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FOCUS NOTES: BULGARIA

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# Bulgaria: Current account surplus reached record levels in January-August 2011

- Current account surplus widens to 4% of GDP in Jan-August surpassing all analyst expectations
- The shift to a hefty current account surplus is accompanied by an increase in capital outflows

**Current account surplus reached historical high levels in Jan-Aug on even higher surpluses in services and current transfers**

The current account surplus in the first eight months has overshot market expectations. The surplus of the current account skyrocketed to €1.56bn in January-August up from €885 mn in January-July compared to €475mn deficit in 2010, a new historical high in the post Lehman period.

As a percentage of projected GDP, the current account surplus widened to 4% in Jan-Aug up from 2.2% of GDP in Jan-July, against a minor surplus of 0.5% in last May. The improvement in the current account in the last two months primarily reflects the robust performance of services and current transfers.

The surplus of services reached 4.7% of GDP in August compared to 0.8% in last May, six times higher. The most important sub-item, travel, which mirrors the inflow from tourist revenues signals that Bulgaria has had a very good tourist summer season.

In addition, the current transfers' surplus amounted to 3.2% of GDP in August up from 2% in last May on increased EU funds absorption. Meanwhile, the deterioration in the balance of income continued in the first eight months, with the corresponding deficit widening to 2.4% of GDP compared to 1.2% in last May.

On the other hand, the trade deficit has stabilized at relatively low levels. The trade deficit inched up to 1.5% of GDP in August against 1.1% in May. Exports continue their robust rebound, still expanding at an astonishing 34% yoy in Jan-Aug. Even though exports slowed down from 48.4% in Jan-May, they still outpaced imports. Imports expanded by 20.3% yoy in Jan-Aug, down from 25.2% yoy in Jan-May. The Bulgarian economy benefits to some extent from the diversification of its export portfolio to high growth areas as well as high commodity prices. Non EU markets destinations represent now 40% of the total export portfolio (e.g. Russia & Turkey).

**The shift to a hefty current account surplus is accompanied by an increase in capital outflows**

From the financing side, the shift to a hefty current account surplus is recording capital outflows. Bulgaria is running a financial account deficit for a second year in a row. The financial account deficit has reached 4.8% of GDP in Jan-Aug compared to 0.5% of GDP deficit in 2010. If the capital account surplus is included, the deficit is contained at 3.9% of GDP in Jan-Aug compared to a 0.3% surplus recorded in 2010.

The most important component, net FDI inflows have dried up. Net FDI inflows remained subdued amounting to only €225 mn in Jan-Aug compared to €926.5mn a year earlier (down by 75.5% yoy). The drying up of net FDI inflows is particularly important from a policy standpoint of view. The Bulgarian economy was a major beneficiary of capital flows in the broader region in the past booming years, which served as the main engine of domestic growth.

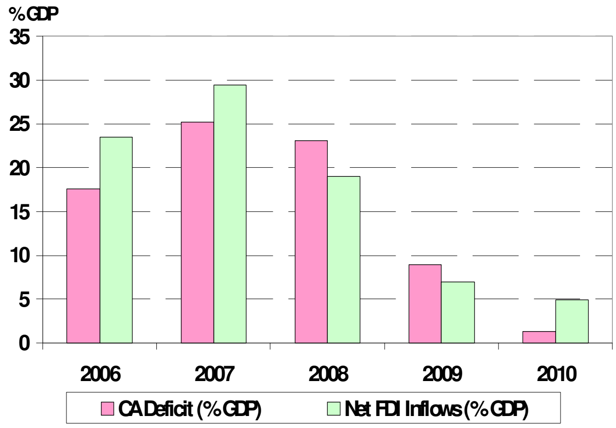
Driven by convergence prospects, the Bulgarian economy received 27.1 bn Euros in FDI inflows during 2004-2008. In the aftermath of the crisis, capital inflows are sharply lower and are highly unlikely to reach their pre-crisis levels. In that challenging environment, it appears that the Bulgarian economy has adjusted relatively well switching the pattern of growth to a more balanced between domestic and external demand mix.

In addition, net portfolio investments remained still negative (-€483mm vs. -€567mn in January-August 2009). More importantly, the financial account deficit has been driven by the negative balance of other investments. Other investments registered a negative balance on both the assets and the liabilities side. The negative balance of €442 mn of other investment liabilities reflects the repayment of foreign debt obligations by the banking and corporate sectors. On top of that, the assets side of other investments registered a negative balance of €1,259mn year to date. The outflow represents deposits of the Bulgarian banking sector overseas. To sum up, the outflows through the channel of other investments have reached a cumulative of €1.7bn in the first eight months of the year.

Overall, if net errors and omissions are included, the balance of payments was positive year to date by €123 mn in the first eight months which explains the slight increase in FX reserves. As a matter of fact, international reserves (FX reserves plus gold and IMF drawing rights) have maintained at relatively high levels (€13.1 bn or 33.2% of GDP in August 2011), enough to cover the country's external financing needs. International reserves coverage of short term debt improved to 122.9% in August vs. 111.5% in August 2009, the highest level in the post Lehman period. Moreover, those international reserves covered 151.6% of the total FX deposits of the population almost unchanged from a year ago.

Once considered the major vulnerability of the Bulgarian economy, the unwinding of the external imbalances has so far proceeded in an orderly and rapid, yet painful, fashion. Over the last two years, the current account deficit dwindled from 25.2% of GDP in 2007 to 8.9% of GDP in 2009 and finally landed to 1.3% of GDP in 2010 (Figure 1). With our conservative calculations, the full year current account surplus could exceed 2% of GDP in 2011. First of all, the trade deficit could widen as the Euroarea slowdown will eventually take its toll on Bulgarian exports and some pick up in imports-particularly energy related- is traditionally expected by the end of the year.

**Figure 1: The current account deficit dwindled within 3 years from 25.2% in 2007 to 1.3% in 2010**




Source: National Bank of Bulgaria, Eurobank Research

All in all, the sharp improvement in the current account balance gradually shifted risk perceptions away from the balance of payments helping Bulgaria contain financial risks of the deepening Euroarea sovereign crisis. However, despite its declining trend, the level of external debt is still at very high levels, which may entail significant refinancing risks in tight global liquidity conditions. External debt stood at 91.4% of GDP (the vast majority of which is private sector denominated) in last August down from 102.8% in 2010.

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