 GDP, which would squeeze Eastern Europe's growth and exports. In Bulgaria, exports have been hard hit by a decline in orders and metal prices.

Economic outlook

GDP growth in 2009 is likely to slow to about 2%, or even 0%, according to one recent forecast.[4] With slower growth, the current account deficit is projected to shrink to 15% of GDP, while a sharp drop in global commodity prices should temper inflation. However, there is significant risk that growth will slow even more. Fortunately, the country's public finances are in good shape, with one of the highest fiscal surpluses in Europe. Nevertheless, the dramatic shift in the balance of payments shows the severe shock the country is experiencing.

In the five months since October, net capital inflows totaled only EUR 800 million, down from EUR 6.1 billion in the previous five months and EUR 5.6 billion in the same period a year ago. Exports in the

1 IMF. Bulgaria. Article IV Consultation–Staff Report. Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Bulgaria February 2009. p. 25.

2 World Bank. *EU 10 Regular Economic Report*, February 2009.

3 Confederation of Independent Trade Unions (2009). "Living standard". Available from: <www.knsb-bg.org/knsb/>.

4 IMF, Bulgaria. Staff Visit; Concluding Statement of IMF Mission, April 2009. See: <www.imf.org>.

first two months of 2009 were 27% lower than in the first two months of 2008, while the drop in imports was even sharper (32%), suggesting that domestic demand has contracted rapidly. As a result, the current account deficit declined from an annualized rate of 25.8% of GDP in the first two months of 2008 to 11.6% in the first two months of 2009.[5] Indeed, leading indicators of economic activity suggest that the economy may already be contracting**.** The International Monetary Fund (IMF) recently predicted that the Bulgarian economy will shrink by around 3.5% in 2009 and 1% in 2010, down 2% from its April 2009 projection.[6]

An international gas crisis in January 2009 practically erased whatever positive momentum remained from 2008. When the dispute between Russia and Ukraine cut gas supplies to Europe, Bulgaria was among the most unprepared countries, with no real alternative sources of gas. The cost in lost production is estimated at more than EUR 250 million (about USD 333 million). The Government officially requested compensation from Russia, but even if some compensation is provided, the long-term effects of the halt in production could pose risks to the entire economy.

Government priorities in fiscal policy

In this difficult environment, maintaining confidence in both the currency board and the financial system is crucial. The two are mutually dependent: a strong and resilient financial system is needed to sustain the currency board; and confidence in it bolsters the financial system. The IMF believes that the currency board can enable the country to cope with the turbulence, since Bulgaria has adequate fiscal and currency reserves. The IMF didn't even consider alternative measures to compensate for negative balance of payments, such as currency devaluation or adoption of the Euro.

Recommendations

Maintain surpluses

Fiscal policy should aim at maintaining large surpluses, not only because they have been a pillar for the currency board, but also to preserve balances in the fiscal reserve account – an important cushion in the event that problems emerge. For 2008, the Government targeted a surplus equal to 3.5% of GDP. Preserving the surpluses in a time of slow revenue increases will require a significant slowdown in the growth of expenditures. However, neither revenues nor expenditures projected in the current budget reflect the expected decline in GDP growth.

Make implementation of the 10% budget rule transparent

The Government plans to contain expenditure growth by restricting spending to 90% of what was originally budgeted for 2009, rather than by revising the budget. The remaining 10% is to be released based on budget developments.[7] This solution could be pragmatic, but it is far from transparent. Indeed, foreign observers, probably not aware of the 10% rule, perceive a budget based on unrealistic revenues.

It is important to ensure that mechanisms to implement the 10% rule are clearly understood. Some plans and programmes may need to be postponed. Ministries should signal their spending priorities early on and make sure they are clearly communicated to the public. Strict budget execution is also essential. Implementation of the 10% rule would only slow spending growth from a budgeted 17% to 11% in real terms. If GDP growth slows to the projected 2%, the fiscal surplus is likely to fall to 2% of GDP.[8]

Accelerate reforms

Fiscal and structural reforms should be accelerated, notwithstanding the election cycle. Problems regarding the disbursement of EU funds underscore the need to further upgrade control systems. The Government has introduced several changes to social security contributions and social policy-– e.g., a decrease in social insurance contribution rates paid by employers and an increase in maternity benefits. In making further reforms, maintaining fiscal neutrality is essential to ensuring the long-term sustainability of the public finances.[9] To accelerate convergence to EU standards, the State has to complete the reform of education, make progress in health care reform and improve the efficiency of the public and private sectors.

Increase wages as productivity increases

The Government is aware that the high growth rate in wages during 2008 cannot be sustained. Although wages are still low compared to those in Western Europe, further increases must be accompanied by improvements in productivity. According to the IMF, the current pace of wage growth is far too rapid for Bulgaria's relatively small productivity growth. Moreover, as the experience of other countries has demonstrated during the downturn, the faster wages grow, the more unemployment is likely to increase.[10]

Moderation in unit labour cost increases is essential given that resources will need to be shifted to export-oriented sectors. As domestic-market sector growth slows, GDP growth can be maintained only if exports take up the slack, but both sectors must remain competitive. Whether they are is a matter of dispute. Although the Government expresses confidence in corporate profitability, NGOs are less certain due to the paucity of data available.

The financial sector

Strong policies will also help the financial sector, which is currently well capitalized and profitable. In the period ahead profitability is likely to decline, as foreign funding is becoming scarce, strong competition for domestic deposits has raised the cost of funds, and lending growth is expected to slow. At the same time, the reliance of banks on foreign funding for new lending makes them vulnerable to the current disruption in international financial markets. Nevertheless, banks are well positioned for a slowdown, and have strong capital and liquidity cushions.

Unemployment will probably not reach double digits. Those most likely to be jobless are young people who lack an employment history, low-skilled workers, elderly workers, people with disabilities and women. It should be noted that the number of unregistered unemployed is at least equal to the number registered, and may be higher. Migrant workers are also returning, which ends the remittances they were sending home to their families. Some projections estimate that some 20% of short-term emigrants may come back—mainly from Greece, Spain and several other EU countries where unemployment is rising sharply.

The civil society perspective

NGOs and trade unions do not agree that reducing social expenditures is acceptable in times of crisis. They have been meager expenses since the establishment of the currency board. Any further reduction could shatter the country's social peace. Although NGO experts support the increase in the share of investment going to transport infrastructure, they are sharply critical of the Government's failure to use EU structural funds allocated to Bulgaria during its first two years of full membership. Only 0.6% of the EUR 2.2 billion had been spent by the end of 2008. Lack of financial capacity, excessive bureaucracy and scarcely transparent procedures have all prevented the funds from reaching their intended beneficiaries.

NGOs insist that both employers and the Government take emergency measures to rein in inflation, negotiate compensation for decreases in real income, guarantee wages, assess the impact of the crisis on the most vulnerable groups in society and take measures to protect basic social and economic rights. ■

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5 Government of Bulgaria. "Plan for economic stability and progress in 2009" [only in Bulgarian]. Available from: <www.government.bg>.

6 International Monetary Fund. *World Economic Outlook*, April 2009.

7 Ministry of Finance. *Report to the Draft Law on State Budget for 2009* [only in Bulgarian]. Available from: <www.minfin.bg/>.

8 Government of Bulgari, *op. cit.*, p.1.

9 Confederation of Independent Trade Union, *op. cit.*

10 Bulgarian workers and employees continue to receive the lowest remuneration in Europe**,** while the level of prices remains comparatively high – with an average monthly salary of EUR 255 (USD 339). This means that with 20% of the average European salary one must cope with price levels that come up to approximately 46% the average European price levels. – This is one of the main claims of the Confederation of Independent Trade Unions (KNSB) for a just and decent pay. May 2008.