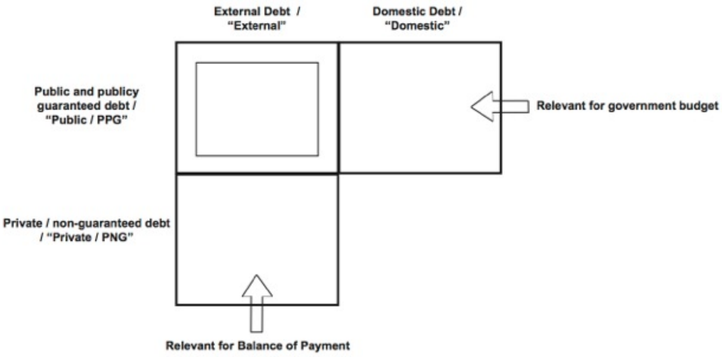
Bulgaria and its debt vulnerabilities

1. Low public debt, but high external debt

Bulgaria has very low and manageable public debt in the range of 20% of Gross Domestic Product - clearly below the European indicative threshold of 60% established in the Maastricht treaty. By the beginning of the last decade it was still closer to 60%, but fell to below 20% since.

Still the country is not free of debt problems: While the public external and domestic debt is manageable. Its total external debt (the section marked as "relevant for the balance of payments" in the graph) was almost US-$ 51bn or 94.8% of Gross National Income at end-2012. This is even above the average and median of the presently high debt levels in the Eurozone.



The reason for this contradiction at first sight lies in the very high level of private non-guaranteed external debt. At end-2012 86.3% of GDP were owed by <u>private</u> Bulgarian individuals, companies and banks to creditors outside Bulgaria, while the <u>public</u> sector was only lightly burdened with external debt, namely 8.5% of GDP.[1] So the lower section of the above scheme was extremely large, while the upper one (marked with the square) was extremely small.

One may assume that given the low public debt the country's public finances are safe from debt risks, because formally there is no public liability for the external debt of the Bulgarian private sector. This, however, was also the scenario in Spain and Ireland at the beginning of the Eurozone crisis: Low public debt and exorbitant exposure of the countries' private (banking and real estate) sectors to investors from abroad. When the Irish and Spanish banks and real estate companies faced difficulties in 2008/9, both governments were pressurized by European partners into guaranteeing the investments made by European and non-European investors into their economies. As a result the states had to borrow themselves in order to enable themselves to keep their banking sectors afloat.

Bulgaria: Gross External Debt

	2012 Est.	2013 Proj.	2014 Proj.
	(Percent of GDP)		
Total	94.8	92.7	92.7
Excluding intercompany lending	55.4	53.9	54.9
Net of international reserves	16.2	18.1	16.1
Public	8.5	7.4	9.3
Private	86.3	85.2	83.4
o/w: Short term nonbank 1/	15.3	15.7	15.8
Loans	10.6	11.0	10.9
Trade credit	3.5	3.5	3.5
Amortization of MLT debt	1.1	1.2	1.3

Sources: BNB; NSI; and IMF staff estimates.

1/ At remaining maturity; excluding intercompany lending.

This is the most critical scenario for Bulgaria, too, although the Bulgarian banking sector looked healthier than those of Ireland and Spain at the beginning of the Global Financial Crisis.[2] Additionally, bank debt stands only for about one fourth of the private sector's external debt, while more than half is inter-company lending from external "mothers" to their Bulgarian "daughters".

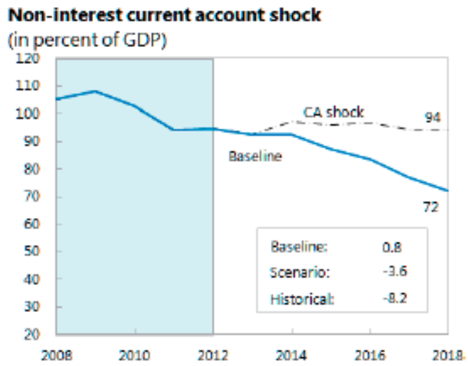
What exactly could now trigger a crisis in Bulgaria, which through a destabilization of the banking sector could jeopardize public financial stability?

Observers agree that the most important threats to financial stability are:

[1] See table, taken from: IMF: Bulgaria 2013 Art.IV Consultation; IMM-Country Report 14/23, p.33

[2] Crisis Talk: Bulgaria and the Financial Crisis; Oct. 29th 2008.

- A current account shock would stabilize the total external debt at around 95% of GDP, rather than allowing it to reach 72% in 2018 (see Graph). Such a shock could be triggered by problems with the provision of gas from Russia through crisis-ridden Ukraine. It shows that in its projection for the period 2012-2018 the IMF had assumed the current account balance to be an annual +0.8% on average until 2018, and the shock scenario -3.6%, while the historical data were -8.2% through the last decade. So the projected reduction of Bulgaria's debt in relation to its economic capcities in built on very optimistic assumptions regarding its external balance (mainly trade in goods and services) which has not been met in the past decades.



- Any problems the small and very open Bulgarian economy may face with regard to its EU export markets.
- Bulgaria presently has one of the lowest tax rates in the EU, but is under pressure from Central and Western European fiscal authorities to reduce this comparative advantage by raising corporate taxes. Were this to happen it might have a strong impact on the inter-company lending, which represents almost half of the private non-guaranteed external debt of Bulgaria, and consequently the balance of payments in the coming years.

2. Debt Relief

Bulgaria has obtained debt relief from its official Paris Club creditors in the early 1990s. However the three arrangements in 1991, 1992 and 1994 only provided restructurings, i.e. a prolongation of repayment periods without any debt write-off.

On the other hand, Bulgaria wrote down most of its own claims on some former allies of the Eastern bloc under the HIPC Initiative: Afghanistan, Ethiopia, Nicaragua, Mozambique, Guinea and Tanzania. Spectacular write-down were additionally implemented for Iraq (write-down of a US-$ 3.6bn claims against a cash payment of 350m) in line with the 2004 Paris Club agreement, and for Libya in the context of the bizarre "Bulgarian Nurses" crisis in 2007.

At present there is no reason for the Bulgarian authorities to raise issues about its external debt sustainability with the country's creditors. However, under any of the above mentioned crisis scenarios this could change quickly.

Jürgen Kaiser, July 21st 2014