Bulgaria next? Budget under investigation

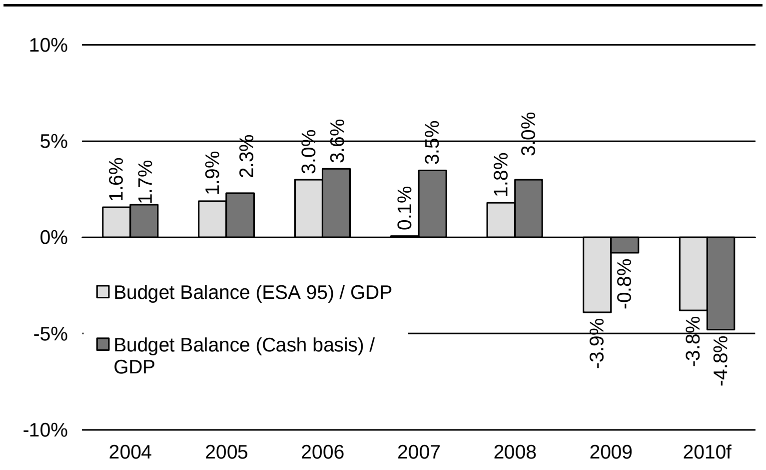
- Following the long Greek saga and last week's comments by some Hungarian officials (regarding the possible poor status of Hungary's public finances), this week the Bulgarian budget was at center stage.

- Tuesday, the EU's Economic and Monetary Affairs Commissioner Olli Rehn expressed his alarm: "We have had some concerns about the statistical performance of Bulgaria and are considering sending a mission shortly". In April, the new centre-right government already revealed dozens of unaccounted public procurement deals signed by the previous cabinet, which forced it to revise its end-2009 budget deficit figure (calculated according to the Eurostat methodology) to 3.9% of GDP (from 1.9% initially). As this has been public knowledge since April, the sharp increase of Bulgarian CDS may provide some selling opportunity.

- To avoid sustainability of its fiscal position being called into question (during the first month of 2010 a deterioration of public finances was visible), the Bulgarian government already implemented a number of austerity measures, with a mix of revenue increases and spending cuts. With belt-tightening measures worth 2% of Bulgarian GDP, Bulgaria can enjoy a very solid fiscal position, we believe. Indeed, Bulgaria has a public debt of 16.1% of GDP compared with around 35% on average for the EEMEA countries and close to 80% for the eurozone.

- However, the tribulations related to Bulgarian fiscal accounts should not be underestimated. First, uncertainty (and revisions) over budget figures is something we regard as very negative, and misinterpretation among the government, investors and EU officials must be avoided. Second, the apprehension about the Bulgarian budget numbers should not be considered the cause of the renewed market tensions that are affecting Central Eastern Europe, rather they represent another clear symptom of market nervousness, in our view.

BULGARIAN BUDGET BALANCE (% OF GDP, ESA95 AND CASH BASIS)



Source: Bulgarian Ministry of Finance, UniCredit Research

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First Hungary…

Hungary was at centre stage during the past week, following the – in our view – astonishing comments by some Hungarian officials that the country "has only a slim chance of avoiding a Greek-style scenario", and that "default talk is not an exaggeration". These comments triggered a sell-off not only of Hungarian assets but they also had an impact on a broader scale.

…now Bulgaria…

This week, **Bulgaria is experiencing a harsh discussion about its budget numbers**. Tuesday, Economic and Monetary Affairs Commissioner Olli Rehn said that "We have had some **concerns as regards the statistical performance of Bulgaria and are considering sending a mission shortly**". These comments emerged in the context of the EU's finance ministers' recent decision to grant to the Eurostat wide auditing powers, with the ultimate goal to help prevent proliferation of a sovereign debt crisis in the EU. The Bulgarian finance ministry said in a statement yesterday that it had been expecting such a mission since May and that "The mission is expected... It neither surprises us, nor worries us". Bulgaria country risk – if measured in terms of 5Y USD CDS – jumped from 250 last week to more than 350 this week (the level of one year ago).

COUNTRY RISK (5YUSD CDS, BPS)

	Today	1 week ago		1 month ago	
	11-Jun-10	4-Jun-10	delta	11-May-10	delta
Spain	206	257	-51	164	41
Portugal	290	353	-62	237	53
Italy	187	245	-58	144	44
Greece	758	791	-33	560	198
Slovenia	90	104	-13	73	17
Slovakia	101	106	-6	78	23
Poland	154	185	-32	125	29
Czech	107	117	-10	87	20
Hungary	326	412	-87	225	101
Lithuania	292	313	-21	259	33
Latvia	370	404	-33	348	22
Estonia	134	133	1	112	22
Romania	392	376	16	247	145
Bulgaria	354	334	20	235	119
Croatia	320	316	3	231	89
Turkey	189	202	-13	174	14
Ukraine	625	639	-13	577	48
Russia	188	201	-13	163	25
Kazakhstan	214	221	-8	189	24

Source: Bloomberg, UniCredit Research

Dozens of unaccounted public procurement deals already revealed

We believe the statement of Commissioner Rehn refers to past development, which is already priced in by the markets' participants; this is why we see the most recent markets' reaction as somewhat exaggerated. In April, the new center-right government revealed dozens of unaccounted public procurement deals signed by the previous Socialist-led cabinet, which forced it to revise its end-2009 budget deficit figure (calculated according to the Eurostat methodology) to 3.9% of GDP (from 1.9% initially), while at the same time the deficit on a cash basis remained unchanged at 0.8% of GDP.

Renewed concerns over the credibility of Bulgaria's national statistics, in our view, reflect general market anxiety over the possible proliferation of the sovereign debt crises in Europe, rather than any concrete alleged wrongdoings of Bulgarian authorities. **The nervousness surrounding the Bulgarian fiscal accounts is hence more a symptom than the cause of the renewed market tensions that are affecting Central Eastern Europe.**

Apart from Estonia, Bulgaria has the strongest fiscal metrics in the EU-27

It is also worth emphasizing, that in the EEMEA region Bulgaria's fiscal metrics are only outperformed by Estonia. Bulgaria has a public debt of 16.1% of GDP compared with around 35% for the EEMEA countries and moving close to 80% for the eurozone founding members. Bulgaria targets a 2010 budget deficit of 4.8% of GDP on cash basis (corresponding to 3.8% deficit on accrual basis – according to the government estimates, see chart), while deficits in the public finances in many EU countries remain far in excess of this level. Bulgaria's interest expenditures for serving public debt are less than 1% of GDP, substantially lower than those seen in many EU member states, not to mention Greece where it may come close to the 10% benchmark this year.

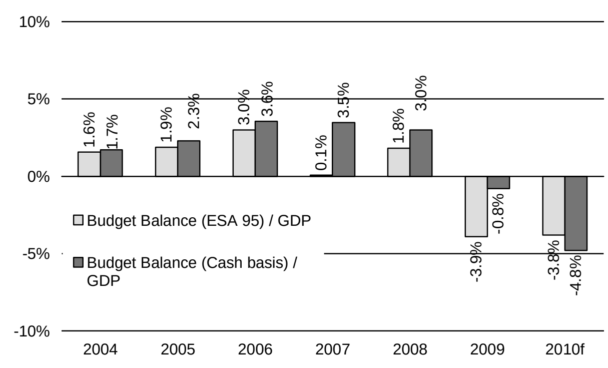
FISCAL METRICS (%, EUROSTAT METHODOLOGY)

Data as of end-2009	Budget deficit / GDP	Public debt / GDP	Interest spending to serve public debt / GDP
EU-27	-6.8	73.6	2.6
Bulgaria	-3.9	14.8	0.8
Czech Republic	-5.9	35.4	1.3
Estonia	-1.7	7.2	0.3
Latvia	-9	36.1	1.6
Lithuania	-8.9	29.3	1.0
Hungary	-4	78.3	4.7
Poland	-7.1	51	2.6
Romania	-8.3	23.7	1.5
Slovenia	-5.5	35.9	1.4
Slovakia	-6.8	35.7	1.5
Greece	-13.6	115.1	5.0

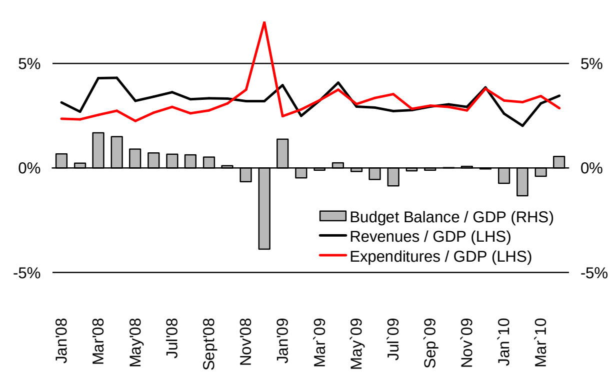
Source: Eurostat, UniCredit Research

BULGARIAN FISCAL ACCOUNTS

Budget balance (% of GDP, ESA95 and cash basis methodologies)



Monthly evolution of Bulgarian fiscal accounts (% on GDP)



Source: Bulgarian Ministry of Finance, UniCredit Research

Belt-tightening measures worth 2% of GDP are being implemented…

To avoid sustainability of its fiscal position being called into question, the Bulgarian government already implemented (or is about to implement soon) a **number of austerity measures, with a mix of revenue increases and spending cuts**. To boost fiscal revenues authorities intend to: #1) impose indirect tax on insurance premium income; #2) raise the share of advance payment of profit tax; #3) raise the dividend payout ratio for state-owned companies from 50% to 80%; #4) impose a new higher tax rate on luxury property; #5) privatize minority stakes in state-owned enterprises; #6) sell and rent state-owned arable land. Spending cuts to be made: #1) lower sickness and unemployment benefits; #2) 15% reduction in subsidies for political parties; #3) a 9.5% cut in total administrative expenses including salaries (with exception of ministries of internal affairs, defense as well as the ministry of labor and social policy); #4) freezing pensions paid from the state coffers; #5) postpone the raise in widowers' pensions, which was one of the pre-election pledges of the GERB ruling party. The **total fiscal effects of the austerity measures envisaged in the budget revision are thus estimated at some BGN 1.4bn, or 2% of anticipated GDP.**

The budget deficit target (on a cash basis) was revised from 0.7% of GDP initially to 4.8%

Importantly, on accrual basis the budget deficit is thus forecast to reach 3.2% of GDP, from 3.9% posted last year

In 2009, the Bulgarian economy felt the effects of the recession and GDP dropped by 5% (slightly better than the Central Eastern European region) and the budget also started to deteriorate. In 2010, belt-tightening proved necessary, as it became clear that **revenues in the initial 2010 budget plan were overestimated**. What's more, the 2010 budget deficit target is likely to be raised from 0.7% of GDP on a cash basis, under the initial fiscal plan, to 4.8% of GDP, under the budget revision, which at the moment is in the final stages of approval in the National Assembly. Importantly, the budget deficit on an accrual basis is thus estimated to reach 3.8% of GDP, lower than 3.9% posted in 2009. **The logic behind drastic cuts in the public administration coupled with the increase in the budget deficit target, according to the government, is to free more fiscal room for growth-enhancing spending**. More specifically, the government intends: #1) to finance additional infrastructure projects of national priority for BGN 180mn (mostly co-financing needed to boost utilization of EU funds); #2) to increase unemployment benefits to cover planned job cuts in the public sector; #3) to spend an additional BGN 220mn in the health care sector, contingent on implementation of the due reforms; #4) to spend BGN 116mn more subsidies for tobacco produce – which is vital for the Turkish minority that is largely dependent on tobacco-related incomes.

We see limited implementation risk for the austerity measures

Bulgarian fiscal situation allows the country to use fiscal policy more aggressively

There is, we believe, limited implementation risk for the planned austerity measures, particularly given the strong track record of the country in doing what is needed in times of tribulation. Moreover, the budget revision envisages a fiscal buffer (contingency reserve) of BGN 1.2bn (1.8% of GDP), which represents an additional guarantee that there is no immediate risk for the sustainability of Bulgarian public finances. What the government fiscal package lacks is a credible plan for bringing back the budget deficit to zero, as soon as the economic upturn takes a firmer hold. One additional factor that helps to explain market anxiety is the – in our view – faulty communication strategy of the Bulgarian government on economic policy matters. It arguably is characterized with a lot of controversy, which sometimes even reaches cacophonic proportions. Apart from these, however, we believe Bulgaria's fiscal metrics will remain strong. In contrast to many other emerging markets, Bulgaria entered the recession with lower government debt and a significant budget surplus. This allows the country to use fiscal policy more aggressively and for a longer period of time, without fiscal sustainability being called into question. What's more, the scale of fiscal consolidation, which Bulgaria needs to implement from 2011 onwards, looks smaller when compared with that required in other peer countries. Thus, Bulgaria's recovery is likely to be less burdened by impending fiscal consolidation when compared with its neighbors. The Bulgarian government, in our opinion, has the will to push through further austerity measures, if such are proved necessary to avoid deterioration in the country's fiscal fundamentals, as demonstrated by the prompt reaction of the government at the deterioration of public finances during the first part of this year.

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