Athens, December 22, 2009

Trip Notes: Bulgaria

Key notes from our recent trip to Sofia: December 10-11

Ratings	Outlook
S&P: BBB	Stable
Moody's: Baa3	Stable
Fitch: BBB-	Negative

Earlier this month, we traveled to Sofia where we met with high-level officials from the BNB, the Finance Ministry, the IMF and the World Bank as well as market participants from the domestic financial sector. Part I of the present note attempts to offer our readers a cohesive overview of current conditions in the domestic economy and markets and the outlook ahead. Part II 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:

- **Full-year GDP likely to contract by less than expected earlier, but domestic economic downturn is not over yet**
- **Macroeconomic imbalances unwind in an orderly, albeit painful, manner**
- **Domestic disinflation is gaining momentum and Bulgaria is expected to fulfill the respective Maastricht criterion in the coming months**
- **New government´s belt-tightening measures help contain the budget deficit to levels around 0.75%-of-GDP in 2009**
- **Domestic lending conditions remain tight; Non-performing loans expected to rise further in 2010**

Bulgaria: Macroeconomic-Indicators

	2008	2009f	2010f
Real GDP (yoy%)	6.0	-4.9	-1.1
Private Consumption	4.8	-4.0	-2.1
Government Consumption	0.0	-0.5	-0.1
Gross Capital Formation	20.4	-25.0	-8.7
Exports	2.9	-13.5	2.3
Imports	4.9	-22.0	-2.8
Inflation (yoy%)			
HICP (annual average)	12.0	2.6	1.6
HICP (end of period)	7.2	0.9	1.5
Fiscal Accounts (%GDP) - *EU Methodology*			
General Gvnt Balance	1.80	-0.75	-0.85
Gross Public Debt	14.1	15.1	16.2
Primary Balance	2.7	0.0	-0.3
Labor Statistics - *National Definitions*			
Unemployment Rate	6.3	7.5	9.0
Wage Growth	21.7	7.5	2.0
External Accounts			
Current Account (% GDP)	-25.4	-10.0	-8.5
Net FDI (EUR bn)	6.1	3.0	3.0
FDI / Current Account (%)	70	90	95
FX Reserves (EUR bn)	12.7	12.8	11.5
Domestic Credit	**2008**	**Q2 09**	**Q3 09**
Total Credit (%GDP)	74.9	75.3	77.1
Enterprises (%GDP)	47.8	47.6	49.7
Households (%GDP)	26.0	26.4	27.4
FX Credit/Total Credit (%)	57.3	57.9	58.5
Private Sector Credit (yoy)	32.3	11.9	5.9
Loans to Deposits (%)	118.9	120.0	118.4
Financial Markets	**3M**	**6M**	**12M**
Policy Rate			
EUR/BGN	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting
Updated: 18.12.09

- **Technical requirements of CAB continue to be met by a comfortable margin**
- **Bulgaria aims to apply for entry into ERM-II in early 2010**
- **Continuation of a prudent domestic policy framework is necessary to prevent further competitiveness losses that would be harder to reverse once inside the euro area**

*Important disclaimer on page 10

Part I
Recent economic developments and outlook

Full-year GDP likely to contact by less than expected earlier; domestic economic downturn not over yet

The domestic economy remains in contractionary territory, though revised GDP data for Q3 were slightly better that initially thought (-5.4% yoy vs. -5.9% yoy reported in the flash report). Yet, this was not sufficient to alter the gloomy picture of a deepening economic downturn, with the pace of output decline in the third quarter of the year being the steepest since the economic crisis of 1997. The breakdown of the latest GDP report showed private consumption in Q3 declined less than estimated initially (-4.2% instead of -10.2%), while investments were down by 36.5% yoy (vs. 22.9% reported in the flash report). The pace of contraction in exports was also milder (6.7% yoy against 13.2%) and imports recorded a less steep decline (-23.4% yoy vs. -28.3% yoy).

Agricultural output rose unexpectedly in Q3

From a sectoral perspective, services contracted by -5.1% yoy (vs. -5.7% in the flash estimate) and industry by -6.0% yoy (vs. -10.0 yoy initially reported) in Q3. On the other hand, agriculture had a positive contribution, despite initial estimates from the Ministry of Agriculture for a worse harvest relative to last year. Agricultural output recorded a surprise increase of 2.3% yoy in Q3, after contacting by 6.3% yoy in the prior quarter. According to our contacts, country-side households, traditionally this period of the year make preparations ahead of the winter. This gave a boost to agricultural production, particularly forestry. On top of that, agriculture output has yet to recapture fully the levels recorded before the poor crop season in the summer of 2007

Positive contribution from net exports masks steep decline in domestic demand

In the first three quarters of 2009, gross domestic product contracted by 4.7% yoy, with private consumption and investments falling by 4.4% yoy and 23.2% yoy, after growing by 5.0% yoy and 22.5% yoy, respectively in the same period a year earlier. The pace of decline in imports was almost double than of exports in January-September 2009 (-23% yoy vs. -12.8% yoy), with external sector's contribution turning significantly positive after being a sizeable drag on overall GDP growth over the same period last year. In conclusion, a significant rebalancing in the structure of domestic growth has taken place in recent quarters, with the positive contribution from net exports partially overweighing a deep contraction in domestic demand. The latter subtracted ca 17.1pps from GDP growth in the first nine months of 2009.

Return to positive growth unlikely before H1 2010 at the earliest

As we have alluded in our last *New Europe Economics & Strategy* monthly bulletin (Dec. 2009), the domestic economic downturn is not over yet, though the pace of decline of gross domestic product is likely to prove slower than envisaged earlier. In our view, the economy is not expected to return to positive growth territory until the second half of 2010 at the earliest. Yet, both the government and the IMF now appear somewhat less pessimistic with respect to the extent and duration of recession. The Ministry of Finance has upped its forecast for real GDP growth this year to -4.9%, from -6.3% seen earlier, while the IMF is about to also revise upwards its own projection. The Central Bank has reaffirmed its forecast of a 4.5% contraction in 2009. With respect to the growth outlook for 2010, the Central Bank now expects anemic growth +0.5%, while the Ministry of Finance has maintained its -2.0% GDP growth projection in the new budget.

Macroeconomic imbalances unwind in an orderly, yet painful for the economy, manner

The correction in the external imbalance is taking place more quickly than previously envisaged. The weakness of domestic demand is behind the ongoing improvement in current account deficit as import volumes continue to decline much faster than exports. The January-October current account deficit stood at 7.4% of projected GDP (or 8.9% in annualized terms), not far from our revised full-year forecast of 10%-of-GDP. Although capital inflows over the first 10 months of the year were much lower than a year earlier (net FDIs down 60% yoy to € 2.2 bn), the corresponding

coverage of the current account deficit improved to 93.5% from 85.9% in the same period of 2008.

Domestic policymakers don't see need for IMF support

The orderly unwinding of external imbalances has major implications. First of all, external re-financing needs are becoming more manageable. The private sector remains able to roll-over its external obligations, given that debt roller ratio was maintained at rates above 90% in the first ten months of 2009.This implies a lesser need for Bulgaria to apply for external financing aid and, understandably, an IMF support package is no longer a policy priority. Let alone that an IMF loan would not bode well for the image of a country preparing to apply for ERM II entry.

Disinflation is gaining momentum

Inflation deceleration has gained momentum in 2009. HICP stood at 0.2%yoy in October vs. 6.0%yoy in the beginning of the year and a peak at 14.8%yoy in June 2008. The most recent price developments provide optimism that Bulgaria will fulfill the Maastricht inflation criteria soon. In our view, domestic price pressures will remain subdued throughout next year (Eurobank EFG Research forecasts average inflation of 1.6% in 2010). This is not only due to the negative output gap and base effects, but also because no other major adjustment of administered prices is expected next year.

Belt-tightening measures help contain the budget deficit

The new government reversed a great deal of fiscal slippage incurred in the pre-election, period, by adopting a more prudent stance. The Minister of Finance embarked on an aggressive cost cutting program, swiftly introducing a 15% reduction in current expenditure, delaying certain other payments and even postponing infrastructure projects, particularly in the energy sector. Additionally, the government has attempted to improve the tax collection by reforming the revenues administration, a move which is expected to yield more tangible results longer-term. As a result, the budget started displaying minor surpluses since October (ca 8 mn leva in October and further 48 mn leva in November) The budget execution for the first 11 months showed a deficit of BGN 501 mn or 0.75% of projected full-year GDP. According to the government projections, this is going to be more or less the final fiscal outcome in 2009. The small budgetary surpluses achieved since September have so far helped to contain the budget deficit at levels recorded back in July, when the new government was sworn in office. The government plans to implement some discretionary spending by the end of the year, which will be directed towards pensions and EU co-financed project However, these are expected to have a neutral effect on the budget deficit, as they will be offset by cancelling out certain obligations. This year's government deficit will not be financed with debt issuance, but instead via running down the fiscal reserve account.

2010 budget targets a broadly balanced position

The budget for 2010 was recently approved by the parliament. It provides for a broadly balanced position. If EU related expenditures and revenues are incorporated, the overall consolidated government budget deficit is expected to reach 0.7% of GDP next year. The target for consolidated government revenues is set at 26.4 bn Leva (41.6% of projected GDP) and for consolidated government expenditures at 26.9 bn Leva (42.3% of projected GDP). The budget provides for a higher tax on gambling (15% vs, 10%) and a 40% increase in excise duties on tobacco. On the other hand, social contributions will be reduced by 1.1 pps. On the expenditures side, public wages and pensions are projected to remain flat next year.

Disciplined fiscal policy improves Bulgaria's EMU entry outlook

In our meetings with officials at the Ministry of Finance and the Central Bank we had the opportunity discuss domestic fiscal developments. Our discussants argued that a vigilant fiscal stance is imperative for Bulgaria, even in a recessionary environment such as the present one. From an EMU-convergence standpoint, fiscal policy prudence ensures fulfill of the respective Maastricht criteria. It is also of primary importance for maintaining confidence on the present FX regime. A disciplined fiscal stance since the establishment of the currency board arrangement allowed Bulgaria to

achieve very strong primary surpluses, which, in turn, promoted a rapid recline in the public debt burden. Even after the small consolidated government deficit expected year, public debt as a percentage of GDP is forecast to come at 15.1% at the end of 2009, compared to 105.1% in 1997. In fact, Bulgaria is expected to record the lowest budget deficit and the third lowest public debt ratio in EU-27 this year. International credit agencies have already shown signs of appreciation for the new government's commitment to fiscal discipline. Standard & Poor's Ratings revised recently its outlook on Bulgaria's long-term sovereign credit to stable from negative, reaffirming its current BBB rating (investment grade).

Domestic lending conditions remain tight; Non-performing loans expected to rise further in 2010

The deepening of the global financial crisis after Lehman Brother's collapse in September 2008 prompted an abrupt end to the lending boom in Bulgaria. BNB´s measures to cut minimum reserve requirements in order to boost liquidity and encourage lending have so far had only partial success. The annual growth rate of credit to the non government sector landed to a single digit in September (5.9%) compared to 47.9% yoy a year earlier. The lack of adequate domestic funding sources, as manifested in a still high loans-to-deposits ratio (118.4% in September) is severely constraining new lending.

During our recent meetings in Sofia we had the opportunity to discuss with our contacts how the domestic banking sector deals with the issue of non-performing loans. NPLs have risen modestly so far from 2.4% at 2008 to 5.2% in last September, as domestic banks managed to renegotiate loan agreement with existing clients. Yet taking into account that NPLs is a lagging indicator of economic activity, it is very likely to see them rising further in the coming months. A couple of our contacts even estimated that NPLs would double by the end of next year. In our view, the banking sector has enough buffers to address the current downturn. This is reinforced by the commitment of large foreign parent banks to maintain their overall exposure in the country at levels recorded in May 2009.

In terms of capitalization, the banking sector scores relatively high in the region. Industry-wide capital adequacy currently stands at 17.6% and the capital-to-assets ratio is 12.7%, which provides enough comfort against rising NPLs. Moreover, resent stress tests conducted by the Central Bank showed that the domestic banking system would remain stable even under an extreme scenario envisioning a 7.5% GDP growth contraction in 2009 and a rise in the share of overdue loans in bank portfolios to 16.5

Shift to a new development model is needed to reclaim past output losses

The Bulgarian economy has been a major beneficiary of international capital inflows to the broader region in recent years. Driven by improving convergence prospects, Bulgaria attracted some €27.1bn in FDI inflows in 2004-2008. The majority of those flows were channeled to non-tradable sectors, with the most representative one being the real estate market. Yet, if there is something the global financial crisis has taught us, is that the time of ease money and abundant capital flowing into emerging economies has passed. As such, Bulgaria needs to tap into new sources of growth in the years to come. Capital inflows cannot longer serve as the locomotive of growth. As a result, a main challenge facing policymakers is to facilitate an orderly shift from the previous credit-driven and consumption-based model of development to a new one, emphasizing competitiveness and exports. In that respect, Bulgaria enjoys a significant comparative advantage over other emerging market economies. Better utilization of EU structural funds could give potential growth a significant boost. To that end, it is rather conforming that the new government has already managed to unfreeze €300m of pre-accession EU funding, thanks to its efforts thus far to combat corruption and organized crime.

Part II
CBA sustainability and EMU entry prospects

Fiscal policy prudence key for CBA sustainability

In a special focus report we publish last July, we presented a thorough analysis on the technical features, peculiarities and sustainability of Bulgaria's currency board arrangement (CBA)[1]. As we noted back then, the present FX regime in Bulgaria exhibits certain intrinsic characteristics that differentiate it from an "orthodox" currency board arrangement in several interesting dimensions. These characteristics provide additional flexibility relative to an orthodox system, albeit at a cost of necessitating a greater degree of coordination and cohesiveness within the overall domestic policy framework, especially fiscal policy.

Similarly to a pure CBA, Bulgaria's arrangement provides:

a) full foreign exchange coverage for its notes, coins and deposit liabilities
b) a fixed exchange rate against the reserve currency (i.e., the euro at a central parity of 1.95583 BGN/EUR)
c) no government spending financing

On the other hand, some of its key differences include:

i) Bulgaria's CBA regulates domestic commercial banks
ii) Bulgaria's arrangement may assume a "strictly limited" lender-of-last resort function in the event of severe liquidity problems in the domestic banking system
iii) Besides supplying only notes and coins - as would be the case with a "pure" CBA - the currency board in Bulgaria also supplies commercial bank reserves and government deposits.

From the three important deviations from a pure system described above we choose to focus on the latter one, as we want to emphasize the importance of ensuring a prudent fiscal stance in the present trajectory of persisting recessionary pressures in the domestic economy and the highly uncertain external environment. Specifically, the presence of a government deposit -- the so-called fiscal reserve account, which currently stands at ca 12.2%-of-GDP -- in the liability side of the CBA´s Issue Department, leaves the door open for the Ministry of Finance to, intentionally or unintentionally, conduct monetary policy operations and thus, affect the domestic money supply. Practically, this can be done by controlling domestic inflows and outflows from the government's deposit with the CBA.

To help clarify the latter point, we provide below a short description of how the money creation mechanism works in Bulgaria. But, before we do that it is imperative to take a brief look at the current CBA structure.

Bulgaria's currency board is comprised of the following thee departments:

(A) the Issue Department,
(B) the Banking Department, and
(C) the Banking Supervision Department

The Issue Department issues domestic currency against foreign assets.
The Banking Department's main role is to perform a "strictly limited" lender-of-last-result (LLR) function in case severe liquidity problems in the domestic banking system.
Finally, the Banking Supervision Department represents the watchdog of the domestic banking system.

Now, money creation in Bulgaria works as follows:

$$MB \equiv C + R + G + B = FX \qquad (1)$$

Where,

[1] See Eurobank Research Economy & Markets, *"Is Bulgaria's Currency Board Sustainable?"*

MB denotes the monetary base i.e., the central bank's monetary liabilities, which is fully covered by exchange rate reserves (FX) and consists of:

- currency in circulation, C,
- commercial bank deposits with the currency board, R,
- the government´s fiscal reserve account, G, and
- the Banking Department's deposit, B, with the CBA´s Issue Department, which effectively represents the funds set aside for conducting lender-of-last resort operations when the need arise

From equation (1) above we get

$MB \equiv C + R = FX - G - B$

which then give us the following equations for the money supply, M,

$$M = m * (FX - G - B) \qquad (2)$$

where m, denotes the money multiplier.

The above equation depicts a reverse relationship between changes in G and the money supply. This, in turn, suggests that the government may -- intentionally or not -- cause an increase (decrease) in money supply by reducing (increasing) its fiscal reserve with the CBA. Such changes could arise from, say, undue fiscal relaxation as a result of overly-generous salaries and pensions payments as well as subsidies to the State budget. The latter point helps to explain why hefty domestic budgetary spending ahead of the July 5 elections conspired with speculation over a break in the Latvian FX peg to fuel market worries over the sustainability of Bulgaria's CAB in the summer months. The chain of developments that could, *ceteris paribus,* induce destabilizing forces on the currency board can be conceptualised as follows:

Undue fiscal relaxation in a recessionary domestic environment & external market pressure leads to a drawdown in the government´s fiscal reserve account with the currency board. This leads to an unwarranted rise in the money supply which, in turn, exerts downward pressure on domestic interest rates. The latter reduces the attractiveness of holding domestic currency and stimulates a flight of capital from lev-denominated assets to foreign currency assets.

The above analysis illustrates the importance of fiscal prudence for ensuring the sustainability of the currency board arrangement in Bulgaria and helps to explain why market worries on that front have subsided in the last 2-3 months. Indeed, in our meetings with high-level policy makers and industry officials in Sofia on November 12 -13, it was transpired to us that there is a broad satisfaction with the new government´s fiscal consolidation measures and the significant spending cuts it has implemented to counterbalance the slippage occurred before the elections and the decline in revenues as a result of the domestic economic slowdown. Of course, the recent easing of market worries over Latvia and the full coverage provided to Bulgaria's current account deficit by FDI (mainly as a result of the sharp decline in the former) also assisted in that direction.

Technical requirements of CAB continue to be fulfilled by a comfortable margin

In this section we provide a brief quantitative assessment of the sustainability requirements of the currency board arrangement in Bulgaria.

First, the **coverage of the monetary base** (= currency in circulation + commercial bank reserves with the CBA) **by FX reserves** excluding monetary gold and other monetary gold instruments stood at 188% in mid-December 2009. The corresponding coverage was 177% at the end of May 2009 and around 180% in the week before the Lehman Brothers collapse (September 2008).

Second, **exchange rate reserves** excluding monetary gold and other monetary gold instruments were €11.4bn in the week ending December 11, 2009, some 7% lower from a year earlier, but still adequate to comfortably cover the overall money base.

Another issue that relates to the sustainability of a currency board regime, especially in periods of increased demand for foreign currency by domestic economic agents, is the degree of foreign exchange cover of **broader monetary aggregates**, including deposits that may be converted into cash upon request. On this axis, note that exchange rate reserves in Bulgaria covered slightly more than 80% of the **lev-denominated portion of M2** (M1 + quasi-money) in late November. This was lower than the corresponding coverage rate shortly before the Lehman debacle (ca 97%), but still sufficient to meet the greatest part of the demand for foreign currency arising under a hypothetically scenario in which all economic agents decided, at once, to convert their lev coins, bills and deposits into hard currency.

Furthermore, **hard-currency reserves** and the **fiscal reserve account** in mid December 2009 amounted to around 45% of projected GDP, providing a strong buffer of support to the CBA.

The points made above indicate that in the absence of a severe external shock or a serious policy mistake domestically that could *e.g.,* propagate a significant drawdown in the country's FX reserves and/or a massive move by local agents away from lev-denominated assets, Bulgaria's exchange rate regime remains safe and technically sound.

Already fulfilling two of the five criteria for euro adoption

As of November 2009, Bulgaria was already fulfilling two of the five **Maastricht Treaty criteria** for Euro zone entry, namely those concerning the country's **fiscal deficit** and the **public debt** ratio. As we have noted already, the fiscal balance is expected to switch from a surplus of 1.8%-of-GDP in 2008 to a deficit of around 0.75%-of-GDP this year, while the general government gross debt is expected to rise slightly from its end-2008 level (to 15.1%-of-GDP in 2009, according to the EC Autumn 2009 forecasts), but remain comfortably lower than the Treaty's 60%-of-GDP threshold. In the absence of any unforeseen -- and extremely adverse -- circumstances, we expect Bulgaria to continue fulfilling these criteria in the foreseeable future.

With regard to **price stability**, the average year-on-year rate of domestic HICP inflation in the 12 months to November 2009 stood at 2.9%, whereas the respective criterion's reference value was 2.0%. Yet, our contacts at the BNB noted that, in terms of current inflation rates *(not 12-month averages),* Bulgaria already satisfies the inflation criterion and appeared confident that domestic price pressures will remain subdued over their forecasting horizon thanks, primarily, to a sizeable negative output gap. The central bank expects the output gap to widen further next year (to around 6%, from 5.5% in 2009) as a result of a further increase in trend GDP growth.

We concur with the notion that inflation in Bulgaria will remain subdued in the following 1-2 years, though we believe a vigilant policy approach will need to be applied to avert any unforeseeable price shocks arising from *e.g.,* a sharp spike in imported inflation or a significantly higher domestic food prices *(unprocessed food and vegetable prices have a disproportionally large weight on the domestic consumer price index).*

The remaining two criteria relate to **long-term interest rates** and the **currency stability criterion**. With respect to the former, the latest Eurostat data shows that the 12-month average of Bulgaria's 10-year government yield stood at 6.53% at the end of November, compared with a reference value of 6.10%. In our view, this criterion will be met in due course, which leaves us with the examination of the last one of the five criteria, i.e., the exchange rate stability criterion.

Bulgaria aims to apply for entry into ERM-II in early 2010

The Maastricht Treaty stipulates that "applicant countries should have joined the exchange-rate mechanism under the European Monetary System (ERM-II) for two consecutive years and should not have devaluated its currency during the period. ERM-II fixes the acceding country's national currency's exchange rate to the euro, within a specified band (normally ±15%)". Note that the European Central Bank and the European Commission do not accept currency board arrangements as a substitute for the participation in the Exchange Rate Mechanism (ERM-

II). Yet, they do not rule out the unilateral operation of a currency board arrangement in the countries where this arrangement already exists. This is presently the case with the currency boards of Estonia and Lithuania (both have been members of ERM-II since 2004) and the same treatment could be applied to Bulgaria if it decides to join the Exchange Rate Mechanism with its present FX regime.

EU decision to primarily involve political considerations, as no formal criteria exist for entry into ERM-II

Since there are not formal criteria for entry into ERM II, one could, understandably, say that Bulgaria deserves to become a member of the Mechanism as early as next year, as other Euro zone candidates already in the Mechanism feature significantly weaker macro fundamentals and/or policy frameworks see *e.g.* Baltic States. Furthermore, the new government seems to have done a good job thus far in fighting corruption and containing the budget deficit, while the sharp economic slowdown has facilitated a sizeable, though painful, correction of the external imbalance (these problems raised in the past significant roadblocks to the country's Euro zone entry aspirations). Yet, a decision by EU authorities on whether to allow Bulgaria enter ERM-II as early as in 2010 remains primarily a political one and as such, one cannot say with certainty whether the country's entry application will be endorsed. Note that new government initially planed to apply for ERM II last November, but this deadline has been extended to March 2010 at the earliest, with the delay being reportedly due to the time extension (until late January 2010) given to member states to submit their new convergence programs. All in all, we believe that Bulgaria has a high chance of entering ERM-II in 2010, thought we remain on the view that the official target for adoption the euro in January 2013 remains a challenging one.

Currency overvaluation and competitiveness issues

In our special focus report on Bulgaria we published in July, we argued in favor of a prudent policy framework aiming to support the currency board arrangement and eventually lead to euro adoption with the least possible disruptions for the domestic economy and markets[2]. As we noted back then, one argument in favor of the present FX regime is that a unilateral decision to abandon it (and implement a *de facto* devaluation of the lev) would inflict immense pain on domestic household and corporate balance sheets, given the extent of foreign-denominated lending in the domestic economy (see table below):

Table: local & foreign ccy denominated credits (% GDP)

	Bulgaria	Latvia	Lithuania	Estonia
Total	71.79	101.11	62.02	111.93
In local ccy	30.59	10.31	19.82	15.07
In FX	41.20	90.80	42.20	96.86

GDP numbers used are the ones estimated for 2009 by the IMF.
For Bulgaria, Lithuania: total loans is the number of total non-government loans
For Estonia: total loans in the domestic economy
For Latvia: total loans to residents

Secondly, the maintenance of the current FX regime would ensure the continuation of the successful macro stabilisation policies that have been in place since 1997 and also mitigate the risk of a disruptive spike in inflation and inflation expectations. Arguably, the latter could arise from sizeable currency devaluation and/or a return to a classic two-tier banking system, under which the central bank is allowed to monetize the fiscal deficit. Furthermore, one should not forget that the currency board arrangement in Bulgaria enjoys very solid political and social support and a decision to abandon it would require a strong majority in the parliament.

Yet, a major argument against the maintenance of the present currency board arrangement relates to the real effective exchange rate appreciation and the development of an acute external imbalance in recent years. If Bulgaria were to adopt the euro with a significantly overvalued currency the argument goes, it would be very hard to reverse the overvaluation once a member of the euro area. The experience with countries of the European South after the formation of the euro area is not very encouraging either. Let alone that the politics of EMU enlargement could change for the worse in a scenario under which old EMU members are no longer as willing to accept new members,

[2] See Eurobank Research Economy & Markets, *"Is Bulgaria's Currency Board Sustainable?"*

unless the latter can somehow ensure the competitiveness of their economies within EMU.

A counterargument to the lev's overvaluation critique is that Bulgaria's inflation is already decelerating rapidly and the current account balance has improved significantly in 2009 as a result of a sharp contraction in imports[3]. As also emphasized by out contacts at the BNB, Bulgaria's external imbalance has a large endogeneity component, with the current account deficit being primarily driven by strong FDI inflows in recent years. Furthermore, domestic currency overvaluation does not appear to be as serious as in other emerging economies in Central, Southern and South Eastern Europe as indicated by *e.g.*, a relevant ULC-based REER index calculated relative to a basket of 36 Industrial counties[4]. According to that index (1999=100), the cumulative currency overvaluation in Bulgaria was around 30% at the end of 2008 vs. 60-70% in the Baltic States and over 100% in Romania. Bulgaria has also made considerable progress in gaining market share in international export markets in recent years.

All factors considered, we maintain that keeping the currency board in place and joining ERM-II at today's exchange rate is a policy that can be effectively administered and ensure timely euro area entry. To that end, the continuation of a prudent domestic policy framework is necessary to prevent further competitiveness losses that would be harder to reverse inside the euro area.

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[3] The BNB forecasts Bulgaria's current account deficit to fall to 11%-of-GDP or lower this year, from levels around 25%-of-GDP in 2008.
[4] See European Commission, Price and Cost Competitiveness, May 2009.

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