

COUNTRY REVIEW

Bulgaria



12 October 2009

ANALYST: Dr. Manfred Stamer

EULER HERMES COUNTRY RISK GRADE: C

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

Strengths

- EU membership and good international relations.
- Relatively low systemic political stability risk.
- Solid fiscal position.

Weaknesses

- Organised crime has been reduced since 1997, but remains an internal security issue.
- After overheating, the economy has hard-landed and entered a serious recession.
- A currency board largely neutralises monetary policy, leaving fiscal policy as the major tool to steer the economy.
- Rapid unwinding of previously large macroeconomic imbalances is potentially socially painful.
- The current account deficit, though narrowing, remains at uncomfortably high levels.
- High external debt (forecast at 110% of GDP at end-2009, 57% of which is short-term).
- Refinancing of short-term debt will be difficult amid the ongoing global financial crisis, such that disruptions in the banking and corporate sectors are likely.
- Corruption and inefficiencies in the legal and regulatory frameworks.

KEY RISKS

- **Serious recession in 2009, with the number of insolvencies to rise sharply**
- **Difficulties to refinance large amounts of maturing external debt, potentially resulting in insolvencies or debt restructurings of banks and companies**
- **Exchange rate risk (in the event that the currency board collapses)**
- **Transfer risk (in the event that the currency board collapses)**

Country Risk Assessment

Ratings	Bulgaria		Median Grade C	Estonia	Peers	
	Latest	Previous			Romania	Hungary
Systemic Political Risk:	P2+	P2+	P2-	P1	P2-	P2+
Systemic Economic Risk:	E5	E5	E5	E5	E5	E5
ME rating:	ME5	ME5	ME5	ME5	ME5	ME5
<i>Structure</i>	3.3	3.3	5.7	2.6	3.3	1.6
<i>Policy</i>	5.2	5.2	5.2	4.2	5.6	5.8
<i>Solvency</i>	4.8	3.8	2.8	4.2	4.8	4.6
<i>External Liquidity</i>	6.0	6.0	4.8	6.0	6.0	6.0
SBE rating:	SBE3	SBE3	SBE4	SBE1	SBE3	SBE2
COUNTRY GRADE:	C	C		C	C	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 Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Sofia
Population:	7.59 mn (2008)
GDP:	USD 49797 mn (2008)
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 GDP at market prices, 2008)		Global Assumptions		2009	2010
Services	62.0%	Real GDP grth (% yr/yr) *	-3.9	0.9	
Industry	31.0%	Inflation (% av) *	-0.1	1.3	
Agriculture and forestry	7.0%	Dated Brent (USD/b)	61	72	
* Major economies					

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Metals (excl. iron & steel)	11.5%	Crude oil & natural gas	17.0%
Clothing & footwear	9.0%	Machinery & equipment	9.5%
Iron & steel	6.0%	Chemicals, plastics & rubber	6.0%
Chemicals, plastics & rubber	5.0%	Textiles	5.0%
Lead Export Markets (% of total exports, 2008)		Lead Import Markets (% of total imports, 2008)	
Italy	9.9%	Russia	17.5%
Germany	9.0%	Germany	11.0%
Greece	8.6%	Italy	8.0%
Turkey	8.4%	Ukraine	3.5%

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	31,642	39,524	49,797	46,504	47,443
Population (mn)	7.69	7.64	7.59	7.54	7.49
GDP per capita (USD)	4,115	5,173	6,561	6,167	6,333
Real GDP growth (% yr/yr)	6.3	6.2	6.0	-4.5	0.2
Inflation (% eop)	6.5	12.5	7.8	-0.3	1.5
Fiscal balance (ESA 95, % of GDP)	3.0	0.1	1.5	-2.0	-2.0
Current account balance (% of GDP)	-18.5	-25.4	-25.3	-12.8	-10.1
External debt/GDP (%)	82.0	100.3	108.4	110.0	115.0
External debt/Exports of goods & services (%)	127.2	158.1	176.4	230.3	223.6
Debt-service ratio (%)	23.7	24.0	23.2	37.3	38.5
Foreign exchange reserves (EUR mn)	8,193	11,179	11,886	10,000	8,500
Import cover (months)	4.7	5.4	5.0	5.9	4.9
Exchange rate assumption, BGN:USD (av)	1.56	1.43	1.34	1.41	1.40
Exchange rate assumption, BGN:EUR (av)	1.96	1.96	1.96	1.96	1.96
f: CRU central forecast					

Sources: National Bank, National Statistical Institute, Ministry of Finance, IMF, ECB, Euler Hermes Country Risk Unit

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 most recent 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 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 PM but opted to head a minority government, in order to rule unfettered by concessions. This decision makes the government reliant on the support of smaller right of centre parties which could jeopardise Borissov's ambitious reform agenda.

EU accession has not ended Bulgaria's transition and integration process, as the unfinished economic and structural reform agenda remains considerable. Anticipating that the loss of the EU "policy anchor" may lead to reform slippages (probably exacerbated by unstable government), the EU has introduced a system of post-accession benchmarking for Bulgaria, which requires biannual progress reports on key areas of concern, particularly the judiciary, corruption and organised crime. The third progress report in July 2008 claimed that Bulgaria had hardly made progress in these areas and resulted in the freezing of several hundred million euro of EU funding earmarked for the country. The fifth report in July 2009 states that efforts to improve the judiciary and combat corruption have gathered some momentum, but it urges stronger reform implementation and broader political consensus. At least, for now, the EU has not imposed further punitive measures (such as advising other members to stop co-operation on judicial issues). It remains to be seen if PM Borissov, who campaigned on judicial reforms and fighting crime and corruption, can accelerate reform momentum.

Generally, Bulgaria's international relations are good. Unlike several other central and eastern European countries hit hard by the global economic crisis, Bulgaria has so far 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

Similar to several other countries in Emerging Europe, the Bulgarian economy has broadly developed along the following pattern in recent years. A credit boom, largely funded by large-scale foreign borrowing of domestic banks from foreign parent banks, fuelled domestic demand (private consumption and investment) and thus boosted real GDP growth. Much of the credit was denominated in foreign currency and directed to real estate, causing exchange rate risk and a housing bubble. Moreover, the booming economy involved soaring wage growth above productivity increases and elevated inflation to double-digits. Furthermore, imports increasingly exceeded exports, resulting in unsustainably high current account deficits, which had to be financed by new credit, driving up (short-term) external debt. The result of this development was an overheated economy, which eventually had to cool down, with severe macroeconomic imbalances and an ever-rising external financing requirement. The latter has become a particular problem amid the ongoing global financial crisis as the sudden global liquidity shortage caused problems in refinancing short-term debt and may result in a domestic banking crisis and/or currency crisis.

The economic downturn that followed overheating set in relatively late in Bulgaria compared with most other countries in the region. Real GDP growth was an average annual 6.3% in 2004-2007 and 7% yr/yr in the first three quarters of 2008. However, growth was relatively unbalanced, mainly driven by soaring private investment which boosted domestic demand while net exports caused a large negative contribution (as imports grew much faster than exports). In Q4 2008 growth slowed to 3.5% yr/yr and real GDP contracted by 3.5% in Q1 and 4.9% in Q2 2009 owing to sharply tighter lending conditions and a reversal of capital inflows that caused domestic demand to decline, as well as to the global economic slowdown which led to falling external demand. We expect a protracted recession, with GDP to shrink by about 4.5% in 2009 as a whole. A return to marginal growth is possible in 2010, though there are considerable risks to the downside.

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. Although the currency board helped to achieve investor confidence and strong economic growth, it also left the central bank with few effective measures to curb credit growth and inflationary pressures since monetary policy is primarily determined externally. Hence the currency board also contributed to the previous overheating of the economy and the mounting macroeconomic imbalances. In turn, rising inflation and a soaring current account balance caused the real effective exchange rate of the BGN to appreciate sharply in 2008, which together with the intensification of the global financial crisis led to some concern about a devaluation.

The currency board arrangement requires that the monetary base is fully backed by the foreign exchange (FX) reserves of the central bank, a requirement that has not been tested so far. Indeed, FX coverage of the monetary base increased from an already solid 155% at end-2008 to 172% at end-August 2009. Further, analysis of the real effective exchange rate suggests that in August 2009 the BGN was about 10% overvalued as compared to the average of the previous 60 months, down from a peak of around 18% in January 2009. It appears that in line with the gradual unwinding of the macroeconomic imbalances amid the ongoing economic downturn, any potential homemade pressure on the fixed exchange rate is gradually waning as well. Moreover, the Bulgarian authorities remain firmly committed to the currency board, even though it potentially harms the country's export competitiveness owing to the recent downward correction in currency values in several countries with flexible exchange rates in the region. In the short term, the main threat to the currency board appears to be contagion from the collapse of a currency peg in one or more of the Baltic States—a significant risk.

Inflation peaked at 15.3% yr/yr in June 2008—the highest since 1990—but has rapidly declined to just 1.2% in August 2009 as global oil prices and domestic energy prices have fallen and domestic demand contracted. On a mth/mth basis, prices have declined since March 2009. We expect a few months of annual deflation towards the end of this year and at the start of next year, with inflation to average 2.6% in 2009 and 1% in 2010.

Private-sector credit growth has been excessive, surging to 62% yr/yr at end-2007. It then fell to 31% at end-2008 which was still 50% above the median of around 150 emerging economies. Meanwhile, annual credit growth has declined to 5.6% in August 2009 as a result of sharply tighter lending in the wake of the ongoing global financial crisis.

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 has deteriorated and shifted into a cumulative deficit in the first seven months of 2009, equivalent to about 0.7% of projected calendar GDP. We forecast fiscal deficits of about 2% of GDP in both 2009 and 2010, which would be modest compared with most other countries in Europe. Public debt is forecast to rise from 16% of GDP in 2008 to around 20% by end-2010, but this is also low by EU standards.

Although improving, Bulgaria's current account deficit remains a cause of concern. After soaring to more than 25% of GDP in 2007-2008, the deficit is expected to narrow to around 13% in 2009, based on January-July figures, and to 10% in 2010. Such levels are still considered unsustainable in the medium term, even though foreign direct investment (FDI) inflows covered about 70% of the current account deficit in January-July. Hence further economic adjustment will be needed in and beyond 2010, posing downside risks to economic recovery and maintenance of the currency board arrangement.

The external debt burden is high and increasing. Strong foreign borrowing by banks and the private sector pushed up gross external debt to a high 108% of GDP or 176% of export earnings in 2008. The private sector share of external debt has continued to rise from just 34% in 2003 to 89% currently. Short-term debt as a share of gross debt is also on an upward trend, having increased from 14% to 35% over the same period. Moreover, net external debt has risen from a manageable 19% of GDP in 2003 to a concerning 57%. The external debt-service ratio is forecast to rise from 23% in 2008 to a hefty 37% in 2009-2010.

FX reserves have gradually fallen from a peak of EUR13.9bn in September 2008 to EUR10.7bn in August 2009 (-23%). This is still sufficient to cover more than six months of forecast imports in 2009 as well as 172% of the monetary base, which is needed to maintain the currency board (see above). However, current FX reserves cover just 61% and 55% of all external debt payments falling due in 2009 and 2010, respectively. The refinancing of maturing debt will remain particularly difficult amid

the ongoing global financial crisis, such that there is a high risk of disruptions in the banking and corporate sectors.

Summary: After overheating up to Q3 2008, the economy has hard landed in the wake of the intensification of the global financial crisis. However, the recession has so far been less extreme than in most other countries in the region. Although narrowing, the current account deficit is forecast to remain at uncomfortable levels of 10%+ of GDP. Bulgaria's external debt ratios are concerning, with gross (net) external debt estimated at 107% (57%) of GDP in mid-2009 and the debt-service ratio forecast at 37% in 2009-2010. Considering the large external financing requirement and still tight liquidity amid the ongoing global crisis, the refinancing of maturing debt will remain particularly difficult. Overall, there is a high risk of disruptions in the banking and corporate sectors, and a sharp rise in the number of insolvencies is to be expected in 2009-2010. Still, solid FX reserves and a firm political commitment to the currency board render it unlikely that board will collapse on its own in the short term. However, contagion from the collapse of a currency peg in one or more of the Baltic States remains a non-negligible risk.

Structural Business Environment

The Structural Business Environment is generally adequate, ranking slightly above average in our assessment of 210 countries and has improved considerably in recent years thanks to liberalisation, privatisation, and lower barriers to trade, foreign investment and capital flows. This improvement has been propelled by the EU accession process, and structural reforms gained renewed momentum in 2006 after the EU warned the authorities that delays in certain areas risked a postponement of the accession until 2008. 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.

Almost complete privatisation (98%), a high level of foreign ownership (87%, though this includes a 13% share of Hungary's OTP Bank) and strong supervision are positive elements of the banking system which appears to have remained relatively stable in the wake of the global financial turbulence. Owing to the currency board arrangement and the obligation to lift administrative limits on bank lending upon EU accession in January 2007, the central bank was unable to curb soaring credit growth—which contributed strongly to the previous overheating of the economy—but meanwhile this problem has been reduced (see Economic Stability section), at least for now. However, substantial exposure to the property sector remains a serious risk for the banking sector. Considerable exchange rate risk would arise in the event of devaluation, since about half of total bank loans are denominated in FX. The share of NPLs in total loans has increased to 5.1% in July 2009 from just 2.1% at end-2007 and as the number of household and corporate insolvencies will rise in 2009-2010, some disruptions in the banking sector are likely. Several foreign parent banks are reportedly committed to maintain credit lines to their subsidiaries, however, some have themselves experienced weakened positions in recent months.

Dr. Manfred Stamer

Hamburg: +49 (0)40 8834 3607

Charts

