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FOCUS NOTES: BULGARIA

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Bulgaria: Output recovery accelerated in Q4:2010

- Bulgaria exited recession in 2010, with real GDP growth accelerating to 0.3%, after contracting by 5% a year earlier
- Deputy Prime Minister, Symeon Djankov, stated that Bulgaria is not planning a Eurobond issue to finance this year's budget deficit
- In its latest progress report on Bulgaria, the European Commission cited partial progress made in judicial reform and the fight against organized crime, urged government to maintain reforms momentum

Output recovery accelerated in Q4: 2010

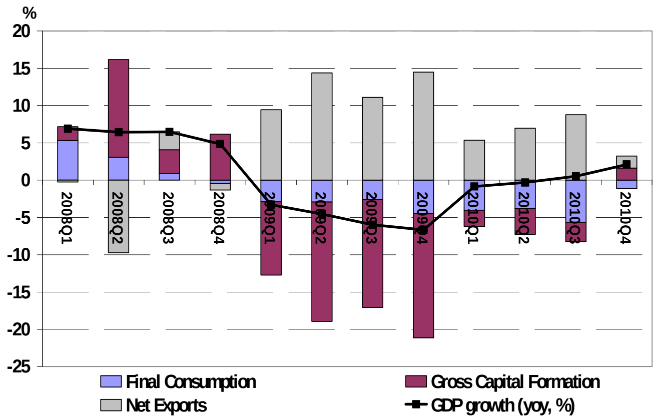
Domestic economic activity recovered further in the last quarter of 2010. According to a flash report released by the Statistical Service, real GDP expanded by 1.7% qoq in Q4 vs. 0.7% qoq in Q3. This performance placed Bulgaria among the four EU countries with the strongest quarter-on-quarter growth performance in the fourth quarter of last year. Having seen the worst of the domestic economic downturn in Q4 2009, Bulgaria exited recession in Q3 2010, at least from a technically standpoint, defined as the generation of two consecutive quarters of positive GDP growth.

On a yearly basis, real GDP grew by 2.1% yoy in Q4 compared to 0.5% yoy in Q3. From a sectoral standpoint, only services were still mired in negative territory in Q4. The contribution of both agriculture and industry was positive. Agricultural output expanded by 4.8% yoy in Q4 against 3.0% yoy in Q3. Industry registered a strong performance in Q4, expanding by 3.6% yoy, following a 1.3% yoy contraction in the prior quarter. In contrast, services declined by 1.8% yoy in Q4 vs. -1.4% yoy in Q3. However, on a quarter-on-quarter basis, the latter's pace of contraction slowed to -0.2% in Q4 from -0.8% a quarter earlier.

From the demand side, both consumption and investments improved. The contraction of private consumption slowed to -1.3% yoy in Q4 vs. -6.4 yoy in Q3. Investments still exerted a negative contribution in Q4. The 4.7% yoy rise in gross fixed capital formation (the first since Q4 2008) was offset by the decline in inventories, so that gross capital formation declined by -2.1% yoy in Q4 vs. -4.9% yoy in Q3. The performance of the external sector remained strong, but it didn't manage to keep up the pace recorded in Q3. Exports growth slowed down to 10.7% yoy in Q4 vs. 18.5% yoy in Q3. In contrast, imports recovery gained momentum in Q4. Imports recovered by 6.9% yoy in Q4 vs. 3.0% yoy in Q3.

All in, we estimate that the pattern of growth witnessed over the first three quarters of last year to have largely repeated itself in Q4. However, domestic demand turned out to be less weak while net exports performance was less robust compared to other quarters. As a result, the positive contribution of net exports declined from 8.8pps in Q3 to 1.6pps in Q4 (Figure 1).

Figure 1: Net exports contribution to GDP growth declined in Q4



Looking ahead, high-frequency indicators point to a continuation in industrial sector's recovery in the first quarter of 2011. Industrial production grew by 6.7% yoy in December bringing the corresponding full-year growth reading to 2% yoy, from -18.3% yoy in 2009. Industrial sales, a leading indicator of industrial production, were up 25.7% yoy in the last two months of 2010.

The Q4 robust output reading brought full-year GDP growth into positive territory. GDP growth came at 0.3% yoy in 2010 compared with a 5.0% yoy contraction in 2009. The 2010 full-year outcome is lower than the 0.7% yoy initial government forecast, but marginally higher than our earlier forecast for flat growth. We expect growth to accelerate to 2.5% yoy or more in 2011, assisted by a sustained exports recovery and improving domestic-demand dynamics. However, we still see a number of downside risks to our forecasts. Firstly, this remains a jobless recovery, particularly in the non-tradable sectors such as services. According to Eurostat data, Bulgaria's unemployment was 10.1% in January (vs. 9.78% according to local statistics), still remaining on a rising trend. As a result, domestic households remain extremely cautious on their spending decisions, continuing to repair their balance sheets. Secondly, there are significant downside risks stemming from a relatively high private-sector external indebtness, in an environment characterized by lingering market worries over a number of debt-laden EMU economies. The external private sector stood at high levels, 89.4% of GDP in 2010 vs. 96% of GDP in 2009. Thirdly, NPLs are still on a rising trend, posting a further rise to 11.9% in Dec 2010, from 10.6% in September 2010.

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	6.0	-5.0	0.3	2.5
Final Consumption	6.0	-5.0	-4.1	2.0
Gross Capital Formation *(Fixed)*	20.4	-26.9	-9.0	2.5
Exports	2.9	-9.8	11.8	5.0
Imports	4.9	-22.3	1.8	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.0	2.7
HICP (end of period)	7.2	1.6	4.4	3.0
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	2.9	-0.9	-3.9	-2.8
Gross Public Debt	15.5	15.5	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	5.0
External Accounts				
Current Account (% GDP)	-23.1	-9.9	-0.8	-2.5
Net FDI (EUR bn)	6.2	3.3	1.4	1.5
FDI / Current Account (%)	75.8	103.6	480.9	160.0
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

Government says not planning a Eurobond issue this year

As we had alluded in our previous *New Europe: Economics & Strategy* issue, last year's better-than-expected budget execution allowed for greater flexibility with respect to government financing. According to preliminary results, the 2010 full-year cash budget deficit came at BGN 2.78 bn or 3.9% of projected GDP, compared to a deficit of 0.9% of GDP in 2009. The outcome turned out to be significantly lower than a *revised* deficit target of 4.8% of GDP.

The government financed the 2010 fiscal deficit by a) drawing down on its fiscal reserve account with the currency board arrangement (cut down to BGN 6 bn from BGN 7.6 bn in 2009) and b) issuing domestic debt. For this year, the Ministry of Finance has announced that it intends to issue less domestic debt i.e., some BGN 1bn, vs. BGN 1.5 bn in 2010. In addition, the government earlier announced plans to issue up to €1 bn in Eurobonds to finance part of the fiscal deficit. However, in anticipation of a lower than expected financing requirement, Deputy Prime Minister Symeon Djankov was recently quoted in Bloomberg as saying that Bulgaria will not issue a Eurobond this year because this is not deemed necessary.

EU progress report acknowledges partial progress in the areas of judicial reform and the fight against organized crime.

The European Commission issued in mid February its semi-annual progress report on judicial reform and the fight against organized crime for Bulgaria. The present report takes note of the continued commitment to implement reforms in those areas and acknowledged the specific measures taken (i.e. amendments to the Judicial Systems Act, the establishment of specialized court and prosecution office for cases related to organized crime). However, the report called for the momentum of reform to be maintained, through further reform of the judicial system and of the police.

In our view, the present report constitutes a small, yet still significant, step towards further European integration. In the past reports, Bulgaria has faced significant criticism in the past, which led to the partial loss of pre-accession EU funds in 2008 (€ 220 mn from PHARE funds).

Making more visible progress in the above mentioned areas is absolutely critical. Firstly, weaknesses do not allow Bulgarian citizens to exercise their full rights as EU citizens. For that reason, France and Germany blocked Romania and Bulgaria's bid to be accepted into the passport-free Schengen zone in early 2011. More importantly, Bulgaria risks losing EU structural funds which are necessary for the development of the country. We will be looking for more progress in the next report to be issued in the summer of 2011.

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