The economies of Bulgaria and Romania

New EU Member States Bulgaria and Romania have hit the ground running as they endeavour to narrow the economic gap between them and their peers. Despite the very real challenges facing the two countries, robust economic and investment growth are making the painful transition period in the early 1990s following the collapse of the Soviet bloc an increasingly distant memory.

Bulgaria and Romania both entered the European Union on 1 January 2007, bringing some 30 million new citizens into the EU fold. This fifth enlargement round means the Union is home to half a billion people and is the world’s largest economy, which has been the case since the 2004 expansion.

“Romanians have a reason for national pride,” Romanian Prime Minister Calin Popescu Tariceanu said when his country’s entry was confirmed in September 2006. Bulgarian President Georgi Parvanov indicated his country’s interest in fulfilling the remaining requirements identified by the European Commission in its final pre-accession monitoring report, which called on the two countries to step up their judicial reform process and combat corruption.

While there are differences between Bulgaria and Romania – particularly in terms of economic size, the level of industrialisation and macroeconomic performance – the two new Member States do share several common features. They both faced a significant outflow of labour in the wake of the economic upheavals in the 1990s. Today, they are both undergoing rapid economic growth (see figure), yet are suffering from relatively low employment levels and serious labour shortages in certain high-skill sectors.

The Bulgarian economy

The 1990s were tough for Bulgaria, faced, as it was, with the loss of its main export markets in the Comecon (the economic counterpart to the Warsaw Pact), the disintegration of neighbouring Yugoslavia and a deep financial crisis in 1996/97. Sanctions against Serbia and Iraq also hurt the Bulgarian economy.

Painful reforms and EU assistance helped Bulgaria navigate its way out of the quagmire and start to improve on pre-1990 living standards.

Nowadays, Bulgaria’s real economic growth rates are more than double the EU average. Real annual GDP growth stood at 5.5% in 2005 and accelerated to 6.1% in the first half of 2006, compared with 1.7% and 2.8% respectively for the EU-25. Along with investment, consumption, which grew by 6.4%, was the main driver of growth. Despite this progress, Bulgaria still has a long way to go before its economy catches up with the rest of the Union. In 2005, Bulgaria’s per capita income was 32.1% of the EU-25 average.
Bulgaria is one of the few European countries running a public sector surplus. For 2006, this is likely to exceed 3% of GDP. This kind of fiscal discipline has helped Bulgaria to lower taxes and to contain a high and growing external deficit. It also means that the country already meets the budgetary conditions for euro introduction. But other challenges remain, for example, in terms of inflation.

Employment has also been growing steadily. By the second quarter of 2006, unemployment had fallen from just over 10% in 2005 to 9% of the workforce. However, the employment rate is still lower than the EU average.

Although the growth of exports outpaced that of imports, the trade deficit rose slightly again in the first half of 2006 to 20.5% of GDP. This pushed the deficit in Bulgaria’s current account up further, to 13.9% of GDP.

Credit where it is due

Bulgaria’s most glowing achievement in recent years has been the stability it has brought to its economy. Following the financial crisis of 1996/97, the government introduced a Currency Board to anchor the economy and facilitate the implementation of important structural reforms – moves which boosted investor confidence.

"Bulgaria’s ambitious structural reforms and very prudent fiscal and wage policies have helped the country to achieve a remarkable level of macroeconomic stability," explained Peter Grasmann, Head of the DG ECFIN Unit for economic affairs within the candidate countries. Despite this enviable level of stability, challenges remain in terms of Bulgaria’s large current account deficit and high credit growth rate, both of which are fairly common manifestations of rapidly growing economies.

Overall, the future looks promising. “Economic growth is expected to accelerate further in 2007 and 2008 as strong investment growth and ongoing enterprise restructuring continue to bear fruit," the ECFIN autumn forecast predicted. Real GDP growth is expected to top 6% in 2008 and the increasing absorption of EU transfers together with continued strong foreign capital inflows will help to sustain relatively high rates of investment growth of around 14% per year. The unemployment rate is expected to drop further and is likely to reach around 7% by 2008. At the same time, a rapidly ageing and declining population limits the potential for further employment growth. Increases in real wages are expected to keep pace with productivity gains. EU membership will also bring its own challenges: implementing the remaining reforms necessary for eventual euro entry and ensuring the efficient use of Structural Funds.

The Romanian economy

Four decades of central economic planning, an obsolete industrial base and a focus on self reliance (i.e. trying to produce everything locally) brought
Romania’s economy to the verge of economic collapse in the final years of the Soviet bloc. The 1990s were a veritable economic roller-coaster ride for Romania, and it was not until 2000 that the economy began to grow on a sustainable basis.

Today, Romania is in the midst of a robust rebound. In 2004, the economy grew by an impressive 8.4% – which slowed somewhat to 4.1% the following year – and, in 2006, growth was expected to bounce back strongly to 7.2%, “driven by a broad-based recovery in industrial activity, construction and agriculture”, according to the ECFIN autumn forecast. It is also underpinned by a significant rise in private consumption – which grew by nearly 10% in 2005 – and in investment, which increases by 15%.

Foreign direct investment – lured by accelerating structural reforms and an improving business environment – has played a particularly important role. It has increased from less than 3% of GDP in the period between 1995 and 2000 to almost 5% of GDP between 2001 and 2005. “Foreign investors have helped pull Romania up the value chain, as demonstrated by the notable change in the make-up of exports towards higher-value-added products,” observes Peter Grasmann.

Employment has only recently started to grow, due to the long contraction of several labour-intensive industries, and employment rates remain relatively low. Unemployment amounted to about 7.6% in 2006. Over the next two years, it is expected to remain stable at around the same level, despite robust economic growth.

Growth in imports outstripped the increase in exports, causing the current account deficit to widen to 8.7% of GDP in 2005 and to about 10% in 2006. However, 75% was offset by net foreign direct investment in 2005. This trend was likely to continue in 2006. For both years, the public sector deficit has hovered around 1.5% of GDP. In 2007 and 2008, it is expected to widen due to accelerated public investment, social transfers and wage expenditure following EU accession. This is not a cause for undue concern, since Romania has a low level of public debt of around 15% of GDP.

Staying on track

One major challenge Romania needs to tackle is to continue structural reforms and sound fiscal policies after accession. Large quasi-fiscal deficits and payment arrears were an endemic phenomenon throughout Romania’s economic transition, but efforts to improve fiscal transparency have been stepped up in recent years – as a special ECFIN Country Focus (1) describes. However, Romania’s similarly good performance when it comes to budget revenues needs to be matched by an equal improvement in the quality of public spending.

Romania struggled in transition to turn around its obsolete industrial base. Having now taken large strides in this area, manufacturing is set to become...
one of its key strengths once it successfully converges with the rest of the EU. The country’s considerable potential rests on its broad industrial base, rich agricultural land, diverse energy sources and well-trained workforce. Over the next two years, real economic growth will remain robust at 5.8% (2007) and 5.6% (2008) and domestic demand will remain buoyant. But an attractive business environment and the efficient use of a growing pool of available resources will be crucial for preserving momentum in the economic catching-up process.