# Bulgaria's successful, currency-constrained, economic adjustment

**Fixed exchange rate was crucial in eradicating hyperinflation and currency instability in the late 1990's**

Bulgaria fixed its exchange rate in the relatively early stages of its transition from a centrally planned to a free market economy. A formal peg to the DEM and later to the euro was adopted in 1997, as part of a broadly based reforms package that put an end to the hyperinflation and currency instability, which devastated the banking sector and inflicted huge losses on the country's living standards during the 1996/1997 crisis. The fixed exchange rate provided a single anchor for monetary policy and shifted the responsibility for structural reforms and adjustment of the economy onto the fiscal authorities. What's more, fixing the national currency to the euro was seen as part of Bulgaria's larger strategy to join the EU and to construct a vision for the country's future development that is alternative to the one that Russia's dominance in the post WWII arrangement of the Balkans had offered.

**Loose monetary policy eventually led to a private corporate sector leverage bubble**

But, between 2005 and 2008, ECB's monetary policy, which Bulgaria in fact imports through its currency peg to the euro, proved far too loose for the needs of its economy. As monetary policy was constrained by the currency peg, the central bank did little to sterilize much of the impact that excessive capital inflows had on the local monetary conditions, which unleashed a private sector led credit boom. This pushed up domestic consumption and investments in the near term, but ultimately led to asset price bubbles and elevated indebtedness.

**Much to the surprise of many, this fixed currency regime proved its worth over the course of recent years**

When the global downturn began in 2008, many believed that a balance of payments crisis was inevitable and that it was just a matter of time before Bulgaria joins the countries seeking international support. But thanks to larger cushions and strong countercyclical fiscal policy that was pursued in good times the country proved shielded from some of the risks associated with the global crisis. The strong starting fiscal position was crucial in mitigating the initial impact that sharp fall in capital flows had on domestic demand. As much of the foreign debt took the form of intercompany loans, which are hard to withdraw on a short notice, fears for a sweeping balance of payment crisis proved misplaced. Also importantly, small share of CHF and USD denominated loans (less than 5% of total) mitigated the adverse impact that excessive currency instability in the early stages of the global downturn had on the local banks' assets quality, which along with higher capital and liquidity buffers that had been imposed by regulators well beforehand, were key to preserve the confidence in the stability of local banks even in the most testing moments of the crisis' evolution.

Chart 1: Changes in employment in CEE since 3Q 08 (3Q 2008 = 0, in %)

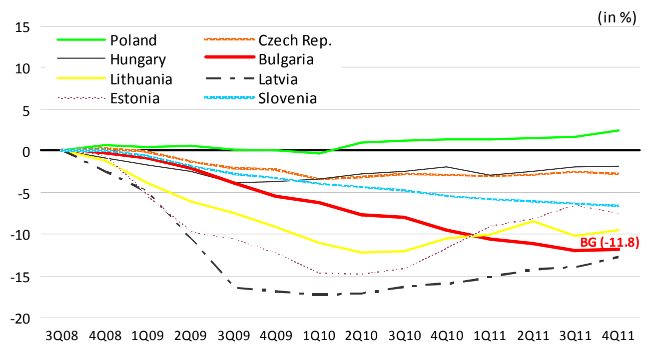
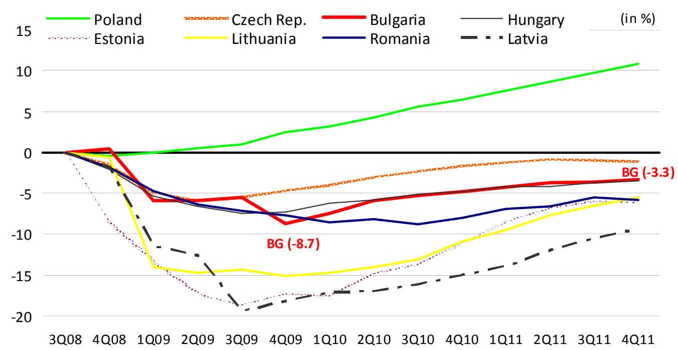



Chart 2: Changes in real output in CEE since 3Q 08 (3Q 2008 = 0, in %)




Source: Eurostat, UniCredit Bulbank Economic Research

## …though there were costs involved

**Labor market adjustment in Bulgaria predominately took the form of drop in employment, while wages remained sticky**

But all these do not mean that Bulgaria went through the crisis unscathed. Similar to other economies with fixed exchange rates, Bulgaria had to pursue an internal devaluation, where wages and prices were pushed down to restore competitiveness. Unfortunately, the labor market adjustment predominately took the shape of an outright drop in employment, while wages remained relatively sticky. This not only made adjustment more painful from a social perspective, but also seems to have slowed the pace of shifting production resources (capital and labor) from the overheated domestic demand oriented sectors toward the export driven part of the economy. Bulgaria's job losses since 3Q2008 were among the most severe in the CEE region (see chart 1). Importantly, the decline in employment since 3Q2008 has erased almost 60% of all jobs that had been created in the period between 2000 and 3Q2008.

**GDP was down by 9.1% from peak to trough, while the growth pattern has undergone significant improvement**

Although Bulgaria's GDP contraction has been shallower than in the Baltic states and broadly at par with that in Hungary and Romania (see chart 2), it is still significant by any reasonable standard and unfavorably compares with the CEE's outperformers such as Poland and Czech Republic. Bulgarian GDP dropped by 9.1% from peak (in 4Q2008) to trough (in 4Q2009) and is now 3.3% below where it was when the crisis started. Still, when looking at the grand scheme of things there are reasons for optimism. When the crisis began, the starting point was the need for substantial rebalancing of the growth model of the economy and reducing the external debt to more sustainable levels. Bulgaria has already successfully completed the first part of this formidable task. The growth model has now shifted from one driven by domestic demand, which was funded with excessive import of international savings, toward a much more balanced one where not only domestic demand, but also net export is having a positive contribution to GDP growth.

**Housing prices now look increasingly closer to what fundamentals suggest**

The crisis sent home prices down 37% from where they were during the 2008 peak, thus hurting corporate, bank and particularly the household sector's balance sheet. And while the negative trend has markedly lost momentum over the last year, and home prices now appear to be close to the levels the fundamentals seem to suggest, their near term outlook is still darkened by the weak domestic demand, the persistent foreclosure, and the large stock of unsold newly build housing property.

**LEADING THE PACK ON FISCAL POLICY…**

Chart 3: Budget deficits, headline & cyclically adjusted

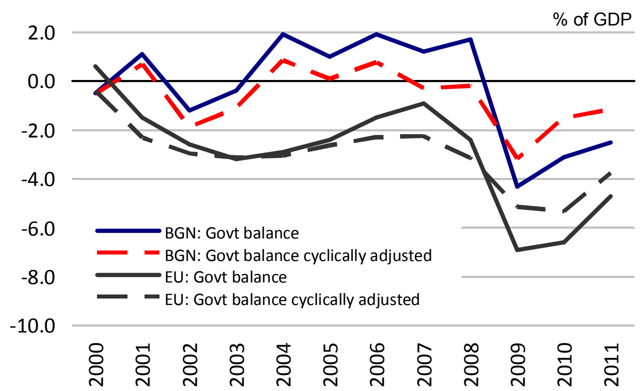
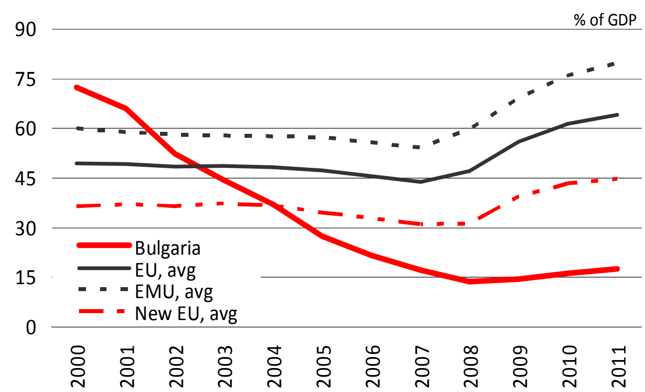



Chart 4: Public debt to GDP




Source: Eurostat, European Commission, UniCredit Bulbank Economic Research

## Fiscal policy played a key cushioning role…

**The combination of budget deficit of just 2.1% of GDP and public debt to GDP ratio of less than 20%, makes Bulgaria's fiscal metrics the second most favorable in the entire EU**

Strong counter-cyclical fiscal policy that the country has pursued in good times has helped to distance Bulgaria from the fiscal troubles in the euro zone's southern periphery. Although fiscal policy played a key role in smoothing the contraction of economic activity in the early stage of adjustment, the sustainability of the public sector finances remained uncompromised. From a surplus equivalent to 1.7% of GDP in 2008, the budget posted a deficit of 4.3% of GDP in 2009 (see chart 3). European Commission estimates put the shift in the structural budget balance over this period at 3.0% of GDP.

The government renewed fiscal tightening in early 2010 and made good progress in the course of last year, cutting the budget deficit to just 2.1% of GDP on a cash basis. Fiscal measures worth more than 2% of GDP were predominately centered on the spending side, while revenues were kept little changed. The government stepped up efforts to strengthen tax compliance which now, approximately two years after the implementation of the key revenue-raising measures, seems to have started yielding the desired results. The constantly improving absorption of EU funds not only propped up the crisis hit domestic demand, but also helped cushioning the adverse impact that plunging FDI has had on the foreign funding needs of the country. Also importantly, the large gap between contracted (70% of total) and actually disbursed (20%) EU funds at the end February this year implies that transfers are set to rise markedly in the near future.

We see Bulgaria's fiscal policy as too tight for the current phase of the business cycle, especially when bearing in mind stagnant GDP growth, coupled with the desperate need for more investments to improve the quality and availability of domestic infrastructure. All these seem to suggest that over the next couple of years at least, Bulgaria can afford running small-to-medium size budget deficits (in the tune of 1.5% to 2% of GDP) without major risks for the sustainability of its public finances, particularly given the stabilizing role that low public debt will continue to have on the country's fiscal metrics.

Meanwhile, the government has run down much of its fiscal reserves, which in February 2012 stood at euro 1.9bn (5% of GDP) compared with euro 6.2bn (28% of GDP) during its peak in November 2008. In the face of debt issuance constraints, caused by the aggravation of the euro zone's sovereign debt crisis, the ample fiscal reserve was crucial to preserve sustainability of the public sector finances. The government has stepped up domestic bonds issuance early this year and is set to tap international sovereign bond markets next month to boost its fiscal reserve before the maturity of EUR 818mln of global 10⅔Y bonds in early 2013. In response, public debt is seen peaking at still very comfortable level of less than 25% of GDP in 2014-15 (see the appendix), before resuming a downward trend thereafter.

**BANKS' EXTERNAL BORROWING HAS ALREADY COME TO MORE SUSTAINABLE LEVELS**

Chart 5: Loans and Deposits change

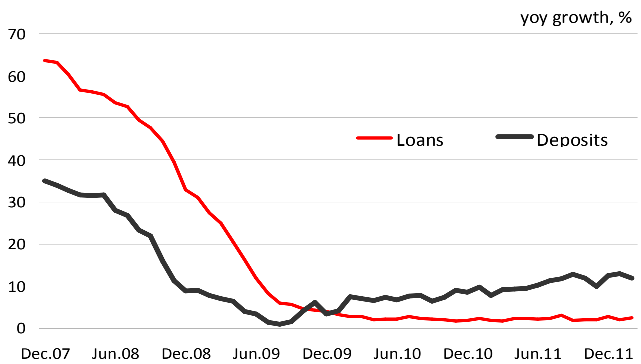
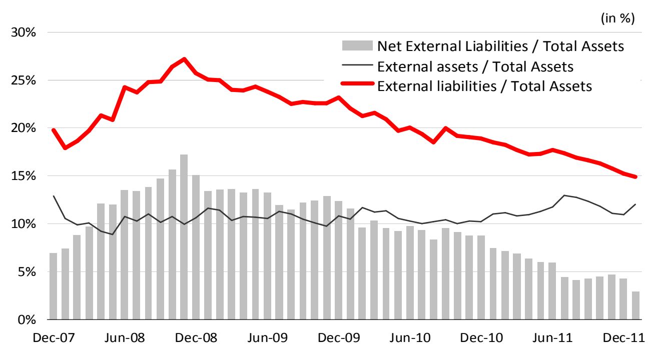



Chart 6: External position of Bulgarian banking sector




Source: Bulgarian National Bank, UniCredit Bulbank Economic Research

## …while banking sector buffers have been built

**Banks remain in good shape, bolstered by raising provisions and capital buffers**

Under fixed exchange rates, banks have to maintain additional capital and liquidity reserves, because the central bank's capacity to act as a lender or last resort is limited. When the global downturn hit Bulgaria, bank lending to nonfinancial corporations and households was expanding at excessively high rates (see chart 5). At the same time, banks were well capitalized, profitable and without direct exposures to toxic assets. To bolster further, already strong banks' capital position, BNB temporarily imposed a ban on dividend payments, thus in fact forcing local banks to add all their current profits to capital.

**Though loans quality deterioration has not come to an end yet, the risk for banks' solvency appears well contained**

Importantly, banks seem to have already absorbed most of the losses associated with the credit boom. Provisions and profits that were accumulated over the last three years have reached 12% of total gross loans as reported at the credit boom exit in the end of 2008. Huge transformation in the savings pattern (gross savings rate to GDP ratio rose from 14.3% on average in the period 2003 – 2009 to 24% in 2011) on top of weak demand for new loans, have helped cutting banks' dependence on external borrowing, which was seen as one of the key sources of vulnerability when the painful adjustment began three years ago. Net external liabilities (or the gap between external liabilities and external assets – see chart 6) stood at just 2.5% of total liabilities of the banking sector in February 2012 (2.7% of GDP), compared with 17.3% at the pre-crisis peak in November 2008 (17.7% of GDP). The downturn in economic activity pushed the share of NPLs up to 14.9% of total gross loans in 2011. But the risk for banks' solvency seems well contained as 46% of NPLs are covered with provisions, while total capital adequacy ratio stands at the very comfortable 17.5% in the end of 2011, suggesting that banks have significant capacity to absorb further losses on their loan books.

**BULGARIA'S C/A ADJUSTMENT**

Chart 7: Private sector adjustment was fierce but was partially compensated by the public sector

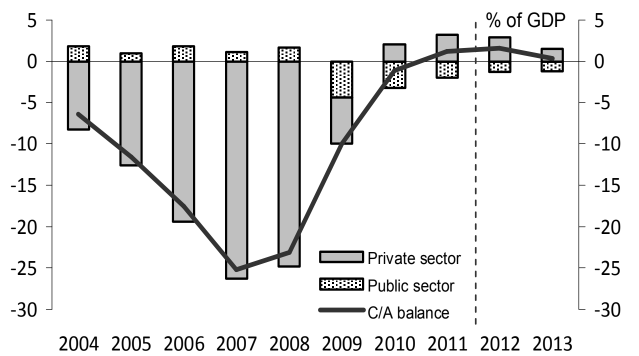
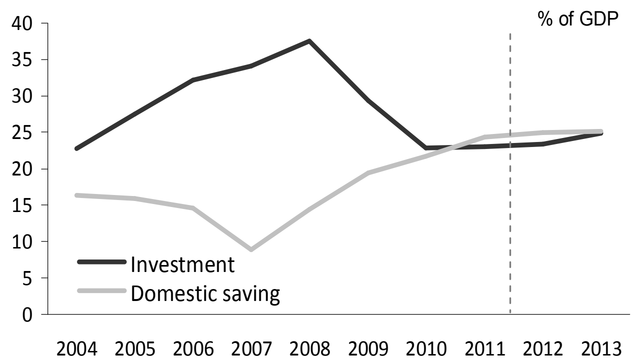



Chart 8: The C/A adjustment was almost equally spread between savings and investments




Source: Eurostat, European Commission, UniCredit Bulbank Economic Research

## …as the C/A balance was forced rapidly into surplus

**Similarly to Baltic states, the external accounts in Bulgaria adjusted significantly…**

Bulgaria's external accounts have adjusted significantly. From a deficit in excess of 25% of GDP in 2007 (see chart 7), the C/A balance, which was seen as one of the economy's most severe structural weaknesses three years ago, posted a 1.2% surplus last year. The private sector drove the increase in investment during the boom years, but as shown in chart 8 this was partially compensated for by an increase in the public sector dissaving. From a savings to investments balance perspective, there was a sharp adjustment on both fronts, when the global downturn began back in 2008.

**…but foreign debt unwinding is not over yet**

Shifting the C/A balance into surplus helped sharply reducing gross external financing requirements of the country. From the peak of 62% of GDP in 2009, gross external financing requirements are now estimated to a still sizeable, but much more manageable 38% of GDP in 2012. At face value, more time would be needed to cutback Bulgarian foreign debt closer to the average levels seen in the CEE region. Still sizeable foreign debt, particularly in the private corporate sector, will continue to act as a major drag on growth in the near term. So far foreign debt payback was led by the banking sector (down to 14% of GDP in January 2012, from 24% in its December 2009's peak), while is progressing at a slower pace in the corporate sector (67.6% of GDP in January 2012 from 76.2% in its December 2009's peak).

Bulgaria has remained in the periphery of the recent trend of moderate strengthening of the capital inflows channeled to CEE. We think that the immediate reason for this is the uncertainty surrounding Greece. But even beyond this year, the path to capital flows recovery will remain challenging due to the elevated foreign debt, which is likely to need another three years to go down close to 80% of GDP, from 88% in January 2012 (see chart 9).

Chart 9: Gross External Debt as percent of GDP

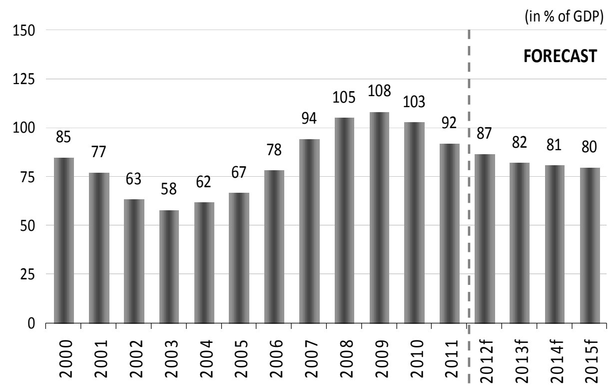
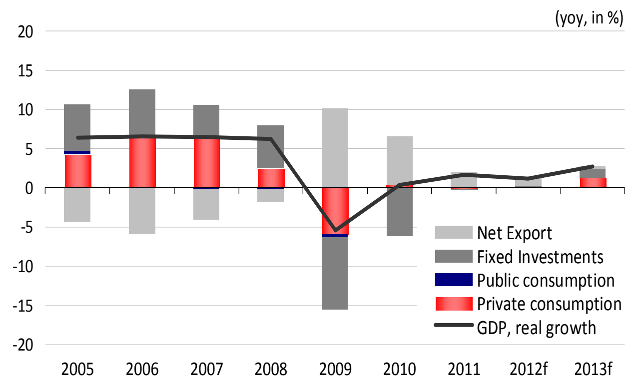



Chart 10: GDP growth and contribution to growth




Source: NSI, BNB, UniCredit Bulbank Economic Research

## Setting an example for EMU economies

**All these have boosted our view that Bulgaria has successfully navigated its economy through most of the challenges associated with the crisis**

Bulgaria joins the Baltics, having undergone a severe economic rebalancing without the aid of an adjustment in its nominal exchange rate. It has also shown how building fiscal buffers in good times helps smoothing economic downturns when bad times come. GDP bottomed out in 2009 but posted positive full year gains in 2010 and 2011 (see chart 10), a trend we expect to continue over the course of 2012-13. Policy makers have also made use of the crisis to bolster banking sector liquidity and capital buffers and to press ahead with some structural measures, such as strengthening tax compliance and boosting EU funds absorption. Nevertheless, Bulgaria remains vulnerable on a number of fronts, including its exposure to the Greek banking sector and elevated corporate sector debt. But for those EMU economies currently in the midst of a variety of reform measures in the face of low to negative growth, it complements the Baltics' example, showing that there is light at the end of the tunnel.

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## APPENDIX – MACROECONOMIC DATA AND FORECAST

| | 2009 | 2010 | 2011 | 2012F | 2013F | 2014F | 2015F |
|---|---|---|---|---|---|---|---|
| GDP (EUR bn) | 34.9 | 36.1 | 38.5 | 39.8 | 41.9 | 44.7 | 47.9 |
| Population (mn) | 7.6 | 7.5 | 7.4 | 7.4 | 7.3 | 7.2 | 7.1 |
| GDP per capita (EUR) | 4 618 | 4 804 | 5 174 | 5 395 | 5 735 | 6 172 | 6 710 |
| **Real economy yoy (%)** | | | | | | | |
| GDP | -5.5 | 0.4 | 1.7 | 1.2 | 2.7 | 3.6 | 4.1 |
| Private Consumption | -7.6 | 0.6 | -0.2 | 0.2 | 1.7 | 3.0 | 3.5 |
| Fixed Investment | -17.6 | -18.3 | -9.7 | 0.7 | 4.9 | 8.9 | 10.4 |
| Public Consumption | -4.9 | -0.5 | -1.8 | -0.7 | -0.5 | 2.0 | 3.1 |
| Exports | -11.2 | 14.7 | 12.8 | 3.9 | 4.7 | 5.2 | 5.2 |
| Imports | -21.0 | 2.4 | 8.5 | 2.4 | 4.1 | 6.0 | 6.4 |
| Industrial output | -17.8 | 1.8 | 6.1 | 2.2 | 3.4 | 4.3 | 4.7 |
| Retail sales | -7.2 | -8.3 | -1.8 | -1.0 | 0.5 | 1.9 | 3.0 |
| **Contribution to GDP growth (%)** | | | | | | | |
| Private Consumption | -6.0 | 0.5 | -0.1 | 0.1 | 1.2 | 2.2 | 2.5 |
| Public Consumption | -0.4 | 0.0 | -0.1 | -0.1 | 0.0 | 0.1 | 0.2 |
| Fixed Investment | -5.8 | -5.3 | -2.3 | 0.1 | 1.0 | 1.9 | 2.3 |
| Inventory Investment | -3.5 | -0.9 | 2.3 | -0.1 | 0.1 | 0.0 | 0.0 |
| Net Export | 10.1 | 6.1 | 2.0 | 1.0 | 0.4 | -0.6 | -0.9 |
| Exports | -6.2 | 7.7 | 7.6 | 2.7 | 3.4 | 3.8 | 3.9 |
| Imports | 16.3 | -1.6 | -5.7 | -1.7 | -3.0 | -4.4 | -4.8 |
| Gross Savings / GDP | 18.8 | 21.5 | 23.9 | 24.9 | 25.2 | 24.0 | 23.8 |
| Monthly wage, nominal (EUR) | 311 | 331 | 362 | 379 | 397 | 422 | 453 |
| Unemployment rate (%) | 8.5 | 11.3 | 11.8 | 12.1 | 11.6 | 11.0 | 10.4 |
| **Fiscal accounts (% of GDP)** | | | | | | | |
| Budget balance | -0.8 | -3.9 | -2.1 | -1.4 | -1.2 | -1.1 | -0.7 |
| Primary balance | 0.0 | -3.3 | -1.4 | -0.6 | -0.3 | -0.2 | 0.2 |
| Public debt | 15.5 | 16.7 | 16.8 | 20.5 | 19.2 | 21.7 | 20.3 |
| **External accounts** | | | | | | | |
| Current account balance (EUR mn) | -3 477 | -419 | 473 | 636 | 126 | -1 206 | -1 677 |
| Trade balance (EUR mn) | -4 174 | -2 574 | -1 883 | -1 948 | -2 304 | -2 993 | -3 259 |
| Services balance (EUR mn) | 1 297 | 1 960 | 2 295 | 2 426 | 2 513 | 2 636 | 2 779 |
| Income balance (EUR mn) | -1 532 | -1 352 | -1 631 | -1 710 | -1 969 | -2 502 | -2 779 |
| Transfers balance (EUR mn) | 932 | 1 547 | 1 693 | 1 869 | 1 885 | 1 653 | 1 581 |
| Net FDI (EUR mn) | 3 372 | 1 593 | 1 186 | 994 | 1 173 | 1 564 | 1 773 |
| Basic balance (EUR mn) | -650 | -384 | 159 | 398 | 838 | 1 206 | 1 342 |
| Gross foreign debt (EUR mn) | 37 816 | 37 042 | 35 431 | 34 487 | 34 489 | 36 072 | 38 153 |
| FX reserves (EUR mn) | 12 919 | 12 977 | 13 349 | 13 746 | 14 584 | 15 790 | 17 132 |
| Current account balance / GDP (%) | -10.0 | -1.2 | 1.2 | 1.6 | 0.3 | -2.7 | -3.5 |
| Trade balance / GDP (%) | -11.9 | -7.1 | -4.9 | -4.9 | -5.5 | -6.7 | -6.8 |
| Services balance / GDP (%) | 3.7 | 5.4 | 6.0 | 6.1 | 6.0 | 5.9 | 5.8 |
| Income balance / GDP (%) | -4.4 | -3.7 | -4.2 | -4.3 | -4.7 | -5.6 | -5.8 |
| Transfers balance / GDP (%) | 2.7 | 4.3 | 4.4 | 4.7 | 4.5 | 3.7 | 3.3 |
| Net FDI / GDP (%) | 9.7 | 4.4 | 3.1 | 2.5 | 2.8 | 3.5 | 3.7 |
| Basic balance / GDP (%) | -1.9 | -1.1 | 0.4 | 1.0 | 2.0 | 2.7 | 2.8 |
| Gross foreign debt / GDP (%) | 108.3 | 102.7 | 92.1 | 86.7 | 82.3 | 80.7 | 79.6 |
| FX reserves / GDP (%) | 37.0 | 36.0 | 34.7 | 34.6 | 34.8 | 35.3 | 35.8 |
| **Inflation/Monetary/FX** | | | | | | | |
| CPI (pavg, %) | 2.8 | 2.4 | 4.2 | 2.2 | 2.7 | 3.1 | 3.2 |
| CPI (eop, %) | 0.6 | 4.5 | 2.8 | 2.3 | 3.0 | 3.2 | 3.3 |
| Deposits (yoy, %) | 3.3 | 8.5 | 12.5 | 8.4 | 7.3 | 7.2 | 7.2 |
| Loans (yoy, %) | 3.9 | 1.7 | 2.8 | 2.9 | 5.9 | 7.6 | 8.2 |
| FX/USD (eop) | 1.36 | 1.47 | 1.51 | 1.59 | 1.50 | 1.32 | 1.35 |
| FX/USD (pavg) | 1.41 | 1.48 | 1.41 | 1.52 | 1.58 | 1.41 | 1.34 |

Source: BNB, NSI, Eurostat, UniCredit Bulbank Economic Research

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