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FOCUS NOTES: BULGARIA

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Bulgaria: On the Moody's review upgrade list

- Moody's put Bulgaria's sovereign "Baa3" rating on review in early April for a possible upgrade, citing its healthy fiscal position
- The general government deficit in ESA 95 terms came at 3.2% of GDP, better than the 3.6% initial estimate
- The continued industrial and exports recovery predisposes for a robust GDP reading in the first quarter of 2011 despite domestic demand concerns

Revised fiscal data (in ESA95 terms) in 2010 beat initial estimate, bring deficit closer to the 3% threshold

The general government deficit in ESA 95 terms (the methodology which calculates fiscal metrics in accrual terms and is used as part of the Maastricht criteria assessment) came at 3.2% of GDP in 2010 vs. a target of 3.8% in last year's budget. The reading is also favorably compared to the initial estimate of 3.6% of GDP, and 4.7% of GDP in 2009. Accordingly, the public debt came at 16.2% of GDP in 2010 vs. 14.6% in 2009.

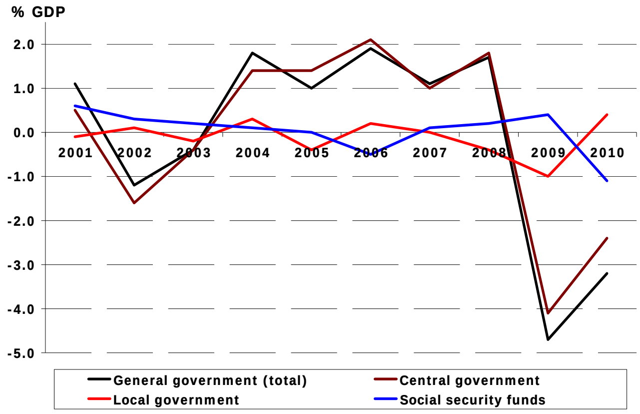
Firstly, the revised outcome brings fiscal deficit closer to the 3% Maastricht threshold. As such, it places Bulgaria among the most fiscally sound countries in the EU-27 and the broader region. Fiscal metrics in EU-27 fare much worse both in terms of deficit (EU-27: 6.4%) and indebtness (EU-27: 80%). In essence, it provides tangible evidence of the authorities' commitment towards fulfillment of the Maastricht criteria. The deficit came as the combined result of the following sectors: the central government posted a 2.4% of GDP deficit down from 4.1% in 2009; the social security fund recorded a deficit at 1.1% of GDP down from a 0.5% surplus. Finally, the sector of local governments had a positive contribution of 0.4% of GDP compared to a 1% deficit in 2009 (Figure 1).

Looking ahead, the government targets a general government deficit at 2.5% of GDP (both in accruals and cash basis) in 2011. In our previous trips in Sofia, back in October 2010 and March 2011, the attainability of the target was a focal point in our discussions. We have argued in favor of the attainability of the fiscal target in 2011. However, we have assessed that the deficit outcome would not only depend upon the headline GDP figure but also on the decomposition of growth. The first indications from the Jan-March data released are sending an encouraging message. The fiscal deficit on a cash basis came down by 55% yoy, reaching 1% of GDP compared to 2.4% of GDP in Jan-March 2010.

The second point to be made refers to predictability and prudence of the fiscal policies in the medium term. This is particularly important for the sustainability of the currency board arrangement. Finally, the government has reiterated its political will to maintain low deficits in the medium term as part of its commitments within the budget framework 2012-2014 and the revised convergence program. Within this framework, the government targets a gradual reduction of the budget deficit to 1.5% of GDP in 2012, 1% of GDP in 2013 and 0.5% of GDP in 2014.

Figure 1

Fiscal performance improved further in 2010



Source: Eurostat, Eurobank Research

Bulgaria comes under the microscope of Moody's for a sovereign rating upgrade; more action should be expected by other rating agencies in the medium term

Furthermore, the robust fiscal performance has not escaped attention from the rating agencies. On April 5th, Moody's Investors Service put Bulgaria's 'Baa3' rating on review for a possible upgrade, citing its extremely healthy fiscal metrics. In the sovereign report assessment released on May 4th, the rating agency praised the conservative fiscal policies that have allowed Bulgaria to avoid the fiscal fate of most of the rest of Eurozone members. In addition, the agency assessed that the target to reduce the deficit to 2.5% of GDP as attainable, yet a lot will depend upon the March-April tax revenue performance. Lastly, Moody's ranks susceptibility to event risk as moderate to reflect the extensive Euroization, the high external debt and weak external liquidity. The latter would only pose a risk in the case of a exchange rate regime change which is seen as very unlikely.

We have long argued in all our past New Europe Economics & Strategy issues over the health of public finances in Bulgaria. The report brings up a more important issue: the sovereign rating of Bulgaria vs. that of its New Europe peers. More importantly, Bulgaria fares much better in terms of fiscal metrics compared to all other Baa countries (according to the Moody's rankings with the exception of Kazakhstan and Russia, which are commodity driven economies).

The Bulgarian economy has fared much better in terms of output contraction, fiscal metrics, external metrics compared to the Baltic peers (Latvia and Lithuania who also have a currency board). In addition, Bulgaria fares better than Croatia (who is still in recession) or Hungary (who resorted to an IMF program to shore up its public finances). Yet Bulgaria is assigned with the same long-term rate by both Moody's and Fitch. Standard and Poor's differentiates from the above assigning Bulgaria a rating one notch higher than Hungary and same rate as Lithuania. From that point of view, Bulgaria qualifies for a rating upgrade.

Last but not least, we do take note that the sovereign rating didn't drop below investment grade in the post-Lehman environment. That said, we anticipate that the economic environment improvement coupled with the improving macroeconomic fundamentals should lead other rating agencies reassess their stance soon (Table1).

The most recent high frequency indicators point to a sustained exports-led recovery in Q1; IMF upgraded its GDP forecast to 3% for 2011 in the latest World Economic Outlook

The most recent high frequency indicators in the first two months of the year point to a continuation of the exports-led recovery. In addition, early signals of recovery from the domestic demand side have shown up. The continued industrial and exports recovery predisposes for a positive GDP reading in the first quarter of 2011 despite lingering downside concerns for domestic demand.

More specifically:

- Exports are still booming: Exports expanded by an astonishing 46.5% yoy in February in addition to the 72.5% yoy in January, which brings the two-month performance at 58.9% yoy. Exports to the non-EU markets are still outperforming those to EU markets (65% yoy to non-EU vs. 55% yoy in EU). On the other hand, imports are lagging behind by 36.3% yoy in the same period.
- Industrial production accelerated to 15.2% yoy in February (-1.4% mom) compared to 10.1% yoy in

January. Although the figure is preliminary and influenced by the low base from February 2010, a comparable figure on a yearly basis has not been recorded since January 2007. The exports-oriented sectors (chemicals, textiles, tobacco, pharmaceuticals) are driving manufacturing production up by 22% yoy in February compared to 15.6% yoy in January.

- Industrial sales performance is keeping up: Industrial sales expanded by 32% yoy in February vs. 35.9% yoy in January.
- After a one off deterioration in March, business confidence improved further in April (by 2.4pps to 17.5) driven by improved perceptions in the industry and services sectors. On the other side of the spectrum, the sectors of construction and retail remain pessimistic.
- The retail sales volume (seasonally adjusted) turned positive on yearly basis in March. Retail sales expanded by 1.4% yoy in March compared to -0.1% yoy in February, up from -0.2% yoy in January and -3.7% yoy in last December.

In our key notes from our last trip to Sofia in late March, we focused on the growth prospects of 2011. Among the key conclusions of our trip was to upgrade our baseline GDP forecast, based on the discussions with our contacts. In our 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 still 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 identified the following factors as presenting the main risks to our 2011 GDP growth forecast:

- Inflation climbed further to 5.6% in March vs. 5.2% in February on rising food and oil prices
- Weak domestic credit activity: Credit to households remains on a negative territory since the beginning of the year (-0.2% year-to-March)
- High refinancing needs of private-sector external debt: private external debt stood at 83.6% of GDP in February down from 89.9% in last December on a steadily declining trend
- High unemployment rate: registered unemployment stood at 9.5% in March vs. 9.2% in last December

Table 1

Sovereign rating actions on Bulgaria vs. its New Europe peers (Long-term-Foreign Currency)

	Moody's			S&P			Fitch		
	Current Rating	Date of last rating action	Action	Current Rating	Date of last rating action	Action	Current Rating	Date of last rating action	Action
Lithuania	Baa1	28.9.09	from A3 to Baa1	BBB	24.3.09	from BBB+ to BBB	BBB	8.4.09	from BBB+ to BBB
Latvia	Baa3	23.4.09	from Baa1 to Baa3	BB+	7.12.10	from BB to BB+	BBB-	15.3.11	from BB+ to BBB-
Hungary	Baa3	6.12.10	from Baa1 to Baa3	BBB-	30.3.09	from BBB to BBB-	BBB-	23.12.10	from BBB to BBB-
Croatia	Baa3	27.1.97	-	BBB-	21.12.10	from BBB to BBB-	BBB-	28.6.01	from BB+ to BBB-
Romania	Baa3	10.6.06	from Ba1 to Baa3	BB+	27.10.08	from BBB- to BB+	BB+	10.11.08	from BBB to BB+
Bulgaria	Baa3	1/3/2006	from Ba1 to Baa3	BBB	30.10.08	from BBB+ to BBB	BBB-	10.11.08	from BBB to BBB-

Source: Rating agencies, Eurobank Research

Since late March, a number of international organizations have published their updated forecasts for the Bulgarian economy. IMF published its semi-annual publication on world economy in April, the World Economic Outlook. IMF upgraded its 2011 GDP forecast for Bulgaria to 3% compared to 2.5% in the previous publication back in October. In contrast, World Bank has maintained its 2.5% GDP forecast in 2011 in the latest EU-10 Progress Report. However, both organizations (IMF and World Bank) forecast growth to accelerate further at 3.5% and 3.4% respectively in 2012.

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