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Bulgaria:

On track with the IMF and with its supply-side revolution

- **An improving credit story.**
- **We maintain our long-held overweight in Bulgaria.**
- **The government and the IMF agree on a prudent 2002 budget.**
- **Tax cuts are being introduced.**
- **Resources are being directed to the disadvantaged.**
- **Acceleration of state asset sales and restructuring of state monopolies.**
- **Bulgaria has outperformed the EMBI+ under a variety of circumstances in both spread and total return terms.**
- **Investors are bullish on Bulgaria.**
- **Deficit target for 2002 can be met.**

An Improving Credit Story

We have considered Bulgaria an improving credit story for over three years in part because the previous government adopted and implemented monetary and fiscal policies that led to macroeconomic stability[1]. In addition, Bulgaria has had solid success in attracting foreign direct investment, especially green field and brown field investment, and has benefited from substantial budgetary support from multi-lateral institutions. More recently we have expressed our conviction that the government formed in July would maintain the currency board, implement prudent fiscal policies, and gain the support of the IMF, while at the same time lowering tax rates and adopting more effective measures to sell state assets[2].

In this article we maintain our long held overweight in Bulgaria because we expect the government's sensible policies combined with its strong relationship with the IMF, World Bank, and EU, to fuel continued outperformance relative to the EMBI+ while offering much lower volatility. We are impressed with the recent progress the government has made in introducing its supply side and social support revolution and in reaching an agreement with the IMF over the 2002 budget and macroeconomic framework. We also note that investors have responded positively to the new government as indicated by the outperformance of Bulgaria's Bradys and by this month's JPMorgan investor survey showing that our clients have added additional amounts of Bulgaria to their portfolios. Finally we examine two inter-related areas that have been concerns for international investors—the government's fiscal performance and plans for 2002 and the deteriorating current-account balance—and conclude that Bulgaria's new government will implement policies to allay those concerns.

The Government and the IMF Agree on a Prudent 2002 Budget

On 19 August Prime Minister Simeon Saxe-Coburg announced an economic and social strategy that promised supply side tax cuts, attainment of high and stable growth, creation of jobs, and increased transfers to the disadvantaged. Shortly thereafter, the IMF indicated that the announced tax cuts could make negotiations between the government and the Fund more difficult. The IMF's strong negative reaction to the Prime Minister's strategy, in our view, was based on the following central idea: a country with a currency board needs balance of payments inflows in order to experience monetary growth[3]. Stagnant or declining monetary aggregates would likely lead to a sharp slowdown in economic growth. That being noted, the

1 See for instance "Bulgaria: An Improving Credit Outlook," Chase's *Next Week* dated October 23, 1998, and "Inklings of a Bulgarian Renaissance: An Example for Russia," Chase's *Next Week* dated January 29, 1999.
2 See "Bulgaria: Supply Side Revolution Unlikely to Endanger Investors' Attraction to Bulgarian Bradys," *EM Today* dated 21 August 2001.

IMF saw the government's proposed measures as leading to a significant increase in the consolidated budget deficit, which in turn would stimulate imports and worsen an already alarming current-account deficit. Bulgaria, according to our perception of Fund thinking, cannot afford a truly large current-account deficit until it proves it can attract capital-account inflows that would more than compensate for its current-account shortfalls.

After negotiating with two IMF missions to Sofia, the government and the IMF recently agreed on a 2002 consolidated budget deficit target equal to 0.8% of projected GDP, and the government expects to keep the 2001 budget deficit under 1.0% of GDP. The government listened to the IMF's reasoning regarding the link between the current-account balance and monetary growth, while the IMF accepted the government's logic with regard to a variety of tax cuts and social policies. Moreover, both realized that the slowing global economy would negatively affect Bulgarian growth next year, and the 2002 growth forecast was lowered to 4.0% from 4.5%.

Tax Cuts Are Being Introduced

One pillar of the government's strategy is supply side tax cuts that are to be funded by a combination of improved tax collection and a reduction in the size of government. In late October, the government and the IMF agreed that, starting in 2002, the corporate profit tax rate for large companies will be reduced five percentage points and personal income tax rates will also decline substantially. The major set back to the government's August proposal was the delay in the introduction of zero tax rate for profit reinvested in machinery and equipment. The IMF felt this idea could easily be abused and would result in an annual loss of revenue in the range of 1.3%-2.0% of GDP. In terms of paying for the tax cuts, the government appointed Emil Dimitrov, formerly of the Finance Ministry and a member of a national anti-corruption movement, as the country's new customs chairman. He has said that the customs authorities may be able to uncover as much as EUR1 billion of illegally imported goods. Collection of the import duties on heretofore unreported imports is expected to compensate for a portion of the above mentioned tax cuts. Separately, the government has announced plans to increase as of January 2002 excises for beer and cigarettes and to require new excise duty labels for packaged coffee, goods sold in duty free shops, and export goods. The Ministry of Finance expects those measures to bring in new revenues equal to at least 0.2% of projected 2002 GDP. Also in late September, the government sent out 2,500 termination notices, fulfilling its commitment to reduce the number of state administrative employees by 10%.

Resources are Being Directed to the Disadvantaged

The second pillar of the government's strategy is to increase the incomes of the most disadvantaged in society, while at the same time introducing policies to create jobs. The cost of these social policies would, according to the government, be partially offset by higher energy prices and by increased entrepreneurship. As of 1 October, the government increased the minimum wage to BGN100 (roughly 36% of the average wage) from BGN 85, having reconsidered its initial promise to set the minimum wage at BGN110. The government also plans to raise pensions by 6.0% next year and to implement two 5.0% increases in budget salaries in January and July 2002. Moreover, the IMF has accepted the government's plan to offer tax concessions to companies that provide jobs for those who have been unemployed for more than two years. In addition, the government has set aside BGN20 million levs (US$9.1 million) to fund a micro credit guarantee fund. Additional funding for that initiative is expected to come from the World Bank. To pay for these social measures, the government introduced on 1 October 10.0% and 6.3% increases in electricity/heating prices and telephone rates.

Let the Private Sector Do It

The third pillar of the government's strategy is to accelerate the sale of state assets, and to liberalize and restructure state monopolies. Already the Privatization Agency has been remodeled into an Agency for Privatization and Post-Privatization Control (APPPC), which will not only be in charge of most of the country's privatization but also will be responsible for ensuring that the commitments made by new owners are indeed observed[4]. The APPC plans to accelerate the sales of large-scale companies, and most companies will

3 Balance of payments inflows, in this instance, are broadly defined to include all unexplained inflows, including the exchange of "foreign exchange under the pillow" for domestic currency.

4 Two exceptions to the APPPC's authority are: the remaining sales of state shares in three banks to be conducted by the Banking Consolidation Company; and the sale of the state's share in the stock exchange and some other minor transactions to be conducted by the Economy Ministry.

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be sold via an auction procedure in which the highest qualified bidder will be the winner or via well publicized and transparent tenders. With regard to state monopolies, the government intends to liberlize the telecommunications sector-first improving that sector's legal framework, then abolishing the state monopoly of the Bulgarian Telecommunications Company (BTC), and finally privatizaing BTC. The government also envisions a similar liberalization of the energy sector, and hopes to develop Bulgaria into an energy hub. In addition, the government has ended the previous administration's support of management/employee buyouts.

Market Outlook

Besides being impressed with the above mentioned government policies, investors see Bulgaria as a relatively high-yielding safe haven in part because Bulgaria has outperformed the EMBI+ under a variety of circumstances in both spread terms and total returns.

In *Table 1*, we examine the bond performance of Bulgaria relative to that of its peers. During the period 5 June (12 days before the country's elections) and 10 September, the spread on Bulgarian IABs narrowed 38 bps, while the EMBI+'s spread widened 165 bps. In that period, Bulgaria outperformed Argentia, Brazil, the Philippines, Russia and Turkey. Moreover, this was a time when the collapse and volatility of Argentin spreads sent tremors throughout the emerging market universe.
In the period 10-18 September (the immediate aftermath of the bombings in the United States), Bulgarian IABs widened 43 bps, better than the EMBI+ and all countries in Table 1 with the exception of the Philippines. For the period of 10 September through 29 October, the spread on IABs widened much less than the spreads on the EMBI+ and many of its components. Only the Phillippines and Turkey did better than Bulgaria during that period.
Total return evidence has been even more compelling. During 5 June - 29 October, the Bulgarian component of the EMBI+ had a period total return of 2.26% and period volatility of 0.9534 compared to the EMBI+ period return of -7.26% and period volatility of 1.0971.

Table 1
Bulgaria's medium-term bonds compared to those of Argentina, Brazil, the Philippines, Russia, and Turkey.
(indicative information as of close on October 29, 2001 unless otherwise noted)

Bond / Coupon	Moody's/S&P Ratings	Spread Duration	5 Jun '01 Ask Spread	10 Sep '01 Ask Spread	18 Sep '01 Ask Spread	29 Oct '01 Ask Spread	5 Jun - 10 Sep Spread change	10 Sep - 29 Oct Spread change
Bulgaria IAB Jul '11 6L +13/16	B2 / B+	5.11	593	555	598	591	-38	36
Argentina Dec '08 7.00	Caa3 / CCC+	3.44	1000	1740	1866	2534	740	794
Brazil Oct '09 14.50	B1 / BB-	4.45	798	919	1006	1119	121	200
Philippines Apr '08 8.875	Ba1 / BB+	4.73	478	520	528	546	42	26
Russia Mar '10 8.25	B3 / B	4.44	839	811	863	899	-28	88
Turkey Jun '09 12.375	B1 / B-	4.49	819	908	968	901	89	-7
EMBI+ Composite Spread			735	900	964	1068	165	168

Source: JPMorgan.

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The October JPMorgan client survey provides independent evidence that investors are bullish on Bulgaria (see *EM Today* dated October 30, 2001 for the survey's full details). During October our clients added more significantly to their Bulgarian positions than to their positions in any other country. In fact, as of late October, dedicated EM accounts, crossover investors, and trading accounts were all significantly overweight Bulgaria. Moreover, Bulgaria as of late October ranked third in our list of biggest overweights, after "cash" and Russia. While the technicals suggest some caution regard overweight Bulgaria, we believe that the new government will continue to impress investors with sensible fiscal policy and an ability to attract foreign direct investment.

This year's fiscal performance suggests the 2002 deficit target can be met

The outcomes of the consolidated budget during the first three quarters of this year (*Table 2*) give support to our opinion that the government can stay within its 2002 fiscal deficit target of 0.5% of GDP. We make six observations, all in terms of % of full year GDP.

Table 2

Consolidated state budget outcomes, Jan-Sep 1999-2001

(IMF definition as % of full year GDP unless otherwise indicated)

	1999 Jan-Sep	2000 Jan-Sep	2001 Prel, Jan-Sep
Total revenue	**30.7%**	**31.3%**	**30.9%**
Tax revenue	**23.7%**	**24.6%**	**24.1%**
Profit taxes	2.7%	2.3%	3.4%
Income tax	3.3%	3.0%	2.8%
VAT	6.1%	6.6%	6.3%
Excises	2.4%	2.3%	1.9%
Customs duties, customs and export charges	0.8%	0.6%	0.5%
Social security contributions	7.3%	8.2%	7.7%
Property taxes and others	1.2%	1.5%	1.6%
Non-tax revenue	**6.3%**	**6.1%**	**5.7%**
Grants and donations	**0.6%**	**0.6%**	**1.1%**
Total expenditure	**30.9%**	**30.5%**	**31.4%**
Current non-interest expndt.	**24.3%**	**24.2%**	**24.8%**
Interests - total	3.6%	3.8%	3.7%
Interests on foreign credits	2.9%	3.0%	3.0%
Interests on domestic credits	0.7%	0.8%	0.7%
Capital expenditure	**3.0%**	**2.5%**	**2.9%**
Budget balance	**-0.2%**	**0.9%**	**-0.5%**
Memorandum item:			
Full year GDP, BGN bns	22,776	25,454	28,461

Source: Romanian Ministry of Finance.

- Total revenue, tax revenue, revenue from VAT, and social security contributions during January-September 2001 were at the average of the outcomes for the previous two years. For next year, we see the decline in profit and personal tax rates being offset by: (1) increases in excise taxes and improvement in the collection of customs duties; and (2) continued generous grants and donations from abroad.
- Profit tax collection in 2001 has been excellent even though the corporate profit tax rate in 2001 was five percentage points lower than in 1999-2000.
- Personal income tax collection in 2001 has been lower than in previous years in large part because personal income tax rates have declined in both 1999 and 2000 to compensate employees for the new health care and pension contributions they are obliged to cover.
- Excise tax collection has fallen in 2001 relative to earlier years in part because the tax has been set at a nominal amount per item. For 2002, excise taxes on beer and cigarettes will be raised and excise duty labels will be required for a wider array of goods. That should lead to better excise tax collection next year.
- Collection of customs related duties and charges has been on a declining trend. According to the new government, this has been due in a large part to the corruption of the previous customs administration. The government has promised to rid the customs administration of the bribe taking that has cheated the government out of its customs duties.
- Property taxes and other taxes have been growing. We expect this to continue in 2002 as successful Bulgarian entrepreneurs and foreign investors amass more property in Bulgaria.
- Current non-interest expenditure in 2001 has been about 0.5% of GDP above the outcomes of pervious years. We attribute this increase to additional pension payments and some pre-election spending. We do not anticipate any pre-election spending next year, and the 10% reduction in state administrative employment should also help to keep current non-interest expenditure under control even though social spending will increase next year.

The balance of payments: The government realizes the potential dangers

As we mentioned above, a currency board needs balance of payments (BOP) inflows in order to experience monetary growth. Stagnant or declining monetary aggregates would likely lead to a sharp slowdown in economic growth. For the first eight months of this year, the overall BOP balance was -US$213 million versus -US$178 million during the same period of last year (*Table 3*).

Moreover, the financing of the BOP outflow has changed in 2001 because Bulgaria has become a net repayer to the IMF and has also received less "other BOP support". The upshot is that during the first eight months of 2001 the FOREX reserves of the Bulgarian National Bank (BNB) decline by US$290 million versus a decline of US$47 million in the same period last year. While broad money in Bulgaria has grown this year because of an increase in the money multiplier (banks have upped their lending activity), the outflow of BNB FOREX reserves is simply unsustainable.

Table 3

Bulgaria balance of payments[1]

(in USD millions, unless indicated otherwise)

	H1 '00	Jul-Aug '00	Jan-Aug '00	2000	H1 '01	Jul-Aug '01	Jan-Aug '01
A. Current Account Balance	**-431.6**	**94.2**	**-337.4**	**-701.6**	**-412.9**	**-17.0**	**-429.9**
as a % of full-year GDP	-3.6	0.8	-2.8	-5.8	-3.0	0.1	-3.2
Goods exports	2283.7	837.4	3121.1	4824.6	2510.5	883.5	3394.0
Goods imports	-2823.9	-979.7	-3803.6	-6000.2	-3188.2	-1201.8	-4390.0
Balance on Goods	-540.2	-142.3	-682.5	-1175.5	-677.7	-318.3	-996.0
Services: credit	905.6	622.0	1527.5	2175.2	1020.6	736.0	1756.6
Services: debit	-773.6	-307.5	-1081.0	-1669.6	-848.3	-396.7	-1245.0
Balance on Services	132.0	314.5	446.5	505.5	172.4	339.3	511.6
Income: credit	156.9	66.7	223.6	323.0	189.0	65.2	254.2
Income: debit	-319.8	-201.0	-520.9	-644.2	-332.3	-181.7	-514.0
Balance on Income	-162.9	-134.3	-297.3	-321.2	-143.3	-116.5	-259.8
Current transfers, net	139.6	56.3	195.9	289.7	235.7	78.5	314.2
B. Capital Account Balance [2]	**25.0**	**0.0**	**25.0**	**24.9**	**0.0**	**0.0**	**-0.1**
Capital transfers, net	25.0	0.0	25.0	24.9	0.0	0.0	-0.1
C. Financial Account Balance [2]	**207.2**	**-130.6**	**76.5**	**883.2**	**280.8**	**-39.7**	**241.0**
Direct investment abroad	-1.9	5.2	3.3	1.8	-3.2	-2.2	-5.5
Direct investment, inward	285.8	174.0	459.8	1001.5	410.1	56.4	466.6
Portfolio investment assets	-100.7	-5.2	-105.9	-63.9	-57.0	-69.5	-126.6
Portfolio investment liabilities	-30.6	15.9	-14.6	-114.7	-23.0	-23.8	-46.9
Other investment assets	-9.7	-302.2	-311.9	-136.7	-101.7	111.0	9.3
Other investment liabilities	64.2	-18.3	45.9	195.3	55.7	-111.6	-56.0
D. Net Errors and Omissions	**148.0**	**-90.3**	**57.7**	**-69.3**	**-26.2**	**2.3**	**-23.9**
OVERALL BALANCE	**-51.5**	**-126.7**	**-178.2**	**137.3**	**-158.4**	**-54.4**	**-212.8**
E. Reserves and Related Items	**51.5**	**126.7**	**178.2**	**-137.3**	**158.4**	**54.4**	**212.8**
BNB Forex Reserves [3]	-56.2	103.5	47.3	-409.2	163.7	126.0	289.7
Use of Fund credit, net	94.3	-27.7	66.6	135.9	-5.3	-71.5	-76.8
Other BOP Support, net	13.5	50.9	64.3	136.0	0.0	0.0	0.0

1/ Analytic presentation, adjusted by removing the US$135 million license fee for the second GSM operator from the current account and placing it in the financial captial account, under direct investment in reporting economy. According to the BNB press release of October 26, the US$135 million fee is subject to reclassification. Data are preliminary.
2/ A minus sign denotes a capital outflow (increase in assets or decrease in liabilities).
3/ Excluding valuation changes in BNB FOREX reserves. A minus sign denotes an increase in reservess, a positive sign a decrease.

Source: Bulgarian National Bank, Balance of Payments and External Debt Division; JPMorgan.

Looking at the BOP's components in detail (*Table 3* contains an adjusted presentation to reflect the IMF's handling of the license fee for a GSM operator, see *footnote 1*), we note that:

- The current-account deficit during the first eight months of 2001 equaled 3.2% of full-year GDP compared to 2.8% of GDP during the same period last year. The driving force behind the deteriorating current account has been the widening goods balance. That has occurred because merchandise exports during January-August 2001 grew 8.7% YOY versus a 15.4% YOY rise in merchandise imports. The service balance has remained virtually unchanged since last year, while both the income balance and net current transfers offset some of the widening goods balance. Note that within the services balance, tourism revenue during January-August gew 14.5% YOY. We believe that the current-account deficit will moderate next year due to slower domestic growth, and higher effective taxation of imports as the customs administration works to eradicate unreported imports. Our one concern is that the war on terrorism may discourage international travel in general, and this may negatively affect tourist revenue in 2002.

- With regard to exports, raw material exports (41.7% of all exports) rose only 0.5% YOY during January-August due mostly to declining international metal prices, and lower international demand for metal. Otherwise, export performance has been encouraging. For example, consumer goods exports (32.8% of all exports) increased 18.1% YOY, and one of its important components-clothing and footwear exports (19.9% of all exports) surged 28.4% YOY. The latter result suggests that Bulgarian exports have not yet been negatively affected by Turkish competition even in light of the collapse in the value of the Turkish lira. Given ongoing investment commitments from earlier privatization and the envisioned corporate tax cut, we expect export growth to be solid next year.

- With regard to imports, consumer goods imports (16.7% of all imports) rose 24.2% YOY during January-September 2001, which is worrisome especially because growth in this category accelerated somewhat in July-August. On the other hand, investment goods imports (24.5% of all imports) shot up 11.8% in January-September, which suggests that investment in Bulgaria has remained buoyant. We predict that higher excise taxes and stricter customs control will contribute to slower import growth going forward.

- In the capital account, inward foreign direct investment (FDI) during January-August rose 1.5% YOY, to US$467 million this year (109% of the corresponding current-account deficit) from US$460 million last year (136% of the corresponding current-account deficit). Looking at the capital account, the problem going forward is not just attracting additional FDI, but also securing portfolio and other capital inflows. The new government, with its emphasis on accelerating the sale of state assets to cash investors and on revitalizing the Bulgarian stock exchange, is well placed to improve the country's capital account.

Let us end our BOP discussion with the latest 2001 current-account forecasts from the government, namely a deficit equal to 5.7% of GDP. We believe the IMF will wait until late November when September BOP data are available to revise its 7.0% of GDP current-account deficit forecast for 2001.

In conclusion, we are impressed with the progress the new technocratic government has made in introducing its supply side and social support revolution and in reaching an agreement with the IMF over the 2002 budget and macroeconomic framework. **We believe that Prime Minister's priorities-membership of NATO and the EU—will force the government to stay on good terms with the IMF, World Bank and the EU, which in our view will translate into a steady improvement in Bulgaria's creditworthiness.**

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