

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.

Strengths

- EU membership and good international relations
- Functioning parliamentary democracy; relatively low systemic political stability risk
- Successful currency board since 1997
- Fiscal surpluses since 2004
- Solid banking sector

Weaknesses

- Organised crime has been reduced since 1997, but remains an internal security issue
- Already large current account deficit continues to widen (estimated at 22% of GDP in 2007)
- High gross external debt (estimated at 96% of GDP in 2007)
- Growing macroeconomic imbalances have increased the risk of economic overheating and a hard landing, particularly in the context of the ongoing global liquidity squeeze
- Corruption and inefficiencies in the legal and regulatory frameworks

Country Risk Assessment

Ratings	Bulgaria		Median Grade B	Romania	Peers	
	Latest	Previous			Estonia	Latvia
Systemic Political Risk:	P2+	P2+	P2-	P2-	P1	P1
Systemic Economic Risk:	E4	E4	E4	E4	E4	E5
ME rating:	ME4	ME4	ME4	ME4	ME4	ME5
<i>Structure</i>	3.3	3.3	4.2	3.3	1.6	3.3
<i>Policy</i>	4.8	4.8	4.2	5.8	4.2	5.2
<i>Solvency</i>	3.8	3.2	2.8	3.8	2.8	4.8
<i>External Liquidity</i>	4.6	3.6	4.2	5.2	6.0	6.0
SBE rating:	SBE3	SBE3	SBE3	SBE3	SBE1	SBE2
COUNTRY GRADE:	B	B	B	B	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 Country Risk Unit

ECONOMIC STRUCTURE

Country Profile

Capital city:	Sofia
Population:	7.69255 mn (2006)
GDP:	USD 31468 mn (2006)
Currency:	Lev (BGN)
Form of state:	Parliamentary democracy
Head of government:	Prime Minister Sergei STANISHEV (since 2005)
Next elections:	Legislative: June 2009 / Presidential: October 2011

Major Industries (% of GDP at market prices, 2006)		Global Assumptions		2007	2008
Services	60.0%	Real GDP grth (% yr/yr) *		2.3	2.0
Industry	32.0%	Inflation (% av) *		2.1	1.6
Agriculture and forestry	8.0%	US 3-month LIBOR (%)		5.2	4.7
		Dated Brent (USD/b)		72	83
		* Major economies			

Main Exports (% of total, 2006)		Main Imports (% of total, 2006)	
Metals (excl. iron & steel)	14.5%	Crude oil & natural gas	18.6%
Clothing & footwear	13.7%	Machinery & equipment	9.5%
Iron & steel	7.5%	Textiles	8.3%
Chemicals, plastics & rubber	5.2%	Chemicals, plastics & rubber	6.8%
Lead Export Markets (% of total exports, 2006)		Lead Import Markets (% of total imports, 2006)	
Turkey	10.7%	Germany	17.5%
Italy	10.2%	Russia	12.5%
Germany	10.0%	Italy	8.7%
Greece	8.0%	Turkey	6.0%

Basic indicators

Selected economic indicators	2004	2005	2006	2007e	2008f
Nominal GDP (USD mn)	24,571	27,259	31,468	38,964	46,111
Population (mn)	7.79	7.74	7.69	7.64	7.59
GDP per capita (USD)	3,152	3,520	4,091	5,098	6,073
Real GDP growth (% yr/yr)	6.6	6.2	6.1	5.7	5.0
Inflation (% eop)	4.0	6.5	6.5	12.5	5.5
Fiscal balance (% of GDP)	1.7	3.1	3.6	3.8	2.5
Current account balance (% of GDP)	-6.8	-11.9	-15.9	-21.7	-22.0
External debt/GDP (%)	69.7	65.3	82.3	95.6	104.2
External debt/Exports of goods & services (%)	122.7	110.2	128.8	150.4	154.8
Debt-service ratio (%)	21.9	41.5	24.1	24.0	20.2
Foreign exchange reserves (USD mn)	8,712	7,992	10,892	16,398	18,500
Import cover (months)	6.2	4.7	5.0	5.9	5.0
Exchange rate assumption, BGN:USD (av)	1.58	1.57	1.56	1.43	1.37
Exchange rate assumption, BGN:EUR (av)	1.96	1.96	1.96	1.96	1.96
e: CRU estimate; 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. Successive governments have broadly continued political and economic reform policies begun under the United Democratic Forces in 1997, which resulted in NATO membership in March 2004 and EU accession in January 2007. Reforms also secured continued IMF support, increasing 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 7% in 2006. Nonetheless, governments tend not to last more than one term, as voters expect an even more rapid improvement in living standards. The current government, a three-party coalition formed after the June 2005 elections, led by the Bulgarian Socialist Party (BSP) and including the National Movement for Stability and Progress (NMSPP; formerly the National Movement for Simeon II) and the Turkish Movement for Rights and Freedom (MRF), may be no exception. Following EU accession, a common goal, the coalition has appeared increasingly unstable as earlier tensions between the centre-left BSP and the centre-right NMSPP have recurred. Moreover, internal division threatens to disrupt the NMSPP, which may be crowded out by the Citizens for the European Development of Bulgaria (CEDB), a new right of centre party that emerged only in 2006 but already enjoys the strongest popular support, according to recent opinion polls. The next parliamentary elections are scheduled for June 2009 but may be called early. While government instability has already slowed the reform momentum and early elections could further do so, systemic political stability is not at risk and continuity of broadly centrist economic policy—as favoured by all major parties—is expected.

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 a weakened government), the EU has introduced a system of post-accession benchmarking for Bulgaria, which requires progress reports on key areas of concern, in particular aimed at judicial reform and cleansing the system of corruption and organised crime. The second progress report in February 2008 states that Bulgaria still needs to strengthen fighting high-level corruption, corruption within local government and organised crime. The EU has not yet imposed punitive measures (such as below-potential EU funding) but has reserved the right to do so in the absence of sufficient progress in the future.

Overall, international relations are good and in the event of a financial crisis, timely multilateral help 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.

Economic Stability

The economy is small, open and increasingly export-intensive—the exports-to-GDP ratio is currently 64%. Estimated per capita GDP of around USD5,000 in 2007 classifies Bulgaria as an upper middle income economy by the World Bank definition, but this is the lowest in the enlarged EU-27. Agriculture accounts for 8% of GDP, industry 32% and services 60%. The EU absorbs roughly 55% of exports and Turkey 11%.

A currency board, which currently pegs the lev to the euro (at a rate of 1.95583 lev/euro), was introduced as part of stabilisation measures that ended the 1996-97 financial crisis. Inflation has dropped to single digits for most of the time, though it can be volatile owing to one-off factors, and monetary stability has underpinned annual average real GDP growth of 4.8% since 1998. The currency board, however, has meant the loss of autonomous monetary policy and this has developed into a problem recently. Confined to administrative instruments and obliged to lift restrictions on new bank lending at the start of Bulgaria's EU membership, the central bank has been unable to tackle growing macroeconomic imbalances in 2007, such as soaring domestic demand, which has been fuelled by rapid credit growth and has also boosted inflation and the current account deficit.

Real GDP growth fell from 6.4% yr/yr in H1 2007 to 4.5% in Q3, owing to a sharp drought-related contraction in agriculture, taking the nine-month rate to 5.8%. Non-agricultural GDP, however, surged to 9% yr/yr in January-September from 6.9% in 2006, raising some concern of economic overheating. Strong private investment expansion, estimated at 20% or so in 2007, was the main growth driver while private consumption grew by 7.5%. In our central case scenario, we expect growth to slow from 5.7% in 2007 to about 5% in 2008, owing to easing export demand from the EU and slowing domestic demand as a result of global liquidity tightening.

The drought-related contraction in agriculture also caused a food price shock in August 2007, which pushed up inflation to 12.5% at end-2007. Assuming that weather conditions return to normal, inflation should fall back to about 5.5% at end-2008, though potential economic overheating causes some upside risk. Adding to such overheating concerns is private sector credit growth, which accelerated anew from a relatively comfortable 25% at end-2006 to 56% in Q3 2007.

The fiscal position has remained strong. Sound growth and improved tax compliance that raised revenues as well as spending restraint have enabled progressively larger fiscal surpluses since 2004. In fact, four consecutive years of bigger-than-planned surpluses — although welcome with the IMF, which is greatly concerned about the very high current account deficit — have raised questions over the government's approach to budgeting. Is public spending too restrictive with possible medium-term negative effects? Lower growth and the temptation to apply some pre-election populist spending measures may reduce the fiscal surplus from an estimated 3.8% of GDP in 2007 to 2.5% in 2008, slightly below the government's 3% target. So far, the government has used the surpluses for prepayment of external debt (Brady bonds and IFI obligations), which has lowered the public debt-GDP ratio to 20% from 48% at end-2003 and 110% in 1997.

The current account deficit widened further to around 22% of GDP in 2007, as surging domestic demand and high oil prices boosted imports, increasing concerns about external liquidity. Positively, net foreign direct investment (FDI) remained strong and covered about 92% of the deficit. 2008 is unlikely to see much change, although net FDI coverage of external deficits is likely to fall gradually over the next years. Foreign exchange reserves grew to USD16.4bn at end-2007, covering almost six months of imports. However, such levels of reserves are only sufficient to cover about 82% of external debt payments falling due in 2008.

Strong foreign borrowing by banks and the private sector have pushed up gross external debt to a worrisome 96% of GDP. The private sector share of external debt has continued to rise from just 20% in 2003 to 78% in 2007; and short-term debt as a share of gross debt has increased from 14% to 33% over the same period. Net external debt of less than 35% of GDP, however, looks more comfortable and gross debt relative to exports earnings is an acceptable 150%. The debt-service ratio is estimated at 20% in 2007 and should be manageable.

Summarising, macroeconomic imbalances have grown in 2007, reflected in surging domestic demand that has come at the expense of rapid credit growth (partly funded by foreign borrowing), a sharply widening current account deficit and rising external debt payments. Inflation has also picked up. These developments have raised concerns of increased external liquidity risk, in general, and of economic overheating and a hard landing in the context of the ongoing global liquidity squeeze, in particular. However, as a result of a track record of fiscal discipline and considerable structural reform—which, importantly, needs to be continued—as well as continued FDI inflows and solid foreign exchange reserves, Bulgaria appears to be in a better position than Latvia or Romania, for example, and should not experience a financial crisis on its own. Nonetheless, (regional) contagion poses a real risk should investor sentiment turn against some or all emerging markets.

Structural Business Environment

The structural business environment is generally adequate, ranking slightly above average in our assessment of 208 countries and has improved considerably in recent years thanks to liberalisation, privatisation, a relatively solid banking sector 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 strong 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.

As a result of the currency board arrangement, almost complete privatisation and stronger supervision, the banking system is now solid—as confirmed by continuously sound bank performance indicators—and should be able to absorb considerable credit, interest rate and exchange rate risks. The renewed acceleration of private sector credit growth, following the lifting of administrative limits on bank lending in January 2007, does not increase systemic risk in the short term as it largely reflects a shifting back of lending and credit risk from non-bank financial institutions to banks (which are better supervised). Moreover, as the booming property market is driven by purchases by non-residents, banks' exposure to that market is still limited, according to the IMF.

Charts

