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www.eurobank.gr/research
research@eurobank.gr

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NEW EUROPE
ECONOMICS & STRATEGY

February 8, 2013

FOCUS NOTES: BULGARIA

Written By:

Ioannis Gkionis:
Research Economist
Coordinator of Macro Research

Fiscal deficit target outperformed in 2012

- Strong budget execution resulted in outperformance of the full-year deficit target: the general government deficit on cash basis came at 0.45% of GDP in 2012 vs. 2% of GDP in 2011
- Fiscal policy to become more growth supportive in an election year 2013 on higher minimum wages and pensions
- The yield of the 10Y government bond has declined below pre-crisis levels. Standard & Poors affirmed the investment grade rating of Bulgaria.

Strong budget execution on the expenditure side resulted in outperformance of the full-year deficit target of 2012

The budget execution data reveals that the full-year deficit target of 2012 was outperformed. The general government deficit (cash basis) declined by 78% yoy to BGN 350mn. According to the Ministry of Finance, the full-year general government deficit in both cash basis and ESA terms is estimated to have outperformed the initial budget target of 1.4%-of-GDP, declining to 0.45%-of- projected GDP in 2012, against 2% of GDP in 2011 and down from 4%-of-GDP in 2010.

Budget revenues improved in 2012, albeit remaining below their pre-crisis levels. Total proceeds expanded by 8.2% yoy, to BGN 27.4 bn assisted by improved tax collection and higher domestic inflation in the second half of the year. The direct connection of companies with the National Revenue Agency (NRA) through an integrated system helped in better VAT tax collection. However, total revenues still lagged behind a corresponding full-year budget target of BGN 28.7 bn. As a percentage of projected GDP, total revenues reached 35.4%, up from 33.7% in 2011. Delving into the revenue side, stronger indirect taxes (+6.8% yoy) boosted tax revenues by 4.5% yoy. Revenue from VAT and excise duties expanded by 6.9% yoy and 5.5% yoy respectively, while custom duties declined by 9.8% yoy. In contrast, direct taxes were up by only 2.7% yoy which reflects the weak labor market conditions. In a similar vein, social security contributions rose by 1.5% yoy.

On the expenditure side, total budget outlays in 2012 grew by 3.2% yoy to BGN 27.8bn, remaining well below the corresponding full-year budget target of BGN 28.9bn. As a percentage of projected GDP, total expenditures reached 31.4%, down from 31.5% in the same period a year earlier. The most important components of budgetary expenditure, i.e., public wages and pensions, remained broadly flat in nominal terms for a third year in a row, while in ppt-of-GDP terms they amounted to 5.3% and 15.3%, respectively from 5.4% and 15.1% in 2011.

More importantly, the under execution of the public investment program facilitated the observed restraint in budgetary expenditure. Only 70% of targeted full-year capital expenditure materialized in 2012 (BGN 3.67bn vs. BGN 5.25bn planned in the budget). In ppt-of-GDP terms, public investment expenditure in 2012 amounted to 4.7%-of-GDP compared to 4.1%-of-GDP in the same period a year earlier.

Bulgaria's fiscal position is one of the healthiest in EU and the region. Standard & Poors affirmed the investment grade rating of Bulgaria.

Bulgaria's full-year deficit compares favorably with the corresponding EU-27 average for 2012 (3.3%-of-GDP as per the European Commission's autumn 2012 Forecasts). Furthermore, the country's public debt is estimated to have reached ca 19.1%-of-GDP in November 2012, the second lowest ratio in the EU in 2011 behind Estonia (Figure 1). After the repayment of the Eurobond (€878 mn to retire the bond placed in 2002) maturing on January 10th and the prepayment of USD 45mn of the bond which matures in 2015, the debt to GDP ratio dropped to 14.75% in January2013. The repayment was financed with the proceeds from the 5 year €950mn Eurobond issued in last July. The debt repayment was accommodated with BGN 1.7bn from fiscal reserve, which dropped further to BGN 4.3bn in the end of January (below the BGN 4.5bn threshold) vs. BGN 7bn in the beginning of 2013.

All in all, the latest budget execution data reinforce our long-held views about the soundness of Bulgaria's fiscal position and the strong track record and consistency of policymaking. This strong track record of fiscal prudence, the low deficit and debt stock is acknowledged by rating agencies so that Bulgaria never lost its investment grade status in the post Lehman period. In late December, Standard & Poors affirmed Bulgaria's credit rating at BBB/A-2. The borrowing costs have declined below pre-crisis levels. The yield to maturity of the 10Y government bond has followed a strong declining trajectory after past July. The yield stood little above 3% in early February 2013 compared to 5.3% in the beginning of 2012. (Figure 2)

Fiscal policy set to become more growth supportive in 2013 driven by increases in pensions, minimum wage and pre-election spending

Looking ahead, the budget targets for the first time after many years a small increase in the fiscal deficit. The budget of 2013 envisages a small widening of the consolidated government deficit (on a cash basis) from 0.45% of GDP in 2012 to 1.3% in 2013. The revenues target is set at 30.6bn Leva (37.5% of projected GDP) increased by 11.4% compared to the realization in 2012. On the expenditures side, the target is set at 31.7 bn Leva (38.9% of projected GDP) increased by 14% compared to the realization in 2012.

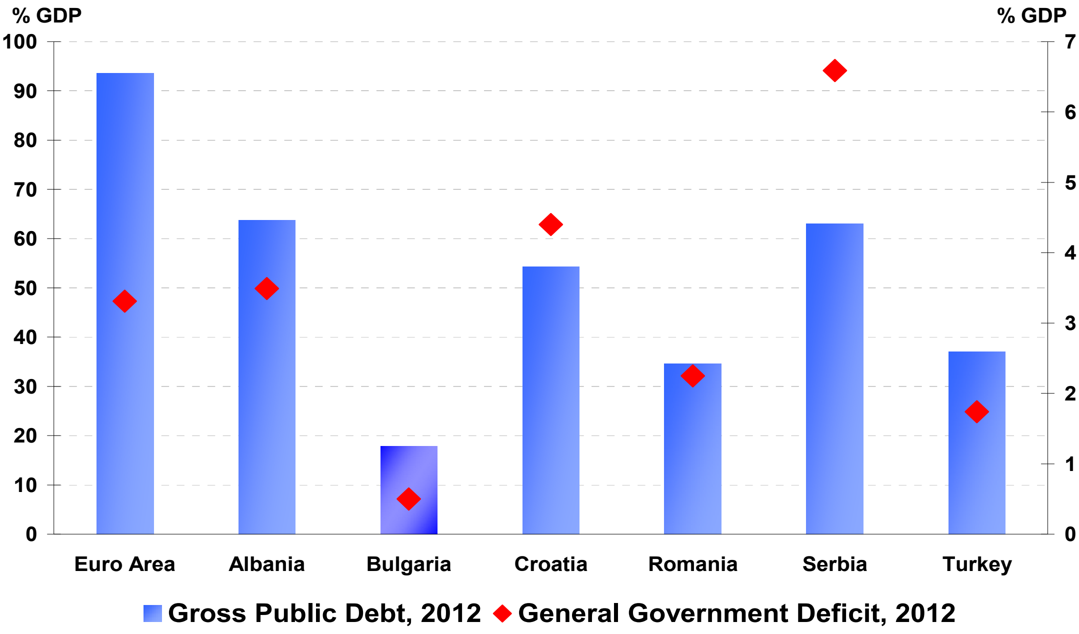
In our view, there are significant downside risks to the implementation of this year's budget. In principle, the achievement of the fiscal target will be harder to attain given that the next parliamentary elections are scheduled for mid 2013. Although provisions for increased discretionary spending have already been made, the government will have a hard task resisting pressures from individual social and professional groups. In any case, even if some fiscal slippage materializes, our base case scenario is built upon the assumption that the fiscal deficit will remain well contained below the 3% of GDP Maastricht threshold.

On the revenues side, the budget assumes that consolidated government revenues will increase by 2% of GDP. Improved EU funds absorption accounts for 80% of that increase which looks overly demanding, if not optimistic. From that point of view, EU transfer receipts ought to increase by 64% to reach 4.5% of GDP in 2013 vs. 2.9% in 2012.

The rest of the increase in revenues-0.4% of GDP-ought to come from the national budget revenues which appears more feasible. To accommodate that purpose, the national budget provides for realistic yet limited revenue raising initiatives. Namely, the budget provides for the imposition of 10% flat tax on interest earned from bank deposits. Until now, Bulgaria was the only country in EU which no such tax was levied on deposits. In principle, that ought to generate BGN 120mn of additional revenue or 0.2% of GDP. The hike in excise taxes of gas and kerosene (from BGN 630 to BGN 645 per 1000l) and the 10% rise in the minimum social security contributions income threshold to capture shadow economy will be utilized to achieve the rest. In contrast, the budget provides for no change in taxation rates. As a result, the personal income tax and corporate tax rates are maintained at 10%, one of the lowest in the EU and VAT tax at 20%. The scope for better tax collection is limited in the short-term given that the interconnection of enterprises with the NRA has largely been completed.

On the other hand, the budget provides for an increase in minimum wages, pensions, public wages of some categories of civil servants and discretionary current spending. Firstly, the minimum wage has already increased from BGN 290 to BGN 310-6.8% rise-since January 1st. Pensions will increase on average by 9.3% effective April 1st. The budget doesn't provide any provisions related to a broad increase of public wages. However, increases within individual categories of civil servants will take place within the budget framework of each ministry. As an illustration of the above policy, the wages of teachers and military personnel are projected to increase by 11% and 7% respectively.

Figure 1: Bulgaria's fiscal position is one of the healthiest in the region and EU-27



Source: National Statistics, IMF World Economic Outlook, Eurobank Research

Figure 2: 10Y Bond yields have declined below pre-crisis levels

Source: Ecowin Reuters, Eurobank Research

Research Team

Editor, Professor **Gikas Hardouvelis**
Chief Economist & Director of Research Eurobank Group

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Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodosios Sampaniotis: *Senior Economic Analyst*
Theodoros Stamatiou: *Research Economist*

Eurobank, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

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