

COUNTRY REVIEW

Bulgaria



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EULER HERMES COUNTRY RISK GRADE: B

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

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Strengths

- EU membership and good international relations
- Relatively low systemic political stability risk
- History of sound fiscal policies
- Generally adequate investment climate

Weaknesses

- Organised crime has been reduced since 1997, but remains an internal security issue
- Failure to make progress on EU-required judicial reform and anti-corruption measures
- Domestic demand remains weak, partly owing to tight credit markets
- High external debt burden
- Foreign exchange reserves have been stagnant since late 2008, currently covering just 50% of all external debt payments falling due in 2011.

Country Risk Assessment

Ratings	Bulgaria		Median Grade B	Median Grade C	Peers	
	Latest	Previous			Croatia	Romania
Systemic Political Risk:	P2+	P2+	P2-	P3+	P2-	P3-
Systemic Economic Risk:	E4	E5	E4	E5	E4	E4
ME rating:	ME4	ME5	ME4	ME5	ME4	ME4
<i>Structure</i>	4.0	3.3	4.8	5.8	3.3	3.3
<i>Policy</i>	2.8	5.2	5.0	5.2	2.9	3.6
<i>Solvency</i>	4.2	4.8	2.3	3.3	4.8	5.2
<i>External Liquidity</i>	3.9	6.0	3.2	4.2	5.2	5.3
SBE rating:	SBE3	SBE3	SBE3	SBE4	SBE3	SBE3
COUNTRY GRADE:	B	C			B	C

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Sofia
Population:	7.564 mn (2009)
GDP:	USD 48455 mn (2009)
Currency:	Lev (BGN)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Boyko BORISSOV (since 27 July 2009)
Next elections:	Presidential: October 2011 / Legislative: July 2013

Major Industries (% of GVA at market prices, 2010)	Global Assumptions	2010	2011	
Services	64.1%	Real GDP grth (% yr/yr)	3.3	2.9
Industry	29.9%	Inflation (% av) *	1.2	1.4
Agriculture and forestry	6.0%	Dated Brent (USD/b)	80	115
		* Major economies		

Main Exports (% of total, 2010)		Main Imports (% of total, 2010)	
Other manufactured products	23.2%	Machinery and transport equipment	23.3%
Machinery and transport equipment	16.7%	Mineral fuel, lubricants, etc.	22.4%
Mineral fuel, lubricants, etc.	13.6%	Other manufactured products	17.0%
Food and live animals	10.7%	Chemical and related products	11.8%
Lead Export Markets (% of total exports, 2010)		Lead Import Markets (% of total imports, 2010)	
EU-27	60.9%	EU-27	58.7%
Germany	10.6%	Germany	11.7%
Italy	9.7%	Italy	7.4%
Romania	9.2%	Romania	7.0%
Turkey	8.5%	Russia	16.1%

Basic indicators

Selected economic indicators	2007	2008	2009	2010	2011f
Nominal GDP (USD mn)	42,087	51,713	48,455	47,618	53,206
Population (mn)	7.64	7.61	7.56	7.53	7.49
GDP per capita (USD)	5,509	6,798	6,406	6,323	7,101
Real GDP growth (% yr/yr)	6.4	6.2	-5.5	0.2	2.0
Inflation (HICP; %, eop)	11.6	7.2	1.6	4.4	5.0
Fiscal balance (ESA 95; % of GDP)	1.1	1.7	-4.7	-3.2	-2.7
Current account balance (% of GDP)	-27.2	-22.9	-8.8	-1.2	-1.4
External debt/GDP (%)	94.3	104.9	108.0	101.8	99.6
External debt/Exports of goods & services (%)	150.9	178.0	224.8	176.1	154.1
Debt-service ratio (%)	33.8	32.0	43.7	33.1	28.8
Foreign exchange reserves (EUR mn)	11,179	11,886	11,241	10,864	9,500
Import cover (months)	5.2	5.1	6.9	6.1	4.4
Exchange rate assumption, BGN:USD (av)	1.43	1.34	1.41	1.48	1.42
Exchange rate assumption, BGN:EUR (av)	1.96	1.96	1.96	1.96	1.96
f: CRU central forecast					

Sources: National sources, IMF, ECB, European Commission, IHS Global Insight, Euler Hermes Economic Studies

Political Stability

Bulgaria has a functioning parliamentary democracy with a clear succession process. Political and economic reform policies begun in 1997 resulted in NATO membership in March 2004 and EU accession in January 2007 and also secured continued IMF support until March 2007 when the latest assistance programme expired. Reform progress increased foreign investor confidence and gave rise to a sustained recovery of the economy after nine years of continuous decline, helping to reduce unemployment from 18% in 2002 to 5.6% in 2008. Nonetheless, governments have tended not to last more than one term, as voters have expected an even more rapid improvement in living standards. The latest parliamentary election in July 2009 saw a landslide victory of the Citizens for the European Development of Bulgaria (CEDB), a centre-right party that was founded only in 2006 by then Sofia Mayor Boyko Borissov. The CEDB clearly defeated the then ruling Bulgarian Socialist Party (BSP) with 39.7% over 17.7% of the vote, but it fell just short of a parliamentary majority (116 out of 240 seats). Borissov was elected Prime Minister but opted to head a minority government, in order to rule unfettered by concessions. Although this decision has made the government reliant on the support of smaller right of centre parties, the minority government has worked fairly well so far, including managing the country through the global economic crisis. Borissov had campaigned strongly on judicial reforms and fighting crime and corruption, key areas of concern for the European Commission which has consistently expressed concern over the lack of action in these areas. However, recent monitoring reports have acknowledged some progress and led to the unfreezing of several hundred million euros of EU funding that were suspended in mid-2008. But the reform process is stronger on paper than in practice and the EU will keep Bulgaria under close scrutiny, continuing to demand judicial reform and results from efforts to combat corruption and organised crime. There are continued scandals. In early 2011, the publication of wiretapped recordings, including leaked tapes of leading government officials, raised concerns. Still, the CEDB in its second year of a four-year mandate has retained fairly robust support in opinion polls (27%), compared with 15% for the main opposition party, the BSP.

Generally, Bulgaria's international relations are good. Unlike several other central and eastern European countries hit hard by the global economic crisis, Bulgaria has not resorted to the IMF or EU for financial support, but in the event that it needs help at some point, timely multilateral support is likely. External security risk stemming from regional volatility in the Balkans has declined over recent years and Bulgaria is unlikely to be drawn into a regional conflict. Organised crime, as the EU has recognised, remains an internal security issue, but the risk for foreign businesses is small. Moreover, terrorism, political violence and widespread ethnic unrest are unlikely. Overall, systemic political stability is not at risk.

Economic Stability

The World Bank classified Bulgaria as an upper middle income country in a survey from January 2011, based on GNI per capita of USD5,770 in 2009. Services contribute about 64% to GDP, industry 30% and agriculture 6%. The export structure shows a strong dependency on the EU-27 which together account for around 61% of merchandise exports, making the economy vulnerable to the European business cycle. Real GDP grew by an average annual 6.4% in 2004-2008. In part, however, this was due to overheating of the economy, which became reflected in mounting macroeconomic imbalances such as an excessive credit boom that fuelled domestic demand, elevated inflation and unsustainably high current account deficits. In the wake of the global financial and economic crisis, this growth model collapsed and the economy fell into recession.

Real GDP declined by 5.5% in 2009 and 4.8% yr/yr in Q1 2010. The economy returned to growth in Q2 2010 and expanded by a modest 0.2% in calendar 2010. The recovery was entirely export-driven as domestic demand remained particularly weak in 2010, with household consumption contracting by 1.3%, public consumption 5% and investment 16.5%. Exports and imports grew by 16.2% and 4.5%, respectively, in 2010. Flash estimates of the Statistical Institute for Q1 2011 indicate that this growth pattern has continued. Seasonally and working-day adjusted Q1 real GDP growth moderated slightly to 0.4% qtr/qtr (from a downwardly revised 0.5% in Q4 2010) and to 2.5% yr/yr (from 2.9% in Q4). Private consumption contracted by 0.5% qtr/qtr in Q1, public consumption 0.7% and investment 4.7%. Exports expanded by 7.3% qtr/qtr while imports declined by 4%. We expect modest full-year growth of about 2% in 2011.

Bulgaria introduced a currency board arrangement, which pegs the local currency, the lev (BGN) to the EUR at a rate of 1.95583 BGN/EUR, as part of stabilisation measures that ended the 1996-97 financial crisis. Two aspects raised some concern about the stability of the currency board in 2009. First, analysis of the real effective exchange rate suggested that the BGN had been more than 15% overvalued (as compared to the average of the previous 60 months) from early 2008 to mid-2009.

Second, speculation over potential currency devaluation in Latvia increased in June 2009, suggesting some contagion risk for Bulgaria. However, the currency board has withstood the pressures from the regional and the global financial crises well. The arrangement requires that the monetary base is fully backed by the foreign exchange (FX) reserves of the central bank. This requirement has not been tested so far as FX reserves have always covered more than 135% of the monetary base since early 2008. Meanwhile, the real effective exchange rate overvaluation decreased to 5% in mid-2010, though it has picked up again slightly, to around 7% in April 2011. It appears that in line with the unwinding of the macroeconomic imbalances amid the economic downturn in 2009-2010, any homemade pressure on the fixed exchange rate has largely waned. Moreover, the Bulgarian authorities remain firmly committed to the currency board. The risk of contagion from the collapse of a currency peg in the Baltic region has also faded for now.

Inflation declined rapidly from a peak of 15.3% yr/yr in June 2008 to an average 2.5% in 2009 and 3% in 2010. Higher food and energy prices have pushed up headline inflation somewhat since late 2010 and we expect it to average about 5% in 2011. Private-sector credit growth decelerated sharply from excessive levels (62% yr/yr at end-2007) to less than 2% in H2 2010 and Q1 2011, reflecting tight credit markets.

Since the currency board largely neutralises monetary policy, fiscal policy is the major tool to steer the economy. Bulgaria has had a long-lasting commitment to fiscal prudence, reflected in many years of fiscal surpluses (annual average 1.6% of GDP in 2004-2008). In the wake of the economic downturn since late 2008, however, the fiscal account deteriorated and shifted into deficit—4.7% of GDP in 2009 and 3.2% in 2010. Noteworthy, in mid-2010 the new government had to revise the 2009 fiscal deficit figure from 1.9% previously, allegedly owing to secret procurement deals of its predecessor. As a consequence, the EU commission stated concerns over Bulgaria's national statistics, indicating that the country may have its data examined under new EU audit powers. We expect a fiscal deficit of about 2.7% of GDP in 2011 and public debt to rise from 16% of GDP in 2010 to around 18% by end-2011, which is low by EU standards.

Bulgaria's current account deficit narrowed rapidly from 23% of GDP in 2008 to just 1.2% in 2010 and shifted to a solid surplus of 3.2% of GDP in Q1 2011. But, the external debt burden remains high and a cause of concern. Strong foreign borrowing by banks and the private sector had pushed up gross external debt to a peak of EUR38bn in late 2008, since when it has remained close to that level, accounting for a worrisome 102% of GDP or 176% of export earnings in 2010. The private sector share of external debt has remained at 89% until February 2011, while total short-term debt as a share of gross debt has slightly fallen to 31% from the 36% peak in late 2008. The external debt service ratio remains high, projected at 29% of export earnings in 2011.

Following a peak of EUR13.9bn in September 2008, FX reserves have hovered in the range of EUR10-12bn, though they fell to a temporary low of EUR9.9bn in April 2011. This is still sufficient to cover more than four months of forecast imports in 2011 as well as 135% of the monetary base which is needed to maintain the currency board (see above). However, current FX reserves cover just 50% of all external debt payments falling due in 2011. The refinancing of maturing debt may remain difficult amid still tight credit markets, such that some risk of disruptions in the banking and corporate sectors is still present.

Structural Business Environment

The structural business environment is generally adequate, ranking above average in our assessment of 211 countries and has improved considerably in recent years thanks to liberalisation, privatisation, and lower barriers to trade, foreign investment and capital flows. In line with continued criticism from the EU (see Political Stability section), however, our assessment shows continuing weaknesses with regard to corruption and inefficiencies in the legal and regulatory frameworks.

The banking sector has weathered the impact of the global financial crisis relatively well and remained well-capitalised and profitable as a whole. However, asset quality has deteriorated. The share of non-performing loans in total loans has continued to rise to 12.7% in March 2011 (2.5% end-2008, 9.5% in mid-2010) and the IMF expects it to peak in H2 2011. As a result, private sector credit growth is expected to remain subdued for some time. Risks to the banking sector also include contagion from any potential deterioration of the sovereign debt/banking crisis in the Euro-zone. The high level of foreign ownership (87% of bank assets) includes about 30% controlled by Greek banks and a 12% share controlled by Hungary's OTP Bank.

Charts

