



## MONTHLY RISK BRIEF

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BULGARIA  
AUGUST 2010

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### **Monthly Risk Brief Contents**

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ISSN 2043-6357

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## 01 AUGUST RISK OUTLOOK AT A GLANCE

### TOP 3 POLITICAL RISKS

- 01 There is a risk that the ruling coalition, the centre-right Citizens for European Development of Bulgaria (GERB), will struggle to implement key structural changes in a wide area of sectors, from the judiciary to healthcare.
- 02 There is little sign that the prime minister, Boyko Borisov, and the president, Georgi Parvanov, who sit at opposite ends of the political continuum, will seek to mend the increasing rift between their institutions. The conflict will impact on the general political landscape but in particular it will determine the country's orientation on strategic issues such as energy, internal security and EU integration.
- 03 The popularity of the ruling GERB fell sharply amidst a deepening economic crisis at the end of 2009 but also as a result of the rivalry between GERB and president Parvanov. This is of concern to the ruling coalition, in government since 2009, as 2011 will see both presidential and municipal elections, thus setting the ground for a potential defeat in the 2013 parliamentary elections.

### TOP 3 ECONOMIC RISKS

- 01 We expect an improvement in the economic climate as a result of positive developments in several key structural indicators, including an increase in foreign direct investment and exports, falling unemployment and a rise in budget revenues.
- 02 The government has announced a higher budget deficit than expected – widening to 4.8% of GDP. We consider this estimate realistic as it is based on the underlying assumption that the recession will continue until the year-end. We do not expect the enquiry by the EU on the validity of the underlying data and statistics to reveal widespread malpractice.
- 03 We continue to expect further instability due to the Greek debt crisis as a significant share of the Bulgarian banking system is owned by Greek banks.

## 02 POLITICAL RISK

### 02.1 NO COHERENT PLAN TO IMPLEMENTING REFORMS

GERB, the centre- right ruling coalition, will continue to struggle to implement key structural reforms across a wide range of areas. Reforms have stalled due to a combination of factors. For example, health reform is delayed by a recent painful transition of power within the health ministry compounded by the near-collapse of the national health insurance fund; the customs administration is having to tackle a sharp decline in imports and thus has delayed curbing its labour force; the government is still struggling to re-draft the rules for infrastructure projects whilst facing a race against time to keep EU subsidies flowing. A failure to absorb EU funds would in turn fetter one of the government's key anti-crisis measures. The judiciary system, which has been widely criticised both within Bulgaria and by the EU, is especially resistant to change. Despite these shortfalls, some government departments are proving more robust than others in their efforts to introduce reforms. For instance, finance minister Simeon Dyankov has threatened to block budget payments to ministries unless they go ahead with planned reforms and cut costs (up to 20% for certain ministries). However, it is still unclear whether such threats will translate into action.

### 02.2 GOVERNMENT POPULARITY DECLINE DELAYS REFORMS

The ruling coalition GERB has recently recorded a sharp decline in its popularity. GERB won the elections in July 2009 promising to curb corruption and restore the country's relations with the EU, badly damaged during the previous, Socialist-led administration. However, the continued recession has increased public sensitivity towards economy-related issues, where the government has performed modestly since taking office. Prime Minister Borisov's approval rating has slid from 57% in September 2009 to 40% in June 2010. Reflecting GERB's commitment to tackle organised crime and corruption, Tsvetan Tsvetanov, the minister of the interior, has seen his personal approval rate reach 48%. However, thus far GERB's declining popularity has increased the share of undecided voters rather than played into the hands of the opposition. At the same time, the loss of popular goodwill is likely to continue to disrupt the government's already hobbling reform efforts. With presidential and municipal elections due in 2011, the government will likely face internal opposition to implementing difficult and unpopular measures.

### 02.3 FRICTION BETWEEN PRIME MINISTER AND PRESIDENT INCREASES

President Parvanov (Bulgarian Socialist party, BSP), whose second, and last, presidential mandate ends in 2011, has emerged as Prime Minister (PM) Borisov's number one political opponent. Only topped in popularity by the PM and the minister of the interior, Tsvetan Tsvetanov, Parvanov is already planning his political future after the 2011 presidential polls.

Parvanov favours improved relations with Russia, which his critics suggest would lead to an increase in Russian influence in strategic areas such as energy or national security. Throughout his tenure, Parvanov has been actively involved in parliamentary politics or leading the negotiations for a Socialist-led coalition government in 2005. He has been the champion of several Russia-backed energy projects in the country, undermining the current government's policy for diversification of energy resources. The form of his future involvement is still unclear; returning as chief of the Bulgarian Socialist Party might not be an option, considering its decline after the humiliating loss in the 2009 elections. More recently, the President has been viewed as an obstruction to the government's reform efforts, especially with regards to energy and security.

## 03 ECONOMIC RISK

### 03.1 BETTER ECONOMIC TIMES AHEAD

The recovery of Bulgaria's economy is led by a gradual increase of exports for the past 6-8 months (culminating in a 36% rise year on year this April), as well as a moderate growth in consumer spending. Foreign direct investments are up (the inflow of FDI in the non-financial sector was marked by a five-fold increase in 1Q2010, YoY, to EUR 513 million), and the 15-months trend of increasing unemployment has been reversed. Despite a sustained decline in GDP, Bulgaria is expected to emerge from the recession and to register modest growth in early 2011.

#### Economic Growth Forecasts, Bulgaria 2010

Growth forecasts				
	2009	Q1 2010, YOY	2010F	2011F
Government	-5.0%	-3.6%	0.3%	2.0%
IMF*	N/A	N/A	0.2%	2.0%
EBRD*	-5.0%	N/A	-1.2%	3.0%
EC*	N/A	N/A	0.0%	2.7%

\* IMF = International Monetary Fund;  
EBRD = European Bank for Reconstruction and Development;  
EC = European Commission.

Bulgaria has managed to struggle through the recession without letting public finances to get out of control: government debt remains at 12%, among the lowest in the EU. Bulgaria's budget deficit – at -3.9% – is also relatively low compared to other EU member states although it is expected to widen further by the year-end. Furthermore, the stability of the currency board arrangements was never really threatened – although in the long run the limitations of the fixed exchange rate could be a burden on a sustained expansion of the export sector.

### 03.2 CURBING THE BUDGET DEFICIT PROVES DIFFICULT

After ending April with a budget surplus of EUR 175 million, and a balanced budget in May, the deficit for the first five months of the year stands at EUR 0.69 billion, mostly due to weak revenue inflows for the period January-February 2010, the worst months of the crisis from a budgetary perspective. The Ministry of Finance has revised the budget and its worst-case scenario projects a deficit of EUR 1.84 billion (4.8% of GDP). The immediate negative implication of this step is that Bulgaria abandoned its plans to apply to join the European Exchange Rate Mechanism in 2010. This move was severely criticised as diluting the only long-term solution: belt-tightening and improving efficiency across the state administration. At the same time, Simeon Dyankov, the finance minister, has been using the widening budget deficit as a political tool to promote reforms.

The government has a strong commitment to reduce the budget deficit to below 3% of GDP in 2011, which it will most likely achieve if economic conditions continue to improve.

The recent revision of the budget deficit has prompted the EU to investigate the country's reported statistics. The capital markets responded promptly by sending credit default swap rates to an 11-month high. We do not expect the audit to uncover anything substantial errors or malpractice with the consequence that the country could distance itself from Greek-type allegations of forging statistics.

### 03.3 GREEK DEBT CRISIS THREATENS ECONOMIC STABILITY

Bulgaria's economy is fully exposed to the Greek debt crisis. Although Bulgaria itself has remained relatively stable throughout the crisis, it is directly exposed to outside shocks coming from across its southern border. Greek banks own between a quarter and a third of all assets in the Bulgarian banking sector. Typically, some of the funding to Bulgarian-based subsidiaries of Greek banks comes in the form of short-term intra-group lending.

A continued deterioration of the Greek financial system would increase the rollover risk within the Bulgarian banking sector and could possibly lead to liquidity problems within it. We expect funding costs to the banking sector to increase, limiting the expansion of bank lending to the real economy (credit to businesses and households has stagnated in the first 5 months of 2010). This will impact on Bulgaria's ability to return to economic growth in the short term.

## KEY MACROECONOMIC INDICATORS

- 01 Official GDP Figures for 2009 underline the depth of the recession and that a recovery is unlikely before 2011.
- 02 Bulgaria's public debt remains low; however, the budget deficit gap has continued to widen and is expected to reach just under 5% by year end.
- 03 Foreign direct investment has picked up in 2010 after a sharp decline in 2009 and is expected to continue its upward trend.
- 04 The current account deficit has adjusted sharply to -1.5 of GDP in Q1 2010.

	2007	2008	2009	Q3 2009	Q4 2009	Q1 2010
GDP (EUR billion)	28.8	34.0	33.8	9.2	9.1	7.2
GDP rate of change (%)	6.2	6.0	-5.0	-5.4	-5.9	-3.6
Gross capital formation (EUR billion)	10.6	13.1	8.9	1.9	2.5	1.7
Exports (EUR billion)	18.3	20.6	16.9	5.3	4.1	3.7
Imports (EUR billion)	24.7	28.3	19.5	4.9	4.9	4.3
Exports YoY change (%)	12.5	12.5	-22.5	-28.8	-22.5	13.5
Imports YoY change (%)	18.1	14.7	-33.2	-35.5	-33.2	-4.7
Industrial production YoY change (%)	9.6	0.7	-18.3	-19.7	-17.0	-3.1
Employed (000s)	2,380.2	2,466.9	2,295.2	-	-	2,190.0
Unemployed (000s)	256	232	338	-	-	380
Unemployment (%)	6.9	6.3	9.1	-	-	10.3
Budget surplus(deficit)/GDP (%)	3.5	3.0	-3.9	-1.1	0.0	-10
Current account/GDP (%)	-26.8	-24.0	-9.4	-7.2	-9.4	-1.5
FDI/GDP (%)	31.3	19.6	9.5	6.7	9.5	0.4
Government debt/GDP (%)	14.2	11.4	12.3	12.1	12.3	12.1
Private debt/GDP (%)	86.2	97.3	99.0	97.0	99.0	94.8
FDI/Current account deficit (%)	117	82	101	92	101	25
Fiscal reserves/months of imports (months)	5.9	5.5	8.1	7.1	8.1	7.8

Source: National Bank of Bulgaria; National Statistical Institute of Bulgaria.

\*Marker Global Estimate