

Economy: External pressures fail to eradicate optimism

By Kerin Hope

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Anelia Gigova, a headhunter, keeps the latest UK human resources software in her office in suburban Sofia. But she has few opportunities to use it as the shortage of suitable candidates becomes acute.

"With the economy growing very fast, the problem's got worse. It's particularly hard to find accountants and chief financial officers for fast-growing companies," Mrs Gigova says.

Accelerated growth and high emigration has seen Bulgaria's unemployment rate fall below 6 per cent. Though this figure falls well short of the EU-27's best performers on unemployment, it represents "something quite close to full employment because of the large number of people over 50 and the Roma community, many of whom lack the skills needed to join the workforce," says Plamen Oresharski, the finance minister.

While wages have risen sharply since EU accession in 2007, with increases for private-sector workers averaging about 23 per cent last year, Bulgarian incomes are still the lowest in the Union.

Mr Oresharski points out that, in spite of wage rises, operating costs in Bulgaria still lag behind central Europe. He is optimistic that a more favourable tax regime – from this year, personal as well as corporate incomes will be taxed at a flat rate of 10 per cent – will help to sustain foreign direct investment close to last year's level of €6bn.

The government forecasts gross domestic product to grow this year by 6.4 per cent on top of 6.2 per cent in 2007. Private economists are less optimistic, predicting 5-6 per cent but the economy outperformed in the first quarter, expanding on an annual basis by as much as 7 per cent. The construction industry experienced a 25 per cent first-quarter rise in exports, reflecting increased investment in the run-up to EU accession – and it is still growing, with Russians and Romanians replacing the UK and Irish buyers who used to drive the second-home market and strong local demand for new housing.

Yet growth is accompanied by soaring inflation, a high current account deficit and strong credit expansion – challenges that loom large as the Socialist-led coalition government heads into an election year. The annual inflation rate reached 14.3 per cent in May, driven by increased prices for oil and food. Still, the monthly increase stood at just 0.9 per cent, bolstering hopes that the year-end inflation target of about 8 per cent can still be achieved.

The current account – equal to 21 per cent of GDP last year – also gives cause for concern. It is set to decline only marginally this year and, in contrast with the past, is unlikely to be covered by inward investment flows.

Domestic demand has slowed but is still buoyant, fuelled by remittances from Bulgarians working abroad, as well as rising incomes at home and the continuing availability of credit from the Sofia-based subsidiaries of Austrian, Italian and Greek banks that escaped exposure to the subprime loan crisis.

The central bank lacks monetary tools to tackle inflation because of Bulgaria's currency board arrangement, which pegs the lev to the euro at a fixed rate.

In a bid to slow rapid credit expansion, the central bank last September increased the banks' minimum reserve

requirement by 50 per cent to 12 per cent of liabilities. "We had to drain liquidity at a time when it was disappearing rapidly elsewhere in Europe because of the credit crunch," says Ivan Iskrov, the central bank governor. "But there's still a strong appetite for lending because of much higher spreads than in the banks' home markets." He forecasts that credit growth will slow to about 45 per cent this year from 62 per cent last December, "which is not so high given that we started from a very low base compared to western Europe". It is left to the finance ministry to combat eroding competitiveness through tighter fiscal policies and further structural reforms. An important strategy is to maintain a sizeable budget surplus – set to increase this year to 3.3 per cent of GDP from 3 per cent in 2007.

Five years of sustained surpluses have enabled the government to reduce the public debt to about 15 per cent of GDP, and build a fiscal reserve of around €11bn, equivalent to 20 per cent of GDP.

"In a time of growing uncertainty a higher surplus is needed to show that imbalances are being addressed. But it's hard because the government needs to spend on renewing infrastructure, and on healthcare and pensions," says Michael Masourakis, chief economist at Greece's Alpha Bank.

The government already faces pressure to loosen fiscal policy ahead of next year's election. Trade unions are demanding the minimum monthly salary should be doubled to €400 (\$625).

Mr Iskrov dismisses the suggestion that the currency board arrangement could be threatened by the present turbulence. One indicator of its stability is that the total amount of lev in circulation is 180 per cent covered by the country's reserves or euros, he says.

He is optimistic about the chances of achieving a "soft landing", in spite of a deteriorating global outlook and recent problems in the Baltic states, with which Bulgaria is often compared.

Mr Iskrov says: "Bulgaria is not like the Baltic countries. Our banking system is more diversified and the foreign players here, unlike the Scandinavian banks, have access to the European central bank for funding because they are part of the eurozone."

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