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www.eurobank.gr/research
research@eurobank.gr

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FOCUS NOTES: BULGARIA

Written By:

Ioannis Gkionis:
Research Economist
New Europe Specialist

Bulgaria: Banking sector troubles subside but political risks remain

- **Banking sector troubles subside on the decisive actions of the authorities and the approval of a EU precautionary line for liquidity support**
- **The polls ahead of the early parliamentary elections suggest that a swift of power to a GERB led government coalition is likely**
- **Significant fiscal relaxation as a result of lackluster growth and banking sector recapitalization costs is underway**

The decisive actions of the Bulgarian authorities and the approval of an EU precautionary line have averted a banking crisis in Bulgaria

The level of stress in the banking sector increased sharply in last June. On June 20th and June 27th, a deposit run on the two largest domestically owned banks forced the Central Bank to intervene. On June 20th, a bank run forced the authorities to put the Corporat eCommercial Bank (Corpbank), the fourth largest bank in terms of assets in Bulgaria, under conservatorship. Depositors withdrew BGN 9.07mn from Corpbank between June 13 and 20. Those deposits are equivalent of 13% of the bank's total liabilities.

For quite some time, both Corpbank and the clash between Mr. Delyan Peevski, a controversial media tycoon and MP, and the major shareholder of the bank Mr. Tsvetan Vasilev was the focus of media reports. Mr. Delyan Peevski came into the spotlight when he resigned from his fresh appointment as Head of National Intelligence last year because demonstrations sparked out against his appointment. Some media reports, owned by Mr. Peevski, suggested that the biggest shareholder of the bank, Mr. Tsvetan Vasilev had been receiving loans on favorable terms to support his business activities. The media turmoil grew even louder when an anonymous letter to the media from a person who claimed to be a Central Bank (BNB) employee sparked rumors for lack of proper oversight of Corpbank.

The immediate response of the BNB was to put CCB under conservatorship initially for one month which was extended to three months, order an asset and liabilities review, remove the management and revoke shareholders' rights. The initial proposal of the BNB provided for the nationalization of the bank, and the recapitalization with the contribution of the Bulgarian Development Bank and the Deposit Insurance Fund.

Following the preliminary review in the books of CCB, the BNB found that 65% of the loan portfolio (BGN 3.5 bn, out of the total BGN 5.4 bn loan portfolio) had incomplete or missing documentation and that most of it was strongly linked to the business activities of the main shareholder. In addition, the conservators' assessment showed that the day before the bank was placed under special custody an amount of BGN205.8 mn (approximately €105.3 mn) in deposits was syphoned out on behalf of the main shareholder.

Based on the findings of the review, which don't allow for an independent assessment and valuation of the loan portfolio of the bank, the BNB drafted another plan. The plan foresaw the license revocation of the Corpbank, the initiation of insolvency procedures, the break-up of Corpbank into a "good" and "bad bank", and the folding of the good bank into the nationalized subsidiary of Corpbank, Credit Agricole Bulgaria (Corpbank had acquired Credit Agricole Bulgaria from the French bank bearing the same name in last May). In addition, it included the repayment of all deposits (both insured and uninsured) except for those linked to the main shareholder. However, the consultations of the BNB with the political leadership failed to reach an agreement on that plan. In turn, up until now it is still unclear what the final resolution of the Corpbank would include. If the bankruptcy procedures in place are to be implemented, deposits only up to €100,000 (or the equivalent of BGN 196,000) are going to be compensated. The BNB has ordered a thorough audit which is expected to be finalized by mid-October and then make a decision on the resolution of the bank. Meanwhile, the bondholders have threatened to sue the government in case the bank defaults on the bonds due on Aug 8th.

The second bank run took place in First Investment Bank (FBI), the third largest in terms of assets domestic bank, on June 27th. The clients of First Investment Bank withdrew BGN 788 mn in a single day. This is the equivalent of 10.5% of its total liabilities. However, FIB managed to remain operational and avoided a liquidity crunch without making use of State Aid. While the first incident appears to be the result of the clash between two oligarchs and former allies, there are indications that the second is the result of a speculative attack on the banking system. The deposit run was triggered by malicious electronic media messages which targeted the bank and implied that there is a fundamental problem with the banking system and the stability of the currency board.

The immediate and decisive response on behalf of the BNB and the unanimous institutional commitment and political parties support to the currency board averted a banking crisis. Moreover, the authorities asked for liquidity support from EU on June 29th. The provision of a precautionary credit line of BGN 3.3bn (around €1.7bn) aimed to provide the banking sector with the necessary liquidity, reassure depositors and in order to respond to speculative attacks. The decisive actions on behalf of the authorities minimized the probability of contagion and helped restoring confidence in the banking system. This is evidenced in the increase of the deposit base in last June. According to the latest available data, total deposits expanded by +0.8% mom/+7.3% yoy in June up from +0.5% mom/+6.7% yoy in May.

The runs on the two domestic banks are isolated incidents in a generally well capitalized banking system. Near term risks on economic activity are contained

The recent developments have put the banks of the country in the spotlight and raised concerns over the stability of the banking sector. In our view, the runs on the two domestic banks are isolated incidents in a generally well capitalized banking system. Available data confirm that the banking system is well capitalized and highly liquid by standard metrics. The capital adequacy ratio (CAD) stood at 20.4% in Q1-2014 up from 16.3% in Q1-2013. The core tier I ratio stood at 18.2% in Q1-2014 up from 15.4% in Q1-2013. The liquid assets ratio stood at 27% in Q1-2014 almost unchanged compared to a year ago. From a fundamentals point of view, that should keep near term risks of a broad disruption and contagion contained. The banking sector is primarily owned by foreign banks (70% of assets belong to foreign groups) which helps insulate them from malpractices. Foreign banks have better risk management practices and stronger corporate governance structures.

On the other hand, the bank runs have raised attention on the issue of banking supervision effectiveness. In that direction, BNB has agreed to submit itself to an independent assessment by the European Banking Authority (EBA) which will focus on assessing the effectiveness of banking supervision and make the results of assessment public. From that point of view, the crisis can turn into an opportunity for further integration of Bulgaria into the European structures. Bulgarian authorities decided to apply for Single Supervisory Mechanism (SSM) entry. If that happens, Bulgaria will be the first non-Euroarea country to join the SSM on a voluntary basis. At the same time, those incidents illustrate the need to strengthen corporate governance in the domestic-owned part of the banking system.

Finally, the collateral damage on the real economy has been minimized. The noise from were short-lived and contained to the specific banks so that the immediate repercussions on economic activity would be very limited. Thus, the two incidents are expected to have a temporary negative impact on sentiment. However, in case the result of the early parliamentary elections is inconclusive, then protracted political uncertainty could have a negative impact on the banking sector.

Significant fiscal relaxation is on the cards in 2014. Yet, the fiscal position of Bulgaria remains one of the healthiest in the EU

Political uncertainty has also started to weigh negatively on fiscal policy implementation. The expansive fiscal policy followed by the outgoing government in order to appease anti-government protests led to a sharp widening of the fiscal deficit in 2013. A number of populist measures (pension hikes, increased social transfers, disbursements for capital investments, VAT refunds) boosted discretionary spending by 1.7% of GDP.

As a result, the consolidated government deficit in cash basis terms came at 1.8% of GDP in 2013 just below the fiscal rule, up from 0.5% of GDP in 2012. In ESA-95 terms, the fiscal deficit stood at 1.5% in 2013 up from 0.8% in 2012 to account for the deferred VAT refunds. The suspension of EU financing weighted further negatively on budget execution in late 2013. The rise in deficit would have been even higher had it not been for the special dividend paid by the state-owned enterprises.

The initial target for 2014 was set at 1.8% of GDP. Nevertheless, the key macro variables and assumptions of the budget framework have already been outdated. The budget implementation in the 1H-2014 has already illustrated the need for revision. The consolidated government result swung at a deficit of BGN 995mn or 1.2% of GDP in 1H-2014 vs. an insignificant deficit (BGN 7.9 mn) a year ago. The lower than expected growth, the deflationary effect on tax revenues, the lower tax compliance led to revenues underperformance. As a result, total revenues were flat in 1H-2014 (tax revenues expanded by 2.1% yoy), much less than the 6.3% full year target. At the same time, spending was up by 7.1% yoy driven by higher capital investment (+30.2% yoy), higher social transfers to the healthcare system (+3.2% yoy) and increased spending on pensions (+7.2% yoy) & public wages (+3.6% yoy).

For that reason, mounting political pressure led to a hefty revision to 2.7% of GDP, just below the 3% Maastricht threshold. However, the outgoing parliament failed to approve the budget revision, leaving little for maneuver to the incoming caretaker government. The budget revision became a contentious issue between political parties ahead of the start of the pre-election period. Yet it is still uncertain if authorities would be able to meet the revised fiscal target. We see a number of downside risks to the revised budget target. If those materialize, the fiscal deficit is more likely to overshoot the revised fiscal target. One of the key uncertainties in the budget implementation in the 2H is the bail-out costs from the cases of Corpbank and First Investment Bank. The costs of recapitalization or any other resolution plan-which are unknown at the moment of the writing - are going to weigh negatively on the fiscal result. In addition, the ongoing political uncertainty and the recent banking sector episodes are more likely to undermine confidence to some extent putting further pressure on growth and tax compliance while deflation doesn't help.

In any case, even under those circumstances, the fiscal position of Bulgaria is one of the healthiest in the EU. The public debt to GDP ratio stood at 18.9% of GDP in 2013, one of the lowest in EU-28, and is projected to reach 22.1% of GDP in 2014 (under the budget revision the debt ceiling increased by BGN 3.4bn). Despite the turmoil in the banking system, Bulgaria was able to tap the international markets at favorable terms. Bulgaria was able to issue €1.5bn offering 10Y bonds. The issue was over-subscribed by more than two times. The yield to maturity of the 10 year benchmark bond came at 3.1% (160bps over mid-swaps).

Bulgaria: Eurobank Research Forecasts

	2011	2012	2013	2014f
Real GDP (yoy %)	1.8	0.6	0.9	1.6
Final Consumption	1.5	2.9	-1.4	0.7
Gross Capital Formation *(Fixed)*	-6.5	4.0	-0.4	2.5
Exports	12.3	-0.4	9.0	6.5
Imports	8.8	3.3	5.7	5.0
Inflation (yoy %)				
CPI (annual average)	4.2	3.0	0.9	-0.4
CPI (end of period)	2.8	4.2	-1.6	1.0
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	-2.0	-0.5	-1.9	-2.7
Gross Public Debt	17.0	18.8	19.1	22.1
Primary Balance	-1.3	0.3	-1.0	-1.9
Labor Statistics				
Unemployment Rate (LFS, %)	11.3	12.3	12.9	12.7
Wage Growth *(total economy)*	5.9	6.6	10.5	3.5
External Accounts				
Current Account (% GDP)	0.1	-0.8	1.9	0.5
Net FDI (EUR bn)	1.3	1.1	1.1	1.0
FDI / Current Account (%)	Na	284.3	Na	Na
FX Reserves (EUR bn)	13.3	15.6	14.4	14.5
Domestic Credit	**2011**	**2012**	**2013**	**Q1 14**
Total Credit (%GDP)	74.4	74.1	74.4	75.8
Credit to Enterprises (%GDP)	47.9	48.9	49.0	50.0
Credit to Households (%GDP)	24.6	23.6	23.7	23.7
FX Credit/Total Credit (%)	63.7	64.0	60.9	60.5
Private Sector Credit (yoy)	3.9	3.8	0.6	1.7
Loans to Deposits (%)	104.0	99.4	92.1	91.0
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

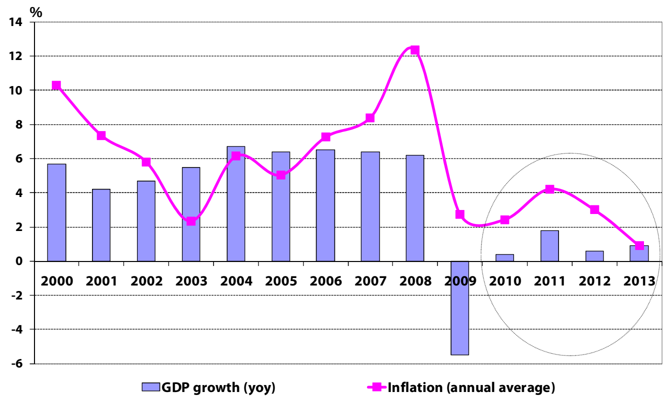
Early parliamentary elections have been called upon October 5th after the ruling coalition failed to get enough support in the Euro-parliament elections

Consensus was reached among political parties on early parliamentary elections to take place on October 5th. After only eleven months in office, the cabinet led by the outgoing Prime Minister Mr. Plamen Oresharsky resigned on July 23rd. Following the disappointing performance of the Socialist Party (BSP) in Euro parliament elections, tensions within the government coalition became stronger. The senior coalition partner, the Socialist Party (BSP) collected 18.9% of the vote followed closely by the junior partner, the Movement for Rights and Freedoms (MRF) with 17.3% versus 30.4% for the main opposition party Citizens for the European Development of Bulgaria (GERB). As a result, the MRF which represents Ethnic Turks and benefits from a low voters turnout withdrew its support from the cabinet calling for early elections.

The ruling coalition BSP -MRF was unstable by construction. Ever since it came into power in late May 2013, the BSP-MRF coalition controlled 120 seats out of the 240 seat parliament, but still lacked absolutely majority in the parliament. Thus, it relied on the implicit support of the ultra-nationalist party ATAKA (23 seats) to survive in the parliament. Despite fragile arithmetic, the cabinet survived five motions of no confidence in the parliament. However, mass antigovernment street protests for a number of months undermined government stability. Internal divisions within the BSP made things only worse. Mr. Parvanov, a former leader of BSP, decided to run with his own list of candidates in the European elections. Mr. Ivailo Kalfin, the head of the party's group in the European Parliament, resigned to run with Mr. Parvanov's new party (ABV-Alternativ for Bulgarian Revival). Last but not least, the issue of the construction of the Bulgarian section of the South Stream has raised a lot of publicity which led to speculation that it may have played a role in the government collapse. The controversial tender for a project contractor resulted in the European Commission opening infringement proceedings against Bulgaria. That came on top on the freezing of EU funds payments for the operational programme of environment on investigation of abuse in the public procurement process.

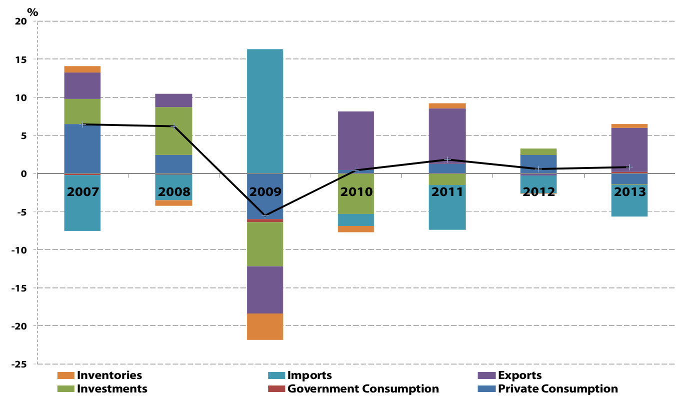
Recent polls suggest that the main opposition party GERB has a clear lead with around 24-26% of the vote versus 15-17% for BSP and around 7% for MRF. Two more parties are likely to cross the 4% parliamentary threshold: the center right Reformist Bloc (Rb) and Bulgaria without Censorship (BwC). At this point, the scenario of a swift of power to a GERB-led government is more likely to materialize. However, given the past experience a repeat of last year's inconclusive election result that may lead to the formation of a multi-party government cannot be ruled out. In retrospect, political uncertainty in the country has increased dramatically over the past year so that policy continuity and credibility in the short and medium term prospects is at stake. Political uncertainty impedes progress in the so much needed structural reforms and casts shadows on the growth prospects of 2014-2015.

Figure 1: GDP & Inflation growth rates



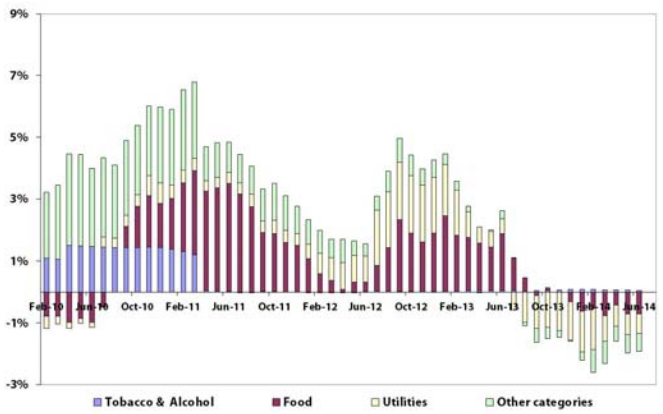
Source:National Statistics, Eurobank Research

Figure 2: GDP growth components



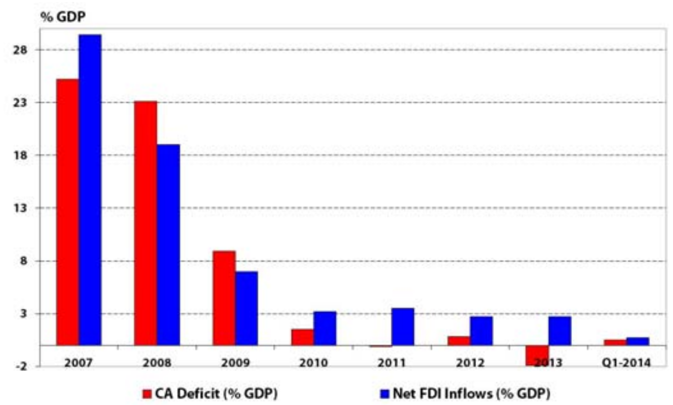
Source:National Statistics, Eurobank Research

Figure 3: Inflation components



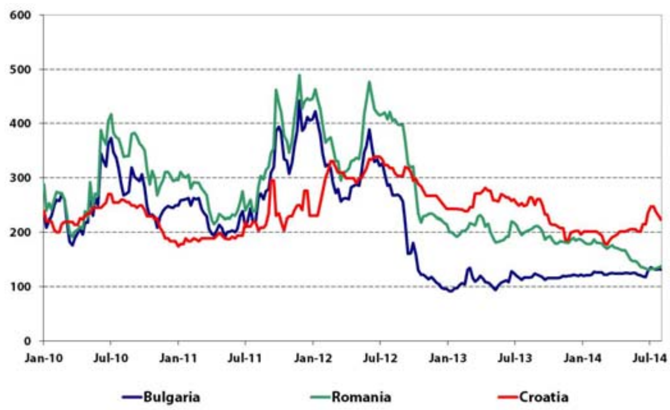
Source: National Statistics, Eurobank Research

Figure 4: CA Deficit & Net FDI inflows



Source: BNB, Eurobank Research

Figure 5: Comparison of regional CDS spreads



Source:Eurobank Research, Ecowin Reuters

Figure 6: Bulgaria's Government Benchmarks 5Y

Source:Reuters Ecowin

Economic Research Team

Economic Research & Forecasting Division
Ioannis Gkionis: *Research Economist*
Stylianos Gogos: *Economic Analyst*
Vasilis Zarkos: *Economic Analyst*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodoros Stamatiou: *Research Economist*

Eurobank, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr