BULGARIA: In limbo, expecting a reset

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Bulgaria's economic and political scene has been recently dominated by the early elections due in October and the collapse of the Corporate Commercial Bank. Somewhat ironically, economic activity had been on the rise in recent months and GDP growth for 2014 as a whole may thus come close to 2%. The expectations are that the upcoming elections will bring about a paradigmatic change in terms of power and policies. Solving the situation created by the Corporate Commercial Bank will also have to await the election of a new parliament and the appointment of a new government.

During the summer months, Bulgaria's economic and political scene was dominated by two main developments: the early elections due in October and the repercussions of the failure of the Corporate Commercial Bank (CCB). Actually, the dynamics of these two developments were closely linked in a one-way causal relationship: the power vacuum after the resignation of the government prevented an immediate bailout action and in all likelihood made any possible subsequent intervention by the authorities more expensive.

The caretaker government that took office in August, after the decision to dissolve the parliament, has no mandate to introduce policy changes, or intervene in the CCB debacle. The economy has been driven by the policy inertia left behind the outgoing centre-left government. On the positive side, there were some favourable carry-over effects of the fiscal stimulus introduced in the previous months that contributed to a modest economic upturn in the course of 2014. GDP growth actually accelerated in the second quarter of 2014 to 2.1% year-on-year, after the 1.4% rate of growth recorded in the first quarter. On the demand side, this upturn was supported by a modest recovery in exports while imports were on a downward trend. Consequently, net exports made a positive contribution to GDP growth in the second quarter, in contrast to a significant negative contribution in the first quarter. Both private consumption and gross fixed capital formation made positive contributions to GDP growth in the second quarter.

Some of these demand-side developments resulted from changes in the environment (both external and internal); others partly contain policy-related effects. The ongoing recovery in total exports was largely due to an upturn in import demand on the part of traditional EU markets while exports to third countries actually dropped from their 2013 levels. The opposite trends in exports and imports are also consistent with price-related real exchange rate developments: in 2013-2014, Bulgaria experienced a very pronounced deflation (one of the strongest within the EU) which was equivalent to a depreciation of the real exchange rate. On the policy side, although the previous government could not put in place a formal reindustrialisation programme, as had been the intention, some public support measures effectuated through the Development Bank (such as promotional export credit as well as subsidised credit to SMEs) also contributed to the recovery in exports. Public investment expenditure continued to expand in the second quarter, supported by better absorption of EU funds, and contributed to the overall recovery in fixed investment while the rise in pensions introduced in January supported the modest upturn in private consumption.

On the other hand, the lingering political uncertainties that overshadowed the functioning of the centre-left government from the moment of its inception in mid-2013 had lasting negative implications affecting, in particular, investor and consumer confidence. Among other things, this – together with the deflationary pressure – triggered wage restraint in 2014: average nominal monthly wages in the first half of 2014 were below their average for 2013 as a whole. However, given the recorded deflation, real wages in the first half of 2014 were above their level in the same period of the previous year.

The lacuna in the policy process may have negative implications for the fate of the CCB which was placed under conservatorship by the Bulgarian National Bank (BNB) in June.[1] CCB is one of the big players in the Bulgarian financial system and the only one in this class in which domestic investors have a controlling stake. While the Bulgarian banking system as a whole was and remains in good financial health, in recent years CCB governance has been gradually taking the wrong course.

CCB was for years the darling of the Bulgarian ruling elite, no matter which party was in power at any given moment. Thanks to cosy relations with the political establishment, the CCB managed to establish a dominant position in servicing state-owned companies. At one point in time it was estimated that some 75% of the deposits of state-owned companies were concentrated in CCB. On average, these were large funds of a long-term nature which, on the one hand, created an unfair advantage of CCB within the banking system and, on the other hand, established an environment inciting opportunistic behaviour both for bank insiders and the political establishment. Apparently, over time this led to distorted insider lending practices which gradually eroded the quality of the bank asset portfolio.

Still, probably the situation would not have been totally out of control if it had not been for a clash between two personalities: the main CCB shareholder (a physical person) and a local oligarch who was a key client of the bank. The dispute started in late 2013 and escalated over time; in the end, the oligarch, who controls a local media empire, started an open media campaign against the bank. The upshot was a run on the bank in late spring of 2014 and, consequently, the CCB was placed under conservatorship by BNB.

BNB was in favour of a quick bailout solution involving public intervention, dividing CCB into two banks: ‘good’ and ‘bad’, arguing (probably correctly) that a quick solution would be cheaper than a delayed one. However, under the currency board, BNB has no instruments of direct intervention; it cannot even extend short-term liquidity support to any bank. So any bailout solution by definition would involve the government and, in case of extraordinary public borrowing, the parliament as well. Unfortunately, the timing of this proposal coincided with the last days of the parliament which were marred by bitter political infighting. Incidentally, no such decision was reached before the resignation of the government and the dissolution of the parliament. Subsequently, BNB tried also the other possible option to save the bank: coordinating, through moral suasion, the main shareholders in a dialogue on a bailout option through a

[1] Conservatorship implies the removal of the previous bank management, appointment of syndics as transient management (with the main task to undertake a detailed audit) and the temporary suspension of all bank operations.

new capital injection. However, so far this has not produced workable outcomes as shareholders insisted on government involvement in the bailout and the parallel injection of public funds.

Thus, at the moment of writing, the CCB case was still hanging in the air, awaiting the election of a new parliament and the appointment of a new government. An internal audit (part of the conservatorship action) was still under way but the extent of the CCB problems (including its solvency) was still unclear, partly due to major flaws in internal book-keeping at the bank, as revealed by the audit. In the meantime, depositors whose money remained blocked in the CCB became more and more nervous, staging various protests and demonstrations.[2] Given the present deadlock they cannot even withdraw the guaranteed part of their deposits (EUR 100,000 in accordance with EU rules): for this to happen, the bank must be declared insolvent. In any case BNB is reluctant to take such a critical decision on its own in the absence of a working parliament and functioning government.

Given this unstable and uncertain environment, it is somewhat ironic that economic activity in the country has been on a rising course. One might even speculate that the political lacuna relieved businesses from some hampering administrative controls and intrusions. Also ironically, the Russian sanctions on the EU will probably have a negligible effect on the Bulgarian economy, as during the past couple of decades Bulgaria has lost almost completely its share on the Russian market for agro food products. Anyhow, the country is likely to remain in limbo until there will be a new government following the October elections. The prevailing expectations are for a return to power of GERB[3] (on their own, or in coalition), which ruled the country until February 2013. In any case, the government changeover is likely to bring about a reset in the paradigm of power and changes in the policy course.

At the economy-wide level, the dynamics of total bank deposits during and after the CCB failure was an indication that the public still has confidence in the banking system as a whole. After a general wave of panic withdrawals at the time of the CCB failure, money started to flow back to the banks and, according to preliminary estimates, by September the level of deposits in the banking system as a whole had recovered.

Overall, GDP growth in 2014 is likely to be marginally higher than that recorded in the previous two years. Deflation is also likely to feature throughout the year and be reflected in the average annual figures, impacting negatively, among other things, on fiscal revenues. Given that a public intervention in some form of a bailout of CCB seems inevitable, the fiscal outcome for 2014 (and probably 2015 as well) is likely to deteriorate further. Depending on the extent and timing of the bailout, the deficit can be higher than indicated in the table.

The recent dynamics of trade flows discussed above suggests a positive current account balance in 2014 and probably in 2015 as well. Developments in 2015 and 2016 will very much depend not only on the external environment (which remains precarious) but also on the policy course that will be followed by the new government. The GDP growth forecasts for these years reflected in the table can be regarded as optimistic in the sense that they assume a continued moderate upturn in domestic demand (both private consumption and fixed investment) and uninterrupted modest rise in exports.

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2 The CCB failure also revealed that Bulgarian deposit insurance regulations are not aligned with the respective EU directives, due to which the EC alerted the government of possible infringement proceedings against Bulgaria.

3 The Bulgarian acronym for the name of the centre-right party ‘Citizens for European Development in Bulgaria’.

Table 1 / Bulgaria: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013	2014	2014	2015	2016
					January-June			Forecast	
Population, th pers., average 2)	7,396	7,348	7,306	7,265	.	.	7,270	7,250	7,230
Gross domestic product, BGN mn, nom.	70,511	75,308	78,089	78,115	35,592	35,614	78,800	81,400	85,200
annual change in % (real)	0.4	1.8	0.6	0.9	0.3	1.8	1.9	2.3	2.6
GDP/capita (EUR at exchange rate)	4,900	5,200	5,500	5,500	.	.	5,500	5,700	6,000
GDP/capita (EUR at PPP)	11,000	11,700	12,100	12,300	.	.	.	.	.
Consumption of households, BGN mn, nom.	43,990	46,725	51,056	48,926	23,588	23,301	.	.	.
annual change in % (real)	0.0	1.5	3.7	-2.3	-2.7	1.9	2.0	2.5	3.0
Gross fixed capital form., BGN mn, nom.	16,077	16,225	16,701	16,170	7,019	7,037	.	.	.
annual change in % (real)	-18.3	-6.5	4.0	-0.3	-4.9	3.9	4.0	5.0	6.0
Gross industrial production 3)									
annual change in % (real)	2.1	5.8	-0.3	-0.1	-1.9	3.9	3.5	4.5	6.0
Gross agricultural production									
annual change in % (real)	-6.0	-2.5	-10.0	0.4	.	.	.	.	.
Construction industry 4)									
annual change in % (real)	-14.9	-12.8	-0.7	-5.3	-3.8	4.2	.	.	.
Employed persons, LFS, th, average 5)	3,053	2,950	2,934	2,935	2,898	2,937	2,960	2,990	3,020
annual change in % 5)	-6.2	-3.4	-1.1	0.0	0.5	1.4	1.0	1.0	1.0
Unemployed persons, LFS, th, average 5)	348	372	410	436	446	407	400	390	370
Unemployment rate, LFS, in %, average 5)	10.2	11.2	12.3	13.0	13.4	12.2	12.0	11.5	11.0
Reg. unemployment rate, in %, end of period	9.2	10.4	11.4	11.8	10.7	10.7	.	.	.
Average monthly gross wages, BGN	648.1	685.8	731.1	807.5	788.7	806.5	.	.	.
annual change in % (real, gross)	3.9	1.5	3.5	9.5	1.1	4.5	.	.	.
Consumer prices (HICP), % p.a.	3.0	3.4	2.4	0.4	1.6	-1.7	-1.0	1.0	2.0
Producer prices in industry, % p.a.	8.5	9.2	4.4	-1.5	0.4	-2.0	.	.	.
General governm.budget, EU-def., % of GDP									
Revenues	34.3	33.6	35.0	37.2	40.7	44.1	.	.	.
Expenditures	37.4	35.6	35.8	38.7	39.1	43.1	.	.	.
Net lending (+) / net borrowing (-)	-3.1	-2.0	-0.8	-1.5	1.6	1.0	-3.5	-2.5	-2.0
Public debt, EU-def., % of GDP	16.2	16.3	18.4	18.9	17.5	20.3	23	25	26
Central bank policy rate, % p.a., end of period 6)	0.18	0.22	0.03	0.02	0.01	0.05	.	.	.
Current account, EUR mn	-534	33	-454	857	205	-66	700	300	0
Current account, % of GDP	-1.5	0.1	-1.1	2.1	1.1	-0.4	1.7	0.7	0.0
Exports of goods, BOP, EUR mn	15,562	20,265	20,771	22,271	10,643	10,290	22,200	22,800	23,500
annual change in %	33.0	30.2	2.5	7.2	7.7	-3.3	-0.3	2.7	3.1
Imports of goods, BOP, EUR mn	18,326	22,421	24,231	24,701	11,909	11,898	25,000	26,000	27,000
annual change in %	15.4	22.3	8.1	1.9	-0.5	-0.1	1.2	4.0	3.8
Exports of services, BOP, EUR mn	5,012	5,354	5,696	5,739	2,216	2,473	6,000	6,100	6,200
annual change in %	2.0	6.8	6.4	0.8	-2.5	11.6	4.5	1.7	1.6
Imports of services, BOP, EUR mn	3,143	3,037	3,426	3,476	1,622	1,768	3,500	3,600	3,700
annual change in %	-13.1	-3.4	12.8	1.5	-1.8	9.0	0.7	2.9	2.8
FDI inflow (liabilities), EUR mn	1,152	1,330	1,142	1,157	825	751	1,200	1,300	1,500
FDI outflow (assets), EUR mn	174	117	270	183	81	96	.	.	.
Gross reserves of NB excl. gold, EUR mn	11,612	11,788	13,936	13,303	13,406	13,085	.	.	.
Gross external debt, EUR mn	37,026	36,295	37,714	37,335	37,544	37,043	.	.	.
Gross external debt, % of GDP	102.7	94.3	94.5	93.5	94.0	91.9	.	.	.
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
Purchasing power parity BGN/EUR	0.8680	0.8780	0.8817	0.8982	.	.	.	.	.

1) Preliminary. - 2) According to census February 2011. - 3) Enterprises with 10 and more employees. - 4) All enterprises in public sector, private enterprises with 5 and more employees. - 5) From 2012 according to census February 2011. - 6) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.