

RATING PERSPECTIVE

Republic of Bulgaria

Concern over the short-term external financing of private-sector debt amid moderating global financial crisis

JCR reviewed the ratings on the local currency and foreign currency long-term senior debts of Republic of Bulgaria and affirmed the ratings with "Negative" outlook in July, 2009 (Exhibit 1). The ratings are supported mainly by Bulgaria's sound fiscal structure as a result of its continued fiscal surpluses and a substantial reduction of the government debt, maintenance of a currency board arrangement through collaboration between the government and the Bulgarian National Bank (BNB), its central bank, and its increased production capacity rendered by robust investments resulting from large inflows of foreign direct investment (FDI) and subsidies from the EU. On the other hand, the ratings are constrained by the large external debt of the Country's

private sector, its constant current account deficit and economic structural changes only in an early stage. The "Negative" outlook reflects our view that the private sector drenched with external finance is still fragile in the global financial crisis, albeit now easing. In this report, we would like to touch upon our viewpoints over the ratings and the future prospect of the Country.

1. Emerging economic imbalances resulting from a sharp increase in the external debt of the private sector

Bulgaria, having joined the EU in 2004, has deepened relationships with the European markets, including capital, trade and labor. The Country has achieved more than 5 percent growth over seven years since 2002 (Exhibit 2). The stabilization of inflation and currency by the currency board arrangement (pegging the *lev* to the euro), and the government's sound fiscal policy and promotion of improved business environments have combined to help foster such economic growth to a large extent. Net FDI inflows increased sharply to 90 percent of GDP at the end of July in 2007¹ and commercial lending increased as well through the major banks, which had become subsidiaries of larger banks in Europe, along with privatization. Bank lending to the private sector expanded rapidly to 76 percent of GDP at the end of 2008 from 36 percent of 2004 (Foreign currency loans accounted for a half of total loans at the end of 2008). The Country's external debt did not increase much in the early period of economic expansion because the inflows of FDI

Exhibit 1. JCR's ratings to the Central and Eastern European Countries

	Foreign Currency	Local Currency
AA	Slovenia/s	Slovenia/s
AA-		
A+	Slovakia/s	Czech Rep./s and Slovakia/s
A	Czech Rep./s	Poland/s
A-	Poland/s	Hungary/s
BBB+	Hungary/n	Bulgaria/s
BBB	Bulgaria/n	Romania/s
BBB-	Romania/n	

p: positive, s: stable and n: negative

Exhibit 2. Main economic indicators: Republic of Bulgaria

	unit	2004	2005	2006	2007	2008	2009(f)	2010(f)
Real GDP growth rate	(%)	6.6	6.2	6.3	6.2	6.0	-5.0	-1.0
Consumer price inflation (YOY)	(%)	6.1	6.0	7.4	7.6	12.0	3.2	3.0
Unemployment rate	(%)	12.0	10.1	9.0	6.9	5.7	6.5	6.8
The central government fiscal balance / GDP	(%)	1.7	3.1	3.5	2.4	3.0	-1.3	1.0
The central government fiscal debts / GDP	(%)	37.9	29.2	22.7	18.2	14.0	15.2	14.8
Current account balance / GDP	(%)	-6.6	-12.4	-18.4	-25.1	-25.3	-12.3	-9.4
Trade balance / GDP	(%)	-14.9	-20.2	-22.0	-25.1	-25.7	-13.3	-11.0
Service balance / GDP	(%)	3.3	3.7	3.7	2.6	2.4	1.5	1.9
Income balance / GDP	(%)	1.2	0.3	-2.7	-3.8	-3.5	-2.5	-2.8
Transfer balance / GDP	(%)	3.7	3.7	2.7	1.2	1.5	2.1	2.5
Net foreign direct investment / GDP	(%)	14.6	13.3	23.9	28.7	16.7	8.1	10.8
Net foreign direct investment / Current account balance	(%)	209.4	116.5	132.4	116.8	71.4	84.9	134.5
External debts / GDP	(%)	63.8	70.1	81.6	101.1	107.7	111.9	118.5
Short-term external debt / total debts	(%)	19.3	25.6	30.2	32.4	36.2	36.7	32.9
Public external debts / exports G&S	(%)	53.2	34.2	22.9	17.0	13.2	15.7	13.8
External debts / exports G&S	(%)	112.5	117.7	127.2	160.0	177.9	235.1	223.0
Foreign exchange reserves / monthly imports G&S	(months)	5.6	4.8	4.7	5.4	5.0	6.0	6.3
Foreign exchange reserves / short-term external debts	(%)	2.6	1.7	1.3	1.2	0.9	0.7	0.8

Sources: Central bank, Eurostat and Ministry of Finance. Figures for fiscal balance are based on ESA 95, Figures for 2009 and 2010 are projections made by JCR

exceeded its current account deficit. In 2007 the current account deficit and the external debt increased significantly, exceeding 25 percent and 100 percent, respectively, of GDP as the Country's economy has continued to grow and at a higher rate than its estimated potential growth rate of around 5 percent since around 2004. The inflation rate increased as well. On the other hand, while the government continued its restrictive fiscal policy aiming at curbing domestic demand and achieved fiscal surpluses since 2004, the general government debt (ESA) shrank significantly to 14 percent of GDP at the end of 2008 from 53 percent at the end of 2002. Also the BNB implemented strict assessment of bank assets and has kept the Country's financial system sound for the purpose of maintaining the currency board arrangement stably.

1. The FDI inflows exceeded 10 percent of GDP every year since around 2003 against a background of heightened expectation of its EU accession and reached an all time high of 8.29 billion euros (28.7 percent of GDP). Although it decreased to 16.7 percent of GDP in 2008, the net FDI balance at the end of 2008 was 30.8 billion euros (90.2 percent of GDP), showing a higher level in comparison to new EU accession countries.

2. Lowering ability to refinance the external debt of the private sector because of the global financial crisis

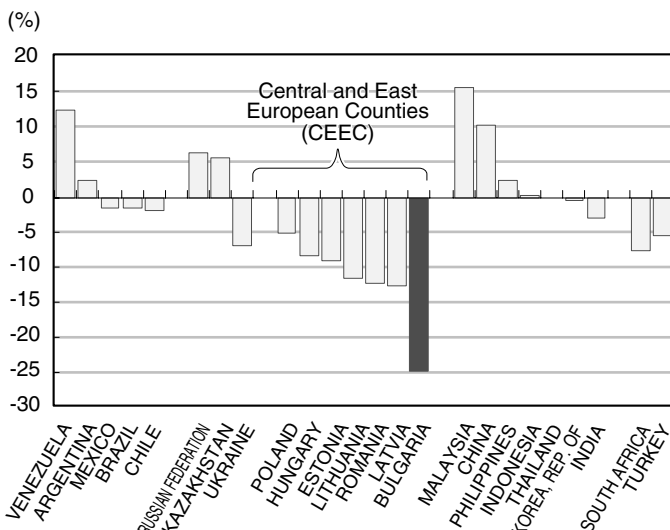
There was a growing concern over external financing of the Central and Eastern European countries, which had relatively larger current account deficits among emerging countries (Exhibit 3), with turmoil by the global financial crisis deepening from September in 2008. As a result, financial markets in those countries were significantly hurt. Those situations made the Country's financial markets unstable, in which its currency lost a more than 10 percent of the value

against the US dollar and inter-bank interest rates were destabilized on deteriorating liquidity at around the end of 2008. The markets are restoring stability as a result of liquidity measures taken by the BNB, such as deposits guarantee and lowered ratios of reserve requirement, in addition to the global financial crisis becoming less serious than before. The central bank found through stress tests that banks have enough equity capital to make up deterioration in the quality of loan portfolios and the Country's financial system remains sound².

On the other hand, although external financing issues did not surface, as inflows of the FDI exceeded the increase of current account deficit until 2007, the FDI decreased sharply and external debt of companies and banks increased significantly in 2008. As a result, the Country's external debt climbed to 107 percent of GDP at the end of 2008 (Exhibit 4), of which the private sector accounted for 93 percent, and its short-term external debt 36 percent. Thus its external financing structure is fragile. There is a likelihood that major banks in Bulgaria, most of which are subsidiaries of large European banks based in Italy and Greece, will face decreased funding from their parent banks, should parents' financial or liquidity positions be deteriorated. Those situations will put further pressure against the Country's external finance³. On the other hand, the public finance is of little concern thanks to the government having maintained fiscal surpluses and efforts to cut debts.

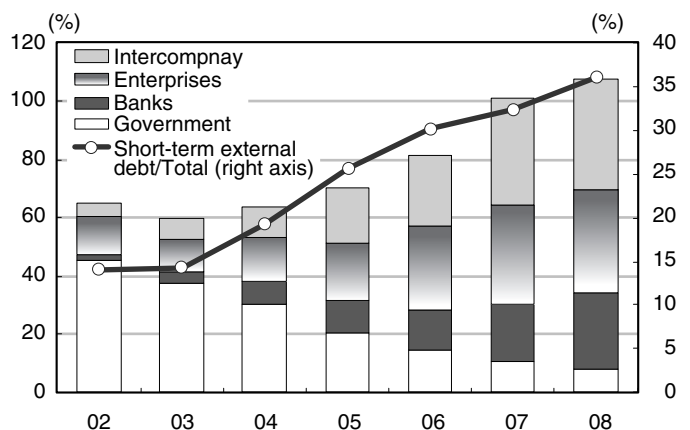
Turning our eyes to the external financing during 2008, the required amount to finance net deficit of the current account comes to approximately 3 billion euros after adding FDI. Therefore, the need of external financing amounts to 3.6 billion euros including 0.62 billion euros appropriated for

Exhibit 3. Relatively larger C/A deficit of CEECs among emerging countries (Current account balance/GDP as of 2008)



Source: EIU

Exhibit 4. Growing external debts led by the private sector (External debt/GDP)



Source: Bulgarian National Bank

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interest payments. The Country's official foreign exchange reserves at the end of 2008 reached 11.9 billion euros, which represented 3.3 times as much as necessary amount of external financing. The ratio would be lowered, however, to 0.7, hardly enough to make up deficiency, if 13.3 billion euros of short-term debt due within a year is included. Thus the Country's external financing position was more vulnerable to the swings in financial markets than it would be should the debts be adequately covered by official foreign exchange reserves (Exhibit 5). Bulgaria is ranked almost equal to the countries which receive financial support from the IMF at the moment, if the same calculation applied to all. The Country's CDS spread is at the same level as Republic of Turkey and Romania, which reflects concern over its external financing position (Exhibit 6).

2. There are no private banks which have received a capital injection using public funds.
3. A verbal survey of major banks which expanded into Bulgaria shows that they will continue their strategically important investments in the Middle and Eastern European countries.

3. 2009 economy is expected to contract for the first time since 1997

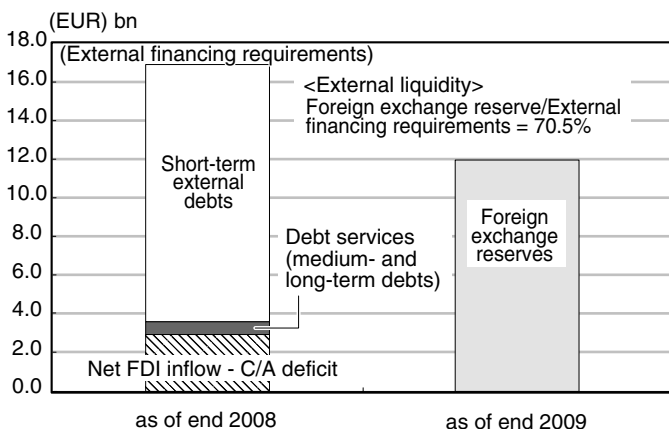
Although the Country's economy showed a rapid growth of 6 percent in 2008, it sharply slowed down in the October-December of 2008 and it contracted by 3.5 percent in the January-March of 2009 (on a year on year basis) (Exhibit 7). Consumer spending and investments, which had bolstered the economy in the past, declined, while net exports expanded, as imports decreased more than exports. Bank lending to the private sector, which had supported expansion in consumer spending and investments, fell 19.9 per-

cent at the end of April in 2009, compared with a year earlier, a 62.5 percent drop from a peak level at the end of 2007 (YoY). In April, 2009, the exports fell 39.8 percent compared with a year earlier, a greater drop than before, and the Country's industrial production was weak, a 22.2 drop YoY. The Country's economy is expected to contract by more than 5 percent as a result of declining bank lending to the private sector and slumping economic conditions in the EU countries, its major trading partners. Although the Country has to experience lower economic growth as a result of weak exports and a reduction in annual expenditures over the short term, expansion of investments resulting from large inflows of FDI and the EU subsidies will contribute to the economic growth over the medium term. Also there is room for further economic growth, with its GDP per capita (purchasing power parity) representing 40.1 percent of the EU average in 2008. Although the consumer price index (CPI) climbed to 15 percent YoY in the middle of 2008, falling fuel and food prices and a slowdown in wage growth pushed down the CPI to around 3 percent YoY in May 2009. The central bank lowered the base rate to a 2 percent level, following in the footsteps of the European Central Bank's aggressive monetary easing policy, although the degree of freedom for its monetary policy is limited as a result of the introduction of the currency board arrangement

4. Continued sound fiscal policy, despite temporary deficits in the government fiscal balance

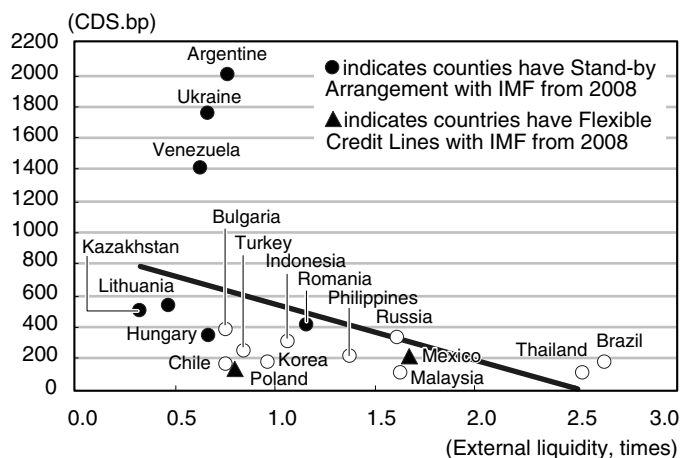
The general government fiscal balance has been in surplus since 2004 and it posted a surplus of 1.5 percent of GDP in 2008. However, the balance is deteriorating sharply because of its decreased fiscal revenue along with an economic

Exhibit 5. Refinancing of the short-term external debt



Source: Bulgarian National Bank

Exhibit 6. Bulgaria's fragile external liquidity (as of end 2008) and CDS spreads (July 2009)



Source: JCR created the chart based on the figures quoted from EIU and statistical institutions of each countries.
External liquidity = Foreign exchange reserve/External Financial Requirements

downturn since the end of 2008 and increased annual expenditure for countercyclical measures. The balance in the January-May quarter of 2009 (GFS) showed a surplus of 1.3 percent, a considerable drop from 5.0 percent in the same period of 2008.

The former government projected 4.7 percent real economic growth and the general government fiscal surplus of 3.0 percent of GDP in its original 2009 budget at the end of 2008. However, the government set up "90 percent rule," which limits the annual expenditure to a 90 percent of the original budget, to cut annual expenditure, as a revenue shortfall is expected on a sharp slowdown in its economy. The former government revised those projections to negative economic growth of 2.4 percent and a slight fiscal surplus of approximately 0.5 percent, as the economic deterioration was worse than it had been expected. The former government also showed the intention to secure a fiscal surplus by taking additional measures of cut in expenditure, in case of the revenue shortfall being expected as a result of further deterioration of the economy. JCR considers that although the fiscal balance will show a slight deficit temporarily in 2009, the balance will return to a surplus in 2010 and thereafter, if a further deterioration in the economy does not occur. Its 2009 budget records an increase in reserves amounting to 1.5 percent of GDP and its fiscal reserve balance reaches 12.6 percent of GDP as a result of the Country's constant fiscal surpluses. The Country now has enough reserves to cope with unforeseen events. The general government debt shrank to 14.1 percent of GDP at the end of 2008, from 18.2 percent at the end of 2007 as a result of early repayment of external debt in several times, including Brady bonds and IMF loans, with the fiscal surpluses increasing

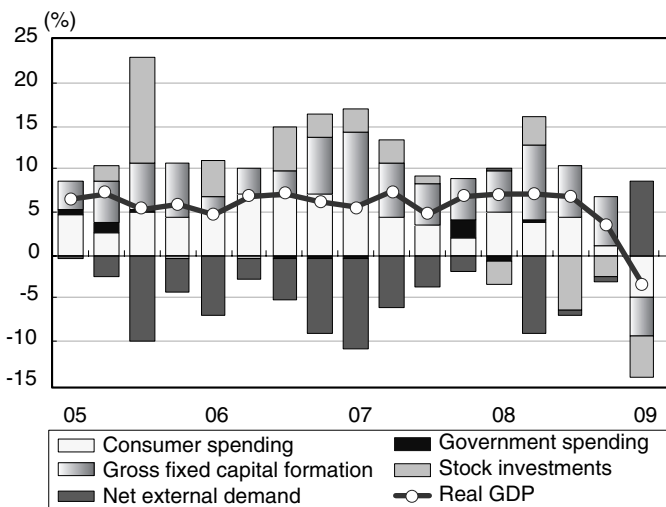
constantly. In our view, the Country is well prepared even against contingent liabilities out of systemic risks. Its general government debt/GDP ratio fell most sharply among the countries⁴ to which JCR has given ratings, only comparable to that of the Republic of Indonesia (Exhibit 8) in the period since 2002 onward.

4. Article 119 of the EU accession treaty prescribes that if a Member State is in difficulties or is seriously threatened with difficulties as regards its balance of payment, the Commission shall state what measures it recommends the State concerned to take. Further if the action taken by a Member State and the measures suggested by the Commission do not prove sufficient to overcome the difficulties which have arisen or which threaten, the Commission shall recommend to the Council the granting of mutual assistance and appropriate methods thereof.

5. The Country's external financing structure is still fragile because of a higher level of short term external debt, despite its shrinking current account deficits.

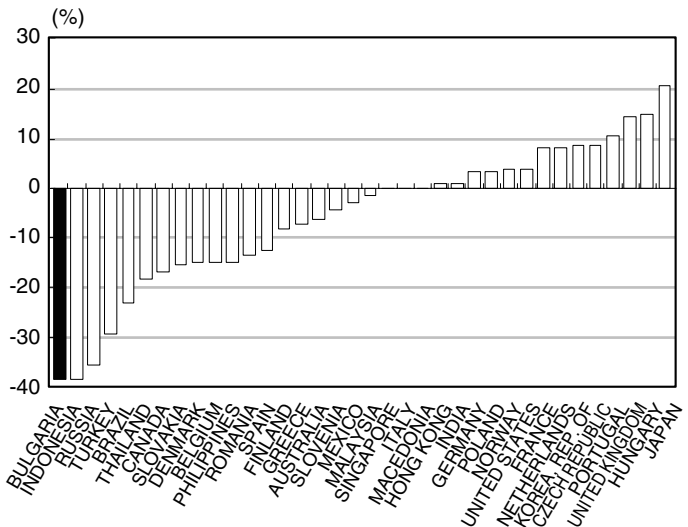
In 2008 the current account deficit increased to 25 percent of GDP. The ballooned trade deficit is largely responsible for it, which in turn was caused by an increase in imports of the FDI induced investment goods and the export related materials, on top of inflated fuel prices. Recently, between January and April 2009, the current account deficit fell sharply to 5.0 percent of GDP, from 8.1 percent in the same period last year, as the imports began to decrease more than the exports. Approximately a half of the current account deficit is financed by the net FDI inflow. Although the external debt at the end of March 2009 still exceeded 100 percent of GDP, it began to decrease from the end of 2008. The country's official foreign exchange reserves decreased to 10.89 billion euros at the end of April in 2009, an approximately 20 percent fall

Exhibit 7. Bulgarian economy slowed down sharply from the end of 2008 (Real GDP growth rate yoy)



Source: Bulgarian Statistical Office

Exhibit 8. Significant reduction of government debts (Government debt/GDP improvement from 2002 to 2008)



Source: EIU

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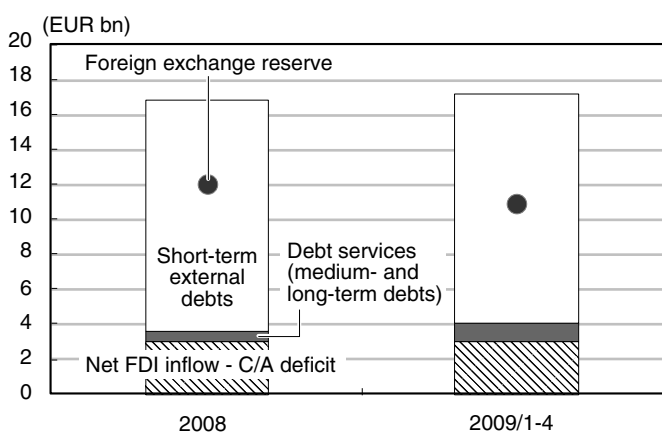
from the end of 2008, as a result of a reduction in the reserve requirement ratio by the central bank. If the ratio computed in Section 2 is applied to the January-April quarter, it was below 70 percent and fell further from the level at the end of 2008, as the ratio of the net FDI to the current account deficit became lower and the short term external debt increased, although the current account deficit decreased. The private sector may have a difficult situation in which its external finance is hampered by a strong demand for money in 2009 in the rest of the world, if there is a relapse of global financial crisis even if it seems to have past the worst. Therefore JCR considers it highly desirable for the Country to obtain a commitment of financial support from international organizations like the IMF and the EU⁴ as a precautionary measure (Exhibit 9).

6. Acceptance of financial support from the IMF and shifting to a steadier financial policy (Exhibit 10)

A new political party, "Citizens for the European Development of Bulgaria (GERB)" formed at the end of 2006 won the general election on July 5 2009 and gained 116 of 240 seats, although it could not obtain an outright majority. The governing Bulgarian Socialist Party lost 42 to 40 seats and was soundly defeated. Entrusted by the electoral result, GERB plans to establish a minority government in cooperation with other right-wing parties on July 27. Boyko Borisov, the former Mayor of Sofia and the leader of the GERB, has become Prime Minister. GERB is a right-of-center political party, which was formed at the end of 2006, and its policy platform includes the maintenance of the currency board

arrangement, an introduction of the euro in 2012, suppression of corruption and crimes, and stressing family values. Although the former government had been hesitant to accept the financial support from the IMF, the new government showed its intention to accept it as a precautionary measure before the election. JCR expects the economic and fiscal outlook for 2009 should be revised from the realistic point of view. The new government will introduce steadier policies in cooperation with other right-wing parties, despite being a minority itself in the parliament. **JCR**

Exhibit 9. Fragile external liquidity in the private sector



Source: Bulgarian National Bank. Figures for January - April are annualized

Exhibit 10. Results of General Election

(Parliamentary seats)	July 2007		June 2005	
	Seats	%	Seats	%
Citizens for European Development of Bulgaria	116	48.3	0	0.0
Blue Coalition	15	6.3	-	-
Democrats for a Strong Bulgaria	-	-	17	7.1
United Democratic Forces	-	-	20	8.3
Coalition for Bulgaria	40	16.7	82	34.2
National Movement for Stability and Progress	-	-	53	22.1
Movement for Rights and Freedoms	38	15.8	34	14.2
Order, Lawfulness, Justice	10	4.2	0	0.0
National Union Attack	21	8.8	21	8.8
Bulgarian People's Union	0	0.0	13	5.4
Total	240	100.0	240	100.0
Ruling parties	116	48.3	169	70.4

Shadow indicates ruling parties