Bulgaria: Adjusting external accounts

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- When the crisis began, it was the corporate sector which suffered the sharpest decline in investment, while improved absorption of EU funds helped to keep public investment little changed when compared with where they were during the boom years.

- Providing a case study for many other EU economies, the public sector played an important stabilizing role over this adjustment period. Consistent, albeit modest, budget surpluses over 2004-08 combined with improved absorption of EU funds allowed the government to keep public investment largely unchanged when the crisis hit.

- Shifting the C/A balance into surplus helped to reduce gross external financing needs from a peak of 62% of GDP in 2008 to an estimated 40% of GDP in 2012. However gross external debt remains large and will be paid down only over a multi year horizon. Bulgaria remains vulnerable to external financing shocks, though less so than in the past.

- Examining a break-down of capital flows, bank flows have been persistently negative since 2009 while FDI, though having bottomed, remains at a fraction of where it stood pre-crisis. While initially prompted by domestic macro developments, the limited availability of external capital at this stage is more reflective of the ongoing EMU crisis. There seems to be little reason to expect an improvement on this front over the coming quarters, capping the recovery in economic activity.

A rapid C/A normalization

Bulgaria's C/A adjustment was equally divided between savings and investment…

Between 2008 and 2010 Bulgaria experienced an improvement in its C/A balance equivalent to a whopping 24.2pp of GDP, sufficient to bring the C/A into surplus. The size of the adjustment was matched only by the Baltic states and was associated with a decline in real GDP of 8.9pp between 4Q08 and 4Q09. A decline in investment played a crucial role. From 32.1% on average between 2005 and 2009, the investment to GDP ratio declined to 23.0% on average in 2010 and 2011 (see Table N1). The positive news is that investment now shows clear signs of stabilization though at 45% below their pre-crisis peak. The corporate sector drove the rise in investment during the boom, while the household sector's contribution was of more limited importance. When the crisis began, it was again the corporate sector which suffered the sharpest decline in investment.

TABLE 1: SAVING TO INVESTMENT BALANCE (AS % OF GDP)

%	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Investment	18.0	20.2	19.7	21.2	22.7	27.6	32.1	34.1	37.5	29.4	22.9	23.1
Non-government	13.3	16.4	16.3	18.1	19.5	24.1	28.2	28.8	32.0	24.4	18.8	20.8
- Households	1.3	1.2	0.5	0.5	0.6	1.3	2.6	1.4	1.7	3.8	2.5	N/A
- Corporate sector	12.0	15.2	15.7	17.6	18.9	22.8	25.6	27.4	30.3	20.6	16.2	N/A
Public sector	3.6	3.4	2.9	2.7	2.8	3.4	4.0	5.2	5.6	4.9	4.8	2.3
Total savings	18.0	20.2	19.7	21.2	22.7	27.6	32.1	34.1	37.5	29.4	22.9	23.1
Domestic Savings	12.4	14.3	14.5	12.1	16.8	15.9	14.5	8.8	14.4	20.4	23.9	24.0
Non-government	7.6	10.6	9.0	6.3	10.9	11.3	9.2	-0.1	7.2	19.6	21.7	23.8
- Households	-13.2	-11.7	-12.0	-12.4	-9.0	-8.1	-8.5	-16.9	-11.5	-1.8	-2.2	N/A
- Corporate sector	20.8	22.3	21.0	18.7	19.9	19.4	17.8	16.8	18.7	21.5	23.9	N/A
General government	4.8	3.7	5.5	5.8	5.9	4.6	5.3	9.0	7.2	0.8	2.2	0.2
Foreign savings	5.5	6.0	5.2	9.1	5.9	11.7	17.6	25.2	23.2	8.9	-1.0	-0.9

Source: National Statistical Institute, UniCredit Research

Domestic savings ratios declined during the boom years but have since recovered. Households were central to the increase in dissaving as consumption expenditure exceeded disposable income by 11.5% of GFP on average over 2000 to 2008. The global crisis brought this unsustainable saving pattern to an end, reducing the household sector's dissaving rate to just 2% of GDP on average in 2009 and 2010. The corporate sector experienced exactly the opposite trend. An average of the corporate savings rate puts it at 19.5% of GDP over 2000 - 2008. This edged up only moderately to 22.7% on average over 2009-2010.

…while the public sector played a stabilizing role

The end result has been that the economy has been left with an investment ratio which is now significantly below its long-term average and a savings rate which is above. We expect the C/A to slip back into deficit this year as public sector savings are not sufficient to finance the private sector's shortfall but any C/A deficit will be much more manageable than in the past.

Lower but still large foreign funding needs

Persistent external deleveraging is likely to limit the pace of recovery

Shifting the C/A balance into surplus helped to sharply reduce the gross external financing needs of the country. From the peak of 62% of GDP in 2008, Bulgaria's gross external financing requirements are now estimated at a still sizeable, but more manageable, 40% of GDP this year. We expect a further modest decline next year while, importantly, any C/A deficit will be financed by non-debt creating flows, e.g. FDI and EU inflows. More time is needed to bring Bulgarian foreign debt closer to the average levels seen in the rest of the CEE region. At 91.9% of GDP last year, it is higher than many other economies in the region, though it is still down from its peak of 108.3% of GDP in 2009.

TABLE 2: GROSS EXTERNAL FINANCING REQUIREMENTS (AS % OF GDP)

%	2005	2006	2007	2008	2009	2010	2011	2012F	2013F
Gross financing requirement	**34.9**	**39.7**	**56.3**	**62.1**	**61.3**	**50.0**	**42.3**	**40.0**	**37.9**
C/A deficit	11.6	17.6	25.2	23.1	8.9	1.0	-0.9	0.3	1.6
Amortisation of medium to long term debt	12.7	7.3	11.0	12.5	15.4	15.4	14.0	12.9	13.1
Government/central bank	8.6	3.5	3.1	1.9	0.9	0.9	0.8	0.9	2.6
Banks	0.8	1.0	1.5	2.0	3.3	3.0	2.1	2.0	1.7
Corporates	3.3	2.9	6.4	8.5	11.2	11.5	11.1	10.1	8.9
Short term debt amortisation	10.5	14.9	20.0	26.5	37.0	33.6	29.3	26.7	23.2
Financing	**30.5**	**54.0**	**66.0**	**64.2**	**61.9**	**50.2**	**43.3**	**39.5**	**38.9**
FDI	13.9	23.0	28.7	17.5	7.2	1.8	3.1	3.1	3.6
Portfolio flows	-4.5	1.1	-1.7	-2.1	-1.8	-1.8	-0.9	0.5	0.3
Borrowing	8.2	9.8	9.5	12.3	7.3	5.2	4.5	7.8	6.2
Government/central bank	1.1	0.4	0.7	0.9	1.6	1.0	0.9	3.7	2.3
Banks	1.9	1.5	2.5	3.4	2.1	1.4	1.3	1.5	1.3
Corporates	5.1	7.9	6.3	8.0	3.5	2.8	2.3	2.6	2.5
Short term	16.9	23.3	30.5	36.5	34.7	31.2	27.6	24.3	22.5
EU transfers	1.0	1.0	0.8	1.1	1.4	1.5	1.9	2.8	2.9
Other	-4.0	-3.1	-1.8	-1.1	13.1	12.2	7.1	1.0	3.5

Source: Bulgarian National Bank, UniCredit Research

So far, deleveraging took mostly the form of banking sector debt reduction

To date foreign debt repayment was led by the banking sector, where deleveraging pushed banks' external liabilities down to 13.8% of GDP in February 2012, from 27.2% of GDP in November 2008. The reduction in corporate sector foreign debt started later and progressed at a slower pace. As a result corporate foreign debt remains elevated at 67.7% of GDP in February 2012, having peaked at 76.2% in Dec-09. Strong counter-cyclical fiscal policy has translated into a marked fall in the public sector debt and particularly its foreign component. From 66% of GDP in end-00, public foreign debt dropped to just 6.7% in February 2012, while being below the 10% benchmark over the entire period since December 2007.

Chart 1: Gross external debt

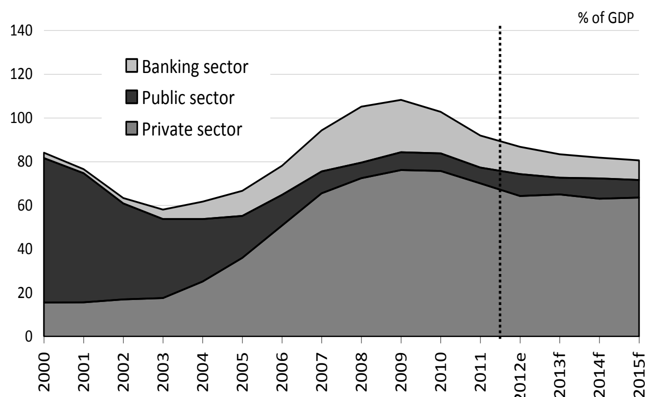
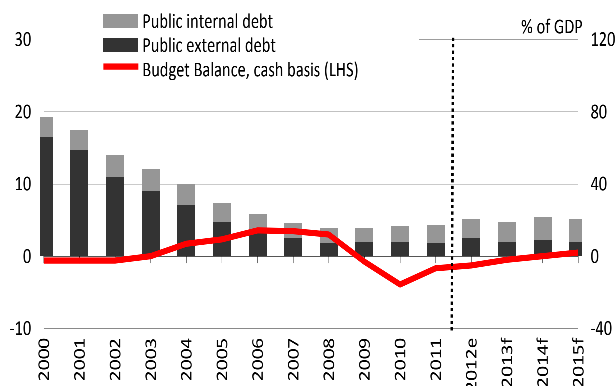


Chart 2: Public sector balance and debt



Source: Eurostat, European Commission, UniCredit Research

We do not see public sector crowding out as a risk

The combination of an improvement in the budget deficit from here and increased external debt issuance by the government means that we do not see public sector crowding out of the private sector as a risk. From 4.3% of GDP in 2009, Bulgaria's budget balance should narrow to approximately 2% of GDP this year before returning to balance in 2015. Meanwhile the government has already stated its intention to increase its presence in the Eurobond market.

Capital flows turned out more cyclical than we hoped

Bank flows have gone through a multi-year contraction while FDI is weak

Digging into the detail on capital flows since 2008, the main weakness in foreign capital flows has come in the form of a reversal of bank flows. From an EUR 3.5bn inflow in 2008, the banking sector posted EUR 0.8bn, EUR 1.2bn and EUR 1.9bn of outflows in the three years thereafter. FDI has slumped from an average of EUR 7bn in the three years preceding the global crisis to EUR 2.5bn and EUR 1.0bn in 2009 and 2010 respectively, after modestly rising to EUR 1.2bn in 2011.

Chart 3: CA composition

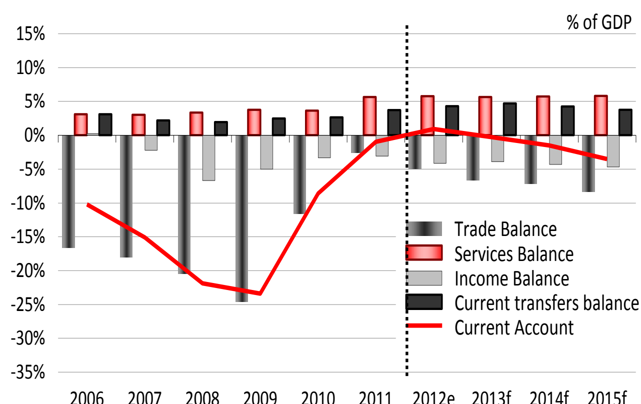


Chart 4: Quarterly capital flows composition, (EUR mn, net)

Source: NSI, BNB, UniCredit Research

External factors are the primary concern at this stage

Weak foreign capital flows initially reflected a re-assessment of Bulgaria and CEE by foreign counterparties but more recently they are attributable to external factors. Bulgaria's exposure to Greece is an obvious disadvantage. Seven percent of Bulgaria's exports went to Greece last year. Greek banks hold 23% of banking sector assets in March 2012, down from 29% in Dec-09 but still significant. Capital adequacy ratios of Greek banks are broadly at par with the average for the whole banking sector, which was 17.5% for total capital adequacy ratio and 15.8% for tier one capital ratio in March 2012. The improvement in the banking sector's net foreign asset position points to a clear decline in reliance on foreign funding but there is nonetheless a tail risk which requires monitoring.

With the above in mind, Bulgaria has done an impressive job of adjusting to a much less favorable environment for capital flows in the past few years but this is also likely to be an environment that will persist, capping the recovery in economic activity, for at least the rest of this year and into next.

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