Euler Hermes Economic Research

Country Report

Bulgaria

Growth is gaining momentum, thanks to domestic demand

General Information

GDP	USD54.5 bn (World ranking 78, World Bank 2013)
Population	7.27 mn (World ranking 99, World Bank 2013)
Form of state	Parliamentary Democracy
Head of government	Boyko BORISOV (Prime Minister)
Next elections	2016, presidential

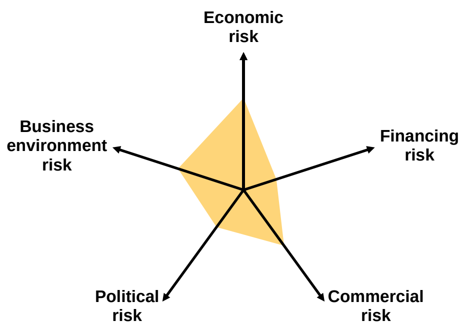
Strengths

- EU membership and good international relations
- Relatively low systemic political risk
- Currency board has withstood global turbulences since 2008 and BGN is currently not overvalued
- History of prudent fiscal policies
- Current account close to balance since 2010
- Generally adequate business environment

Weaknesses

- Failure to make progress on EU-required judicial reform and anti-corruption measures
- Public discontent about living standards
- Continued tight credit markets
- Deflation since August 2013
- High external debt burden
- Banking sector is vulnerable to financial contagion from the eurozone debt/banking crisis. Deposit runs on two domestic banks in 2014 raised concern about banking supervision

Country Rating B2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	12%	1	16%	Russia
Turkey	9%	2	12%	Germany
Italy	9%	3	7%	Italy
Romania	8%	4	7%	Romania
Greece	7%	5	6%	Turkey

By product (% of total)

Exports		Rank		Imports
Machinery and transport equipment	19%	1	25%	Machinery and transport equipment
Fuel and fuel products	13%	2	20%	Fuel and fuel products
Food and live animals	10%	3	13%	Chemicals
Chemicals	9%	4	8%	Crude materials, inedible (non-fuel)
Crude materials, inedible (non-fuel)	7%	5	7%	Food and live animals

Source: National Statistical Institute of Bulgaria (2014)

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Return to domestic demand-led growth in 2014-2016

Real GDP growth picked up to +1.7% in 2014 from +1.1% in 2013 and +0.5% in 2012. The breakdown of GDP reveals a return to domestic demand-driven growth from export-led expansion in 2013. Private consumption increased by +2% in 2014 (-2.3% in 2013), public consumption by +3.9% (+2.8% in 2013), fixed investment by +2.8% (-0.1% in 2013), and inventories contributed about +0.3pps to 2014 growth (-0.8pps in 2013). Net exports made a negative contribution of -1.1pps to 2014 growth (+2.9pps in 2013) as export expansion decelerated sharply to +2.2% (+9.2% in 2013) while imports moderated only slightly to +3.8% (+4.9% in 2013). Euler Hermes expects the gradual recovery to continue and forecasts full-year growth of +2% in 2015 and +2.5% in 2016 as domestic demand should remain robust and net exports benefit from lower oil prices. The impact of the Russia crisis on economy will be limited as only 2.4% of Bulgarian exports went to Russia in 2014.

Banking sector turbulences in 2014, but systemic crisis unlikely

In June 2014, deposit runs on two large domestic-owned banks caused concerns about financial stability, but swift action by the Bulgarian National Bank (BNB; central bank) helped contain the pressures and sustain confidence in the overall banking system. Corporate Commercial Bank (CCB; then 4th largest lender) was taken over by the BNB and First Investment Bank (FIB; 3rd largest lender) managed to restore confidence quickly with immediate BNB support. The immediate market response was calm: The government raised EUR1.5 bn in a Eurobond with a yield at just 3.1% shortly after the "mini crisis". Overall, the banking sector has remained liquid and well-capitalised, and the non-performing loan ratio, though still quite high (15.4% in mid-2014), is declining and provisioning is comfortable (>70%). And Bulgaria's financial system had weathered the impact of the 2008-2009 global financial crisis relatively well and was also largely unaffected by the swings in capital flows to emerging markets from May 2013 to early 2014. Nonetheless, some concerns also remain owing to banks' heavy reliance on funding from EU parent banks – whose subsidiaries dominate the sector (25% Greece, 15% Italy, 12% Hungary) – which still makes it vulnerable to financial contagion from the eurozone debt/banking crisis. Moreover, deleveraging by eurozone banks continues to retard credit growth.

Currency board limits scope of monetary policy to tackle deflation

Bulgaria's currency board (BGN1.95583:EUR1) has withstood the pressures from the 2008-2009 global financial crises well and does not appear to be at risk in the short term as the real effective overvaluation of the BGN, which exceeded 15% from early 2008 to mid-2009, has given way to stabilisation, indicating that Bulgaria has regained relative competitiveness. Moreover, foreign exchange (FX) reserves continue to cover the monetary base (a requirement for a currency board) clearly. However, the currency board largely neutralises monetary policy.

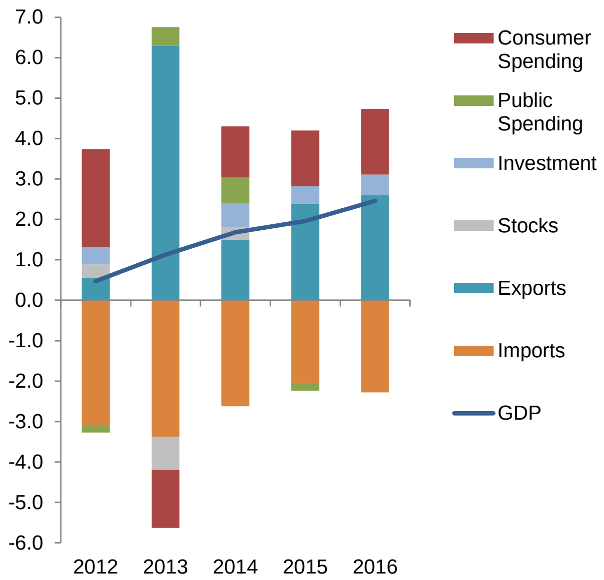
Headline consumer price inflation entered deflationary territory in August 2013 amid a protracted low growth environment and reached a

Key economic forecasts

	2013	2014	2015f	2016f
GDP growth (% change)	1.1	1.7	2.0	2.5
Inflation (%, end-year)	-1.6	-0.9	1.0	1.5
Fiscal balance (% of GDP)	-1.2	-3.7	-3.3	-2.5
Public debt (% of GDP)	18.3	27.7	28.5	29.0
Current account (% of GDP)	2.1	0.0	1.5	1.4
External debt (% of GDP)	90.0	94.3	96.0	95.0

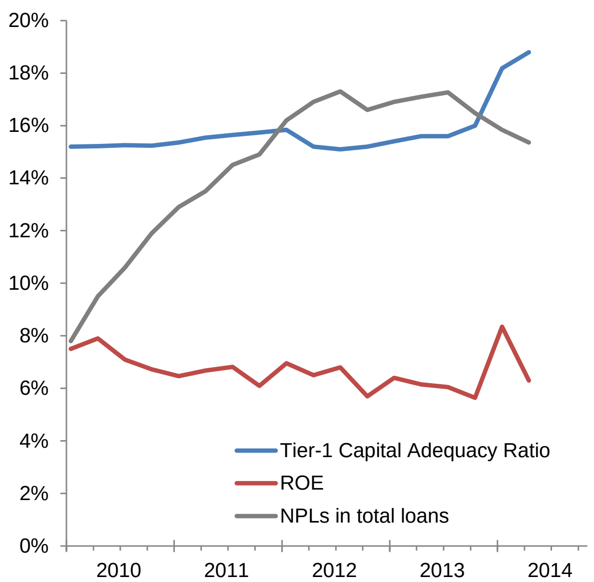
Sources: National sources, IHS, Euler Hermes

GDP growth (%) and contributions (pps)



Sources: National sources, Euler Hermes

Banking sector soundness indicators (%)



Sources: Bulgarian National Bank, Euler Hermes low of -2.3% y/y in February 2014. Although the economy has gradually recovered since, deflation has persisted (-1% y/y in January 2014) mainly owing to sharply lower oil/energy costs and falling food prices. Euler Hermes expects deflationary pressures to continue in H1 before inflation is forecast to pick up slightly in H2 and 2016.

Public finances remain adequate despite fiscal cost of banking sector turbulence

Bulgaria has had a long-lasting commitment to fiscal prudence, reflected in many years of fiscal surpluses or small deficits. The -3% of GDP Maastricht threshold for fiscal deficits was only slightly exceeded in 2009 and 2010 in the wake of the global financial crisis, followed by an annual average -1.2% of GDP in 2011-2013. Public debt has rapidly declined from 73% of GDP in 2000 to just 14% in 2008 before gradually rising to 18% in 2013.

In 2014, the banking sector turbulences have had a fiscal cost, for example the government lent BGN2 bn to the State Deposit Guarantee Fund. The fiscal deficit is estimated to have increased to about -3.7% of GDP and public debt to 28% of GDP. Euler Hermes forecasts the fiscal deficit to reach about -3.3% of GDP in 2015 before it should fall back to below the Maastricht threshold in 2016. Public debt should remain just below 30% of GDP in the next two years, which is still very low by EU standards.

Current account is close to balance but external debt burden remains high

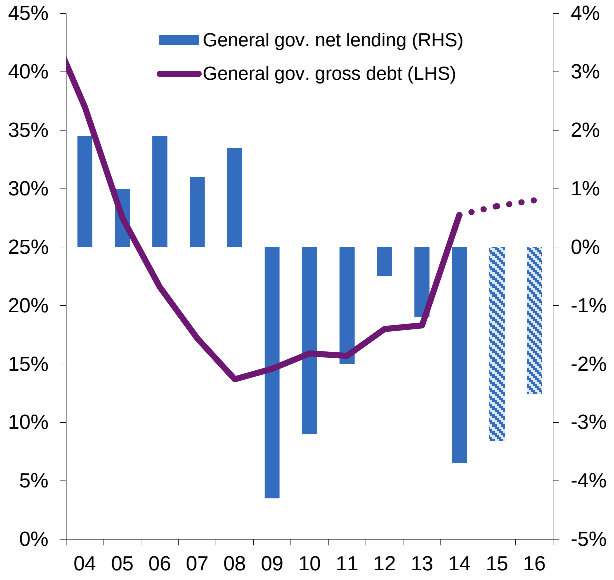
The current account has been close to balance since 2010 and should remain so in 2015-2016. Foreign direct investment inflows have remained robust and amounted to about 2.8% of GDP in 2014.

However, the legacy of large current account deficits from 2003-2009 has left Bulgaria with a very high external debt burden. Gross external debt stood at EUR40 bn at end-2014, accounting for a worrisome 94% of GDP. The private sector share of external debt was 83%, while total short-term debt as a share of gross debt has fallen to 26% from the 36% peak in late 2008. The external debt service ratio fell to 18% in 2014 and should remain below 20% in 2015.

FX reserves are fairly adequate

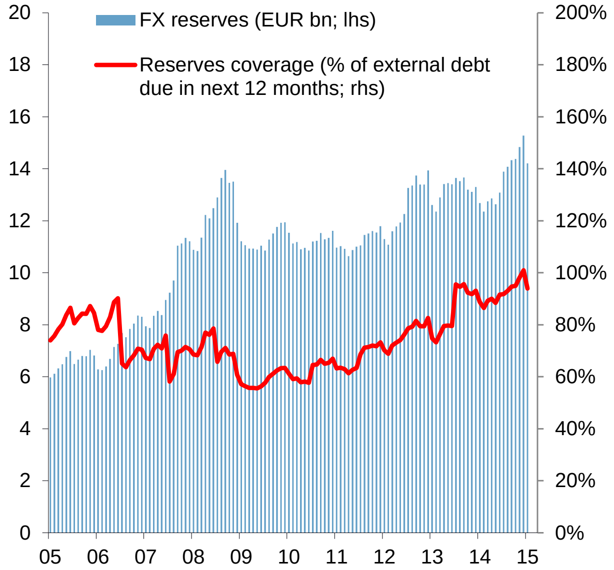
FX reserves have increased since end-2013 and stood at EUR14.2 bn in January 2015, a comfortable level with regard to import cover (more than five months). In other terms, however, reserves cover about 94% of the estimated external debt payments falling due in the next 12 months. Although this ratio has improved from 80% a year ago, it remains slightly below an adequate ratio of 100%.

Public finances (% of GDP)



Sources: National sources, IMF, Euler Hermes

Foreign exchange reserves and coverage of external debt payments falling due within 12 months



Sources: National sources, Euler Hermes

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