ECONOMIC DEVELOPMENT OF BULGARIA AND ROMANIA IN THE POST CRISIS PERIOD

Iskra CRISTOVA-BALKANSKA[1]

Abstract

The success of the integration process of Bulgaria and Romania is reflected by their nominal and real convergence process. These tendencies are of special importance considering further economic development of Bulgaria and Romania, and the shortening of the economic distance with more developed economically EU countries. The real convergence process is important considering the future entrance of Bulgaria and Romania in the euro area. The contribution is trying to divulge the experiences gained in real convergence in both countries, the catch up process and the future prospects.

Keywords: Economic growth, FDI, economic convergence, catching up process, EU structural Funds

JEL Classification: F15,F21, F63

EU membership, economic growth and investments in Bulgaria and Romania

Bulgaria and Romania are considered with similar paths to market transition and integration to EU structures. However, they differ in size of economies, in some features associated with industrialization, different macroeconomic developments, because of the adopted strategic choices of monetary policies. The monetary and fiscal policies in Bulgaria, which adopted the currency board regime, have guided the country's economic activity to the private sector, which thus become the central point of economic shocks and mechanism. Discretionary policies applied by the Romanian Central Bank influenced the policies towards the accumulation of public finance deficit. Differences in monetary policies applied respectively in Bulgaria and Romania have had an impact on the entire economic and political system of the two countries.(Nenovsky et al.2013)

Despite the differences in monetary regimes, the integration of Bulgaria and Romania to the EU had the same positive impact on the realization of economic growth, driven by private consumption, the investment activities, the increase of export, the stabilization of the financial sector, and the decrease of the unemployed persons.

Bulgaria held, according to the currency board arrangement, strict financial discipline. Budget surplus has amounted to 3% of GDP. Financial discipline allows tax cuts, aimed at the attraction of investments into the economy from local and foreign investors, and the easing the tax burden on the population. Under the currency board, the lack of monetary policy is compensated by the accumulation of funds in Bulgarian National Bank (BNB), which were a buffer against the occurrence of a liquidity crisis and other external shocks. Banks' credit growth contributed to maintaining production and employment and for the expansion of the domestic consumption. The Foreign trade policy has been characterized by the rapid increase in imports at the expense of the slower increase in exports and the trade balance deficit of the current account balance was negative. The Increased consumption, investment activity, and the lower taxes allowed the maintaining a high current account deficit of the balance of payments. The main concerns about macroeconomic stability in Bulgaria came from the growing current account deficit of the balance of payments and the increase in domestic credit. Foreign direct investments (FDI) in Bulgaria also have increased in line with the increase in domestic consumption, which grew in Bulgaria by about 6.4%.

In Romania, FDI have increased, attracted by the structural reforms and the improving of business climate. FDI contributed to employment growth, which so far has been heavily dependent on long-term reduction of production in labor-intensive economic sectors of the Romanian economy. Attracting FDI in the Romanian economy allowed the inclusion of Romanian industries in European value chains network. This improves the structure of Romanian exports of goods with higher added value.

[1] Economic Research Institute, Bulgarian Academy of Sciences

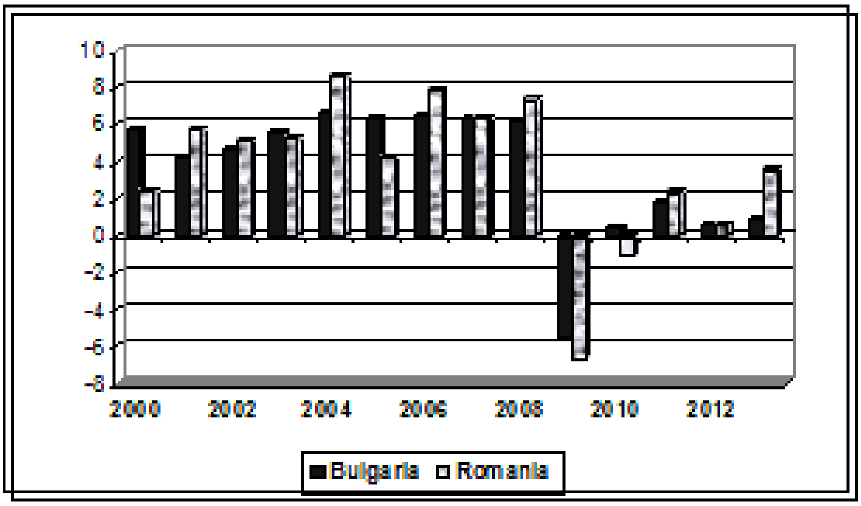

Figure 1. Real GDP Growth Rate of Bulgaria and Romania 1 Year % change (2000-2013)

Source**:** Eurostat data

Economic growth in Romania is 8.4%, decrease to 4.1% (2005) and in 2006 is increasing again to 7.2%. The main engines of the Romanian economic growth were the industrial activity, the construction and the agriculture. The average economic growth rate of Bulgaria and Romania averaged 6% per year, compared to 1.7% (2005) and 2.8% (2006) respectively for the EU-25. (Figure 1)

The favorable economic situation in EU is influencing positively growth of Romania and Bulgaria in the years 2006, 2007,2008.

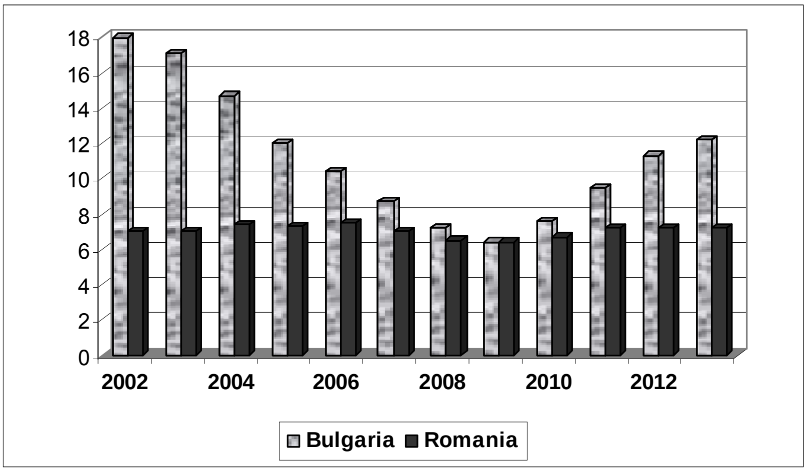

Figure 2. Unemployment rate - 3 year average %, 2002 2013.

Source: Eurostat

Unemployment rate in Bulgaria averaged 10.10% from 2003 to 2014, reaching 15.6 % in 2003 and 5% at the end of 2008. The unemployment rate in Romania averaged 7.01% from 2006 until 2014, reaching 8.10 % in March of 2010 and a record low level of 5.40 % in September of 2008. (Figure 2)

FDI is an indispensable part of the economic development strategy. FDI stock is between 20-30% of GDP in Bulgaria in 2005-2008 and around 10% of GDP in Romania (2004-2008). FDI stock is between 20-30% of GDP in Bulgaria in 2005-2008 and around 10% of GDP in Romania (2004-2008). In Romania this process accelerate after 2004. Most of the total FDI stock comes from the EU countries, and about 50% of the total stock stems from just three countries: Austria, the Netherlands and Germany. The privatisation-related FDI, which have been significant in sectors like public utilities (gas, electricity, telecommunications), the banking and construction sector, represent half of total FDI from. Austria, Netherlands and Germany.

Romania and Bulgaria have been attractive for foreign investors investing in labor intensive production, while the most advanced “Visegrád” countries (Poland, Czech Republic, Slovakia, Hungary) were most preferred destinations for high technological investments. (Figure 4)

The economic crisis discontinued the tendency of economic growth and this changes the macro economic balance in Bulgaria and Romania. The two economies suffered from the impact of the global economic recession more than some countries in Central Europe (Poland). GDP in Romania fell in 2009 by 8% and in Bulgaria with 5.5%. (Figure 1) The unemployment rate in Bulgaria decreased to 11.40 % in the second quarter of 2014 from 13 % in the first quarter of 2014. The unemployment rate in Romania remained unchanged at 7.10 % in August of 2014 from 7.10 % in July of 2014.

Gross fixed capital formation (GFCF) decreased more in Romania in 2006 and 2007, and in 2008. The GFCF in Bulgaria increased in 2008, was insignificant in 2009 and after that started to growth. (Figure 3)

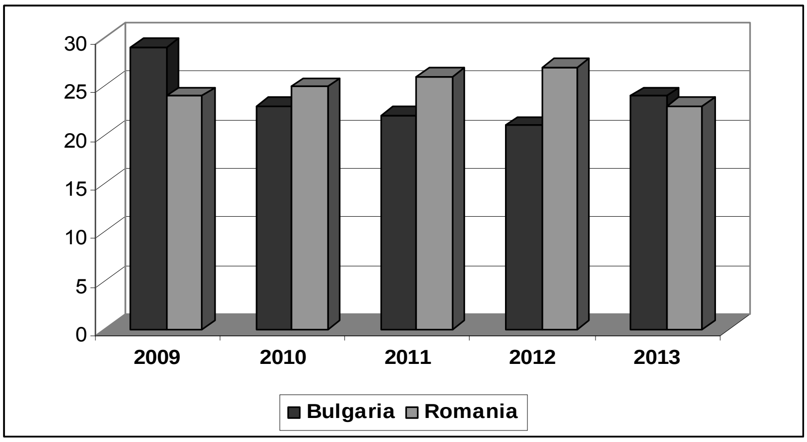

Figure 3. Gross Fixed capital Formation (GFCF) as % of GDP for 2009 to 2013.

Source: World Bank data

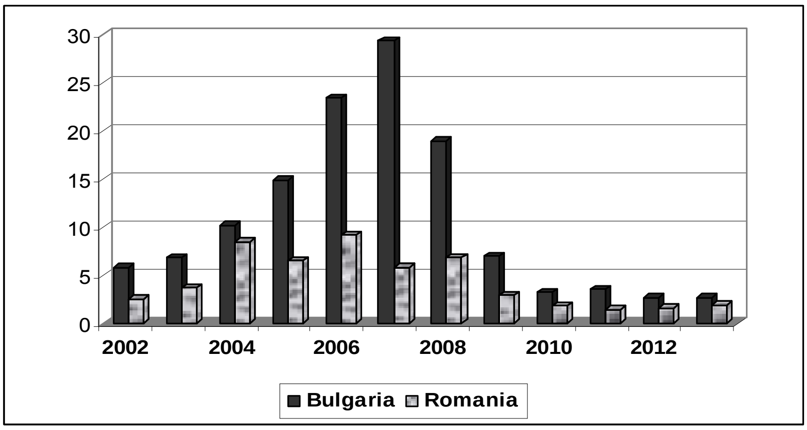

Figure 4. Inward FDI as a % of GDP of Bulgaria and Romania 2002-2013

Source: Eurostat, World bank data

The contraction of FDI has led to the deterioration of financial conditions in domestic credit. The high cost of financing of the economy and the further deterioration in the economic outlook has forced banks to limit lending. Bulgaria and Romania, whose GDP growth was fueled largely by foreign capital inflows, felt sharply their reduction, because the two countries relied on foreign capitals to finance credit expansion. This explains to some extent sharp contraction of output in the two countries. In Romania (and also in the Baltic countries) the credit growth fell by an average of more than 35% between the last quarter of 2008 and third quarter of 2009. (ECB, July 2010, p.88). Conversely, countries with greater reliance on the domestic sources of financing had not been so affected by the acute fall in loans to finance the economy.

In Romania has a stable outlook and real GDP growth in 2013 is 3.5%, thanks to exports of industrial production and good agricultural harvest. However the economic growth is expected to slow in 2015 to 2.5%.

Three years since the IMF and the EU financial assistance the Romanian economy achieved some positive economic achievements. The financial assistance program improves of the effectiveness of production and the rigidity labor market was overcome with the amelioration of economic growth. Main engines of growth are net exports and possibly boosting domestic demand. The credit is still relatively low in 2013 and this is due to abstinence from consumption of households and the need to reduce the debt of the banking sector, after the deterioration of the securities during the crisis. Since the entry into EU, the governments one after another, all had applied rigorous management of public finances and until 2009, the Bulgarian budget was in surplus then in response to the crisis the deficit reached 4.3% in 2009 to 2.1 in 2011. The weight on the total public debt (15.3% of GDP in 2011) is bearable and low compared to the EU average,

Bulgaria's economy expanded by 0.9% in 2013, while GDP growth for 2012 was revised marginally down to 0.6% of GDP. Private consumption and investment contracted in 2013, while exports and public expenditure supported the modest economic growth. Growth is projected to broaden and increase gradually to 2.0% in 2015, as domestic demand is forecast to recover and complement exports, which have been the main driver of growth thus far.(Figura 1) The increase in domestic consumption and investment will pull up the imports and may turn fragile the increase of net exports. The surplus in the current account of the balance of payments (BOP) reached 2% of GDP in 2013, but is expected to decline by 2015. In Bulgaria household purchasing power fairly increases relative to wage growth combined with a low inflation. Interest rates decline improve credit conditions. However, households are cautious in spending money.

There has been some improvement in consumption, despite that private consumption dropped by 2% in 2013. Investments are recovering, but they are still low. Investments are supported by the relatively stable banking sector, however tension in the financial system appear with the closure by the Supervisory Bodies of the BNB the Corporate Commercial Bank.

Romania has taken actions towards the participation in the Single Resolution Fund and will take the necessary steps to join the Bank Union. These reforms include the privatization and the measures aimed at boosting sales performance, the reform of public investments, the payment of arrears and the improved EU funds management system. These reforms underpin fiscal consolidation and nominal convergence as well. In parallel, the structural reforms required the restructuring and improvement of debt management. In Romania, the effects of the economic slowdown in EU economies and the debt crisis have tarnished the upturn. The credit to enterprises and households is continuing to be scarce because the foreign affiliates of Greek and Austrian banks are not ready to ease the financing of the Romanian economy. The public sector salaries are frozen after been devaluated by 25%. Romanian economy is also in an adjustment phase and not still in the process of convergence. In parallel, the important economic progress in 2013 and the outlook of preserving this trend in the upcoming years give confidence that Romania will made important progress with structural reforms, which helps meeting the real convergence criteria.

Economic convergence or divergence and economic development

Seven years after the accession into the EU, Bulgaria and Romania continue to substantially lag behind in the process of catching up with the more developed countries in Europe. According the report on "European Catch up Index", Bulgaria is on the bottom of the overall ranking among the EU member states as well as in four categories of the index . In some indicators of quality of life, the country is behind neighboring candidate countries like Serbia and Montenegro. Bulgaria occupies 29th position among 35 countries in the ranking by overall score, sliding one notch down in comparison to the 2011 index. Economy is the category where the country performs the best in relative terms at 28th position. Among the individual indicators, Bulgaria performs well in the level of government debt. (Second ranking after Estonia.) And the worst ranking is for energy efficiency with a score of 35. Regarding the processes in Europe the index registers the effects of the economic crises in Europe and outlines the possible groups in a Europe of different speeds. The most lagging behind countries are Bulgaria and Romania. This confirms the tendency for an increasing divide between the West, the Central and the Southeastern Europe in economic standard and accumulation of wealth. For them is very difficult to become competitive economies soon , given that the standard of living, level of production, training of workforce and professional realization, financing of R&D and innovation need deep structural reforms.

The catch-up and convergence process can not be regarded as an automatic result of the integration of Bulgaria and Romania in the EU. The catch-up process was accelerated after the EU integration; however the incomes have not been substantially increased.

Compared with other EU NMS, wages growth in Bulgaria appears high even when they are adjusted towards the relatively high productivity growth. In 2007-2009 unit labor cost (ULC) of Bulgaria has deteriorated and the ULC-deflated real effective exchange rate (REER) has appreciated. (Figure 5) Nevertheless, while wage cost competitiveness has deteriorated rapidly, other indicators of external competitiveness appear more favorable. Notably, a solid rise in global market shares suggests that rising unit labor costs were compensated for by non-cost factors like quality improvements and temporary factors like favorable export price trends in world markets (European Commission, 2012).

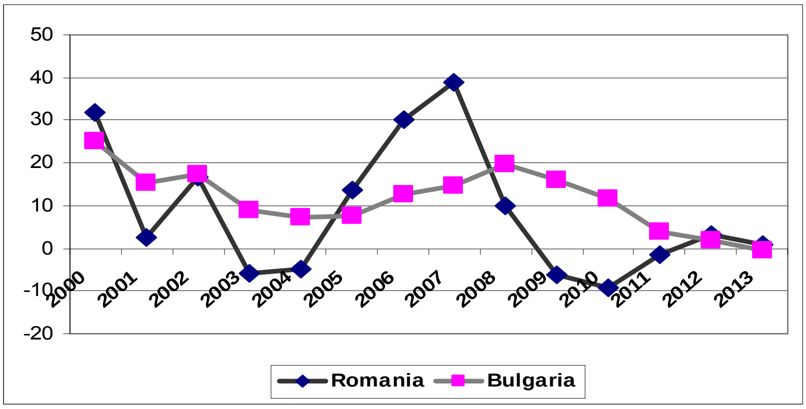

Figure 5. Real effective exchange rates - Euro area trading partners - 3 year % change

Source: Eurostat

Also, while the wage rates appear rapid, the starting position was relatively low. Bulgarian external competitiveness might be helped by having the still-lowest wage level in the EU. In 2013, the average hourly labor costs in EU 28 (excluding agriculture and public administration) were estimated to be €23.7 and €28.4 in the euro area (EA17). This average masks significant differences between EU Member States, with the lowest hourly labor costs recorded in Bulgaria (€3.7), Romania (€4.6). In purchasing power standards, wages in Bulgaria amount to 37% of the EU average, at par with Romania.

At first sight, the lower hourly labor costs in Bulgaria and Romania seem to be a strong competitive position relative to other higher-wage EU countries. The level of productivity in Bulgaria is the lowest in the EU, with nominal GDP per capita head at 20% of the EU average, or 45% when adjusted for purchasing power standards. (Figure 6) Competitiveness does not yet seem to be strongly affected by the ULC increases, wage growth over 2009-2011 is not in line with the labor market equilibrium, as manifested by rising unemployment. In the future, wage levels will most likely converge towards the EU average as productivity levels also converge.

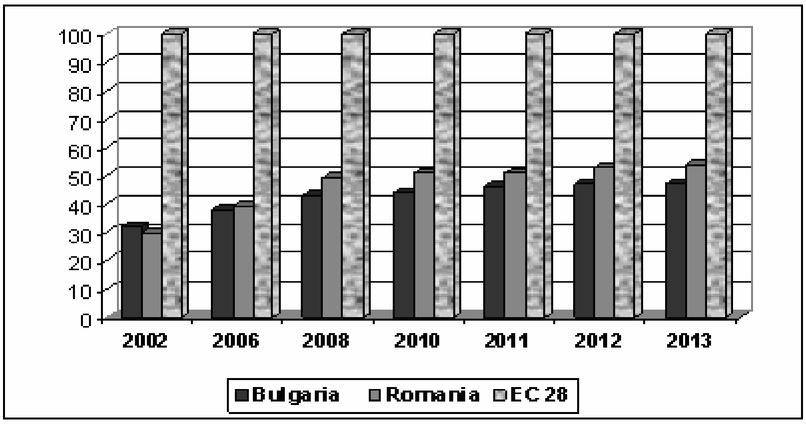

Figure 6. GDP per capita in PPS, Index (EU28 = 100)

Source: Eurostat

Real convergence inside and outside the euro area is a determining factor for economic strategy and policy for most of the NMS in the medium term. The equilibrium real exchange rate appreciation (price level convergence) is considered a natural consequence of the economic catch-up (De Grauwe and Schnabl (2005). Appreciation of the real exchange rate, which depends on monetary policy and exchange rate levels, could be implemented by the nominal exchange rate and its appreciation and / or increase in domestic inflation. The rate of convergence of incomes, increased domestic demand than GDP and the exchange rate regime are significant determinants of the price level of the dynamics of convergence of prices. (Darvas and Szapáry (2008)).

In the short-term factors such as the nominal exchange rate and its movement, the effects of changes in food prices and general global resources may temporarily divert inflation trends that support the convergence of prices. Some structural factors such as trade liberalization, competition in product markets may have similar effects. Not all differences in inflation would be consistent *with the need to need*. At the same time not all inflationary differences might be consistent with the need for ensuring competitiveness and external stability of the economy in the medium term. In some NMS unsustainable domestic demand causes high inflation. The processes were fueled by very optimistic expectations of economic agents or inadequate economic policies.

Looking at the price convergence, over a longer period back, consumer price inflation in Bulgaria has been volatile, ranging from 0.4% to 12.0% on an annual basis over the past ten years The increase in inflation in 2004-08 reflected adjustments in administered prices, the harmonisation of excise duties with EU levels, a series of supply-side shocks and increasing demand pressures. The sharp fall in inflation in 2009 was partly a result of lower commodity prices and the contraction in economic activity. In 2010 and 2011 inflation gradually picked up again, to 3.0% and 3.4% respectively, largely reflecting higher commodity prices.The easing of commodity price pressures combined with weak internal and external demand resulted in the gradual decline in inflation in 2013.

Insufficient EU Funds in Bulgaria and Romania The Structural Funds and the Cohesion Fund of the EU are considered to have an impact on the "catching up" process. By their size, they can stimulate and have an important impact on economic development of the two countries. The Funds can be quickly committed and absorbed by the market and reduce the unemployment. In Romania, these funds could represent each year 3.8% of GDP increase.

The launch of the operational programs was difficult in both countries, as the lack of experience and lack of especially formed adequate administrative and legal capacities are the main causes. Projects began to be implemented in Bulgaria in early 2009. As for the commitment rate in January 2012, they amounted to 15% in Romania and 19% in Bulgaria. These are the lowest rates in the EU27. The absorption rate would amount to respectively 19% and 4%.

Everything has already been said about the irregularities in the tendering and certain bad practices that come from the lack of control from the management authorities (some of them have also lost the approval of the European Commission). The payments have been suspended in Romania in 2011 and 2012, because of irregularities in a development program of human resources funded by the European Social Fund (ESF). This resulted in six months interruption and Romania has to improve the measures and the operation of the system of management and control of the program. The low level of absorption of European funds shows the difficulties of Bulgaria and Romania, because of the rules of law are not completed and the administrative and the judicial officials are not reliable yet. In 2011 and 2012 the performance of the utilization of funds had increased in Romania and Bulgaria because it has been necessary to demonstrate a more convincing behavior when have been negotiating the new EU funds allocations for 2014-2020. IBulgaria has consumed only 19% of the allocated sums during the period 2007-2013. Absorption of EU structural and cohesion funds in Romania increased in 2013 and reached 33.7% utilization of funds by the end of December 2013.

For 2014 – 2020 EU Structural and Investment Funds allocated to CEE 6[2], EUR 167 bn over the half of the total EU funds. Romania and Bulgaria, as the least developed members of the EU, were allocated a lower total amount of EU funds than they should have been. To balance that, the two countries will also receive financial assistance from other European programs, such as the Common Agriculture Policy.

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[2] CEE6 – Czech Republic, Slovakia, Hungary, Romania, Croatia, Poland.

An expectation for the deepening of collaboration and strengthening of economic relations of Bulgaria and Romania is the EU cross-border co-operation programme, launched in 2007. The programme is expected to have a significant impact on economic development, the environment and mobility in the cross-border region. The eligible area is characterized by marginality and isolation from the economic and decision-making centres. Borders limit economic, social and cultural exchanges and affect the joint, efficient and effective management of the territory.

Conclusions

The continuation of the reform process, in Romania particularly the fiscal consolidation process, based on the preventive financing agreement concluded with the EU, IMF and the WB can bring coherence to the macroeconomic and financial policies, thus adding to the consolidation of investors' confidence and preserving the macroeconomic and fiscal stability. In the medium run, the specific objective of the budgetary policy is to further adjust the budget deficit, with the planned targets situated at 2.2% of GDP in 2014 and below 2% of GDP for the interval 2015-2017 (according to ESA). Broad balanced macroeconomic development for Romania is downside risks to economic growth which include the effects of faster deliveraging by households and by financial institutions. In terms of economic development it is necessary to attract effective FDI and to increase the effective absorption of European funds. However, the imbalances persisted and Romania still faced the pressure for the implementation of structural reforms on the basis of the stabilization of public finances.

From a macroeconomic perspective, the most serious risk for economic development and the catch up process stems from less-expected economic recovery in Bulgaria. The household consumption remains low and it is due to contracted Bulgarian labor market and low consumer confidence. However, in periods of weaker domestic demand the Bulgarian economy has been able to partly compensate this with higher net exports. The decline of FDI entries in Bulgaria can be stimulated by the improvement of EU Structural Funds absorption rate.

If Bulgaria and Romania achieve a higher level of utilization of EU funds, they will be able to reduce the economic gap with the EU Central European states. . In the long term, Bulgaria and Romania have a long road ahead in terms of improving their still low absorption capacity. To achieve that, they need to significantly reduce bureaucracy, introduce more transparent processes of project selection, and establish closer regional cooperation. Economic catch-up and development depends largely on the implementation of policies that support economic growth and macroeconomic stability in the context of EU objectives. This will be a difficult task in the context of increasingly intense international economic and political environment.

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