2009-43
January 29, 2010

Bulgaria (the Republic of)

Foreign LT: BBB/Negative, Local LT: BBB+/Negative

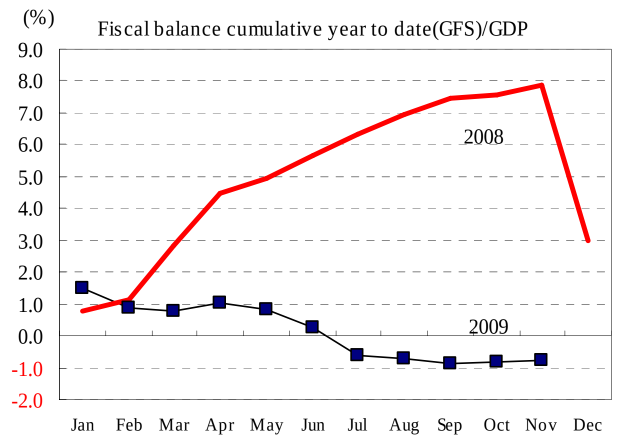
<Rating Perspective>

Positive Factors

- Low level of government debt with moderate fiscal deficit
- The maintenance of the currency board arrangement
- Expanding production capacity rendered by robust investment amid massive foreign direct investment (FDI) inflows

Negative Factors

- Continuing current account deficit despite recent improvement
- Sizable foreign debts owed by the private sector
- Transformation of industrial structure still at a primary stage



Source: Bulgarian Ministry of Finance

<Updated: from October 2009 to January 2010>

Positive Factors

- The Ministry of Finance revealed a preliminary 2009 figure of fiscal deficit (GFS) of Lv 499 million, falling below the 0.8% of GDP target envisaged in the budget.
- Prime Minister Boiko Borisov declared that Bulgaria will apply to adopt the euro at the end of January 2010.
- Bulgarian banks posted a combined profit in 2009 though it halved from the previous year.
- The current account deficit in the first eleven months of 2009 narrowed sharply to 3.9% of GDP from 22.5% a year earlier. The deficit was almost covered by FDI inflows.
- Goods exports in November 2009 grew 3.8% year-on-year for the first gain in fourteen months.
- The foreign exchange reserves stood at EUR 12.9 billion at the end of November 2009, increasing month-on-month for the fourth consecutive month.
- The government unveiled plans to privatize state corporations including Bulgartabac in 2010 either through stock exchange listing or sellout to strategic investors.

Negative Factors

- Real GDP in the July-September quarter of 2009 contracted 5.4% year-on-year on slumped domestic demand.
- The unemployment rate surged to 7.8% in November 2009 from 5.1% a year before.
- Net capital inflows (FDI, portfolio investment and other investments) in the first 11 months of 2009 fell to 6.7% of GDP from 34.4% a year earlier.

<Outlook and Points to Watch>

New government keeps stringent fiscal policy

(1) Economy is expected to grow only slightly in 2010

The Bulgarian economy continued contracting since the January-March quarter of 2009. It shrank a further 5.4% in real GDP terms in the July-September quarter of 2009 after a 4.9% contraction in the previous quarter. Industrial output and retail sales remained stagnant, but their year-on-year contraction started easing in October. By contrast, the growth of bank lending to the private sector, which had fueled consumer spending and investment, decelerated considerably to around 3% on year in November as banks tightened their credit conditions. Amid the worsening unemployment rate and growing nonperforming loans, banks will keep their tight credit policy in 2010. JCR projects that the economy will restore a positive growth rate in 2010 but that the recovery momentum will remain weak. While external demand will pick up moderately on continued economic recovery in major European trading partners, domestic demand will stay subdued on worsening employment and wage conditions, continuation of a strict credit stance by banks and a tighter government fiscal policy. The country's financial system remains sound with adequate capitalization to absorb any deterioration in the quality of assets held by banks.

(2) Private sector's external financing position remains weak

Bulgaria's foreign debt swelled to 108% of GDP at the end of 2008, but a further increase was averted as the debt stayed almost

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unchanged at 109% of GDP at the end of October 2009. The current account deficit in the first eleven months of 2009 narrowed sharply to 3.9% of GDP from 22.5% a year earlier. The deficit was almost covered by FDI inflows. However, the private sector's external position remained weak as net capital inflows (FDI, portfolio investment and other investments) in the same period fell drastically to 6.7% of GDP from 34.4% a year earlier due in part to the private sector's repayment of foreign liabilities. The foreign exchange reserves increased for four months running in November, but were not large enough to cover the short-term foreign debts. The worst of the global financial turmoil may now be behind, but it remains crucial whether Bulgaria can maintain international investors' confidence and have the short-term foreign debts owed by the private sector rolled over without a hitch.

(3) Spending cuts help improve fiscal deficit

A deteriorated fiscal balance looks unavoidable in 2009 and 2010 due mainly to revenue shortfalls stemming from a severe economic downturn. Nonetheless, with its fiscal reserves standing at a level equivalent to 12.4% of GDP at the end of November 2009, the government has sufficient provisions to meet unforeseen events. The general government fiscal balance (GFS) in the first eleven months of 2009 fell into a deficit equivalent to 0.8% of GDP (Lv 498 million) in a turnaround from a 7.9% surplus a year earlier. While the growth of expenditures in the same period was kept at 15.2%, almost as envisaged in the budget, revenues contracted by a steep 10.8% amid the economic downturn. The Ministry of Finance estimated the fiscal deficit for the whole year at less than 0.8% of GDP, well within its target. The new government of the Citizens for European Development of Bulgaria (CEDB) which took office in July 2009 tightened the fiscal policy and adopted in September 2009 anti-crisis measures aimed at a balanced budget for both 2009 and 2010. Thanks to spending cuts, the monthly fiscal balance has turned around into a surplus since October 2009. Considering a weak economic recovery and a continuation of the tight fiscal policy in 2010, JCR forecasts that the fiscal balance in the year will end with a modest surplus. Meanwhile, Bulgaria's government debt (GFS) is one of the lowest in the EU. Its ratio to GDP stayed low at 16% at the end of October 2009.

(4) New government will keep more credible policies with support from other small parties

The minority government led by the center-right CEDB has kept policies to uphold the currency board arrangement, restore fiscal balance and fight against crimes and corruption with the support from smaller right-wing parties. CEDB holds 116 out of 240 parliamentary seats, five short of a simple majority. In view of the main opposition Bulgarian Socialist Party's waning popularity, JCR thinks that CEDB will be able to pursue its policies with the backing of other center-right and right-wing parties.

Following the prime minister's announcement of an intention to apply to join the euro zone, the government is expected to apply to enter the EU's exchange rate mechanism (ERM2) within months. Bulgaria managed to keep the currency board arrangement even during the global financial turmoil and has met three convergence criteria (fiscal deficit, public debt and inflation rate) except for long-term interest rate. However, it finds itself less competitive as compared with its neighboring countries whose currencies lost their value drastically in 2008. Furthermore, other EU member countries are less likely in the present situation to give Bulgaria a unanimous approval of its ERM2 entry bid even after the end of the financial crisis. JCR will keep a close watch on future developments.

Main Economic Indicators: The Republic of Bulgaria

		2005	2006	2007	2008f	2009 (f)	2010 (f)	2011 (f)
(Convergence criteria for adopting the euro)								
1. CPI (annual average)	-0.7%(note)	6.0	7.4	7.6	12.0	2.5	2.8	3.0
2. 10 year government bond yield	4.8%(note)	3.9	4.2	4.5	5.4	7.1	n.a.	n.a.
3. General government balance / GDP	Below-3.0%	1.9	3.0	3.4 (Note2)	1.8	-0.8	-1.0	1.0
4. General government debt / GDP	Below 60%	29.2	22.7	18.2	14.0	15.1	16.5	16.0
Real GDP growth rate	(%)	5.3	6.3	6.3	6.1	-5.0	0.5	2.5
Unemployment rate	(%)	10.1	9.1	7.0	5.7	6.6	7.5	6.8
Current account balance / GDP	(%)	-12.4	-18.4	-25.1	-25.4	-4.8	-4.9	-7.1
Trade balance / GDP	(%)	-20.2	-22.0	-25.1	-25.2	-7.5	-7.9	-9.9
Net foreign direct investment / GDP	(%)	13.3	23.9	29.0	17.8	2.4	6.9	7.9
Net foreign direct investment / C/A balance	(%)	107.3	129.4	115.3	70.1	49.2	140.8	111.2
Forex reserves (excl. gold)	(EURmn)	6,690	8,193	11,179	11,886	12,794	13,500	14,200
Forex reserves / monthly imports	(months)	4.8	4.7	5.4	5.0	8.2	8.0	7.3
Forex reserves / ST external debt	(times)	1.7	1.3	1.2	0.9	1.0	1.0	1.0
Gross external debt / GDP	(%)	70.1	81.6	101.1	108.4	107.5	107.5	108.7
Gross external debt / exports (G&S)	(%)	117.7	127.2	160.0	179.7	206.6	196.4	189.3
Gross public external debt / exports (G&S)	(%)	29.0	18.0	10.6	7.0	7.7	8.0	6.3
Debt service ratio	(%)	44.3	26.4	34.3	36.0	37.0	39.3	33.1

(Note1) Figures for criteria 1 and 2 are moving average between December 2008 and November 2009. Figures for 2009- 2011 are projection made by JCR
(Note 2) the figure excludes a debt cancellation towards Iraq.
(Sources) The Bulgarian National Bank, Ministry of Finance, Eurostat

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