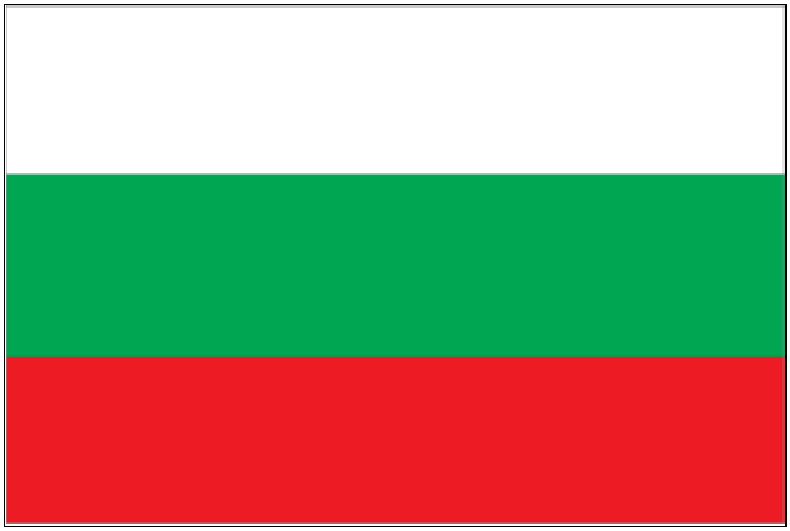
Country report

BULGARIA



Summary

Similar to other Eastern European countries, the financial crisis hit Bulgaria mainly through a drop in export demand, tighter credit facilities and general risk aversion against the region. The economy shrunk by 5% in 2009. A weak recovery is expected for 2010, as Bulgaria's export markets are expected to linger behind and domestic demand remains subdued. The external vulnerabilities of Bulgaria are significant. The current account deficit is expected to improve from 25% of GDP in 2008 to 9-10% of GDP in 2009/10, still worryingly high. Moreover, the foreign debt level is around 100% of GDP with almost a third of the total debt being short term. The external vulnerabilities are counterbalanced by the government's fiscal policy. Its fiscal prudence, even during the financial crisis, and low public debt are commendable. It allows the country to support its currency board with the euro and props up investor confidence. In other areas, such as fighting organized crime and corruption, the government needs to increase its efforts. The newly elected cabinet has pledged to address these issues, which has already improved the relations with the EU.

Things to watch:

- Economic recovery
- Fiscal prudence
- Current account deficit
- Addressing corruption
- Support of Greek parent banks to Bulgarian subsidiaries

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Bulgaria

National facts	
Type of government	parliamentary democracy
Capital	Sofia
Surface area (thousand sq km)	111
Population (millions)	7.5
Main languages	Bulgarian (84.5%)
	Turkish (9.6%)
Main religions	Bulgarian Orthodox (82.6%
	Muslim (12.2%)
	other Christian (1.2%)
Head of State (president)	Georgi Parvanov
Head of Government (prime-minister)	Boyko Borissov
Monetary unit	leva (BGN)

Economy (2009)		
Economic size	*bn USD*	*% world total*
Nominal GDP	49	0.08
Nominal GDP at PPP	90	0.13
Export value of goods and services	24	0.16
IMF quotum (in mln SDR, 2008)	640	0.29
Economic structure	*2009*	*5-year av.*
Real GDP growth	-5.0	6.3
Agriculture (% of GDP)	8	8
Industry (% of GDP)	28	30
Services (% of GDP)	65	61
Standards of living	*USD*	*% world av.*
Nominal GDP per head	6509	71
Nominal GDP per head at PPP	12048	109
Real GDP per head	4138	53

Social and governance indicators	rank / total
Human Development Index (rank)	61 / 182
Ease of doing business (rank)	44 / 183
Economic freedom index (rank)	75 / 179
Corruption perceptions index (rank)	71 / 180
Press freedom index (rank)	68 / 175
Gini index (income distribution)	29.2
Population below $1 per day (PPP)	n.a.

Foreign trade (2008)			
Main export partners (%)		*Main import partners (%)*	
Greece	10	Russia	15
Germany	9	Germany	12
Turkey	9	Italy	8
Italy	8	Ukraine	7
Main export products (%)			
Other metals			11
Clothing & footwear			9
Iron & steel			6
Chemicals, plastics & rubber			5
Main import products (%)			
Crude oil & natural gas			17
Machinery & equipment			10
Chemicals, plastics & rubber			6
Textiles			5
Openness of the economy (2009)			
Export value of G&S (% of GDP)			50
Import value of G&S (% of GDP)			60
Inward FDI (% of GDP)			8.2

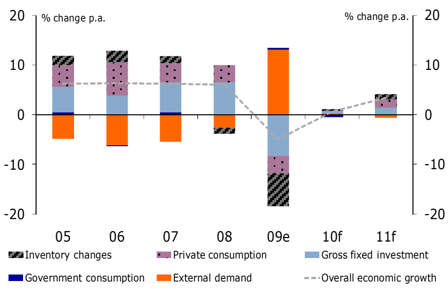
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Economic growth dropped considerably during the financial crisis from a steady 5-6% growth since 2002 to a 5% decline in 2009. The drop in external demand and, probably even more important, the tightening of foreign credit are the main reasons behind this drop. In previous years, Bulgaria's growth was supported by the ample availability of (foreign) credit, which boosted domestic demand, investment activity and the housing market. Besides a steady growth path, which Bulgaria needs to catch up with the rest of the EU, it also created a high level of foreign debt and huge current account deficits (see also sections below). As domestic demand was hit, import demand dropped too. In fact, import demand (-22% yoy) plunged even faster than export demand (-12% yoy), creating a positive net contribution of external demand to growth in 2009.
Contrary to most Eastern European countries, the Bulgarian economy continued to deteriorate in the third quarter. Growth fell from -3.5% yoy in the first quarter and -4.9% yoy in the second quarter to -5.4% yoy in the third quarter. Bulgaria's recession is expected to bottom out early 2010, with overall growth this year not much above zero. The reasons that Bulgaria is behind the curve are likely to be found in the destination and type of exports, the fixed exchange rate (undermining competitiveness), tight fiscal policy and low household demand. Greece and Turkey, both important export markets, are struggling with negative growth. The iron and steel sector also stays behind, as its main customers are construction companies across Europe. Private consumption is hindered by the still tight credit market, the negative wealth effect of lower house prices and increased unemployment. The government strives to reduce the size of the public

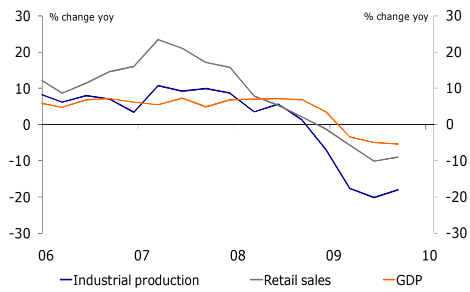
sector, both to lessen the pressure on the budget and to limit the possibilities for corruption. However, this adds to the cyclical woes of the labor market. Official unemployment increased from 6.3% in 2008 to 9.1% in 2009 and is expected to stay at this elevated level this year.
When looking at the longer-term prospects of the economy, Bulgaria still has a long road ahead. It remains one of the poorest countries within the EU with an average income around USD 6900 in 2010 (for comparison, Hungary has an average income of more than USD 12,000). As Bulgaria is said to have one of the largest grey economies in the region (generally estimated at 20-30% of GDP), the real average income will be somewhat higher. Moreover, competitiveness is an important theme. With the fixed exchange rate, competitiveness needs to be supported by productivity growth and/or restricted wage growth. Foreign investment, which could boost productivity, is constrained by by high levels of corruption, red tape and bureaucracy and a weak legal and judicial system.

Chart 1: Economic growth



Source: EIU

Chart 2: Growth per quarter



Source: EIU

The banking sector is dominated by Western European (mainly Greek) banks, which have about 85% of the market share. Although many parents are in a tight spot, they have expressed their intention to support Bulgarian subsidiaries, which has also proven to be true so far. The banking system seems well capitalized, but the rising number of non-performing loans (NPL) is putting pressure on the financial sector. The general downturn of the economy and the stagnation on the housing market are behind this. With the credit lines wide open, many Bulgarians took out foreign currency loans. Almost three quarters of all private sector loans are in foreign currency. Contrary to neighboring countries, the repayment capacity was not affected by a depreciating currency. However, a devaluation of the fixed exchange rate would be extremely painful.

Political and social situation

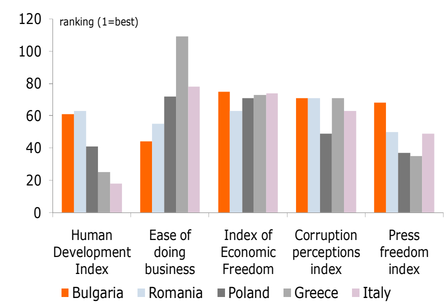
The parliamentary elections of July 2009 brought victory to the Citizens for the European Development of Bulgaria party (CEDB). The liberal, central-right CEDB beat the coalition of the Bulgarian Socialist Party, which had governed from 2005-2009, by gaining 116 out of 240 seats (while the socialists only got 40). The CEDB won on promises to fight corruption, reform the judicial system, reduce the size of the state and spur economic recovery by liberal economic reforms. It is indeed all necessary, but also very challenging, not to say unrealistic. The CEDB is governing with a minority cabinet and it relies on the two right parties Ataka and Blue Coalition to achieve a majority in parliament. Being a minority cabinet seems to have improved the efficiency of the cabinet, although it also presents some risk to stability. Approval rates for prime minister Borisov are still high, half a year into his term. The fiscal tightening and weak economic growth seem to only affect his popularity slightly, likely because he has also taken several populist measures.

The government faces several significant challenges. A major issue is organized crime and corruption in combination with a weak judicial system. On paper, Bulgaria has made good progress in the past years, but in reality many new laws are still not fully implemented. The EU has strongly criticized Bulgaria for the lack of progress. In 2008, several EU funds were held back for this reason. Last year's report from the European Commission shows some steps forward and the new prime minister was commented for his stance against corruption. As a result, funds were released and the relationship with the EU has improved somewhat, but it remains a stumbling block in the relations.

Other challenges are the low living standards, as mentioned above, and the need to investment in infrastructure and to privatize several loss-making state companies. Moreover, the wish to secure energy supply is still high on the agenda. In January 2009, the gas supply from Ukraine was temporarily cut off. This winter the threat of cut off was present again, thereby reinforcing the notion to secure energy. In the longer term, the government will need to deal with the ageing population, as the shrinking labor population will undermine growth if nothing is changed.

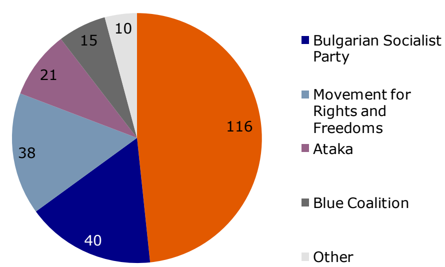
Internationally, Bulgaria might have some troubles in its relationship with the EU, but the relations with other EU members are good. The relationship with Turkey is a bit volatile, but Turkey is too important as trading partnet to let this get out of hand. The presence of a large Turkish minority is likely behind this occasional anti-Turkish sentiment.

Chart 3: Social indicators



Source: EIU

Chart 4: Results elections July 2009



Source: EIU

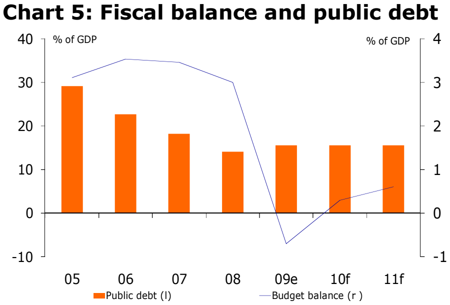
Economic policy

Bulgaria has a strong track record of fiscal prudence and low public debt. Helped by strong economic growth, the government managed a fiscal surplus of around 3% of GDP in the period 2005-2008. Having a surplus, the level of public debt steadily decreased from 38% of GDP in 2005 to 14% of GDP in 2008. As the recession hit Bulgaria, the tax revenues dropped and cyclical expenditures increased. Moreover, the July elections motivated the government to approve additional spending. When the new government was installed, it quickly reversed the situation by cutting spending. Overall, the fiscal balance of 2009 tipped into red, but only by 0.7% of GDP. This was the lowest budget deficit in the EU in 2009. For 2010, a small surplus is expected. The current government is expected to continue with the current fiscal policy, as it seems to realize the importance of the fiscal discipline for the investor confidence in the country and especially in the currency peg.

The Bulgarian leva has been pegged to the euro since the 1996-97 crisis. Depreciating pressure on the currency raised the question of devaluation in the past year. However, political support remains strong for the peg and the financial position of the government provides ample room to support the currency. The wish to join the euro outweighs the fact that competitiveness is harmed. As most countries in Eastern Europe have a floating exchange rate (with the Baltics being the main exception), their competitiveness gained from the depreciation of their currencies early 2009. Given the political support, the currency board is expected to stay in place. If the Baltic states, led by Latvia, give up their currency board, this could create significant pressure, but the central bank is expected to defend the board to quite some extend.

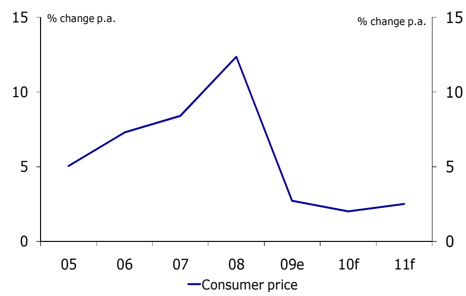
The government aims to apply for ERM-II entry (the waiting room for euro adoption) in the spring of 2010. Euro adoption is not expected before 2014. The high inflation in the past years (with a peak of 12.3% in 2008) hindered application so far, while the public debt and the fiscal balance are well within the limits. Inflation came down during 2009 to 2.7% on the back of lower oil and domestic energy prices as well as reduced demand. Moreover, the peg of the leva to the euro kept imported inflation in check, compared to the eastern European countries with a floating exchange rate. Oil prices and therefore domestic energy prices are expected to increase again in 2010. However, as domestic demand will be subdued, credit growth low and wage growth minimal, the inflationary pressure in 2010 will be limited. Inflation is expected to be around 2% in 2010.

Chart 5: Fiscal balance and public debt



Source: EIU

Chart 6: Inflation



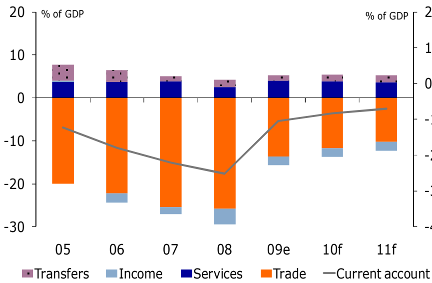
Source: EIU

Balance of Payments

Bulgaria's growing current account deficits have been a worry in the past years. Since 2002, the deficit has been on a downward trend, deteriorating from 2% of GDP in 2002 to a whopping 25% of GDP in 2008. In the fast growing economy up to 2008, the demand for import goods pushed the trade balance deep into the red. Although this partly reflected the import of products used to export again as well as investment good, consumer good accounted for a significant part of the import bill. When the financial crisis hit, the external demand for export goods shrunk, but the domestic demand for imports dropped even faster. As a result, the current account deficit improved to 10% of GDP in 2009. For this year, a further improvement is expected to 8-9% of GDP. Import demand is expected to stay subdued as economic recovery is not in full swing yet. Unfortunately, the recovery in Bulgaria's main export markets (e.g. Greece) is also limited, thereby suppressing export demand. It must be noted that although it is a huge improvement, a current account deficit of around 8% of GDP is still worryingly high. Moreover, the current slump in economic growth is behind the improvement rather than a structural shift. When the economy picks up again, the current account deficit is likely to increase again.

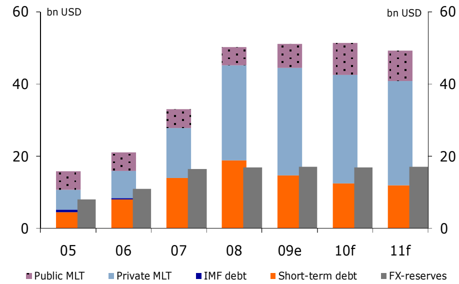
The deficit on the current account balance can largely be covered by the net inflow of foreign direct investment (FDI). FDI covered about two thirds of the deficit in 2008 and three quarters of the deficit in 2009. For 2010, FDI is expected to cover more than 100% of the current account deficit. Due to the financial crisis, the investment flow decreased over 2009, but is expected to slowly pick up again in the future. Net portfolio investment flows are small and rather volatile. The remaining financing gap is covered by borrowing, which is also needed to cover the debt service costs (see also next section).

Chart 7: Current account balance



Source: EIU

Chart 8: Foreign debt

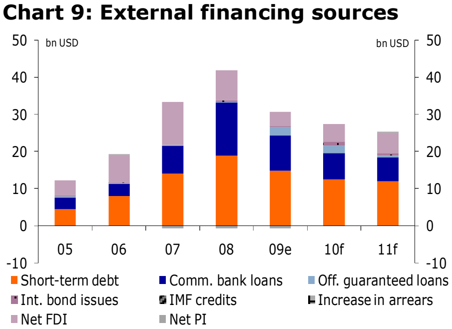


Source: EIU

External position

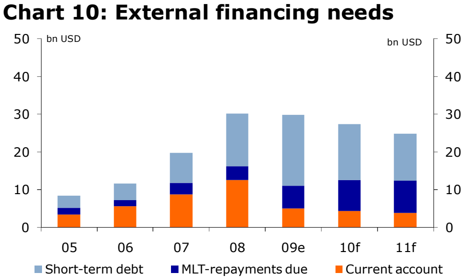
Bulgaria's external position is rather vulnerable. Not only does the country run significant current account deficits, its level of external debt is also rather high. On the back of ample worldwide liquidity, Bulgaria's foreign debt level tripled from USD 15.7bn (58% of GDP) in 2005 to USD 51bn (105% of GDP) in 2009. With tighter credit conditions (commercial bank loans are an important source of external financing) and less domestic demand, the growth of foreign debt slowed during 2009. This year the level of foreign debt is expected to stay roughly at the level of 2009. Credit conditions are not quite back to normal and domestic demand is expected to remain behind.
Adding to the vulnerability of Bulgaria's debt level is the size of the short-term debt. As short term debt is a major source of financing, almost a third of all debt was short term in 2009. This is expected to decrease to about a quarter in 2010. Short term debt thus still accounts for the mainstay of the financing requirements in 2010.
The foreign exchange (FX) reserves are expected to stay around USD 17bn in 2010. They are sufficient to cover short-term debt during 2010, but will run short to cover the entire debt service due. If looking at the imports, the FX reserves can cover about 7 months of the import bill, helped by the fact that import demand has dropped strongly. However, the most likely use of the FX reserves, if necessary, will be to support the currency peg of the leva to the euro.
Although the figures for Bulgaria's external position are far from good, there are some mitigating factors. As tested in the past year, investor confidence in Bulgaria is relatively strong compared to other Eastern European countries with huge external imbalances. The prudent fiscal policy of the government is likely to be a cornerstone of this confidence. Moreover, support from IMF and EU would likely be available to Bulgaria if necessary. In that case, the conditions of fiscal prudence are probably much easier to meet for Bulgaria than for example for Romania, Latvia or Hungary.

Chart 9: External financing sources



Source: EIU

Chart 10: External financing needs



Source: Ecowin

Bulgaria

Selection of economic indicators	2005	2006	2007	2008	2009e	2010f	2011f
Key country risk indicators							
GDP (% real change pa)	6.2	6.3	6.2	6.0	-5.0	0.6	3.4
Consumer prices (average % change pa)	5.0	7.3	8.4	12.3	2.7	2.0	2.5
Current account balance (% of GDP)	-12.3	-17.9	-22.0	-25.2	-10.4	-8.4	-7.1
Total foreign exchange reserves (mln USD)	8041	10943	16478	16824	16998	16930	17010
Economic growth							
GDP (% real change pa)	6.2	6.3	6.2	6.0	-5.0	0.6	3.4
Gross fixed investment (% real change)	23.3	14.7	21.7	20.4	-23.0	1.2	4.3
Private consumption (% real change)	6.1	9.5	5.3	4.8	-5.0	0.2	2.3
Government consumption (% real change)	2.6	-1.4	3.1	0.0	3.0	-3.0	0.5
Exports of G&S (% real change)	8.5	8.7	5.2	2.9	-12.4	1.2	2.2
Imports of G&S (% real change)	13.1	14.0	9.9	4.9	-22.6	0.6	2.5
Economic policy							
Budget balance (% of GDP)	3.1	3.5	3.5	3.0	-0.7	0.3	0.6
Public debt (% of GDP)	29	23	18	14	16	16	16
Money market interest rate (%)	2.0	2.8	4.0	5.2	3.5	3.4	3.1
M2 growth (% change pa)	24	28	31	9	1	4	7
Consumer prices (average % change pa)	5.0	7.3	8.4	12.3	2.7	2.0	2.5
Exchange rate LCU to USD (average)	1.6	1.6	1.4	1.3	1.4	1.4	1.4
Recorded unemployment (%)	11.5	9.6	7.7	6.3	9.1	9.0	7.3
Balance of payments (mln USD)							
Current account balance	-3347	-5673	-8716	-12645	-5055	-4290	-3810
Trade balance	-5450	-7028	-10071	-12934	-6623	-6030	-5490
Export value of goods and services	11754	15101	18575	22707	17436	18660	19850
Import value of goods and services	17204	22130	28646	35640	24059	24690	25340
Services balance	1000	1189	1515	1302	1955	1970	1910
Income balance	90	-679	-624	-1808	-1014	-1050	-1120
Transfer balance	1013	844	464	795	626	810	890
Net direct investment flows	4005	7390	11443	8265	3900	4820	5400
Net portfolio investment flows	-159	85	-715	-770	-660	-80	310
Net debt flows	3109	5641	10704	16075	2000	-430	-1470
Other capital flows (negative is flight)	-4236	-4383	-6937	-10536	-14	-100	-450
Change in international reserves	-628	3060	5779	390	171	-70	-10
External position (mln USD)							
Total foreign debt	15700	20990	32968	50179	51078	51270	49280
Short-term debt	4443	8040	14037	18791	14729	12440	11860
Total debt service due, incl. short-term debt	5656	6759	12279	19270	26132	24460	23030
Total foreign exchange reserves	8041	10943	16478	16824	16998	16930	17010
International investment position	-12260	-20316	-38988	-51750	n.a.	n.a.	n.a.
Total assets	15658	22861	28544	28664	n.a.	n.a.	n.a.
Total liabilities	27918	43176	67532	80414	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-20.0	-22.2	-25.5	-25.8	-13.6	-11.7	-10.2
Current account balance (% of GDP)	-12.3	-17.9	-22.0	-25.2	-10.4	-8.4	-7.1
Inward FDI (% of GDP)	15.8	23.9	29.6	17.9	8.2	9.7	10.5
Foreign debt (% of GDP)	58	66	83	100	105	100	91
Foreign debt (% of XGSIT)	83	91	117	142	180	175	158
International investment position (% of GDP)	-45.0	-64.1	-98.6	-103.2	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	30	29	43	55	92	84	74
Interest service ratio incl. arrears (% of XGSIT)	3	3	4	5	5	5	6
FX-reserves import cover (months)	5.6	5.9	6.9	5.7	8.5	8.2	8.1
FX-reserves debt service cover (%)	142	162	134	87	65	69	74
Liquidity ratio	111	114	105	88	87	92	97

Source: EIU