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TRIP NOTES: BULGARIA

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Trip Notes: Bulgaria

Key notes from our recent trip to Sofia: March 17th- 18th

Earlier this month, we traveled to Sofia where we met with high-level officials from the Finance Ministry, the IMF, think tanks as well as market participants from the domestic financial sector. The present note attempts to offer our readers a cohesive overview of current conditions in the domestic economy and markets and the outlook ahead. In addition, it provides an update on issues related to the sustainability of the Currency Board Arrangement (CBA) as well as the opportunities and challenges facing Bulgaria in its road towards euro adoption

Key points

- ✓ **Economy exited recession in 2010, with full-year real GDP growth bouncing to +0.2%, following a contraction of 5.5% in the prior year**
- ✓ **Output growth is expected to strengthen further in 2011, with domestic demand taking the lead over net exports as the primary driver of economic recovery; Eurobank research now expects 3.2% GDP growth in 2011, with risks to the latter forecast remaining skewed to the downside**
- ✓ **Fiscal performance improved markedly in 2010; achievement of this year's deficit target is critical for fulfilling the nominal convergence criteria, and supporting market perceptions over the stability of the Currency Board Arrangement (CBA)**
- ✓ **The legacy of prudent fiscal policies is about to be enshrined into national legislation, helping to increase policy predictability and credibility going forward**
- ✓ **The government remains firmly committed to swift euro adoption, despite the lingering EMU sovereign debt crisis; conditions for applying to ERM II mechanism likely to improve further this year**
- ✓ **Besides facilitating nominal convergence, Bulgaria also needs to emphasize real convergence by pushing ahead with ambitious structural reforms**
- ✓ **Real estate prices close to bottoming out; more future investment opportunities likely to be found in the tradable sector**
- ✓ **The adjustment of earlier macroeconomic imbalances surpassed all expectations in 2010. Yet, the current account is expected to widen anew this year on a higher energy bill and improved domestic demand prospects**
- ✓ **Credit activity remains weak despite solid conditions in the domestic banking system**

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Output recovery gained momentum in Q4 2010, with domestic demand exerting a positive contribution

The domestic macro outlook has improved further since our previous visit in Sofia in October 2010. As we forecasted back then, the Bulgarian economy exited recession in Q3 2010. Real GDP recorded a further acceleration to 2.1%/2.8% qoq/yoy in Q4 2010, from 0.7%/0.5% qoq/yoy in the prior quarter. After the latest revision, Bulgaria actually exhibited the strongest quarter-on-quarter growth performance in EU-27 during the fourth quarter of last year.

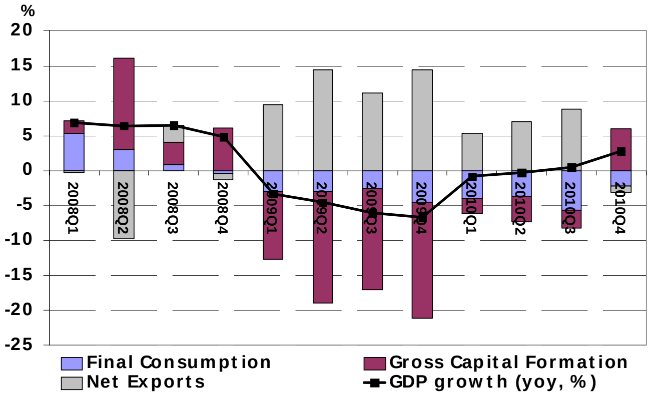
Looking more closely at the underlying drivers of domestic output growth, the positive surprise in Q4 data came mainly from domestic demand (+3.7ppts contribution to GDP growth vs. -8.2ppts in Q3 2010), More specifically, total consumption registered its first quarterly rise since Q4 2008, accelerating to +1.7% qoq from -2.7% qoq in the prior quarter. Both private and public spending showed a significant improvement. The annual pace of contraction in real private spending slowed down to -1.3% yoy in Q4, from -6.4% yoy. In addition, public consumption grew by +12.7% yoy compared to -7.8% yoy in Q3.

Another element of surprise was the rebound in investments, which exerted a positive contribution to Q4 GDP growth. Gross fixed capital formation rose for the first time since the onset of the international crisis in Q4 2008, registering annual growth of 7.2% yoy. In combination with the built up of inventories, gross capital formation expanded by 4.0% yoy in Q4 from -4.9% yoy in Q3.

The strong performance of the external sector continued in the fourth quarter of last year, though its contribution to overall economic growth deteriorated relative to the prior three quarters. Exports growth eased to +16% yoy in Q4 (revised upwardly from 10.7% yoy in the flash estimate), from +18.5% yoy in Q3. On the other hand, imports recovery gained momentum in Q4, with the corresponding annual growth rate accelerating to 15.0% yoy in Q4, from 3.0% yoy in the prior quarter. As a result, the positive contribution of net exports became marginally negative in Q4 to the tune of -0.9pps, compared to a positive contribution of 8.8pps in Q3.

Figure 1

Domestic demand had a positive contribution in Q4-2010



Source: National Statistics, Eurobank Research

To recoup, after recording output losses of 5.5% in 2009, the economy exited recession in 2010, managing to generate marginally positive GDP for the full year. The main driver behind the recovery was net exports with domestic demand lagging behind during the greater part of 2010. Exports of goods and services were the brightest spot of the Bulgarian economy last year, growing by 16.2% yoy in real terms, following a 11.2% yoy contraction in 2009. In contrast, full-year imports growth remained negative (-4.5% yoy), with the overall external sector contributing ca +6.2pps to GDP growth vs. +11.8pps a year earlier.

2011 growth outlook improves

The growth prospects for 2011 dominated our discussions with our government and industry contacts. The majority of our discussants are in the process of revising their own macroeconomic forecasts, based on the latest higher-frequency data releases and the recent GDP data revisions. Overall, there was a unanimous agreement that the economic environment has improved considerably since last October.

The consensus view among all of our discussants is that growth will accelerate in 2011, though there were diverging opinions over the magnitude of the rebound. That is because, understandably, the speed of the economic recovery depends on the evolution of a number of important parameters that are still subject to high volatility *e.g.* prices of commodity exports and imports (oil, base metals, and agricultural products prices).

With respect to most recent domestic macro data, private consumption, one of the key GDP growth drivers, is already exhibiting some preliminary, though not yet entirely convincing, signs of recovery. On the positive side, big ticket items such as car sales registered an unexpected increase in the late months of 2010 (October-November), albeit from a low base. In addition, retail sales remain in slightly negative territory, though they have been gradually improving lately. The volume of retail sale was marginally negative in January (-0.3% yoy), following declines of 2.9% yoy and 5.2% yoy in December and November, respectively.

On the other hand, the industrial sector continues to thrive, with sales growth accelerating to 36% yoy in January, from 25.7% yoy in November-December 2011. This positive trend was underpinned by sales abroad which expanded by 65.5% yoy in the first month of this year. These upbeat developments have been also reflected in the most recent BoP statistics, which saw exports of goods and services registering growth of 71% yoy in January 2011. Industrial production grew by 10.8% yoy in the corresponding month, with the major contribution coming from investment and intermediate goods.

In view of these positive developments, our discussions with government and industry representatives primarily focused on the potential growth drivers in 2011. On that front, the prevailing view is that these drivers are likely to allow domestic demand taking a lead over next exports as the primary engine of GDP growth this year. The picture portrayed by the revised Q4 GDP data is a good illustration on that account. Private consumption is expected to remain relatively subdued for the greater part of this year, though a shift to a positive territory remains in the cards in the period ahead. On the later view, our optimism primarily stems from two important factors. Firstly, real wages are still rising (up by 3.3% yoy economy-wide in 2010). Secondly, the prospect of indexation of lowest pensions (if tax revenues turn out better than expected) announced by Minister of Finance Simeon Djankov may prove another catalyst supporting a faster turnaround in private spending. However, uncertainties with respect to the recovery of the household sector are still very high. In any case, expectations for a dynamic rebound of domestic consumption this year were judged to be rather premature at this stage. On top of that, public consumption is not expected to contribute positively given the fiscal consolidation process underway.

News from the investments side is significantly more encouraging. After recording two consecutive years of sharp contraction, investments are expected to record positive growth this year. The ongoing improvement in the business climate survey (headline index up by 8.5 points in February) provides a clear manifestation supporting the latter view. There are a number of good reasons behind this optimism. Firstly, investments are going to receive increased support from the continuing rise in EU funds absorption (which is mainly headed towards infrastructure investments) and the government's privatization program (state owned tobacco company, ammunition industries etc). Secondly, the situation in the real estate sector has stabilized, with prices now bottoming out. However, the higher return investment opportunities in the post crisis period are likely to be found in the tradable sectors, in our view. Such a process would be welcomed, helping to increase the exporting capacity of the economy. The rebuilding of inventories, a factor which has not come into effect during 2010 will also play out this year.

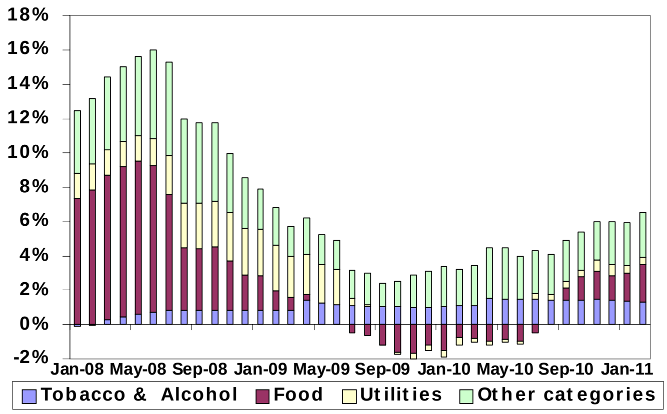
Exports are expected to improve further in 2011, yet to at a slower pace relative to last year. Anecdotal evidence relating to both orders and prices of commodity exports confirms that trend. In addition, the all important tourism sector is expected to receive a boost from the ongoing upheaval in Middle East and North Africa region. Imports are also expected to rise in 2011, following an extended period of negative growth. The domestic demand recovery (primarily from the investments side), Bulgaria's high energy dependency and the high import component of exports are all going to contribute to such a trend. All in, the contribution of net exports is expected to remain positive in 2011, but to a lesser extender than in the prior two years.

According to our baseline projections, GDP growth this year may exceed the 3% mark, taking into account the set of assumptions described above. The improvement in the economic environment during the last quarter of 2010, in combination with our global outlook forecast assumptions, led us to upgrade our GDP forecast to 3.2% from 2.5% previously. Our updated forecast lies significantly above consensus, yet we still find it attainable and realistic.

Having said that, risks to our GDP forecast remain high and skewed to the downside. Such risks relate mainly to the outlook of the household sector. In our analysis, we identify the following factors as presenting the main risks to our 2011 GDP growth forecast: rising food and oil prices, weak domestic credit activity, high refinancing needs of private-sector external debt and the still high unemployment rate (currently close to its December 2010 multi-year peak of 9.8%). On the other hand, recent developments on the inflation front remain a source of concern, with a further significant increase in consumer prices threatening to derail household consumption recovery. Inflationary pressures have been on the rise in recent months, mainly as a result of high food and energy prices (ca 45% weight in the domestic CPI basket). In fact, the recent rally in food and energy prices has stirred a heated social and political debate domestically, which eventually pushed government popularity even lower.

Figure 2

Inflationary pressures on the rise



Source: National Statistics, Eurobank Research

2010 fiscal deficit target outperformed; legacy of strong past fiscal performance to be formally enshrined into national legislation

Among the key points of our previous Trip Notes report on Bulgaria (October 2010) was that achievement of last year's fiscal target should more or less be considered as a done deal. In fact, we had diagnosed back then that there was room for overachieving the target, given the apparent reversal of the earlier negative trend in tax revenues. Indeed, the full-year budget execution data vindicated our expectations.

Specifically, the 2010 full-year cash deficit came in at BGN 2.78bn or 3.9% of GDP compared to a deficit of 0.9% of GDP in 2009. This proved out to be significantly lower than the mid-year revised target of 4.8% of GDP. In addition, the general government deficit in ESA95 terms came in at 3.6% of GDP, down from 4.7% of GDP in 2009.

The importance of this strong performance should be not underestimated. Firstly, it places Bulgaria among the most fiscally sound countries in the EU-27 and the broader region. Secondly, it reinforces market confidence over the sustainability of the currency board arrangement (CBA) and maintains sovereign borrowing costs at low levels. Last but not least, it revitalizes ERM II application prospects by providing tangible evidence of the authorities' commitment regarding fulfillment of the nominal convergence criteria (even though there is no formal prerequisite for ERM II entry).

Furthermore, the government has presented a framework to ensure that fiscal discipline is instilled in the legislation. Minister of Finance, Simeon Djankov, has presented a draft of the so called *Financial Stability Pact*. The Pact provides for a set of rules to strengthen longer-term fiscal discipline, while, at the same time, rationalizing the redistributive role of the state. More analytically, there is a proposed 37%-of-GDP cap on government expenditure. That is, without accounting for the contributions to the EU budget or participation in EU co-financed projects. In addition, there can be no changes in direct taxation rates or the introduction of new direct taxes without a two-thirds majority in the parliament. But more importantly, the framework guarantees a broadly balanced budget position (or at least a deficit of not more than 3% of GDP), provided that public debt would not exceed 40% of GDP, depending upon the evolution of the economic cycle.

Following our discussions with domestic officials, we became even more convicted about the usefulness of adopting a certain kind of fiscal rule. The most important benefit from such a mechanism is that the proposed framework institutionalizes the prudent fiscal policy stance of the recent years. In addition, it allows some valuable room for the implementation of counter-cyclical fiscal policies in economic downturns, while providing for the creation of buffers at economic boom times.

However, it is important to note that the proposed legislation is stricter than any other fiscal rule applied in Western Europe. That is because it touches upon the socially sensitive issues of taxation and reduces fiscal policy flexibility in a macroeconomic environment already constrained by an ultra-rigid monetary policy regime.

Finally, the proposed changes are subject to public consultation at the moment and an issue of negotiations with political parties and social partners. Yet, the consensus view at the moment is that major opposition parties will not consent to the fiscal rule becoming a part of the constitution.

Successful implementation of 2011 fiscal target is only one of the challenges on the road to ERM II

Looking ahead, our discussions with officials focused on the fiscal target for 2011. The target is ambitiously set at 2.5% of GDP both at an accruals and a cash basis. In our previous trip to Sofia, we had delved into the attainability of that target. Back then, our view was that the final deficit outcome would not only depend on the evolution of headline GDP growth in 2011, but also on its composition. Naturally, that is because a shift towards a more domestic-demand oriented growth environment has, by definition, higher tax content. Provided that there is no significant fiscal relaxation and given our expectations for a more pronounced domestic demand recovery this year, we now believe that the probability of attaining the 2011 fiscal target has increased. The state budget execution data for the first two months of this year are encouraging in that respect. The budget deficit declined by 55% yoy in January-February, reaching ca 0.84% of projected GDP compared to 2% in the same period a year earlier.

Besides nominal convergence, we maintain that promoting real convergence is another vital issue domestic authorities need pay increasing attention to. Among other important reasons, that is because financial markets have recently increased their level of scrutiny on real convergence issues for new euro area entry aspirants. To that end, speeding up EU funds absorption is an important tool in the government hands to facilitate that process.

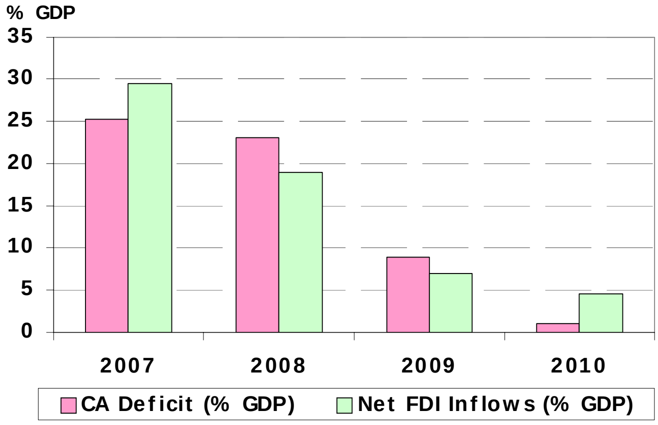
In our view, the successful implementation of this year budget should be seen an integral part of an ERM II application strategy. Another important element in that process is the acceleration of the structural reforms in the judicial, health care and education sectors. The current solid fiscal position offers domestic authorities a valuable time window to implement these reforms in a gradual and orderly manner. For that reason, structural reforms in those areas should not to lose momentum ahead of Presidential and municipal elections in autumn.

Current account gap undershot market expectations in 2010; deficit set to re-embark on widening trend this year

The creation of serious macroeconomic imbalances was a contentious issue during the boom years. However the onset of recession in early 2009 accelerated the process of their unwinding. Over the last two years, the current account deficit dwindled, gradually shifting risk perceptions away from the balance of payments. As a result, the current account deficit landed to 1% of GDP in the end of 2010, significantly undershooting analyst expectations. The latter reading compares favorably to deficits of 8.9% of GDP and 23% in 2009 and 2008, respectively.

Figure 3

Current account deficit dwindled within 3 years



Source: BNB

The improvement in the current account deficit reflects primarily a smaller trade deficit (down 5.3pps last year to 6.7% of GDP). Exports grew by an astonishing 33% yoy in 2010 (growth rates in excess of 40% yoy in five out of the full twelve-month period), recovering strong from a 23.1% yoy decline recorded in 2009. As a result, last year's exports exceed by ca10.4% its pre-crisis level in 2008. According to an analysis of the Bulgarian Industrial Association, some 60% of the rise in exports is attributed to the rise in the volume of goods sold abroad, with the rest 40% being attributed to the increased prices.

Analyzing the most recent trends in exports and competitiveness developments was an additional focal point in our discussions. Bulgarian exports have been a major beneficiary of two favorable underlying trends. Firstly, the rise in commodities prices worldwide and secondly the geographical diversification of exports portfolio to the most dynamic emerging market economies in the world. More specifically, exports to the non EU markets continue to expand rapidly, mainly benefiting by the strong rebound in the Turkish economy.

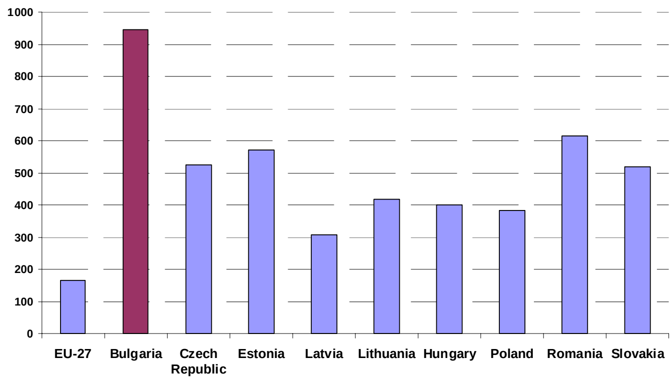
On the other hand, exports' relatively low adding value remains an issue of concern. According to the World Bank, Bulgaria's strong export performance is concentrated in industries processing natural resources as well as in lower value-added, labor-intensive manufacturing. That said, only 7% of Bulgarian exports are high-technology products, below both the EU-27 average (20%) and the rest of Eastern Europe (Hungary-24%; Czech Republic-14%; Croatia-9%).

From the funding side, the capital and financial account registered a minor surplus of €289 mn or 0.8% of GDP in 2010 (revised upwardly from a deficit of €403 mn) compared to €1.7bn or 4.8% of GDP in the prior year. The most important component, net FDI inflows, recorded a steep decline for a second consecutive year (-32% yoy in 2010). These amounted to €1.6bn (upwardly revised from €1.2bn), against €2.4bn in 2009. Overall, the private sector's gross external debt declined to 89.9% of GDP compared to 96.0% in 2010, a clear sign that the deleveraging process in the private sector continued.

In our view, the current account deficit is set to widen again in 2011, reaching around 4% of GDP. The main driver behind the reversal is expected to be an increased energy bill. According to Eurostat, the Bulgarian economy is the least energy efficient in the EU-27, with industry being the most energy consuming sector. According to 2008 data, Bulgaria's energy intensity, defined by kilogram of oil equivalent per 1000 Euros GDP, is five times higher than in EU-27 (944 toe/M€ '00 vs. 167 toe/M€ '00).

Figure 4

Energy intensity of the economy 2008
Gross inland consumption of energy divided by GDP (kilogram of oil equivalent per 1000 Euro)



Source: Eurostat

Recent trends in the domestic banking sector: Credit activity remains weak; Household deposits on a rising trend

Recent domestic banking sector developments were also an integral part of our discussions in Sofia. On that account, we broadly agreed with our contacts that recent credit developments have not been supportive to the economic recovery so far. Yet, the ongoing improvement in the domestic economy should translate into higher demand for credit going forward. Solid condition in the domestic banking system and the ongoing improvement in global economic trends would also facilitate that process. Yet, credit expansion to the domestic economy is not likely to recover to anywhere near pre-crisis levels in the foreseeable future as the repair of domestic private sector's balance sheets continues and the lingering EMU sovereign debt crisis constrains the ability of foreign parent banks to extend credit to their local subsidiaries.

Credit to the non-government sector remained broadly stagnant in 2010, with its annual growth easing to 2.7% yoy, from 4.5% yoy in 2009. Credit to households remained on downward trend throughout last year, shifting to a slightly negative territory (-0.5% yoy vs.7.5% yoy in 2009). In contrast, the corporate segment has been more vibrant particularly in the late months of last year. As a result, credit to corporates expanded by 3.7% yoy in 2010 compared to 2.6% yoy in 2009.

Last year's decline in household credit was the combined result of two trends: a contraction of consumer loans to the tune of -3.8% yoy, which was partially offset by the rise in mortgage loans by 3.2% yoy. These developments have partly to do with households' response to the recession. Households have focused on repairing their balance sheets and increasing precautionary savings. A clear illustration of this is the concomitant rise in household deposits. Household deposits growth accelerated further to 13.6% yoy in 2010 from 12.1% yoy in 2009. In addition, banks tightened lending standards to protect themselves from further asset-quality deterioration in their portfolios. However, an improvement in that direction comes out from the financial sector survey conducted in Q4 2010. From the supply side, there has recently been a relative shift of focus in domestic banks' strategy away from concerns about the macro-environment, rising NPLs and liquidity management. Currently, banks look more eager to extend new loans based on stricter credit screening criteria such as income. By and large, this is considered to be a leading positive signal of future credit dynamics.

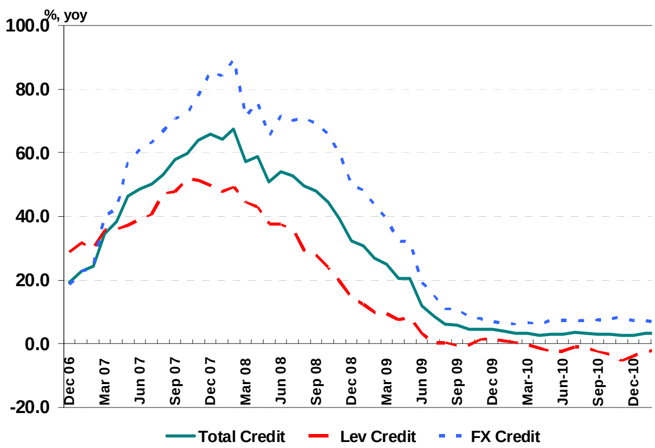
Non-performing loans are a more sensitive and difficult to analyze. The NPLs ratio (non performing loans above 90 days) climbed further to 11.9% in 2010, from 6.4% in September 2009, remaining though relatively low by regional standards. There are two caveats with respect to NPL data. First, the ratio doesn't include restructured loans, which domestic banks have successfully renegotiated with existing clients. If restructured loans are added, the ratio rises to 18.1% at the end of 2010 and to 19.1% in February 2011. Secondly, NPLs is a lagging indicator of economic activity. The latter effectively means that the corresponding ratio may rise a little further in the following period. On the positive side, the latest growth reading of NPLs was the lowest recorded since the beginning of the downturn, which makes us optimistic that the peak is around the corner.

Furthermore, the banking sector has maintained strong capital buffers throughout the crisis. The capital adequacy ratio stood at 17.5% in late 2010 (Tier I ratio at 15.2%) against 14.3% before the onset of the crisis in September 2008. This provides enough comfort against rising NPLs and optimism for the banks' capacity to absorb new provisions for potential losses.

Overall, the domestic banking sector has fared pretty well during the economic downturn. Part of the resilience to the global credit crunch and, more recently, to the euro area sovereign debt crisis can be attributed to its geographically diverse ownership structure, which is a crucial difference relative to the Baltic region. Another explanation is the prudent supervision policies followed during the boom years. Banks are still profitable even though profits may have plunged (down from 1.4bn Leva to around 0.6bn Leva). That said, the domestic banking sector is at a good starting point to reap the benefits of the forthcoming recovery.

Figure 5

Credit activity remains weak



Source: BNB, Eurobank Research

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	6.2	-5.5	0.2	3.2
Final Consumption	2.6	-7.3	-1.1	1.0
Gross Capital Formation *(Fixed)*	21.9	-17.6	-16.5	4.5
Exports	3.0	-11.2	16.2	8.5
Imports	4.2	-21.0	4.5	6.5
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.0	3.7
HICP (end of period)	7.2	1.6	4.4	3.2
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	2.9	-0.9	-3.9	-2.5
Gross Public Debt	15.5	15.6	16.7	19.5
Primary Balance	3.7	-0.2	-3.3	-2.0
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	6.3	9.1	9.2	8.9
Wage Growth *(total economy)*	26.5	11.8	6.3	7.5
External Accounts				
Current Account (% GDP)	-23.0	-8.9	-1.0	-4.0
Net FDI (EUR bn)	6.7	2.4	1.6	2.2
FDI / Current Account (%)	82.4	77.4	460.0	145.0
FX Reserves (EUR bn)	12.7	12.9	13.0	13.5
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	75.2	79.2	78.7	76.3
Credit to Enterprises (%GDP)	47.8	49.4	49.4	48.2
Credit to Households (%GDP)	26.0	28.2	27.4	26.3
FX Credit/Total Credit (%)	57.2	58.6	60.9	61.3
Private Sector Credit (yoy)	32.3	4.5	2.7	2.1
Loans to Deposits (%)	119.3	120.5	116.0	112.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research

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