

# RATING PERSPECTIVE

## Republic of Bulgaria

Focal points are growing inflation and financing of current account deficit

JCR affirmed its ratings for Bulgaria after reviewing the ratings on its local- and foreign-currency long-term senior debts in August 2008 (Exhibit 1). The ratings are mainly supported by the country's sound fiscal structure as proven by continued fiscal surpluses and a substantial reduction in the government debt, its maintenance of a currency board arrangement through collaboration between the government and the Bulgarian National Bank (BNB), and its strengthened production capacity rendered by increased investment based on foreign direct investment (FDI) inflows. On the other hand, the ratings are mainly constrained by the country's large current account deficits and the fact that the transformation of its economic structure still remains at a primary

stage (its per capita GDP in PPP terms is estimated at approximately 38% of the EU25 average and its energy efficiency remains poorer). This report will review those factors related to the ratings and their future outlook.

### Solid economic fundamentals on the back of structural reforms and robust FDI inflows

Following the currency crisis in 1996, Bulgaria introduced an austerity budget policy and a currency board arrangement under its agreement with the IMF. After becoming an EU candidate country in 2000, it carried out wide-ranging structural reforms in preparation for adoption of the EU's advanced political, economic and fiscal systems.

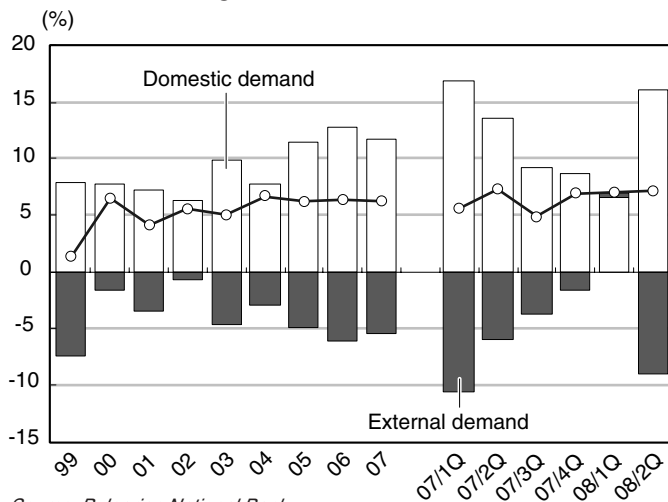
The reform initiatives proved successful. Bulgaria attained its EU accession along with Romania in January 2007. Further progress in structural reforms and prudent fiscal and monetary policies as well as massive FDI inflows have resulted in the country's strong economic expansion led by domestic demand. The economy has been growing at an annual rate higher than 6% since 2004 (Exhibit 2). In particular, the annual volume of FDI inflows has exceeded 10% of GDP since around 2003 amid rising expectations for the country's EU accession. In 2007, the volume rose to a record EUR5.92 billion (20.5% of GDP). As a result, the net balance of FDI inflows as of the end of 2007 reached EUR24.4 billion or 84% of GDP, which was substantially higher than those of

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./p, Slovakia/s
A	Czech Rep./p	Hungary/s, Poland/p
A-	Hungary/s, Poland/p	Bulgaria/s
BBB+	Bulgaria/s	Romania/s
BBB	Romania/s	
BBB-		

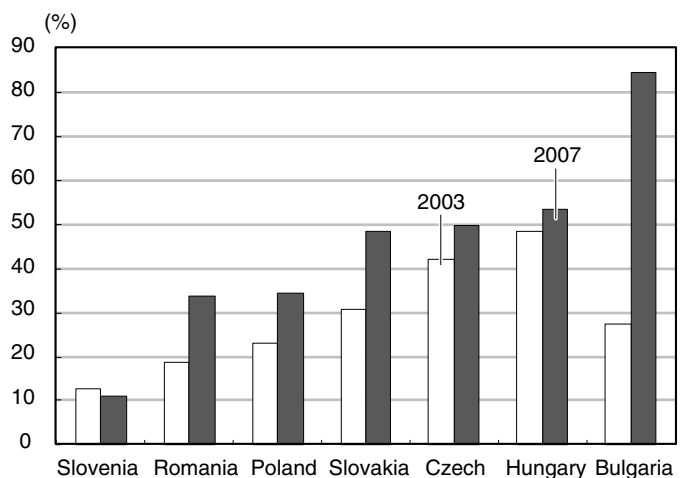
p: positive, s: stable and n: negative

Exhibit 2: Real GDP growth rate



Source: Bulgarian National Bank

Exhibit 3: FDI stock as % of GDP



Source: Central Bank of each country

other new EU member countries (Exhibit 3). The voluminous FDI influx stimulated investment to grow at an annual rate close to 20% in the past three years, with gross fixed capital formation accounting for more than 30% of real GDP in 2007. JCR holds that with its production capacity boosted by such brisk investment, Bulgaria's potential growth rate has now reached somewhere around 5%. However, with its per capita GDP (in PPP terms) estimated at only 38% of the EU27 average in 2007, there is still much room for the country to make further progress in the future.

**Inflationary pressures persist amid continuing economic expansion**

On the other hand, there are growing inflationary pressures caused by a tight labor market as employment and wages continue rising amid sustained economic expansion. The unemployment rate (Eurostat), which had exceeded 10% in 2004, fell to a record-low 5.7% in the middle of 2008. Real wages have been increasing faster than productivity improvement. While the currency appreciation eased the inflationary pressures to some extent, the consumer price inflation (Eurostat) rose to 14.7% year-on-year in June 2008 as the higher wages were joined by the surge of food prices (Exhibit 4). Bulgaria's dependence on imported energy is approximately 50%, which is not as high as those of other EU countries thanks to its higher reliance on domestic nuclear and coal power generation. However, its energy efficiency is the worst among the EU27 countries and its economic structure is still energy intensive. At the moment, the inflationary pressures are somehow easing off due to a lull in the surge of food and fuel prices. But they remain persistently strong on continuing wage increases. A comparison of inflation rates among the EU27 countries shows that the core inflation

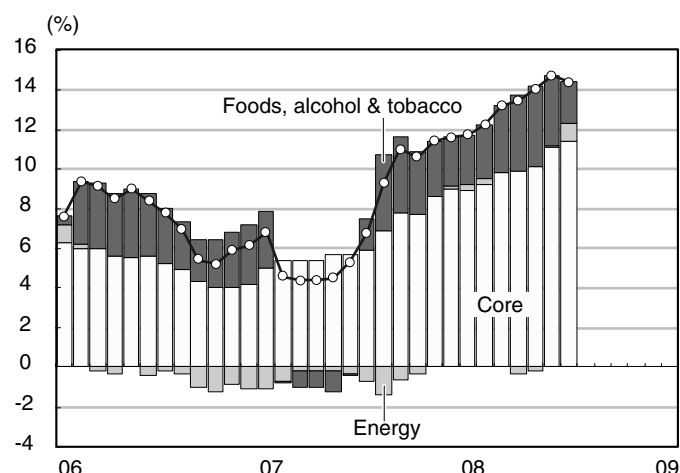
rates are particularly higher in the three Baltic countries, Romania and Bulgaria where economic growth rates are high (Exhibit 5).

**Risks of refinancing current account deficits need to be watched amid global financial turmoil**

Bulgaria's current account deficits have been expanding sharply since 2005, reaching 21.5% of GDP in 2007 (Exhibit 6) on a rapid increase in imports caused by growing domestic demand and higher fuel prices. Particularly to blame for this was a steep rise in the trade deficit brought by increased imports of FDI-related investment goods and materials for export production as well as rising fuels prices. The current account deficit in the first half of 2008 reached an annualized 27.5% of GDP, indicating that it is growing faster than the previous year. With rising imports, the trade deficit has been further deteriorating as exports have been slowing down since the spring of 2008 amid deceleration of the European economy. The three Baltic countries, Romania and Bulgaria incur prominently larger current account deficits than other Central and Eastern European countries as their fast economic expansion requires increased imports (Exhibit 7).

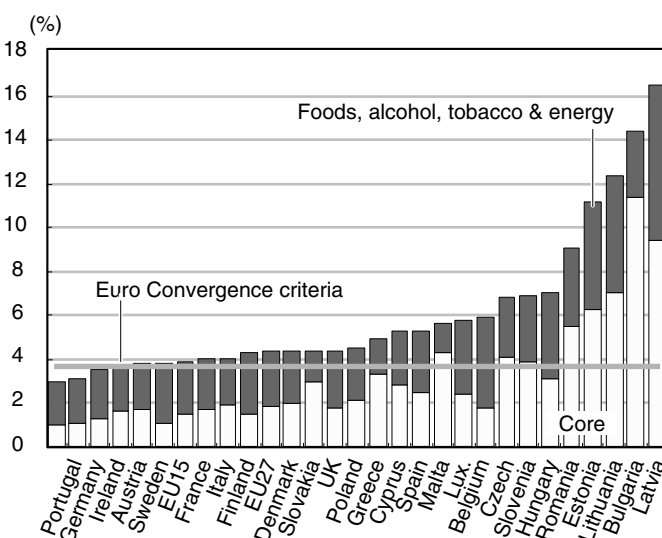
Bulgaria has managed to cover much of its current account deficit with FDI inflows (Exhibit 7). However, it has begun relying on bank loans in addition to FDI (Exhibit 8). Net FDI inflows in the first half of 2008 contracted 12% year-on-year due in part to the worsening European economy. Should the current account deficit continue widening hereafter, Bulgaria would need to finance it with debt-creating funds. The country's foreign currency reserves exceeded EUR13.2 billion as of the end of June 2008, enough to cover approximately six months of its imports. However, its external debt has been growing rapidly, led by aggressive bor-

**Exhibit 4: Consumer price inflation (YOY)**



Source: Eurostat

**Exhibit 5: Consumer price inflation of EU27 in July 2008**



Source: Eurostat

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rowing by the private sector, exceeding 90% of GDP at the end of June 2008. While the global financial turmoil has not seriously affected Bulgaria so far (Exhibit 9), JCR takes a cautious view of the prospect of its current account deficit and its finance, as capital inflows into the country may contract in the future.

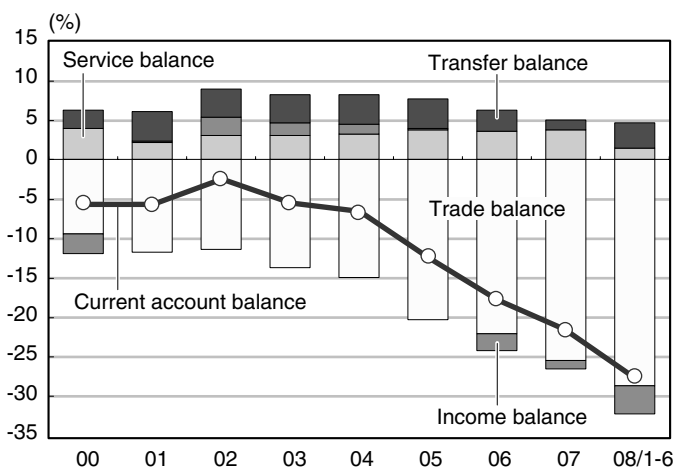
### Bulgaria to keep prudent fiscal and monetary policies in 2008 and 2009

The government and the BNB have been acting in concert to maintain tight fiscal and administrative measures aimed to curb the current account deficit. The general government fiscal balance has been in surplus since 2004, with the sur-

plus widening to 3.4% of GDP in 2007 (Exhibit 10). In recent years, the government has been maintaining the fiscal soundness while seeking to reduce tax burdens. Although the government implemented a 10% uniform income tax hike in early 2008, it logged a fiscal surplus equivalent to 5.1% of GDP in the first five months of 2008, substantially up from 3.3% in the same period of 2007, on better-than-expected revenue gains and restrained expenditures. The fiscal reserve swelled to BGN9.76 billion or 14.9% of GDP as of the end of May 2008 thanks to the growing fiscal surplus. This has added to the economy's resilience to unexpected external shocks. The general government debt (ESA95) was cut by half to 8.2% of GDP in the past three years to the end of December 2007 as the government moved up repayment of its external debt including IMF loans and Brady bonds. Bulgaria has been reducing its government debt at the fastest pace among the countries rated by JCR.

The country's monetary policy has limited discretion under the currency board system. However, the BNB has raised its reserve requirement ratio and carried out demand control measures with an aim of curbing the growing balance of bank loans, one of factors responsible for the robust expansion of personal consumption. Furthermore, it has implemented a strict assessment of bank assets in order to keep their quality sound. Through these steps, the good quality of bank assets has been maintained as the growth of bank lending to the private sector has peaked out. More than 80% of Bulgaria's financial system is controlled by the subsidiaries of major European banks, which have been less affected by the deepening global financial unrest. For this reason, the impact on the country's financial market has been rather modest so far. However, JCR will closely monitor how the balance sheets of banks will be affected by possible falls in real estate prices. The country's real estate prices have

Exhibit 6: The current account balance as % of GDP



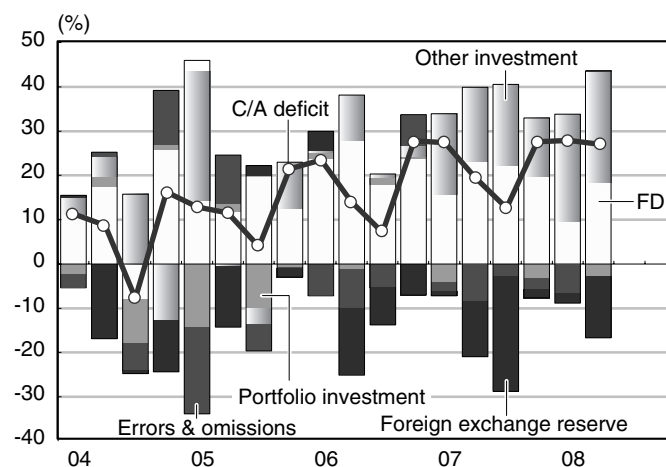
Source: Bulgarian National Bank. figures for the first six months of 2008 are annualized

Exhibit 7: Financing of the current account balance

	Current account deficit/GDP (a)		Foreign direct investment/GDP (b)		(b)/(a)	
	2004	2007	2004	2007	2004	2007
Latvia	12.9	22.9	4.6	8.4	35.5	36.6
Bulgaria	6.6	21.5	13.8	21.1	209.1	98.1
Estonia	12.3	17.3	8.2	11.3	66.8	65.1
Romania	8.5	13.8	8.5	5.8	100.0	42.0
Lithuania	7.7	13.7	8.2	11.3	106.7	82.5
Cyprus	5.0	9.7	7.1	8.6	142.3	88.6
Hungary	8.4	4.9	4.4	4.0	52.4	81.5
Slovakia	7.8	3.0	7.2	3.8	92.3	126.7
Malta	5.9	5.6	n.a.	n.a.	n.a.	n.a.
Poland	4.0	3.7	5.2	4.2	129.6	112.2
Slovenia	2.7	4.9	2.5	3.2	92.4	65.7
Czech	5.1	2.4	4.4	5.0	87.0	210.1

Sources: Central Bank of each country, Eurostat

Exhibit 8: Financing of Current account deficit



Source: Bulgarian National Bank

been soaring since around 2006 amid the steady economic expansion and increased investment from the UK and other foreign countries. (They rose more than 30% on a nominal basis in 2007.) There is the possibility that real estate prices may begin to set back as foreign investors recede in the future.

**Political stability to continue; euro adoption unlikely before 2010**

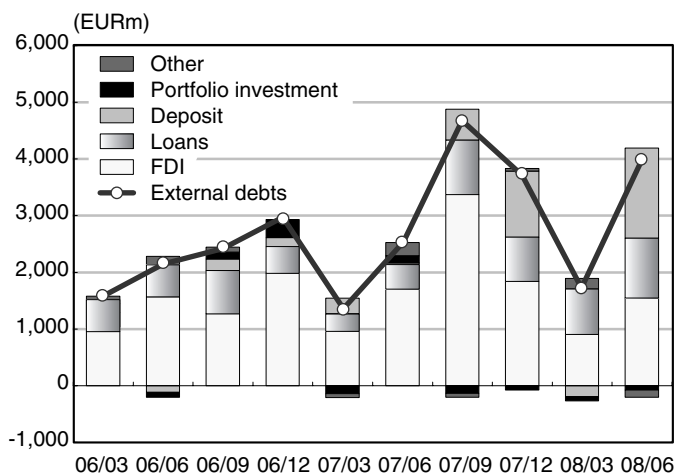
The coalition government consisting of the left-wing Bulgarian Socialist Party (BSP), the centrist National Movement for Stability and Progress (NMSP) and the nationalist Movement for Rights and Freedoms (MRF) controls more than two thirds of the parliamentary seats. It led the country to EU membership in January 2007 and pursued prudent economic and fiscal policies. However, a string of domestic issues have come to the fore now that the shared goal of EU accession has been achieved. The approval rating for the coalition government which spearheaded the reform initiatives has been on the decline lately. The NMSP was soundly defeated in the European Parliamentary and local elections in 2007. Soon afterwards, 16 NMSP parliamentary members left the party and joined a newly established parliamentary group, the Bulgarian New Democracy. Earlier in 2006, a group of parliamentarians formed the center-right Citizens for European Development of Bulgaria (CEDB) by enlisting support from the NMSP. This new party is drawing more public support at the moment. Under these circumstances, JCR holds that the coalition government is unlikely to dissolve the parliament and call for a snap election. (The next general election is scheduled for June 2009). It also considers that whichever party may win the next general election, the possibility of major policy changes will be rather remote now that the country has become an EU member.

The coalition government has not set any specific date for the country's euro adoption. However, it has expressed its intention to aim for it after participating in the ERM2 (the European Exchange Rate Mechanism-2) at an early date following the EU accession. Bulgaria, which needs to meet the five "convergence criteria" before introducing the euro, has so far cleared two of them -- annual fiscal deficit and government debt (Exhibit 11). Since the country has already introduced the currency board arrangement (that pegs its currency to the euro), it may find it comparatively easier to participate in the ERM2. The remaining hurdles are price stability (inflation) and long-term interest rates. As earlier mentioned, Bulgaria may take some more time to stabilize its inflation rate. Given all these elements, JCR considers that the country's euro adoption will not come before 2012.

**Economic imbalance to improve moderately; increased spending ahead of election needs to be watched**

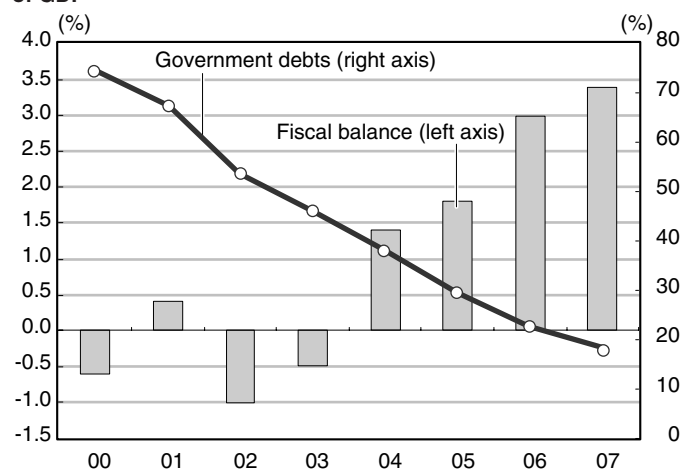
There is the greater possibility that Bulgaria's current account deficit may go on narrowing moderately as the economy will grow at around 6% in 2008 and 2009 on balanced expansion of both domestic and external demand. A slowdown of exports will be inevitable due to the economic deceleration in the rest of the EU27 countries, its major export markets. However, increased investment triggered by FDI inflows and massive EU subsidies (estimated at approximately EUR6 billion in 2007-2013 or 18.5% of GDP) will bolster the economic expansion. There will be no marked improvement on the inflation rate in 2008 and 2009. The effect of lower food prices and the currency appreciation will be neutralized by the planned excise tax hike and growing inflationary pressures brought by the tightening labor market. Risks of refinancing the current account deficit are likely to be reduced as there will be more FDI and

**Exhibit 9: Changes of external debt from previous quarter**




Source: Bulgarian National Bank

**Exhibit 10: General government fiscal balance and debts as % of GDP**



Source: Eurostat

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financial capital inflows in anticipation of the government's continued sound policy management and sustained economic expansion. The country also has sufficient foreign exchange reserves. The general government fiscal surplus may remain at around 3% of GDP in both 2008 and 2009 as projected by the government. However, JCR sees it necessary to watch if the coalition government, faced with dwindling popularity, will seek to expand budget expenditures ahead of the general election scheduled for mid-2009. 

**Exhibit 11: Fulfillment of Convergence Criteria of new EU member countries**

Criteria	Fiscal figures		Inflation*	Long-term interest rate †	Exchange Rate ‡	Target date for the euro adoption
	Fiscal balance as % of GDP	Fiscal debts as % of GDP				
	Below 3% (2007)	below 60% (2007)				
Slovenia	-0.1	24.1	3.8	4.6	Jun, 2004	Jan, 2007
Cyprus	3.3	59.8	2.2	4.6	May, 2005	Jan, 2008
Malta	-1.8	62.6	0.7	4.8	May, 2005	Jan, 2008
Slovakia	-2.2	29.4	1.9	4.6	Nov, 2005	Jan, 2009
Estonia	2.8	3.4	6.7	n.a.	Jun, 2004	not specified
Latvia	0.0	9.7	10.1	5.1	May, 2005	not specified
Lithuania	-1.2	17.3	5.8	4.9	Jun, 2004	not specified
Czech	-1.6	28.7	3.0	4.6	-	not specified
Poland	-2.0	45.2	2.6	5.9	-	not specified
Hungary	-5.5	66.0	7.9	6.9	-	not specified
Bulgaria	3.4	18.2	7.6	5.1	-	ASAP
Romania	-2.5	13.0	4.9	6.9	-	2014

The figures in shadow indicates fulfillment of the Convergence 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 States by more than 2%.

‡ The exchange rate to be kept within the normal margin of fluctuations as stipulated by the Exchange Rate Mechanism II.

### Main economic indicators: Republic of Bulgaria

	unit	2005	2006	2007	2008 (f)	2009 (f)
Real GDP growth rate	(%)	6.2	6.3	6.2	6.2	5.7
Consumer price inflation (YOY)	(%)	7.5	7.3	8.4	11.0	7.5
Unemployment rate	(%)		9.1	7.0	5.5	5.0
The central government fiscal balance/GDP	(%)	3.1	3.5	3.5	3.5	3.4
The central government fiscal debts/GDP	(%)	31.3	24.6	19.8	14.8	11.6
Current account balance/GDP	(%)	-12.4	-17.8	-21.5	-19.0	-18.0
Trade balance/GDP	(%)	-20.2	-22.0	-25.5	-24.5	-23.8
Service balance/GDP	(%)	3.7	3.7	3.8	3.9	3.7
Income balance/GDP	(%)	0.3	-2.1	-1.1	-1.5	-1.8
Transfer balance/GDP	(%)	3.7	2.7	1.2	3.0	3.9
Net foreign direct investment/GDP	(%)	13.3	23.1	20.5	14.0	12.6
Net foreign direct investment/Current account balance	(%)	116.5	132.8	98.2	77.6	76.7
External debts/GDP	(%)	69.8	73.7	97.3	107.4	113.4
Net external debts/GDP	(%)	39.2	41.2	58.6	68.2	73.5
Public external debts/exports G&S	(%)	33.7	23.4	16.7	13.2	10.3
External debts/exports G&S	(%)	117.2	114.8	155.4	171.2	179.7
Foreign exchange reserves/monthly imports G&S	(months)	4.8	4.7	5.5	5.7	5.8
Foreign exchange reserves/short-term external debts	(times)	1.8	1.3	1.2	0.9	0.8

Sources: Central Bank, Eurostat and Ministry of Finance. figure for fiscal balance is based on ESA 95, figures for 2008 and 2009 are projections by JCR