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Trip Notes: Bulgaria

Key notes from our recent trip to Sofia: October 14th- 15th

Earlier this month, we traveled to Sofia where we met with high-level officials from the BNB, the Finance Ministry, and the IMF 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

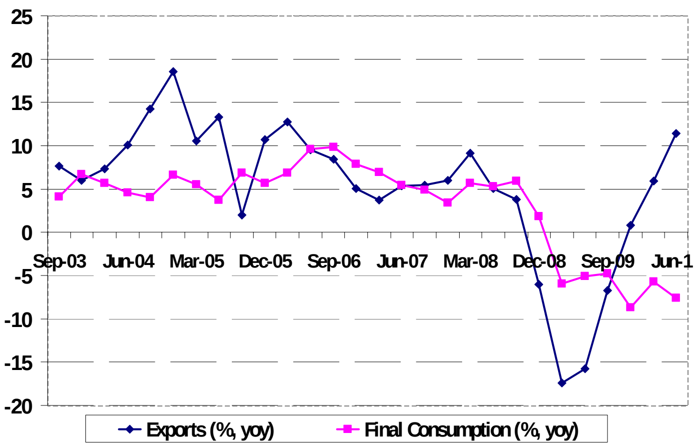
- ✓ **Economic recovery underway, driven mainly by higher exports. GDP growth seen accelerating further in 2011 on improving domestic demand dynamics**
- ✓ **The government remains firmly committed to swift euro adoption; Conditions for ERM-II entry application may become more favorable by the end of next year, provided that the government will stick to the announced fiscal target for 2011**
- ✓ **Bulgaria needs to accelerate structural reforms in the pension system, health care and education sectors in order to ensure medium-term sustainability of its public finances**
- ✓ **The silver lining of the economic recession is the rapid absorption of earlier macroeconomic imbalances. The latter can lay the foundation of a more balance growth environment medium-term**
- ✓ **Credit conditions remain tight despite the adequate capitalization and sufficient liquidity of the banking system. The deleveraging process in the household sector appears to be reaching a trough, yet vulnerabilities in the corporate sector remain**
- ✓ **Bulgaria's Currency Board Arrangement remains sound and sustainable, with foreign exchange reserves providing strong coverage of the monetary base and broader monetary aggregates.**
- ✓ **The apparent elimination of an earlier lev-overvaluation provides an overwhelming case for maintaining the present FX regime until euro adoption**

Economy is slowly emerging from recession, driven primarily by higher exports

The domestic macro outlook has brightened since our last visit to Sofia in December 2009. Having seen the worst of the recession in Q4:2009, the Bulgarian economy is recovering slowly, with the pace of contraction in real GDP growth easing to 1.4% yoy in Q2:2010, from 3.6% yoy in the prior quarter. On a quarter-to-quarter (seasonally adjusted) basis, domestic output grew by 0.5% in Q2, after declining by 0.5% in the first quarter. Notably, the majority of our discussants forecasted another positive q-o-q reading in Q3 and thus, a termination of the domestic recession, at least from a technical standpoint.

The pattern of recent economic recovery largely repeated itself in Q2:2010, with domestic demand falling behind. The pace of contraction in private consumption appears to have slowed to - 4% yoy from -6.8% yoy in Q1. Government spending was also particularly weak (-19.2% yoy in Q2) affected by the government's fiscal consolidation program. Furthermore, investment recorded a steep decline of -12.2% compared to -15.8% yoy in the prior quarter and -24.9% in the year 2009 as a whole. On a more positive note, the contribution of net exports to overall GDP growth turned even more positive in Q2, compared to the first quarter of 2010, mainly reflecting higher exports. The latter recorded astonishing growth of 12.4% yoy in Q2, after rising by 7.6% yoy in Q1. At the same time, imports stayed flat on yearly basis in Q2 vs. -2.6% yoy in Q1.

Figure 2: Final consumption remained weak in Q2



For the time being, the continued slump in domestic demand is outweighing the recovery in net exports. For the year 2010 as a whole, domestic demand is not anticipated to have a positive contribution to overall GDP growth, given the former's steep pace of contraction in H1. Yet, the contribution of domestic demand is expected to gradually become less negative in the coming quarters, which, along with a continuing positive contribution from next exports, should see annual real GDP growth turning positive in the second half of the year, starting from Q4:2010.

Growth expected to pick up in 2011 on improved domestic demand dynamics and sustained exports recovery

The domestic macro outlook for 2011 and beyond was a focal point in our discussions with government and industry officials. There was unanimous agreement among our contacts that next year should see both a significantly faster and a more balance economic growth trajectory, though there were diverging views over the magnitude of the expected recovery.

We also anticipate an acceleration of the pace of domestic economic recovery next year, with the contribution of domestic demand turning positive and that of next exports lessening somewhat relative to the current year, mainly as a result of higher imports growth. Our baseline forecast for Bulgaria's GDP growth in 2011 lies at 2.5% yoy, with risks being broadly balanced. Among the upside risks to the domestic growth environment, we rank high the utilization of EU structural funds and the country's sound fiscal position. A faster utilization of EU funds could provide a significant boost to domestic investment over the next several years, especially in an environment of more difficult conditions in world credit markets and reduced FDI inflows. The Bulgarian government has recently demonstrated significant progress regarding the absorption and efficient utilization of EU funds, with the respective absorption rate climbed to around 8% in September 2010 compared to less than 1% a year earlier. According to one of our contacts, the continuation of such improved performance could add between 1.0 and 1.5pps to annual GDP growth over the coming few years.

Most importantly, the relatively solid fiscal position lays the foundations for a stronger economic rebound next year, while, at the same time, allows for greater predictability with respect to the government's policies on wages and pensions. In addition to the aforementioned, recent readings in a range of higher-frequency macro indicators and improving consumer and business surveys signal stabilizing conditions in the domestic economy and lay the foundations of a more pronounced economic recovery in 2011. On the other hand, there is a number of downside risks to our GDP forecasts. Among others, these include the impact of a potential growth slowdown in main trade-partner economies that could not be offset by increased exports to new markets. Bulgarian exports have diversified geographically in recent years with a growing volume now being destined to Middle East and Turkey. Yet, the risk of slower exports growth in 2011 is not minimal, if only on the back of unfavorable base effects. Last but not least, stagnant credit growth could prevent a more sustained recovery in domestic demand dynamics next year.

Achievement of the fiscal target in 2010 considered more or less a done deal

In our meetings with officials at the Central Bank and the Ministry of Finance, we had the opportunity to discuss the latest fiscal developments and the budget outlook for 2011. The broad picture is that Bulgaria still enjoys a comfortable fiscal position, as measured by standard sustainability metrics and in comparison with other countries in the broader region. First of all, the fiscal deficit in Bulgaria remains one of the lowest in EU-27. Even after accounting for a number of revisions to past fiscal data as a result of the hidden procurement annexes discovered last March, the 2010 budget deficit is projected to reach 4.8%-of-GDP on a cash basis and 3.8%of-GDP in ESA-95 terms. Moreover, gross public debt is expected to reach 18.6% of-GDP this year, comparing to 84.7% in EU-16 and 79.6%-of-GDP in EU-27. The respective figure stands significantly below the Maastricht Treaty's 60% threshold, remaining the second lowest in EU-27 after Estonia.

The revision of this year's fiscal target in July (to 4.8%-of-GDP, from 0.7%-of-GDP envisioned initially) brought the respective deficit projection closer to current economic reality. The revised budget forecasts total revenues to reach BGN 15.2 bn this year *i.e.,* 11% yoy (or 2.9%-of-GDP) lower relative to the initial target. On the expenditures side, total budget outlays this year are now seen amounting to BGN 18.9 bn or 5.7% yoy higher than the initial target. The budget execution data for the first eight months have demonstrated that the achievement of the fiscal target of 2010 is more or less a done deal. In fact, higher tax revenue during the remainder of the year could even facilitate an outperformance of the fiscal deficit target in 2010. There are a number of potential reasons for such a favorable development, including: a) an improved tax collection mechanisms, b) recovering domestic demand 3) higher than forecast domestic inflation boosting nominal tax revenues.

According to preliminary data, the fiscal deficit reached BGN 1.5 bn year-to-September or 2.1% of projected 2010 GDP, remaining steady relative to the January-August period. Importantly, the negative trend in revenues collection has started to reverse, though total revenues were still declining on an annual basis in the first eight months of the year, albeit at a slower pace than in early 2010. (Total revenue down 9.8% yoy in January-August vs. -13.6% yoy in 1H). Among other categories, VAT revenues jumped strongly in recent months, currently standing not far from their pre-crisis levels. Specifically, they reached around 61.9% of the full-year budget plan in August against only 43.1% in June. In addition, the implementation of additional belt-tightening measures since last March has resulted in total expenditures declining by 1.2% yoy year-to-August vs. -0.5% yoy in 1H.

Our discussions with BNB and finance ministry officials focused on two additional issues. The first one relates to the financing of this year's fiscal deficit. The revised budget foresees that financing will come from both the fiscal reserve account and domestic resources, with domestic debt issuance forecasted to reach BGN 2.0 bn by the end of 2010 against BGN 1.2 bn planned initially.

The government made use of its fiscal reserve account to finance the fiscal deficit in 1H: 2010. (In fact it had started drawing down the fiscal reserve account for budget-financing purposes since July 2009, when deficits started to emerge). As a result, the fiscal reserve declined to BGN 6.0 bn in June 2010, from BGN 7.6 bn in December 2009. According tour discussants, the use of the fiscal reserve to finance the fiscal deficit was terminated in June 2010, with the contingency reserve climbing to BGN 6.7 bn in September. That said, the Ministry of Finance resorted to domestic financing sources in more recent months, issuing in September some €234mn in 15-year EUR-denominated bonds at 6.45%. The aforementioned issue was extremely successful, being oversubscribed by five times, relative to the initially intended issue size (€45 mn).

Successful execution of 2011 budget seen as key prerequisite for reapplying to ERM-II mechanism

Another important issue we delved into during our recent Sofia meetings was the attainability of the 2011 fiscal targets. The new budget foresees the fiscal deficit to decline to 2.5% of GDP on a cash basis, based on a 3.6% GDP growth assumption for 2011. That would be the combined result of expenditures staying flat in nominal terms and total revenues growing by 5.2% yoy. Most of our discussants argued that next year's fiscal target remains within reach. Yet, some of them expressed certain reservations regarding the official forecast for GDP growth next year. We *do* share these concerns. However, we note that the final deficit will depend not only on the headline GDP outcome, but also on the *composition* of growth next year. Naturally, that is because a shift towards a more domestic-demand oriented growth environment has, by definition, higher tax content (because of the VAT).

The government has stated that it does not intend to change the present VAT or the corporate and personal income tax rates next year. However, it has announced its intention to raise excise taxes on some goods. In addition, it intends to increase the social security contribution rates, most probably by 3pps, taking back the prior year's reduction. The government has a number of options to finance the 2011 budget deficit with domestic and external resources, but it has not made clear yet the precise financing mix it intends to use. Among the options is the issuance of Eurobonds in international markets worth €1.0-1.2bn.

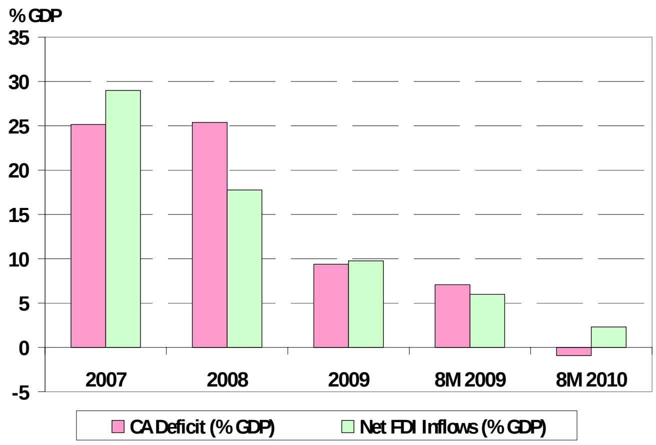
There are two important implications with respect to the achievement of the fiscal target in 2011. The revelation of the hidden annexes in public contracts last March had a negative impact on the image of the country, but not a devastating effect on the credibility of its fiscal statistics. Yet, the breach of the 3%-of-GDP deficit threshold was enough to defer the ERM -II application and put the country in the adventures of the excessive deficit procedure. For that reason, it is imperative that the fiscal target of 2011 is achieved. From our discussions with the authorities and a number of high-level industry officials we concluded that the government remains committed to swift euro adoption as soon as domestic and external macroeconomic and political conditions allow. As such, an official application for ERM-II entry could materialize as early as in 2012, especially if the government manages to meet next year's fiscal target.

Last but not least, the government needs to ensure successful execution of its fiscal consolidation program in order to strengthen medium-term sustainability of public finances. An important element in that process is the acceleration of the structural reforms in the pension system, 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 next year's Presidential elections

The silver lining of the recent recession is the quick absorption of earlier macroeconomic imbalances

One of the side effects of the recent recession in Bulgaria is the quick retreat of earlier macroeconomic imbalances. In particular, the decline in the current account deficit has exceeded by far earlier analyst expectations. According to the latest data, the current account swung into surplus in August for a third month in a row. As a result, it recorded a surplus of €323 mn in January-August, which represented 0.9% of the projected full year GDP vs. a deficit of 7.3% of GDP in the first eight months of 2009 (Figure 2).

Figure 2: Current account swung into surplus in Jan-August 2010



This improvement reflects mainly a smaller trade gap (down 4.8ppts of GDP year-on-year in January-Aug 2010 at 3.7% of GDP), owing to a strong recovery in exports (+32.2% yoy over that period). In August only, exports were growing at the astonishing rate of 47.6% yoy against a decline of 25.5% in August 2009. Imports grew by 7.2% yoy over the same period, having recorded negative annual growth until April. Exports to non EU-markets expanded more rapidly, benefiting mainly by the rebound in the Turkish economy. Besides a lower trade gap, other elements have also contributed to the current account improvement year-to-August. Although revenues from tourism and transportation from foreign visitors remained flat compared to last year, net services recorded a surplus increased by 45.5% yoy thanks to less transportation and tourism services used by domestic residents. In addition, the incomes deficit came out much lower than a year earlier (down 20.2% in January-August), as foreign-owned companies paid out less dividends to mother companies abroad. Moreover, net current transfers recorded a higher surplus (+69% yoy), thanks to increased EU funds inflows.

From the funding side, the capital and financial account recorded a deficit of €695mn in the first eight months of this year. The most important component, net FDI inflows, remained sharply lower (down 60.5% vs. a year earlier), amounting to €835 mn. The sectors affected the most were real estate and financial intermediation. However, the FDI-to-current account coverage improved to 237% year-to-August, from 82% in the corresponding period last year. Elsewhere, net portfolio investments remained negative (-€483mm vs. -€567mn in January-August 2009), while the negative net balance of €1083 mn of *other investment* reflects the repayment of foreign debt obligations by the banking and corporate sectors. Overall, the private sector's gross external debt registered a small decline to 93.6% of GDP in August compared to 96% in late 2009.

The rapid improvement of current account deficit entails significant policy implications. Once considered the major vulnerability of the Bulgarian economy, the unwinding of the external imbalance has so far proceeded in an orderly, yet painful, fashion. That is because, given the high export content of Bulgarian imports, the decline in the current account deficit has so far been primarily driven by a sharp fall in FDI inflows. The latter implies, in turn, that the balance-of-payments improvement can prove sustainable in absence of significant structural deficiencies. Secondly, it creates a new economic environment and a set of new challenges. The Bulgarian economy has been a major beneficiary of capital flows in the broader region in the past, which served as the main engine of domestic growth. Driven by convergence prospects, the Bulgarian economy received 27.1 bn Euros in FDI inflows during 2004-2008. The majority of those inflows were channeled to non-tradable sectors. The most representative sector was the real estate market which flourished in the booming years. Given that capital inflows are highly unlikely to reach their pre-crisis levels, the pattern of growth will have to switch to a more balanced between domestic and external demand mix.

Currency Board Arrangement remains strong and sustainable

Bulgaria's currency board arrangement (CBA) remains strong and sustainable[1], with foreign exchange reserves continuing to provide ample coverage of the money base (ca 160% in August 2010 i.e., not far from pre-Lehman levels).

Figure 3: Coverage of local currency denominated portion of M2 by FX reserves (1xtimes)

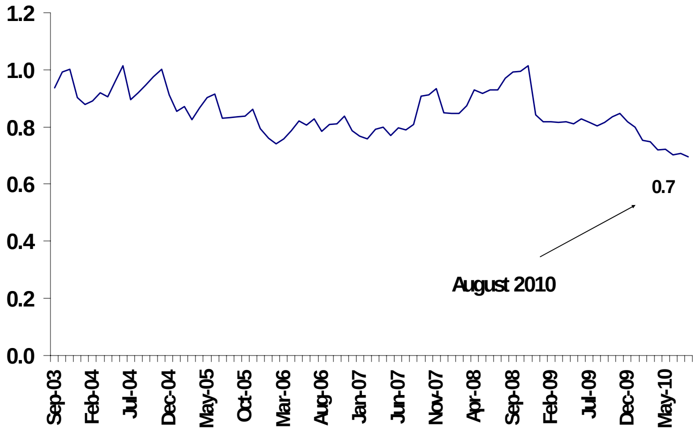
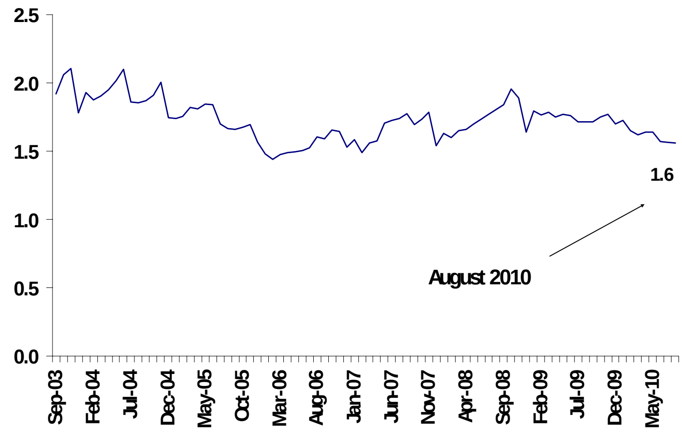


Figure 4: Money base coverage by FX reserves (1Xtimes)



[1] For a detailed analysis on the sustainability of the currency board please see Hardouvelis and Monokrousos, Is Bulgaria's Currency Board sustainable? Economy& Markets, July 2009

FX reserves also currently cover a significant part of the country's (Lev-denominated part of) M2 and also continue to provide strong coverage of broad money, which is presently among the highest in the emerging markets universe (~ 50% vs. 35% average). In addition to fulfilling these technical requirements, there is also overwhelming political support to, as well as a strong social and cultural component in the CBA. From a more structural medium-term perspective, it appears that the sharp inflation decline and a significant improvement of macroeconomic imbalances in recent months have eliminated the earlier lev overvaluation, provides an overwhelming case for maintaining the present FX regime until euro adoption[2].

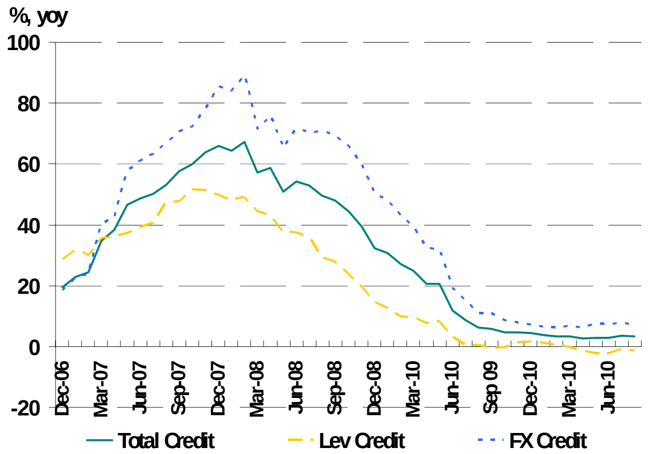
Credit conditions in the domestic market remain tight; growth of NPLs have started to moderate

The Lehman Brothers collapse in September 2008 brought an abrupt end to the lending boom in Bulgaria, with the Central Bank's measures to boost domestic liquidity and encourage lending (e.g. cuts in minimum reserve requirements) having so far only partial success. Credit growth to the non government sector landed to a single digit of 4.5% yoy at the end of 2009 compared to 47.9% yoy a year earlier. Ever since, credit creation remained stagnant, growing cumulatively by just 0.5% yoy in January-August 2010.

The continued tightness of domestic credit conditions stems, primarily, from the demand side. Credit growth is not constrained so much by the lack of adequate supply on credit by domestic banks, despite the still relatively high loans-to deposits ratio (113.9% in August 2010). It is the lack of demand that is severely constraining new lending. Households and corporates have started to save more and repay their debts. For that reason, deposits have recorded a strong bounce since the beginning of the year, growing cumulatively by 5.5% yoy in January-August.

The process of deleveraging in the household sector seems to have been approaching a trough lately. Credit to households has retreated slightly in January-August, by -0.1% yoy cumulatively. The insignificant decline is owed to two opposite trends within the consumer segment. Housing mortgage loans grew by 2.1% yoy, while consumer lending decreased by 2.2% yoy cumulatively over that period. Furthermore, credit to corporates registered negligible growth of 0.2% yoy year-to-August.

Figure 5: Credit activity remains stagnant



Overall, it appears that 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 Baltics region. In addition, domestic banks have been very successful in renegotiating loan agreement with existing clients.

The NPLs ratio has risen relatively modestly compared to the rest of the region so far, reaching 9.5% in June 2010 compared to 5.2% in September 2009. Yet taking into account that NPLs is a lagging indicator of economic activity, the corresponding ratio may rise a little further in the coming months. However, the growth rate of NPLs has started to moderate, which predisposes for a peak in the ratio in the coming months.

Moreover, the local banking sector carries strong capital buffers. Those are reinforced by those large foreign-own subsidiaries who have committed to maintain their overall exposure in the country to at the levels recorded in last May. In contrast to 1997, where a banking crisis turned into an economic crisis, the solid domestic banking system now appears to be an anchor of stability in the Bulgarian economy. In terms of capitalization, the banking sector scores relatively high in the region. The capital adequacy stood at 17.3% in H1 against 14.3% before the onset of the crisis in September 2008 which provides enough

[2] See, for instance, *IMF June 2010*: Lev REER undervalued by 4% vs. 16% overvaluation in 2009 according to external sustainability approach)

comfort against rising NPLs and optimism for the banks to extend new lending when economic conditions improve.

Bulgaria: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (yoy%)	6.0	-5.0	0.0	2.5
Final Consumption	6.0	-5.0	-4.0	2.0
Gross Capital Formation *(Fixed)*	20.4	-26.9	-6.5	2.5
Exports	2.9	-9.8	13.0	5.0
Imports	4.9	-22.3	2.5	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.1	2.7
HICP (end of period)	7.2	1.6	4.2	3.0
Fiscal Accounts (%GDP) - *EU Methodology*				
General Government Balance	1.7	-4.7	-3.8	-2.8
Gross Public Debt	13.7	14.7	18.6	21.7
Primary Balance	3.9	0.0	-2.0	-1.5
Labor Statistics - *National Definitions*				
Unemployment Rate (% of labor force)	6.3	7.6	9.0	8.0
Wage Growth *(total economy)*	26.5	8.5	4.5	2.5
External Accounts				
Current Account (% GDP)	-25.4	-9.4	-2.5	-5.5
Net FDI (EUR bn)	6.2	3.3	1.2	2.0
FDI / Current Account (%)	75.8	103.6	135.0	100.0
FX Reserves (EUR bn)	12.7	12.9	12.5	11.5
Domestic Credit	**2008**	**2009**	**Q1 10**	**Q2 10**
Total Credit (%GDP)	75.2	79.2	78.9	79.2
Credit to Enterprises (%GDP)	47.8	49.4	49.2	49.4
Credit to Households (%GDP)	26.0	28.2	28.1	28.1
FX Credit/Total Credit (%)	57.2	58.6	59.5	60.1
Private Sector Credit (yoy)	32.3	4.5	3.3	2.8
Loans to Deposits (%)	119.3	120.5	116.3	114.3
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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