Bulgaria
Currency board special

October 2010

Abstract

The Currency Board Special report focuses on indicators related to the functioning of the currency board arrangement (CBA) and briefs on ERM II entry intentions of the Bulgarian Government and the fulfilment of the Euro area convergence criteria. The general findings are that the key economic indicators are supportive to the CBA and the country has good chances of adopting the single European currency over the medium term.

Table of contents

Analysts:
Raiffeisenbank (Bulgaria) EAD

Kaloyan Ganev, PhD
kaloyan.ganev@raiffeisen.bg

Hristiana Vidinova
hristiana.vidinova@raiffeisen.bg

Raiffeisen Bank International AG, Vienna

Martin Stelzeneder
martin.stelzeneder@raiffeisenresearch.at

Highlights

- ✓The official position of the Government and the Bulgarian National Bank (BNB) is that the CBA will be maintained at the current EUR/BGN exchange rate peg until the country becomes a member of the Euro area. There is a strong commitment of institutions to enter ERM II as soon as possible. The planned budget consolidation in 2011 would strongly facilitate Bulgaria's advance to the Euro area. EMU membership looks realistic for early 2014. Currently there are no political risks to the currency board arrangement.
- ✓The high FX coverage ratios indicate that the FX reserves guarantee the smooth operation of the currency board arrangement.
- ✓Prudent fiscal policy has been very beneficial to the stability of the currency board arrangement. It has provided sizable buffers and flexibility during the economic recession.
- ✓The fiscal reserve has both provided an additional guarantee of the currency board stability and has helped the government finance its deficit in a year of volatility on the international financial markets.
- ✓The low level of public debt reduces substantially budget execution risks since repayment amounts are relatively low.
- ✓The current account has rebalanced automatically after the source of inflating its deficit – financial inflows – has receded. This suggests the absence of persistent structural problems in the Bulgarian economy.
- ✓The banking system proved its resilience to the economic crisis.
- ✓In Bulgaria deposits and loans are highly euroized. A change in the official peg in either direction would have a substantial negative balance-sheet effect – on lenders, in case of appreciation, and on borrowers, in case of devaluation.
- ✓Inflation has moderated significantly. No major domestic-market pressures are expected. Although acceleration of the inflation rate is expected over the short-to-medium term (e.g. as a result of the convergence to EU price levels), due to the projected slow recovery of demand it is most likely to stay well below the 2007 and 2008 figures.
- ✓The labour market has cooled off and currently does not exert pressure on the inflation rate. It is expected to remain close to equilibrium over the medium term.
- ✓Labour productivity has improved significantly since the introduction of the currency board arrangement. The process of its convergence to the EU averages has already restarted, after the mid-crisis slump.
- ✓Unit labour costs are still moderate and facilitate the competitiveness of the Bulgarian economy vis-a-vis its EU partners.

Introduction

The currency board arrangement was introduced in Bulgaria in 1997, replacing the old monetary regime of floating exchange rates. Under this arrangement, the local currency (BGN) is pegged to the euro at the rate of 1.95583 (initially to the German Mark at the rate of 1000 BGL to 1 DEM). According to the Law on the Bulgarian National Bank (BNB), the aggregate amount of monetary liabilities of the Bulgarian National Bank shall not exceed the lev equivalent of the gross international reserves, and the lev equivalent shall be determined on the basis of the official fixed exchange rate. The FX reserves cover all banknotes and coins in circulation issued by the Bulgarian National Bank, and the bank reserves held at the BNB – i.e. the monetary base, as well as the deposits of the government and other governmental institutions in the BNB and the BNB's Banking department deposit. Thus the coverage of the monetary base by FX reserves is higher than 100%. The currency board arrangement requires strict fiscal discipline, and the Law prohibits the central bank from issuing loans to the Government.

Under the currency board arrangement in Bulgaria, monetary policy tools are limited. Open market operations by the central bank are impossible, and so is lending to banks. The only monetary policy instrument available is minimum required reserves which are used rather seldom. The function of the central bank as a lender of last resort can only be used in cases of systemic risk but only up to a legally specified limit and against a restricted set of accepted collaterals.

So far the currency board arrangement, which has been coupled with prudent fiscal policies, has proved to be one of the main pillars of macroeconomic stability of the country. It has demonstrated its viability throughout the years remaining practically unaffected by major international economic disturbances such as the Asian crisis, the Russian crisis, the Yugoslavia war, as well as the recent global financial and economic crisis.

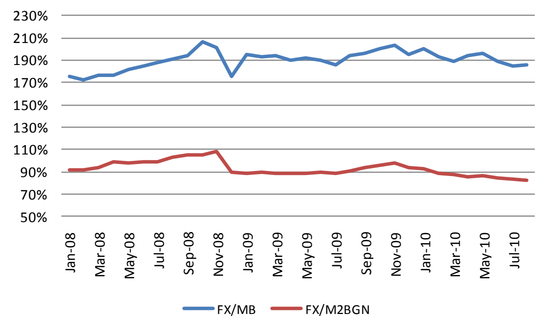
Factors underpinning the currency board arrangement

FX reserves coverage of the monetary base

The monetary base in Bulgaria is defined as the sum of notes and coins in circulation, and the liabilities of the Bulgarian National Bank to banks. As of 30 September 2010, the FX reserves of BNB amounted to EUR 12.8 bn. The monetary base was covered 188.6%, far above the required minimum. This provides a large cushion supporting the functioning of the currency board arrangement. In fact, by design, the assets of the Issue Department cover also BNB's liabilities to Government and to governmental budget institutions, and BNB's Banking Department deposit.

The coverage of the BGN-denominated part of the M2 monetary aggregate was also high in August: 82.8%. The ratio of the gross international reserves to GDP was 35.6% as of September 2010.[1]

Figure 1: Monetary base and BGN-denominated part of M2 coverage by FX reserves (%)



Source: BNB, Raiffeisen RESEARCH

[1] Raiffeisen RESEARCH's latest GDP forecast used (EUR 35.8 bn).

Politics

The current government took power in July 2009, after the political party Grazhdani za Evropeysko Razvitie na Balgariya (GERB)[2] won the parliamentary elections. It is a minority government since GERB holds only 117 seats out of 240 in the Bulgarian Parliament. Nevertheless, it is supported by Ataka (21 seats) and the Blue Coalition (14 seats), which makes its ruling position stable.

The government continues the line of policy adopted by all previous governments since 1997 to render unconditional support to the currency board arrangement (CBA). This support is shared among all parliamentary-represented parties, and thus there are no political risks threatening the existence of the CBA currently or in the foreseeable future.

In the beginning of October 2010, in its end-of-mission statement, the IMF reconfirmed the positive role of the CBA: "Bulgaria's prudent macroeconomic framework, anchored by the currency board, has been crucial in preserving stability through the global economic crisis".[3]

Fiscal policy

Fiscal policy has been prudent throughout the years since the introduction of the currency board arrangement. This has led to sizable budget surpluses, respectively to the accumulation of a sizable fiscal reserve, which currently is used to finance the budget deficit.

In 2008 the budget ended with a cash surplus of 2.9% of GDP. In 2009 the revenues contracted sharply due to the ongoing economic recession, while in the first half the government spending was even higher than the H1 2008 level. The newly-elected government resorted to spending cuts in the second half of the year with a view to restrict the size of the annual budget deficit. A cash deficit was eventually generated, but very small in size: 0.9% of GDP. This was achieved at the expense of delayed payments to businesses, thus leading to an accrual-based deficit of 3.9% of GDP. Since this value exceeded the Maastricht ceiling of 3%, an Excessive Deficit Procedure was launched against Bulgaria in July 2010 by the European Commission.

In July, taking into account the revenue underperformance with respect to planned values, the Parliament voted for a revision of the 2010 budget, targeting a new cash-based deficit of 4.8%. The forecasted accrual-based deficit is 3.8% of GDP.

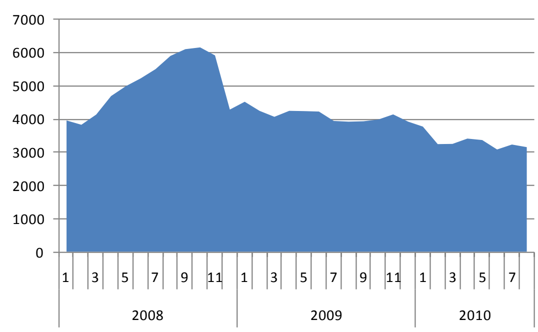
Fiscal reserve

The fiscal reserve has played (and continues to play) a very important role in the management of public finances. In the economic boom years it was used in a counter-cyclical fashion to accumulate revenue windfalls thus restricting absorption growth and counterbalancing the deterioration of the current account balance. In the second half of 2008 it reached almost EUR 6.2 bn, due to unprecedented revenue overperformance. The then-ruling government spent (after a sanction by the Parliament) a substantial amount in the last quarter in an attempt to counteract the negative impact of the global economic crisis, to get to a fiscal reserve of EUR 4.3 bn at the end of the year. Similar levels of the fiscal reserve were maintained until the end of June 2009.

Since July 2009 the fiscal reserve started being used as the major source of financing the emerging budget deficit. Nevertheless, it did not fall below EUR 3.9 bn until the end of 2009.

The practice of financing deficits through past-accumulated funds gained momentum in the first half of 2010. The fiscal reserve hit its lowest level in June 2010: EUR 3.1 bn, after which it slightly recovered to EUR 3.2 bn in July, mainly due to the inflow of EU transfers, and diminished by EUR 78 mn in August.

Figure 2: Fiscal reserve (EUR mn)



Source: Ministry of Finance

[2] Translated as Citizens for European Development of Bulgaria.

[3] IMF, Press Release: Statement at the end of an IMF Mission to Bulgaria, 4 October 2010.

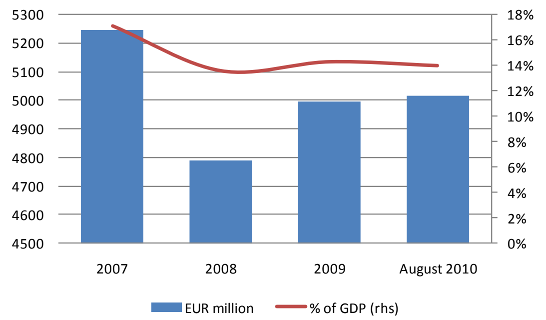
Public debt

Public debt was very low in 2008. Several governments stuck to prudent debt management using extra collected budget revenues to repay public debt before its maturity, refraining at the same time from extensive borrowing. As of December 2008 the level of total public debt amounted to 13.6% of GDP. The ratio climbed up a bit in 2009 to 14.3% due to the decline in GDP and some minor local borrowing.

In August 2010 the public debt was EUR 5 bn (very close to the end-2009 level). Due to the forecasted nominal increase in GDP and the expected levels of local borrowing until the end of the year the public debt/GDP ratio will most likely stay around its 2009 value.

This level of public debt ranks the country among the three best performers in the EU. It implies low repayment burden and therefore does not pose significant risks to budget stability, respectively to overall economic development.

Figure 3: Public debt



Source: Eurostat, Ministry of Finance, Raiffeisen RESEARCH

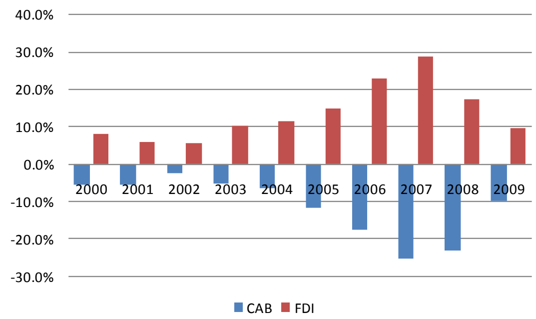
Current account balance

The current account deficit has been quoted in the recent years as one of the biggest threats to the Bulgarian economy. In 2007 it soared to 25.2% of GDP and remained high at 23.1% in 2008. It was regarded as a signal for an overheated economy. The deficit was fuelled mainly by the financial inflows in the country (FDI inflows comprising the major part of those flows), which stimulated imports. This is supported also by the fact that, with the exception of 2008, all C/A deficits so far have been fully covered by FDI.

In 2009 the C/A deficit started shrinking rapidly to get to 9.9% of GDP at the end of December.

The rebalancing of the C/A continued in 2010, and in July it even came out positive at EUR 530 mn. For the January-July period its deficit reached as low as 0.8% of forecasted GDP.

Figure 4: Current account balance (CAB) and net foreign direct investment (FDI) (% of GDP)



Source: BNB, Raiffeisen RESEARCH

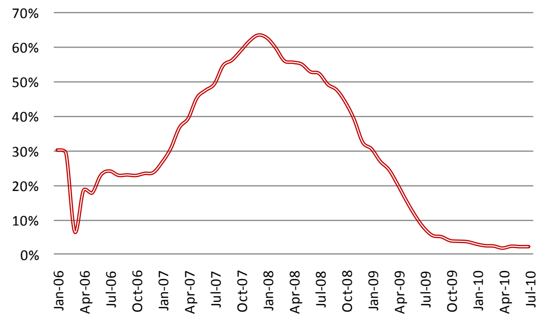
As a consequence of the cautious behaviour adopted by both investors and consumers, Bulgaria is not expected to return to the growth pattern exhibited in 2007 and 2008. Therefore, the C/A deficit is expected to remain at moderate levels over the medium term, although imports will pick up after the economy starts recovering.

Banking sector

The banking system has been stable since the introduction of the CBA in 1997. It remained such after the start of the current economic crisis in 2008. Practically, there have been no signs that the financial crisis has been felt seriously and there has been no necessity to provide liquidity support to any bank in the country through the lender-of-last-resort option envisaged in the Bulgarian National Bank Law, or to nationalize banks in trouble. The banking system has been well capitalized, with banks' capital adequacy ratio increasing to 18.03% as of 30 June 2010. At the same time the share of exposures past due more than 90 days in total gross loans increased to 9.45% in Q2 vs. 7.29% vs. in Q1 but the operational income was sufficient to cover it. As of 30 June 2010, the reported profit of banks was EUR 180 mn (about 29% decrease compared to the same period of 2009). The return on assets was 0.99% as of the same date.

After the world economic crisis started being felt in Bulgaria in the second half of 2008, the high growth rates of credit observed during the economic boom rapidly decelerated, from over 60% at the end of 2007 to about 33% at the end of 2008 and 3.6% at the end of 2009. In the first seven months of 2010 credit growth to the non-financial enterprises and households remained positive but at very low rates (2.3% on average). The current state of the economy and the ongoing shift in growth structure imply that over the short-to-medium term credit will not be likely to accelerate substantially. This is further supported by the fact that credit demand in the country is very fragile although there is some revival in banks' willingness to extend loans.

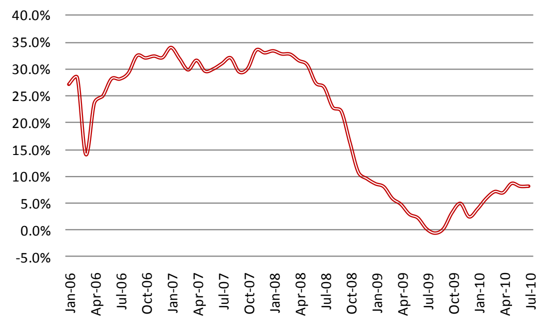
Figure 5: Bank loans to non-financial enterprises and households (% yoy)



Source: BNB, Raiffeisen RESEARCH

The annual growth rate of bank deposits of households and non-financial enterprises decelerated considerably from over 30% in the first several months of 2008 to less than 10% at the end of the same year. It bottomed in the summer of 2009 when it fluctuated close to 0% for several months. In the autumn of 2009 it started climbing up smoothly to get to about 8% in July 2010. The deposit growth in the last twelve months was almost entirely due to the increase of household deposits. Households were attracted by the high interest rates, while they increased their saving rate due to precautionary considerations.

Figure 6: Deposits of households and non-financial enterprises (% yoy)



Source: BNB, Raiffeisen RESEARCH

Deposit growth is expected to pick up slightly with the recovery of the Bulgarian economy in 2011, but will not reach the pre-crisis rates due to limited income growth.

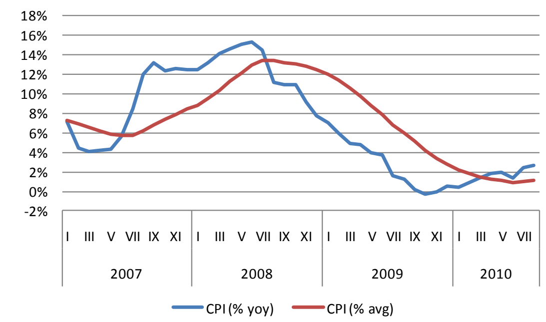
Euroization

The Bulgarian population has got used to operating in both national currency and euro due to the currency board arrangement. Thus, it has euroized a substantial share of its assets and liabilities. As of August 2010, 58% of all loans to households and non-financial enterprises were in euro. Likewise, the share of euro-denominated deposits in all deposits of households and non-financial enterprises was 43%.[4]

Inflation

The inflation rate accelerated significantly during the economic boom in 2007 and 2008. The price increases were fuelled mainly by the high international prices of foods and energy resources (oil in particular), by high demand (both domestic and external), and by the high domestic wage growth. In 2007 the annual average inflation reached 8.4%, further accelerating to 12.3% in 2008. Following the price moderation at international markets and the cooling-off of the Bulgarian economy, in 2009 the annual average inflation came down to 2.8%. The 2010 developments also displayed low figures, to get to the bottom annual average figure of 0.9% in June.

Figure 7: Inflation developments



Source: NSI, Raiffeisen RESEARCH

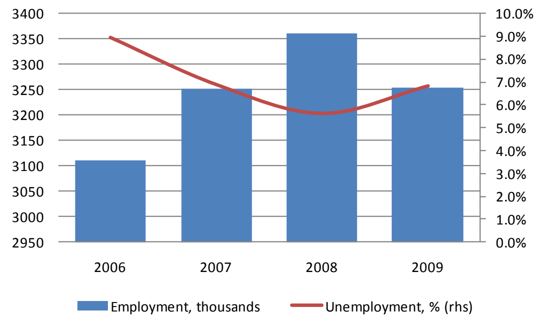
Labour market

The high real growth of the economy in 2007 and 2008 was accompanied by extensive growth of employment. In those same years

[4] In Bulgaria lending to households in currencies such as Swiss francs and Japanese yen is almost non-existent. In this respect Bulgaria differs significantly from other CEE countries.

employment increased by 4.6% and 3.3% respectively. Unemployment decreased to an average of 6.9% in 2007, and fell further to 5.6% in 2008, quite below its natural rate[5]. In 2009 employment went through a correction concentrated mainly in the second half of the year. It decreased by 3.2%, while unemployment climbed back to 6.8%. The annual average unemployment rate is likely to stabilize around 9% in 2010 and 2011.

Figure 8: (Un)employment



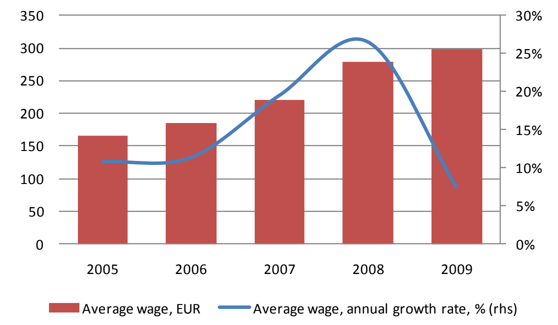
Source: NSI, Raiffeisen RESEARCH

In 2007 the average monthly wage increased by 19.5%, and in 2008 – by additional 26.5%, reflecting the labour market shortages, the severe competition among employers, as well as institutional factors. In 2009 the average monthly wage also increased (by 7.4%, according to first-release data) but the underlying reason was of purely statistical nature – employers were laying off first the lowest-paid workers.

Being the lowest in the EU, the average wage level is still far from threatening Bulgaria's competitiveness. Due to convergence considerations, it is expected to continue increasing, especially in the high-skill segment, but its overall increase will most likely be in line with productivity growth.

[5] According to Raiffeisen RESEARCH estimates it was about 9% during that period.

Figure 9: Average monthly wage

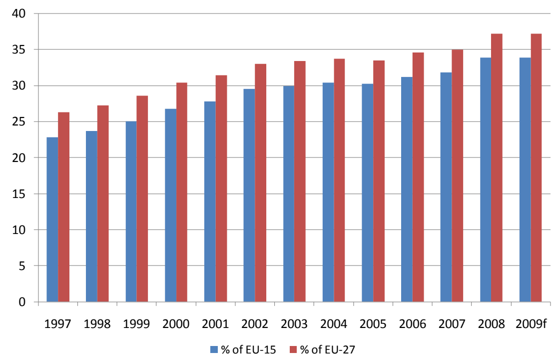


Source: NSI, Raiffeisen RESEARCH

Labour productivity

Labour productivity[6] in Bulgaria measured in Purchasing Power Standards (PPS)[7] has increased from 22.8% of the EU-15 average in 1997 to 33.9% in 2009. Compared to the EU-27 average it has increased from 31.5% in 1997 to 37.2% in 2009.

Figure 10: Labour productivity of Bulgaria as a percentage of EU averages (in PPS)



Source: Eurostat

In terms of real labour productivity[8] per person employed, the index for Bulgaria has increased from 100 in 1997 to 155.2 in 2009, and is forecasted by Eurostat to increase to 160.4 in 2011. At the same time, the indexes for Euro area 16 (EA-16), EU-27 and Germany in 2009

[6] Labor productivity in PPS is the ratio between gross value added (GVA) in PPS and the number of persons employed.

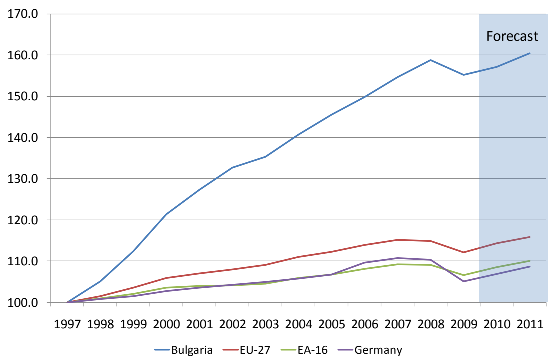
[7] The purchasing power standard (PPS) is an artificial currency unit independent of the national currency which is used in cross-country comparisons for correcting distortions stemming from differences in price levels.

[8] Real (price-deflated) GVA used in the calculation.

were respectively only 108.5, 114.3, and 108.6.

After the declines in 2009, in the first two quarters of 2010 real labour productivity has increased at high rates – respectively by 6.5% and 7.4% yoy. This shows that it has only been temporarily negatively affected by the economic recession.

Figure 11: Labour productivity per person employed (1997=100)

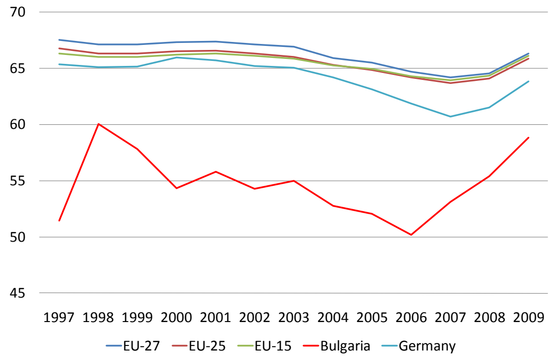


Source: Eurostat

Unit labour costs[9]

Being one of the indicators of cost competitiveness, Bulgaria's unit labour cost (ULC) remained much below the EU-15, EU-25 and EU-27 averages (and also below Germany as an additional reference). Despite the steep rise in unit labour costs in 2007-2009 there is still a cushion allowing for further increases in ULC before competitiveness is endangered. In other words, Bulgaria remains relatively more labour-cost competitive compared to EU-15, EU-25, EU-27, and Germany.

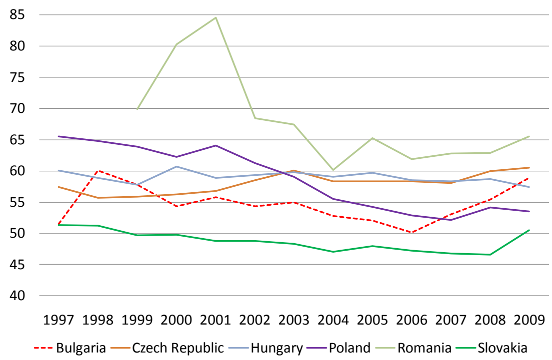
Figure 12: Unit labour costs, levels, Bulgaria, EU and Germany



Source: Eurostat, Raiffeisen RESEARCH

Compared to other CEE countries[10], Bulgaria was more labour-cost competitive than the Czech Republic and Romania, and close to Hungary, Poland and Slovakia.

Figure 13: Unit labour costs (levels), Bulgaria and CEE non-peggers



Source: Eurostat, Raiffeisen RESEARCH

It is also worth noting that although increasing considerably in 2007-2009, in 2009 unit labour costs in Bulgaria were still below their 1998 value.

Compared to the CEE peggers, Bulgaria had lower unit labour costs than those of Estonia, and comparable to those of Latvia and Lithuania.

---

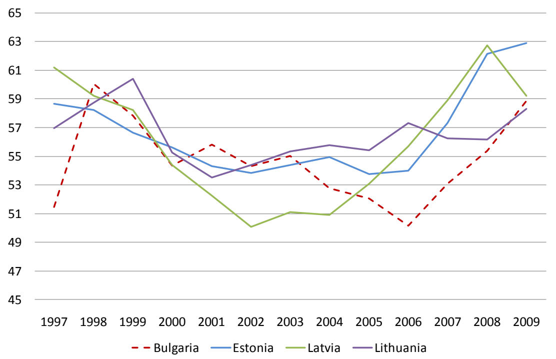
[9] Unit labor costs (ULC) are calculated as:

$$ULC = \frac{CoE / E}{GVA / TE},$$

where CoE is compensation of employees, E is the number of employees, GVA is gross value added, and TE is total employment.

[10] The Czech Republic, Hungary, Poland, Romania and Slovakia. The choice of countries in this chart is intentional – it omits peggers such as Estonia, Lithuania, and Latvia, and longer-term Euro area members (Slovenia). The purpose is to see how Bulgaria has differed from countries with floating exchange rates.

Figure 14: Unit labour costs, levels, Bulgaria and CEE peggers



Source: Eurostat, Raiffeisen RESEARCH

The labour productivity and unit labour cost sections provide evidence that the country has amassed sizable productivity gains since 1997. Also, Bulgaria has managed to maintain labour costs per unit produced lower than selected EU benchmarks, which has helped it remain competitive compared to most of the EU Member States.

ERM II and the Euro area

In 2009 the newly elected government announced a strong commitment to enter ERM II in early 2010. However, after the discovery of unaccounted contracts signed by previous governments and the resulting accrual-based budget deficit to 3.9% in 2009, the plans for ERM II membership were postponed for the beginning of 2011 (although there are no formal criteria for ERM II membership). The July revision of the 2010 budget, however, could jeopardize this intention since the new fiscal target still exceeds the Maastricht reference value. At the time being, 2012 looks more realistic to become the year of ERM II entry, if the government succeeds in fulfilling its plans for budget consolidation and brings the 2011 budget deficit below 3%.

Table 1: Maastricht criteria for Euro area membership

Fiscal criterion
The annual government deficit (accrual-based) must not exceed 3% of GDP for the preceding fiscal year. One-off effects may be excluded from the calculation. Gross public debt must not exceed 60% of GDP.
Monetary criteria
Consumer price inflation (annual average) measured by the Harmonized Index of Consumer Prices (HICP) must not exceed by more than 1.5 percentage points the average inflation rate for the three best-performing EU Member States in terms of price stability.
Long-term interest rates must not exceed by more than 2 percentage points the average long-term interest rates for the three best performing EU Member States in terms of price stability.
The exchange rate of the local currency should not fluctuate by more than +/-15% around the central rate against the euro agreed at ERM II entry, for a period of at least 2 years. No devaluation of the local currency central rate is allowed, while appreciation is possible.

Source: European Central Bank (ECB)

Table 2: Fulfilment of the Maastricht criteria by Bulgaria

Budget balance (accrual-based)	2007	2008	2009	2010e	2011f
Benchmark	-3.0%	-3.0%	-3.0%	-3.0%	-3.0%
Bulgaria	0.1%	1.8%	-3.9%	-3.8%	-2.5%
Gross public debt/GDP	2007	2008	2009	2010e	2011f
Benchmark	60%	60%	60%	60%	60%
Bulgaria	17.1%	13.6%	14.3%	14.2%	15.9%
Inflation (HICP)	2007	2008	2009	2010e	2011f
Benchmark	2.8%	4.0%	1.5%	0.6%	2.7%
Bulgaria	7.6%	12.0%	2.5%	2.7%	3.8%
Long-term interest rates	2007	2008	2009	2010e	2011f
Benchmark	6.4%	6.2%	5.9%	4.5%	5.0%
Bulgaria	4.5%	5.4%	7.2%	6.1%	7.0%

Source: Eurostat, ECB, Raiffeisen RESEARCH

Disclaimer

This document does not constitute an offer or invitation to subscribe for or purchase any securities and neither this document nor anything contained herein shall form the basis of any contract or commitment whatsoever. This document is being furnished to you solely for your information and may not be reproduced or redistributed to any other person. Any investment decision with respect to any securities of the respective company must be made on the basis of an offering circular or prospectus approved by such company and not on the basis of this document. RBI may have effected an own account transaction in any investment mentioned herein or related investments and or may have a position or holding in such investments as a result. RBI may have been, or might be, acting as a manager or co-manager of a public offering of any securities mentioned in this report or in any related security. Information contained herein is based on sources, including annual reports and other material which might have been made available by the entity which is the subject of this document. RBI believes all the information to be reliable, but no representations are made as to their accuracy and completeness. Unless otherwise stated, all views (including statements and forecasts) are solely those of RBI and are subject to change without notice. Investors in emerging markets need to be aware that settlement and custodial risk may be higher than in markets where there is a long established infrastructure and that stock liquidity may be impacted by the numbers of market makers which may therefore impact upon the reliability of any investments made as a result of acting upon information contained in this document. Special regulations for the Republic of Austria: This document does not constitute either a public offer in the meaning of the Kapitalmarktgesetz („KMG") nor a prospectus in the meaning of the KMG or of the Boersegesetz. Furthermore this document does not intend to recommend the purchase or the sale of securities or investments in the meaning of the Wertpapieraufsichtsgesetz. This document shall not replace the necessary advice concerning the purchase or the sale of securities or investments. For any advice concerning the purchase or the sale of securities or investments kindly contact your RAIFFEISENBANK. Special regulations for the United Kingdom of Great Britain, Northern Ireland (UK) and Jersey (Channel Islands): Raiffeisen Bank International AG (RBI). This publication has been either approved or issued by Raiffeisen Bank International AG in order to promote its investment business. RBI London Branch is authorised by the Austrian Financial Market Authority (FMA) and subject to limited regulation by the Financial Services Authority (FSA). Details on the extent of the London branch's regulation by the Financial Services Authority are available on request. This publication is not intended for investors who are Retail Customers within the meaning of the FSA rules and should therefore not be distributed to them. Neither the information nor the opinions expressed herein constitute or are to be construed as an offer or solicitation of an offer to buy (or sell) investments. RBI may have effected an Own Account Transaction within the meaning of FSA rules in any investment mentioned herein or related investments and or may have a position or holding in such investments as a result. RBI may have been, or might be, acting as a manager or co-manager of a public offering of any securities mentioned in this report or in any related security. The RBI Jersey marketing representative office is not regulated by the Jersey Financial Services Commission as it does not perform any financial services activity in Jersey as defined by the Financial Services (Jersey) Law 1998 (FSJL).Special regulations for the United States of America (USA) and Canada: This document or any copy hereof may not be taken or transmitted or distributed, in the USA or Canada or their respective territories or possessions nor may it be distributed to any USA-person or person resident in Canada by any means other than via a US Broker Dealer. Any failure to comply with these restrictions may constitute a violation of USA or Canadian securities laws. Detailed disclaimer and disclosure as per Sect. 48f of the Stock Exchange Act: http://www.raiffeisenresearch.at-> "Disclaimer"