Republic of Bulgaria

The deteriorating current account deficit is likely to improve as the economy returns to sustainable growth

In its annual review of the Republic of Bulgaria on June 27, 2007, JCR affirmed the ratings on foreign-currency and local-currency long-term senior debts (BBB+/stable for foreign-currency debts, A-/stable for local-currency debts). The affirmation of the ratings was mainly supported by Bulgaria's sounder fiscal structure underpinned by a continued fiscal surplus and a substantial reduction of the government debt, and stabilization of prices and its currency under the currency board arrangement. Also supporting the ratings were the country's high economic growth prospects mainly bolstered by an expanding production capacity rendered by massive foreign direct investment (FDI) inflows in recent years and a substantial amount of subsidy from the EU as well as the continued prudent fiscal and monetary policies.

Exhibit 1. Ratings to the Central and East European Countries

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

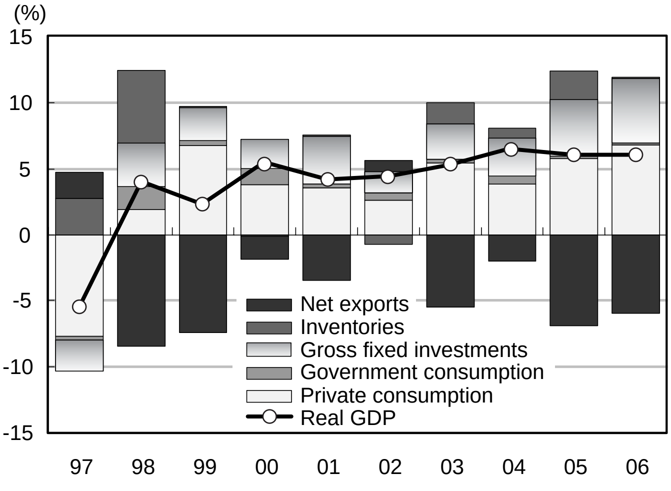
On the other hand, the ratings remained constrained by a deteriorating current account deficit resulting from strong imports caused by robust private-sector demand and the fact that industrial transformation is still at a primary stage, with per capita GDP (in PPP terms) estimated at around 35% of the EU25 average. The deteriorating current account deficit is likely to improve as the economy returns to sustainable growth in the years ahead, bolstered by the maintenance of prudent fiscal and monetary policies. This report reviews and projects some of the main factors for the ratings.

1. Robust economic expansion led by private-sector demand

Following the EU accession in January 2007, The Bulgarian economy has kept growing robustly led by strong private-sector demand amid the progress on structural reforms and the maintenance of prudent fiscal and monetary policies as well as the massive FDI inflows in recent years. It grew 6.1% in real GDP terms in 2006 on strong investment and consumer spending, expanding more than 6% for three years in a row (Exhibit 2).

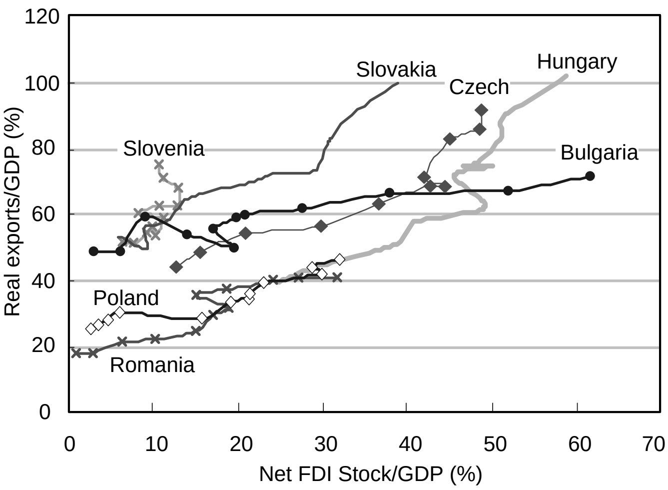
The Bulgarian government introduced the currency board arrangement based on the agreement with the IMF after the currency crisis in 1996, and pushed ahead with wide-ranging structural reforms with a view to inducing the EU's more sophisticated political, economic and fiscal systems follow-

Exhibit 2. Real GDP Growth Rate



Source: National Statistical Institute

Exhibit 3. Net Foreign Direct Investment Stock & Exports (1995-2006)



Source: The Central Bank of respective countries ing the country's recognition as an EU candidate country in 2000. These reforms initiatives have paved the way for further economic growth. The actual economic growth rate has continued accelerating in recent years. Amid growing expectations on EU accession, net FDI inflows have been increasing more than 10% annually since 2003, reaching EUR 4.23 billion or 16.8% of GDP in 2006, the highest on record. As a result, the net balance of FDI came to EUR 15.46 billion or 61.1% of GDP at the end of 2006, expanding at the fastest pace among the new EU member countries (Exhibit 3). The robust FDI inflow stimulated domestic investment, which grew almost 20% annually in the past three years. Consequently, the ratio of real gross fixed capital formation to real GDP rose to 30% in the October-December quarter of 2006. The strong investment contributed not only to spurring private consumption but also expanding production capacity. The country's potential growth rate is now estimated to have risen to around 5%, sustained by the expansion of capital stock and improvement of labor productivity.

The unemployment rate, which exceeded 20% in the early 2000s, improved markedly to reach 9.5% in 2006 due to increased employment amid the strong economic expansion. The annual inflation rate in consumer price terms has remained stable at single-digit levels since 2001. CPI accelerated to 7.3% in 2006 due primarily to the hike of excise tax rates and the surge of energy and food prices, but slowed down to 4.2% year-on-year in April 2007 as the impact of those special factors wore off. Inflation pressure caused by higher wages remains subdued as the pace of wage increases is kept lower than the growth of labor productivity. The country's financial system also remains sound in the absence of any deterioration of bank assets, with the capital adequacy ratio kept at an appropriate level under the strict supervision of the Bulgarian National Bank (BNB).

2. Risks of refinancing controlled despite deteriorating current account deficit

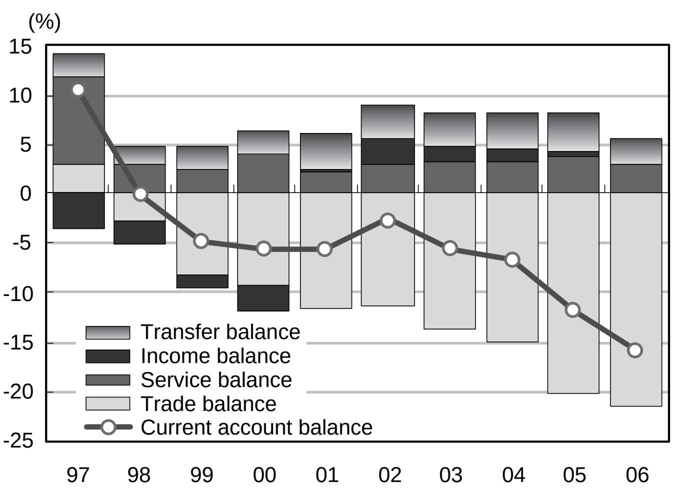
The current account deficit continued deteriorating on surging imports driven by strong domestic demand and higher energy prices. It widened to 15.8% of GDP in 2006 from 12.0% in 2005 (Exhibit 4). The trade deficit widened to 21.5% of GDP in 2006 on strong imports of energy and FDI-related capital goods and raw materials which were to be turned into export products. On the other hand, both services and transfer balances remained in surplus on increased travel income, remittances by migrant workers and subsidy from the EU.

The risk of refinancing the large current account deficit remains controlled as it has been covered by massive FDI inflows since 1998 when the current account balance turned around deficit. The record net FDI inflow in 2006 was 1.03 times as much as the deficit for the year (Exhibit 5). Furthermore, inflows of financial capital such as net portfolio investment and bank loans also reached a record EUR 1.4 billion or 5.6% of GDP in 2006. This has sent the foreign exchange reserves soaring to a record EUR 8.9 billion at the end of 2006, enough to cover more than five months of imports. Meanwhile, the country's total external debt rose to 78.4% of GDP at the end of 2006 from 69.0% the year earlier as banks increased their foreign liabilities amid a shortage of domestic savings.

3. In a bid to rein strong domestic demand, the government and the central bank maintained restrictive fiscal and monetary measures

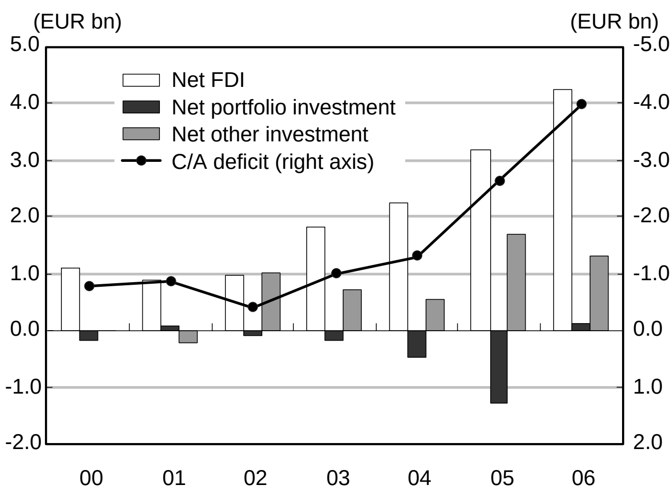
Faced with the robust domestic demand which led to widening the current account deficit, both the government and the BNB have kept a series of restrictive fiscal and monetary measures in place since 2004. As the government has main-

Exhibit 4. Current Account Deficit/GDP



Source: Bulgarian National Bank

Exhibit 5. Finance of the C/A Deficit



Source: Bulgarian National Bank

tained a tight fiscal policy, the fiscal balance has been in surplus for three years running since 2004. The general government fiscal surplus (ESA95) widened to 3.3% of GDP in 2006 from 1.9% in 2005 (Exhibit 6). While tax revenues grew markedly on economic expansion and tightened tax collections by the National Revenues Agency, expenditures stayed largely in line with the levels projected in the annual budgets. The government had initially envisaged a fiscal equilibrium under the 2006 cash-based budget plan, but later revised it to produce a surplus equivalent to at least 3.0% of GDP, based on its agreement with the IMF aimed to reduce the current account deficit. The government successfully met the target as the surplus came to 3.5% of GDP. The favorable fiscal developments boosted the fiscal reserve to BGN 5.8 billion at the end of 2006 or equivalent to 11.9% of GDP. The ratio of government debt to GDP halved to 22.8% at the end of 2006 as compared with three years before thanks mainly to advanced debt prepayments (Exhibit 7).

The BNB has taken a series of prudential measures since 2004 with the aim of cooling down the growing bank lending to the private sector, one of factors that had spurred domestic demand. The measures included an increase of the reserve requirement ratio and tighter restrictions on bank lending. As a result, the growth of bank lending to the private sector decelerated to 24.6% year-on-year at the end of 2006 from 48.6% at the end of 2004 (Exhibit 8).

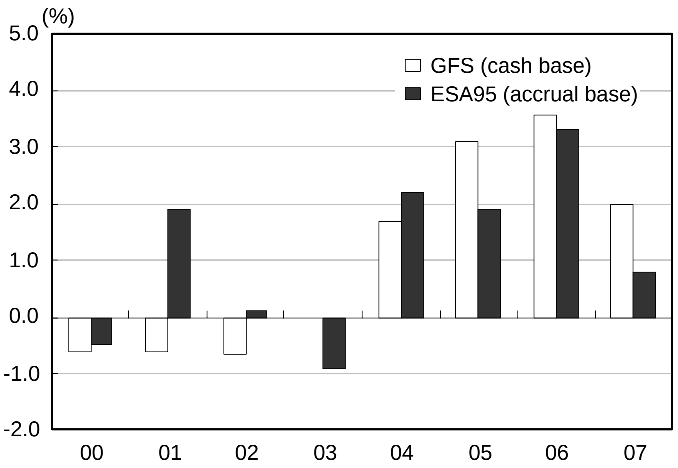
4. Current account deficit to improve on restrictive fiscal and monetary

JCR holds that the current account deficit will improve as the economy returns to sustainable growth of around 5% in 2007 and 2008 amid the continued restrictive fiscal and monetary policies. The BNB removed demand-curbing measures in January 2007 but continues its strict supervision in a bid to prevent possible deterioration of bank assets. There is a possibility that the fiscal policy may be eased in 2007 as the government has projected the fiscal surplus for the year to decrease to 2.0% of GDP (on a cash basis) from 3.5% the previous year. However, the fiscal estimate includes Bulgaria's contribution to the EU budget equivalent to more than 1% of GDP. Given the government's track records of budget implementation, JCR believes that a fiscal policy aimed to curb demand will in effect be maintained in 2007. It should also be noted that the government has earmarked a contingency fund equivalent to 0.6% of GDP under its 2007 budget plan.

5. Political situation to remain stable; euro adoption to come after 2010

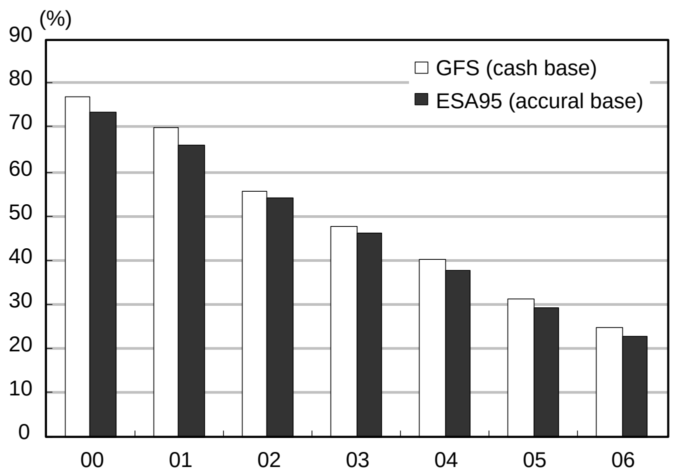
The three-party coalition formed by the leftist Bulgarian Socialist Party, the ethnic Movement for Rights and Free-

Exhibit 6. General Government Fiscal Balance/GDP



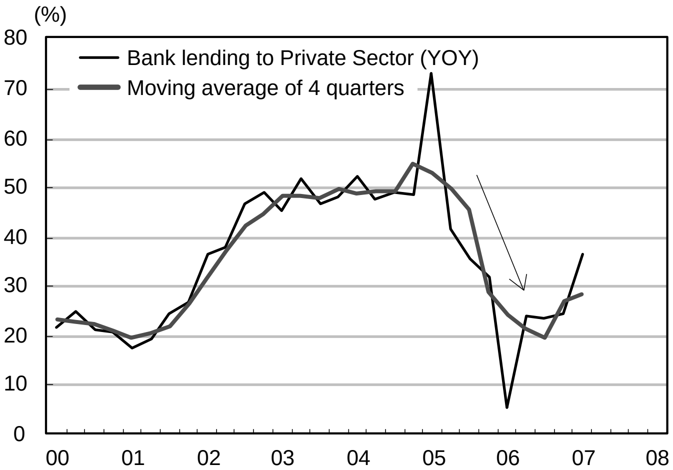
Source: Ministry of Finance. The figures for 2007 are based on the projection of the government

Exhibit 7. General Government Debts/GDP



Source: Ministry of Finance

Exhibit 8. Bank Lending to the Private Sector (YOY)



Source: Bulgarian National Bank

doms and the centrist Party Simeon II National Movement following the elections in June 2005, secured more than two thirds of the parliamentary seats. The coalition promoted reforms in the run-up to the country's EU accession in January 2007. There had been concern over the policies of the new government as the leftist BSP won a major election victory to claim the leading position in the coalition. So far, however, the BSP has only pushed through with a marginal increase in expenditures on social security. Now that Bulgaria has become an EU member, it is unclear if the three parties will maintain their cooperation within the coalition until the next parliamentary elections in June 2009. However, the political stability will be maintained at least for a while.

While the government has yet to decide when to apply for euro adoption, it is set to join the ERM2 at an early date by maintaining the currency board arrangement. Bulgaria fulfilled two Convergence criteria (fiscal deficit and fiscal debt) out of the five (Exhibit 9). Given the maintenance of the currency board arrangement (which pegs its currency to the euro), an introduction of the ERM2 does not look to be too difficult. Among the remaining criteria, inflation and long-term interest rate will take some time to comply with. Bulgaria needs to adjust its indirect tax rate with that of the EU. In this situation, Bulgaria's euro adoption may not come before 2010.

Exhibit 9. Achievement of convergence criteria for the euro adoption

	Fiscal figures		Inflation*	Long-term interest rate †	Exchange Rate ‡	Target date for the euro adoption (yy/mm/dd)
	Fiscal balance as % of GDP	Fiscal debts as % of GDP				
Criteria	within -3%	below 60%	3.0%	5.4%	2 years	
	2006	2006	06/5-07/4	06/5-07/4	entry date	
Slovenia	-1.4	27.8	2.6	4.0	June 2004	2007.1.1
Malta	-2.6	66.5	1.8	4.3	May 2005	2008.1.1
Cyprus	-1.5	65.3	1.9	4.3	May 2005	2008.1.1
Slovakia	-3.4	30.7	3.6	4.5	Nov. 2005	2009.1.1
Latvia	0.4	10.0	6.9	4.7	May 2005	unspecified (initially 2008)
Lithuania	-0.3	18.2	4.2	4.3	June 2004	unspecified (initially 2007)
Estonia	3.8	4.1	4.7	n.a.	June 2004	unspecified (initially 2008)
Czech Rep.	-2.9	30.4	2.0	3.9	Not Yet	unspecified (initially 2010)
Poland	-3.9	47.8	1.6	5.3	Not Yet	unspecified (initially 2009)
Hungary	-9.2	66.0	6.2	7.1	Not Yet	unspecified (initially 2010)
Bulgaria	3.3	22.8	6.3	n.a.	Not Yet	unspecified
Romania	-1.9	12.4	5.2	n.a.	Not Yet	unspecified

Sources: The European Commission, Convergence program of respective countries

Highlighted area indicates fulfillments of criteria
* The inflation rate not to exceed the average of three best performing Member States by more than 1.5%.
† Long-term interest rate not to exceed the average of three best performing Member State by more than 2%
‡ The exchange rate to be kept within the normal margin of fluctuations as stipulated by the Exchange Rate Mechanism II.

Exhibit 10. Economic indicators of the Republic of Bulgaria

	unit	2004	2005	2006	2007 (f)	2008 (f)
Real GDP	(%)	6.6	6.2	6.1	5.5	5.0
Per Capita GDP	(EU25=100)	32.4	33.7	35.8	36.8	38.2
Consumer price inflation	(%)	6.2	5.0	7.3	4.5	3.5
General government fiscal debt/GDP	(%)	40.1	31.3	24.7	20.3	17.3
Current account balance/GDP	(%)	-6.6	-12.0	-15.8	-14.2	-12.7
Trade balance/GDP	(%)	-14.9	-20.2	-21.5	-19.6	-18.8
Net Foreign direct investment	(%)	11.3	14.5	16.8	13.0	10.5
Net FDI/CA deficit	(%)	172.3	121.2	106.2	92.0	82.7
Foreign debt/GDP	(%)	63.8	69.0	78.4	81.9	83.8
Net foreign debt/GDP	(%)	29.2	35.3	42.8	44.9	45.4
Foreign debt/Exports	(%)	112.5	115.8	123.1	119.3	115.5
Public foreign debt/Exports	(%)	53.2	33.9	22.9	17.4	13.8
FOREX/Monthly imports	(months)	6.1	5.3	5.2	5.1	5.1
FOREX/Short-term foreign debt	(%)	2.8	2.0	1.5	1.4	1.5

Sources: Bulgarian National Bank, Eurostat and Ministry of Finance. Figures for fiscal statistics are based on ESA95, Figures for 2007 and 2008 are projection of JCR