The Crisis in the Real Economy and the Stability of the Bulgarian Banking System

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Summary:

The global economic and financial crisis has had a heavy impact on the economies of most European Union member states and the countries all over the world. The crisis in the Bulgarian economy has also been caused by domestic processes and phenomena such as overproduction in a number of key industries – construction, tourism etc., incomplete structural changes in the economy, at times inadequate economic policy. The aim of this article is to analyze the relation between the crisis in the real economy and the state of the banking system as the most important element of the financial institutions. The focus is on the stability of the banking sector, which, despite the potential risks, was not significantly affected by the economic crisis. Despite the existing risks such as more non-performing loans, resource deficit, decline in depositors' confidence in the system, low evaluation of the banks provided by the stock exchange, the financial institutions in the banking sector are stable and solvent. They do not experience liquidity and capital adequacy problems. They maintain a good profitability level, savings are increasing. The crisis as a whole has affected favourably both the commercial banks which tightened their discipline and the government which despite the budget deficit has not taken measures concerning its monetization. The analysis of the real economy crisis and its effects on the banking system gives reasons for drawing the conclusion that the banking sector has experienced a healthy development and has created a favourable environment for the economy to get out of the crisis and recover.

Key Words: macroeconomics, banks, business fluctations

JEL: B22, E32, E44, G21.

The global economic and financial crisis has had a heavy impact on the economies of most European Union member states and the countries all over the world. In some countries it has caused major shocks which prevented their economies from performing properly over certain periods of time. It can hardly be claimed that the economic crisis in Bulgaria is the result of a crisis which started outside the country, although this claim can be substantiated by the fact that the Bulgarian economy is closely related to the European ones and the drawbacks resulting from the reduced export and the decreased rate of foreign investments. The crisis in the Bulgarian economy has also been caused by domestic processes and phenomena such as overproduction in a number of key indus-

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tries – construction, tourism etc., incomplete structural changes in the economy, at times inadequate economic policy. The crisis in the real sector of the economy has affected the developments in the financial sector of the country. However, the impact it has had in Bulgaria is limited, even negligible which determines the effective functioning of the financial structures, the commercial banks in particular.

The aim of this article is to analyze the relation between the crisis in the real economy and the state of the banking system as the most important element of the financial institutions. The focus is on the stability of the banking sector, which, despite the potential risks, was not significantly affected by the economic crisis. The country's banking system is one of the best performing sectors of the economy, which partially mitigates the adverse effects of the crisis on the other economic sectors and activities. The article is divided into two main parts – first, analysis of the crisis in the real economy and second, its impact on the banking system. It explores the risks generated by the inequalities in the economic development which also pose a threat to the stability of the banking sector. An attempt has been made to examine some favourable effects the crisis has had on the commercial banks in the country.

I.

In the first years of the new millennium Bulgaria's economy followed an upward trend, which started after the financial and economic crisis of the mid 90s of the last century. It is only natural that over a decade it would reach a relatively high level (compared to its initial positions) and then fall into a recession. Thus it could be said that the crisis has played the role of a 'health officer' in the economy doing away with unprofitable activities, excessive parameters and a hectic boom in certain activities. The data in Chart 1 indisputably shows that the year 2009 marked the beginning of the real decline in GDP when the European and American economies had already been in a recession for two years. The most sig-

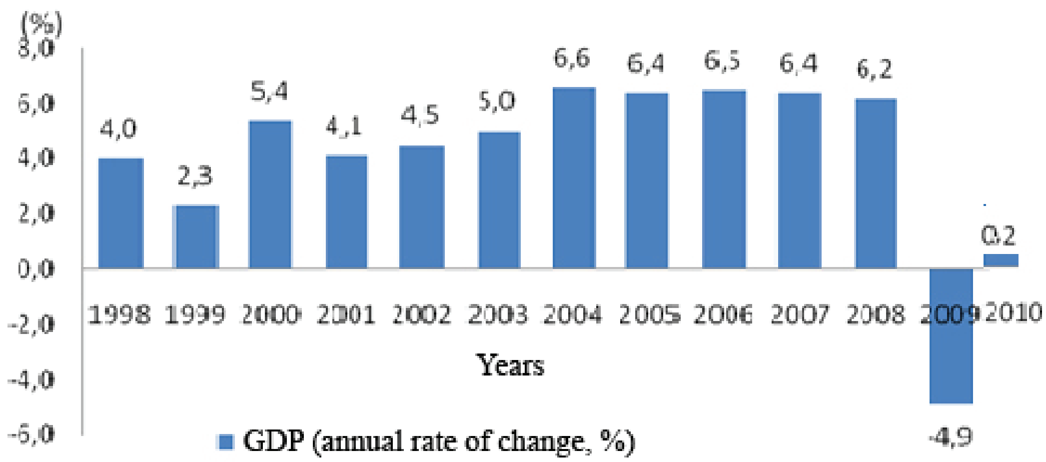

Chart 1. **GDP Real Growth Rate,** % *Source: BNB, NS*

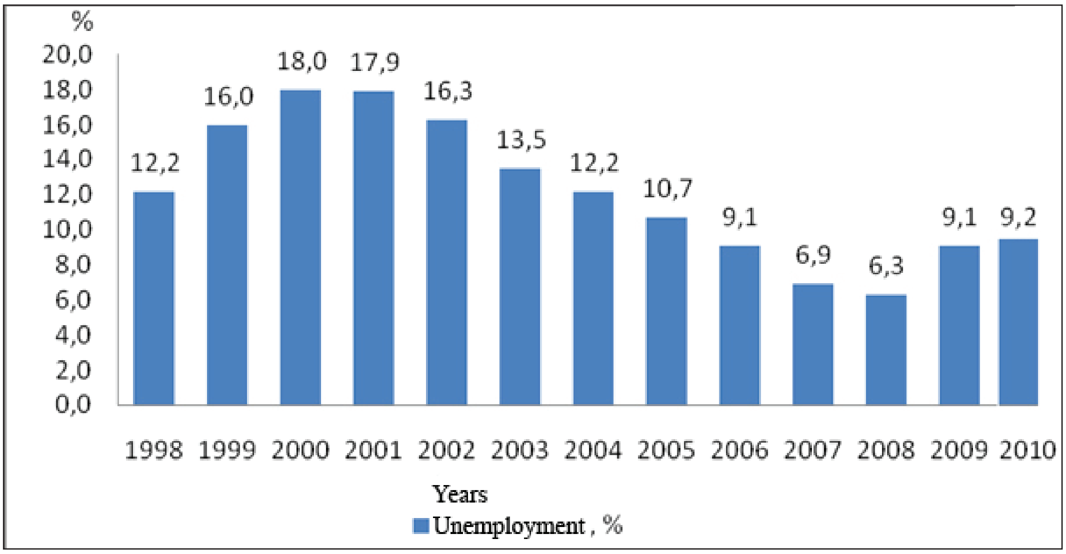

Chart 2. **Unemployment Rate,**%**,** *Source: BNB, NSI*

nificant economic decline was recorded in 2009 when the GDP went down by 4.9% compared to 2008, whereas the domestic value added decreased by 3.3% despite the sluggish revival on a global scale. The drop in sales and incomes in the export-oriented sectors combined with a low purchasing activity of the population on the domestic market. The decrease in the domestic demand for durable consumer goods and investment goods was influenced by factors such as preserving income levels, increase in unemployment rate, especially in the second half of the year, lower inflow of foreign direct investments and low lending rates.

In 2010 the Bulgarian economy started to recover from the crisis at very slow rates and the real growth of GDP reached 0.2%.

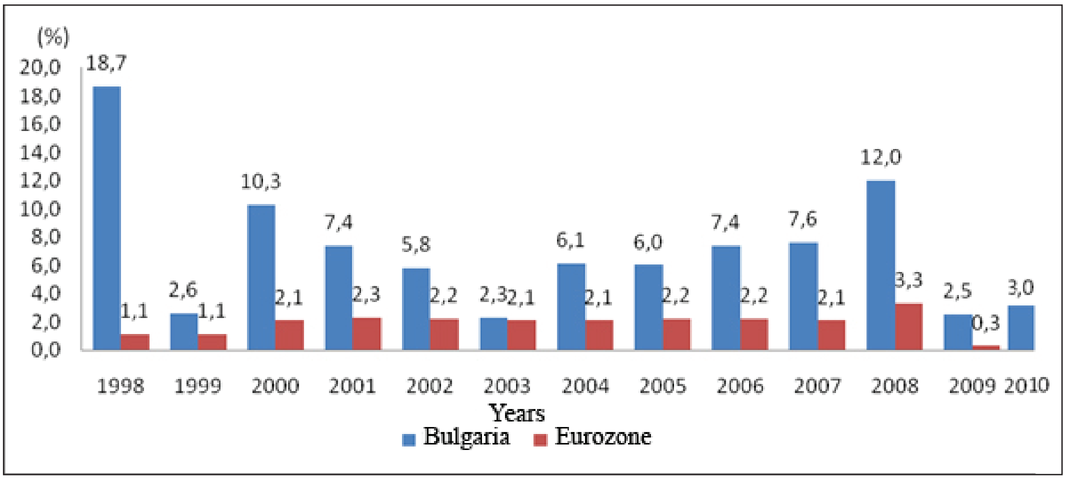

Chart 3. Inflation Level in Bulgaria and Eurozone, %Source: BNB, NSI, Eurustat

Analyses show that Bulgaria's export was the main factor which has contributed to this growth. However, domestic demand - both consumer and investment – kept on falling. The growing unemployment affected unfavourably the income levels, consumption and the standard of living. The expected rate of real GDP growth for 2011 is 1.7%.

The rate of unemployment is yet another major macroeconomic indicator illustrating the unfavourable economic trends. The data in Chart 2 shows that the official rate of unemployment in 2010 was 9.2% of the entire workforce. The year 2009 witnessed layoffs mainly in the manufacturing industry, while in 2010 in the service sector. Above 35% of the registered unemployed are those who have been without a job more than 12 months. The 2011 unemployment level reached nearly 11.4%, but the number of the so-called discouraged workers increased to 235 thousand, which resulted in a much higher real unemployment rate.

Price levels are yet another measurement of the developments and state of the macro-system. Inflation, i.e. the change in the general level of prices in the country, gives an idea about the stability of the pricing sphere and a rise can generate waves of inflationary expectations among businesses and the public. The consumer prices harmonisation index data is presented in Chart 3, which provides a comparison of the inflation rates in the Euro zone member states and those in Bulgaria.

Over the years Bulgaria has experienced a lasting exceeding of the average price level compared to that in the countries which have adopted the euro as a legal tender. The data gives cause for concern among micro politicians since they outline a lasting tendency towards failing to meet one of the main criteria under the Maastricht treaty. The comparisons arrived at in Table 1 give grounds for drawing this conclusion. The inflation rate is the only element of the Maastricht criteria which Bulgaria does not meet. In terms of the other criteria, including the currency which is pegged to the euro, the country mostly fulfils the requirements for the Euro zone membership.

Table 1. Maastricht's Criteria, 2007-2010, Source: Ministry of Finance, Eurostat

	2007		2008		2009		2010	
	Bulgaria	Reference Value	Bulgaria	Reference Value	Bulgaria	Reference Value	Bulgaria	Reference Value
Budget deficit/surplus to GDP, %	0,1	3	1,8	3	-3,9	3	-3,6	3
State Debt to GDP, %	19,8	60	16,2	60	14,8	60	13,7	60
Inflation Rate, HICP,%	7,6	2,8	12,0	4,1	2,5	1,6	1,7	1,0
Interest rate,%	4,5	6,3	5,4	6,2	7,2	6,1	6,0	5,8

II.

The crisis in the real economy has affected the state, dynamics and developments in the Bulgarian banking sector. Its consequences for the banking system can be organised along two lines – negative and positive. The second line focuses on the fact that as a whole the banking sector in the country has preserved its relatively good level of performance and stability. There are no serious structural problems. Bulgarian banks still form one of the most profitable sectors in the economy.

Bulgaria's banking system is the basic integral element of the financial sector. It changes alongside the developments in the real economy, but there are periods when the two processes do not develop in the same direction. This is what we have observed since 2008 when the economy was hit by the crisis and banking intermediation has been a profitable business without experiencing any difficulties.

In fact the Bulgarian banks are stable and solvent. They carry out their functions as usual – lend to businesses and the public and attract savings. Depositors do not abandon the national banks and debtors do not switch to other sources. The reasons for all that are mostly domestic. In the first place they are related to the reasonable monetary policy conducted by the central bank – BNB, and secondly – the actual management of the credit institutions. Naturally, the crisis has posed some risks in front of the banking system. These are related to:

- **Increasing number of non-performing loans** (risk exposure). The 2010 results show an increase in the share of defaults on credit amounting to 11.92% of all loans granted, while for the first quarter of 2011 this percentage grew to 13.2%. This signals an increased insolvency of the receivers of financial resources – both firms and households. The reasons lie in the continuing depression in the Bulgarian economy and the sluggish recovery, which lead to a low income level and employment.

Growth in non-performing loans combined with the unfavourable prospects for the economy lead to shrivelled lending intermediation. The data in Table 2 gives grounds for drawing such conclusions.

Slow lending brings about another risk. It is quite likely that it will make some of the households turn to other sources of lending – for instance, loan offices, which offer a much higher interest in comparison with the interest on consumer loans. Another option that households and medium and small businesses have is to borrow funds from the grey sector of the economy. This would favour criminal structures and increase the dependence of decent market players on the grey sector. At the same time these processes are closely related to a considerable redistribution of low household incomes in the country.

- **Resource insufficiency**. In the first place this involves the potential risk of

Table 2. Credit Intermediation Dynamic, Source: BNB

	1998	2000	2005	2006	2007	2008	2009	2010
Rate of Change,%	64,61	25,66	33,15	23,90	97,22	42,18	3,58	1,10
Share in Bank Assets,%	24,28	30,95	59,57	54,01	75,99	80,17	81,55	79,22
Inflation Rate, HICP,%	8,55	11,84	43,45	46,38	79,45	80,47	84,54	82,86
Interest rate,%	4,5	6,3	5,4	6,2	7,2	6,1	6,0	5,8

withdrawing or redirecting the external funds deposited in the banking system. The crisis decreased considerably the chances for the banks to use long-term resources from their head offices or the capital markets. The liquidity crisis in the big European banks has been deepening since the autumn of 2007 and although BNB lowered the minimum reserve requirements , it has resulted in withdrawing part of the liquidity from Bulgaria. From December 2008 to March 2009 deposits held by non-residents amounting to above 1 bln euro were withdrawn. The most affected banks were those from group 1 – UniCredit Bulbank, DSK Bank, UBB, Raiffeisen Bank, Eurobank EFG, all being subsidiaries of the big European commercial banks. This situation has occurred despite the fact that there is an international agreement called 'Vienna Initiative' between the big European banks, the international financial institutions and the European Commission under which agreement the transnational banks performing in Central and Eastern Europe undertake the commitment to prevent mass withdrawals of assets. In the middle of 2009 BNB sent a letter to the parent banks insisting that they should make an adequate commitment to the local banks, i.e. to prevent bank-runs.

Under the current situation the domestic market has become the main source where banks can find money to settle their debts. This poses two risks which have impact on the entire country – on the one hand, the pessimism that inevitably exists in times of crisis and lack of confidence in the market which caused bank isolation. On the other hand, a deposit war has been declared and banks started to compete for attracting funds by offering high interests, some reaching 10% on a one-year deposit. This pyramid-like type of thinking is controlled by the big banks in the country. And it is only logical that since the price of attracted deposits has become very high, the banks would raise interest rates on loans, fees and commissions out of proportion. Thus, they are building a firewall against future shocks.

Bulgarian banking system does not experience liquidity problems. Bulgarian commercial banks are liquid and solvent. A contributory factor to generating additional liquidity is the adoption of the EU finance ministers' decision (of 07/10/2008) to guarantee all deposits in the member states up to q 50,000, later the ceiling was raised in the commercial banks to the equivalent in leva of £ 100,000 (196,000 leva) in Bulgaria too. It is common knowledge that until then the Bulgarian Deposit Insurance Fund (BDIF) guaranteed deposits of £ 20,000 (around 40,000 leva) in one bank. This level of deposit insurance covers 99.13% of all deposits. As a figure, however, the remaining 0.87% represents a big share – around 20 bln leva or almost 60% of the total deposits. These funds belong primarily to big companies and are extremely mobile. The Bulgarian financial system is an entirely open one and should Bulgaria keep lower levels of guaranteed deposits, this would result in export of finance to the benefit of foreign banking systems which provide higher guarantees.

- **Decline in depositors' confidence in the financial system**. A problem in this respect could be posed by Greek capital due to its strong presence in the Bulgarian banking system. A sixth of the working credit institutions in Bulgaria are Greek, but because of their size they hold a fourth of the assets in the sector. Two of them – United Bulgarian Bank (UBB) of National Bank of Greece and "Eurobank EFG Bulgaria" ("Post Bank") are among the five credit institutions which belong to the first group in terms of their asset size. Other banks that have business in the country are: Piraeus Bank Bulgaria and Emporiki Bank-Bulgaria (whose parent company is Emporiki and is owned by the French Credit Agricole), and Alfa Bank has a branch in our country. Greek banks hold assets amounting to around 20,5 bln. leva, which is almost 20% of the total assets in the Bulgarian banking system which amounted to 74.2 bln. leva at the end of March 2011.

The recession in Bulgaria just like the beginning of the financial crisis has taken some time and has inevitably affected companies' investment projects and consequently – the demand for bank loans. This has affected negatively the profitability in the sector since the banks have a considerable deposit portfolio and due to the high interest rates offered at the moment. This trend is backed by the Greek banks which maintain high deposit interest rates in order to attract clients and to secure the necessary resources. This might be a signal for a forthcoming consolidation in the sector.

- **Levels of interest rates**. As economic risk increases along with the growth in non-performing loans, banks become more conservative in their lending policy. They raise the interest rates on loans to individuals and businesses. The average lending interest rate for businesses in 2011 varied between 10% and 13%, while for households it was between 15% and 18% on credit cards.

To form the lending interest rate banks take into consideration the country risk, the applicant's credit profile, the sector he works in or his business is in, his income etc. To the interest rate we also add fees and commissions for servicing the debt, which subsequently makes the effective interest rate high, sometimes even exceeding 20%.

Generally the country has one of the highest interest rates on loans in Central and Eastern Europe. The interest rates in the Euro zone are much lower since banks there can rely on cheaper resources provided by the European Central Bank – about 1% interest. The rules of the Currency Board which are applicable in Bulgaria rule out refinancing of credit institutions except if there is a systemic risk. The expensive access to funds affects unfavourably business`s investment activity in the first place. This can be seen in Chart 4. The year which marked the most dramatic drop in manufacturing – 2009, also witnessed a considerable decrease in investments – by almost 12% of GDP.

The tendency toward increasing interest rates cannot be defined as predominantly adverse, neither can we blame the banks

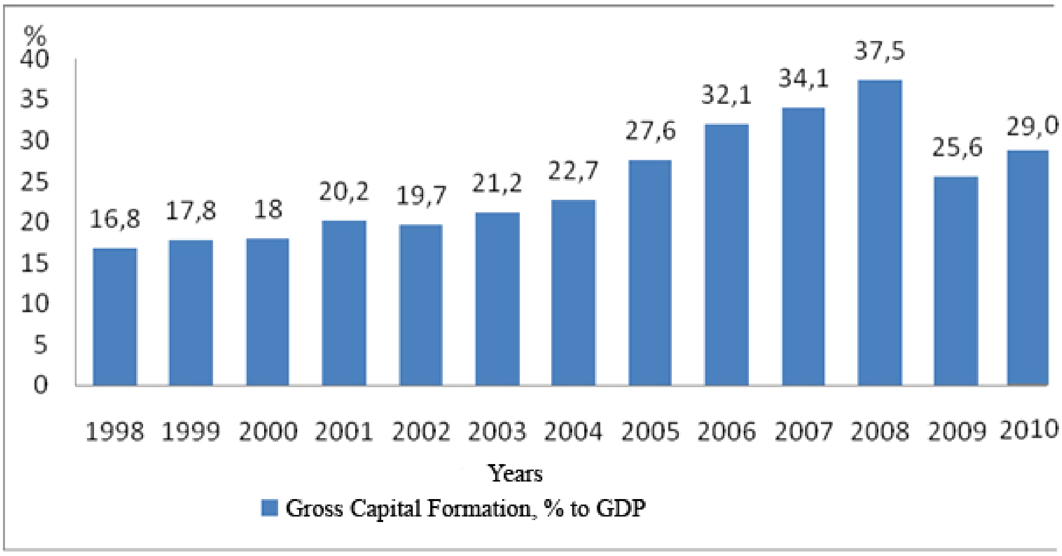

Chart 4. Gross Capital Formation, %, Source: BNB, NSI.

for impeding the investment activity of businesses and the reduced demand of households. Banks are institutions aiming at gaining profits, which determines the high price of their primary product – loans. In a risky situation (for 2011) – unemployment rate exceeding 12%, intercompany indebtedness exceeding 150 bln. leva – almost twice the level of GDP, sluggish economic growth – banks insure themselves against possible losses resulting from adverse selection and moral hazard. High interest rates impose control upon borrowers and streamline the use of the borrowed capital.

- **Low coefficients of stock exchange assessment**. The shares of only four banks are traded on the Bulgarian stock exchange. These four banks are: Corporate Commercial Bank, Central Cooperative Bank, First Investment Bank and Bulgarian-American Credit Bank. Corporate Commercial Bank had the highest assessment for 2010-2011. Two of the other three institutions recorded positive financial results and only Bulgarian-American Credit Bank has had profit problems which are due to the worsened credit portfolio. In general, the evaluation of all banks traded on the stock exchange has been either deteriorating or has remained unchanged since 2009, which points at an unfavourable attitude of the financial markets to the banking sector. This conclusion does not apply to the entire banking system since the prevailing part of the remaining 20 banks and 6 branches demonstrate a healthy financial state as a whole.

The real economy crisis has generated not only negative consequences for the banks in Bulgaria, but it also has had some positive effects on the activities and the state of the banking system. These are related to imposing more effective bank discipline, streamlining banks' activity and gradually reducing the losses resulting from shocks in the real economy. The following several trends, which are far from being exhaustive, can be outlined.

- **The crisis exerts more effective bank discipline**. Banks streamline the process of extending loans by tightening the requirements to their clients. This process is accompanied by raising interest rates – the price of loans, which by applying the rules of reasonable bank policy is seen as a natural process in times of crisis and recession. The conservative behaviour of banks is a prerequisite for their day-to-day functioning and meeting the requirements set out in BNB regulations. This way of performing complies with the basic requirements of the Currency Board under which the Central Bank cannot refinance the commercial banks, which forces them to look for other liquidity sources. Such sources are the funds on the interbank market which for the period between 2009-2011can be described as liquid, stable, giving credit institutions the opportunity to exchange between themselves free financial funds at a relatively low price – of around and below 1%.
- **The profitability in the sector has maintained a reasonable level**. This conclusion is substantiated by the data in Table 3. Despite all difficulties, the commercial banks in Bulgaria are forced to fulfil much more demanding requirements than their counterparts abroad because of the Currency Board implemented in the country. Due to that, their risk exposure is at a lower level, while their capital adequacy is much above the average in Europe. The existing capital buffers guarantee a total capital adequacy ratio considerably above the conservative minimum of 12%, which is required by the Bulgarian legislation. The total capital adequacy indicator is above 18%.

The liquidity coefficient still exceeds 20% and unlike other EU countries there are no reasons to worry about the liquidity risk despite the partial worsening of the credit portfolio. This holds true for all banks registered in Bulgaria including the ones with Greek owners since they should comply with the Bulgarian legislation and are under the supervision of BNB. A secondary result of the banking sector stability is the good performance of the entire financial system in the country. It is completely bank dominated – the bank assets comprise a major share of the assets in the financial sector – between 80 and 90%, which predetermines the stability in the sector.

- **Growth in savings**. There is a steady tendency toward growth in savings in the country. This can be seen in Table 4. Their share of GDP of Bulgaria is above 50% and their growth rate was 8.4% for 2010. In a situation like this we cannot draw a conclusion about decreasing liquidity in the system or a drop in confidence. The growth in national savings offsets the withdrawal of resources by the foreign parent banks. This also serves as evidence of the reasonable level of confidence the people and businesses have in the banking system.

The increase in savings of internal origin offsets the decline in foreign direct investments. Chart 5 illustrates the dynamics of foreign direct investments in the country for

Table 3. Profitability of Bank Intermediation, %, Source: BNB

	1998	2000	2005	2006	2007	2008	2009	2010	2011
Return on Assets (ROA)	5,32	2,8	2,0	2,2	2,4	2,1	1,1	0,8	0,78
Return on Capital (ROE)	39,59	22,6	21,6	23,7	23,9	20,3	8,9	8,9	6,1
Profit, mln. BGN	126,9	274,2	573,0	786,0	1273,7	1374,0	752,0	600,0	586,0

the period between 1999 and 2010. A peak was reached in 2007, followed by a considerable decline in foreign direct investments reaching levels of 4.9% of the GDP. This has significantly limited the new money resource for the different sectors of the economy.

the government securities, which means that there is no real danger of depreciation of assents put into foreign bonds and shares.

Chart 6 illustrates the dynamics observed in the balance of the budget since

Table 4. Saving`s Dynamics

	1998	2000	2005	2006	2007	2008.	2009	2010
Growth rate,%	7,91	16,88	22,27	34,81	33,13	9,44	2,74	8,4
Share in Bank Liabilities,%	64,96	65,66	62,22	65,36	61,13	57,41	59,19	61,86
Share in GDP, %	22,87	23,90	47,81	56,19	57,19	51,05	53,20	55,92

- **Government's inability to use direct loans from the BNB and the commercial banks** imposes strict discipline on public finance. This is an indirect consequence for the banking system, but has positive effects in as much as it does not redirect society's free public resources to financing various kinds of government spending, including the provision of public wealth.

The government budget is experiencing problems which can be identified mostly as budget deficit. On the other hand, the main component of the securities portfolio Bulgarian banks hold are

1998. Massive deficits have been run up over the past two years – 2009-2010, which deviate from the Maastricht criteria for the first time since the implementation of the Currency Board in the country.

The analysis of the adverse and favourable effects of the national economic crisis on the developments in the banking sector of the country lead to the conclusion about balanced development that has not been markedly affected by the unfavourable tendencies in the economy. The reasons for that are mostly of domestic character, whilst the surrounding international financial environment sets

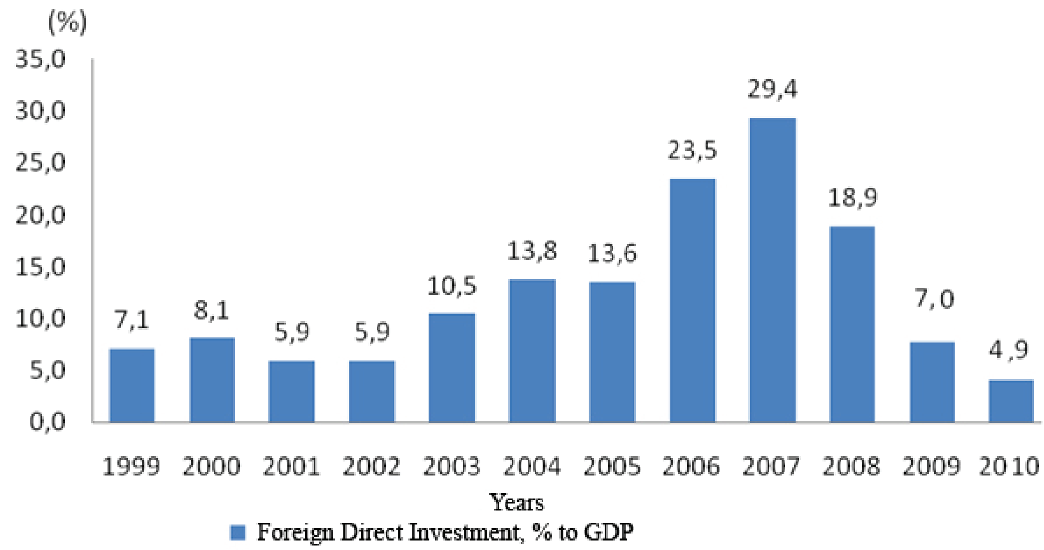

Chart 5. **Foreign Direct Investment, Source: BNB**

an unfavourable backdrop for the performance of the Bulgarian banks. In general there is an increasingly prudent behaviour of bank institutions. At the end of 2011 and the beginning of 2012 they were still cautious, especially in terms of extending loans. The reason for that lies in their high risk assessment in terms of solvency of legal entities and individuals who are their clients. On the other hand, deposits have been increasing since companies have free financial resources and the public have cut their capital expenditure. Banks have gradually lowered their losses in-

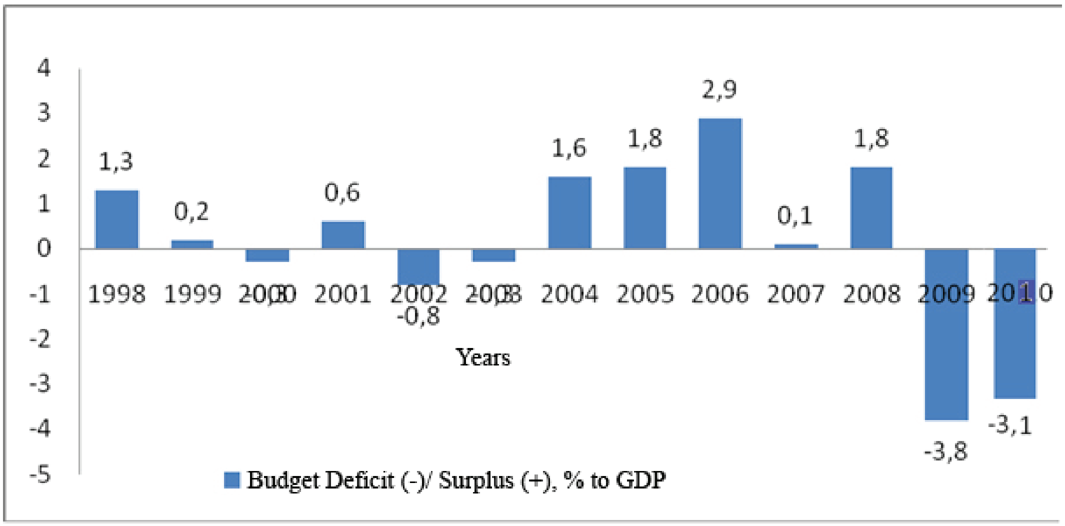

Chart 6. Balance in the State Budget, Source: Ministry of Finance

curred through defaults on loans, but they would rather capitalize their profit than expand lending.

The economic crisis in Bulgaria after 2008 has not affected considerably the development of the banking system. Despite the existing risks such as more non-performing loans, resource deficit, decline in depositors' confidence in the system, low evaluation of the banks provided by the stock exchange, the financial institutions in the banking sector are stable and solvent. They do not experience liquidity and capital adequacy problems. They maintain a good profitability level, savings are increasing. The crisis as a whole has affected favourably both the commercial banks which tightened their discipline and the government which despite the budget deficit has not taken measures concerning its monetization. The analysis of the real economy crisis and its effects on the banking system gives reasons for drawing the conclusion that the banking sector has experienced a healthy development and has created a favourable environment for the economy to get out of the crisis and recover.

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