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Bulgaria Macroeconomic Situation

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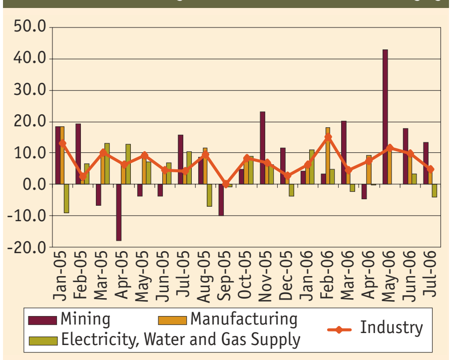
Summary

- In July, the growth of Bulgaria's real sector was driven by the expanding industrial sector, whose sales grew by 4.9% year-over-year (yoy), and retail trade, which surged by 12.6% yoy.
- The consolidated budget surplus posted very positive developments, accelerating in nominal terms in January-July by 46.3% yoy up from 25% yoy in January-June.
- The consumer price index (CPI) continued to decelerate for the third month in a row and in August it stood at 6.8% yoy compared to 7.6% yoy in July.
- The deterioration of the current account (CA) deficit experienced some slowdown. In January-July, Bulgaria's CA deficit deteriorated only marginally and reached EUR 1.82 billion, which is almost the same level demonstrated in January-June. The existing deficit in the CA can be translated into 7.6% of the country's period GDP.
- In a recently released report by the World Bank, Doing Business 2007 — How to Reform, Bulgaria was ranked 54th and is up by 5 points compared with the previous year's ranking.

Economic Growth

In July, Bulgaria's real sector continued to demonstrate positive developments. However, the country's industrial sector posted some deceleration in its rate of growth during the month. In July, industrial sales grew by 4.9% yoy, which is half of the previous month's level. The slowdown in Bulgarian industry is due to deceleration in the rate of growth of each of the sector's components.

Economic Growth by Sectors in 2005–2006, % yoy



Source: Bulgarian National Statistical Institute

The mining sector, which saw significant growth over the last several months and was one of the most important drivers for overall industrial performance, grew by 13.4% yoy in July down from 17.8% yoy in June. Some slowdown in the rate of growth in mining had a spillover effect on manufacturing, whose sales decelerated from 10.0% yoy in June to 5.6% yoy in July. Another downward factor for industrial sector performance was decreased sales in the utility sector. In July, it shrunk by 4% yoy after the previous two month period of growth. However, very good performance of Bulgaria's industrial sector in the first six months of the year built a solid basis for the country's positive year-end economic performance outlook.

Within the country's mining sector, the most accelerated growth was seen in the mining of metals and ores, which has been steadily growing since the beginning of the year and is driven by stable demand on both international and domestic markets. The existing favorable situation on these markets should ensure positive developments for Bulgarian mining production in the coming months.

A structural breakdown of the country's manufacturing shows that those sub-sectors that are related to metals have been growth leaders since the beginning of 2006. In July, Bulgaria's manufacturing companies increased their sales by 33.1% yoy, keeping the same rate of growth as in the previous month. Throughout this year, the top growth leader within the country's manufacturing sector remains production of machinery and office equipment. In July, it demonstrated growth of 89% yoy, posting an average monthly rate of growth at a level of 59.3% yoy since the beginning of the year. On the opposite side, the deepest decline continues in manufacturing of radio and communication equipment, which shrunk in July by 37.2% yoy following the previous month's decline of 33.6% yoy. The on going changes in the structure of the country's manufacturing sector support the idea of continuous structural reforms in Bulgaria's real sector.

Expansion of the real sector is supported by the growing retail sector. In July, retail sales surged by 12.6% yoy, posting the same pace of expansion as in the previous month. The performance of wholesale trade was weaker than retail trade. However, it was on an upward trend, accelerating from 3.2% yoy in June to 3.9% yoy in July.

Fiscal Policy

In January-July 2006, the government continued to conduct prudent fiscal policy. During the period, the fiscal surplus reached Lev 1.7 billion (EUR 847.6 million), rising at an accelerated rate of 46.3% yoy as compared to 25% yoy in January-June. As a percentage of full-year GDP, the fiscal surplus reached 3.6%, exceeding the expected level of 3% at the end of the year.

On a positive note, there was some acceleration in the rate of growth of revenues after some slowdown in January-June period. During January-July, revenues grew at a rate of 9.6% yoy and reached Lev 11.3 billion (EUR 5.8 billion) or 25% of full-year GDP. The largest share in revenues, 80.4%, was still attributed to taxes, although their share declined slightly from the January-June period. This was due to deceleration in the growth rate of tax revenues, which grew by 11.6% yoy as compared to 12% yoy in January-June and reached Lev 9.6 billion (EUR 4.6 billion). In January-July, the growth rate of grants accelerated by a strong 36.7% yoy, up from a -8.5% yoy decline in January-June. At the end of July, the amount of received grants reached Lev 365 million (EUR 187 million). At the same time, their share in total budget revenues changed only marginally from 2.1% in January-June to 3.2% in January-July.

Consolidated Fiscal Program in January–July 2006

	EUR million	% of total	Change, % yoy
Revenue	**5,773.9**	**100**	**9.6**
Tax	4,642.6	80	11.6
Non-tax	944.8	16	–2.8
Grants	186.6	3	36.7
Expenditures	**4,926.4**	**100**	**5.1**
Public Wages, insurance	749.2	15	52.6
Social and Health Insurance Contribution	241.0	5	36.6
Social Expenditure	2,027.5	41	13.6
Capital Expenditure	454.2	9	–7.4
Other	1,454.5	30	–16.7
Balance	**847.6**		**46.3**

Source: Bulgarian Ministry of Finance

In contrast to revenues, expenditures demonstrated some deceleration in their rate of growth in January-July. During the period they grew by 5.1% yoy, which is 0.9 pps slower than in the previous month, and reached Lev 9.6 billion (EUR 4.9 billion) or 21% of full-year GDP. Deceleration in the rate of growth was observed in all expenditure items. Social expenditures, which constituted 41% of total expenditures, increased at a rate of 13.6% yoy, which is 0.6 pps lower than in January-June, and reached Lev 3.9 billion (EUR 2 billion). Public wages and insurance, another large expenditure group, increased at a rate of 52.6% yoy as compared to 54% yoy in January-June, reaching Lev 1.5 billion (EUR 0.7 billion). On the negative side, capital expenditures dropped for the second month in a row, although their share increased to 9.2%, up from 8.9% in January-June.

The 2007 draft budget was approved with planned revenues in the amount of Lev 21.151 billion, or 41.7% of GDP, expenditures in the amount of Lev 20.14 billion or 40.9 % of GDP (excluding Lev 634.4 million of contributions to the EU budget), and a surplus of 0.8% of GDP.

In January-July, the government continued to demonstrate sound debt management. Since June, the total amount of public and publicly guaranteed debt has declined by EUR 15.8 million and constituted EUR 6.4 billion, which translated into 27.3% of forecasted full-year GDP. The size of the internal debt declined by EUR 21.4 million, reaching EUR 1.52 billion, and its share in total public debt constituted 23.9% as compared to 24.2% in January-June. The amount of external debt has not changed significantly since the last month. It rose by EUR 5.6 million and amounted to EUR 4.85 million, occupying

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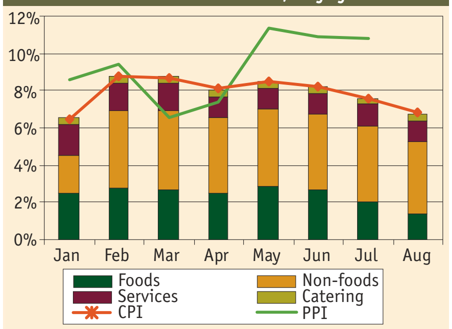
76.1% of the total debt stock. At the end of July, the residual maturity of almost 80% of external debt was over 5 years. A breakdown of external debt by creditor showed that the World Bank, International Monetary Fund and European Union remained the largest lenders to the country. Shares of these international institutions in total debt stock constituted 16.6%, 6.4%, and 5.3% respectively.

Monetary Sector

In August, consumer price inflation (CPI) continued to decelerate for the third month in a row and stood at 6.8% yoy by the end of the month, as compared to 7.6% yoy in July. Deceleration was also observed on a monthly -basis — CPI dropped by 0.2% compared to the previous month. As in July, the main reason for CPI deceleration in August was the decline in the food prices, whose annual growth rate slowed down by 1.8 pps and monthly growth rate dropped by 1 pps. Deceleration was also observed in the growth rate of non-food prices, which slowed by 0.6 pps and constituted 12.9% yoy, down from 13.5% yoy in July. The annual growth rate of service prices remained stable at 4.1% yoy, which is almost the same level as in the previous month.

Changes in CPI, its Major Components, PPI and M3 in 2006,% yoy



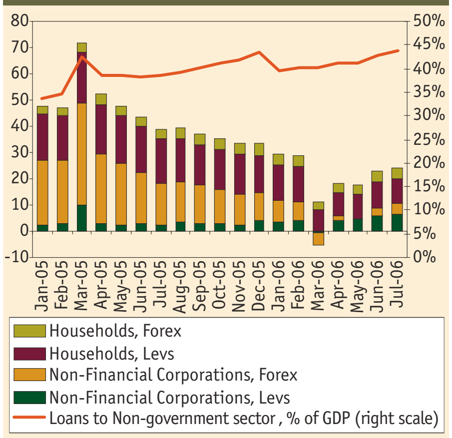
Source: Bulgarian National Statistical Institute

The producer price index (PPI) demonstrated a slowdown in July, backed by disinflation in manufacturing prices. During the month, PPI grew by 10.8% yoy, which is 0.1 pps slower than in June. At the same time, producer prices in the manufacturing sector slowed down by 1.4 pps to 7.3% yoy as compared to 8.7% yoy in June. Growth of the PPI has remained relatively high since May, driven mainly by rising prices in the mining sector. In July, prices in the mining industry grew by 54.2% yoy vs 47.9% yoy in June, backed by the high growth of prices in metal ores mining.

In July, money supply (M3) continued to grow at an accelerating rate of 21.3% yoy and reached Lev 28.2 million. At the same time, the monetary base grew at a faster pace of 33.1% yoy reaching Lev 9.7 million, and the monetary multiplier constituted 2.89 in July, which is close to the lowest level of 2.87 reached in April 2000. The fastest growing major component of money supply in July was M1, which grew by 23.4% yoy, driven by acceleration in the rate of growth of overnight deposits, especially those denominated in Levs. The later grew by 35% yoy in July, up from 27.4% yoy in June. The M2 component, on the contrary, grew at a lower rate of 19.4% yoy, due to some deceleration in the growth rate in all of its components.

In August, the base interest rate continued to be raised and constituted 2.8% per annum (p.a.) by the end of the month.

Growth Rates of Banks Credits, yoy %, and Volume of Bank Credits as % of GDP in 2005–2006



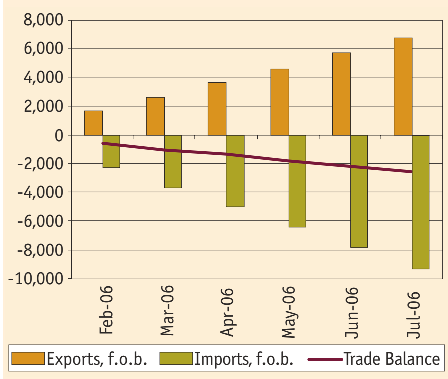
Source: Bulgarian National Bank

The stock of bank loans to the non-government sector grew at an accelerated rate of 24.2% yoy in July and reached Lev 20.1 million, which can be translated into 44% of full-year GDP. At the same time, credits to non-financial institutions continued to grow at an accelerated rate for the second month in a row. In July, they grew by 17.2% yoy or 3% mom, and their share in total credit stock to the non-government sector reached 59.2% as compared to 58.9% in June.

International Trade and Capital

In January-July, the Bulgarian trade deficit in goods and services continued to widen, reaching EUR 2.6 billion compared with EUR 2.2 billion in January-June. The existing trade deficit represents 10.8% of the country's period GDP. The trade deficit continue to demonstrate an upward tendency, mainly due to surging prices for energy resources and some deceleration in the rate of growth for metals' prices. Moreover, depending on the geographical location of the market, prices for some types of metals started to experience a decline. However, on a positive note, the rate of growth of the trade deficit experienced some deceleration, which is a result of faster growth in exports than in imports. Moreover, July was the third month in a row when exports grew at a faster rate than imports.

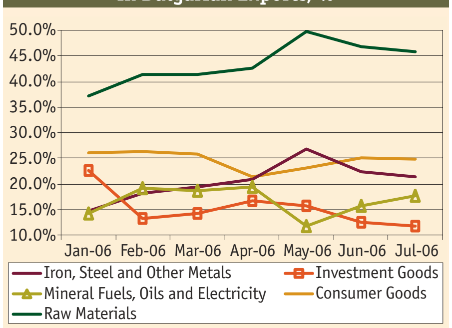
Bulgarian foreign trade indicators, in EUR million (cumulative)



Source: : Bulgarian National Bank, own calculations

In January-July, exports grew by 29.1% yoy, which is only marginally lower compared with the previous two months' performance when exports grew by 30% yoy. The main driving force for surging exports was the still relatively high prices for metals and increasing demand on international markets for mineral fuels and electricity. While the share of metals in Bulgarian exports in July was almost unchanged as compared with June, the share of mineral fuels, oils and electricity increased by 2.2 percentage points (pps). Given the current state of the international market for Bulgaria's major exporting commodities, it is likely that the same rate of growth in the country's exports will remain over the next several months.

Weight of Some Commodities in Bulgarian Exports, %



Source: Bulgarian National Bank, own calculations

In July, Bulgarian imports demonstrated some deceleration in their rate of growth, declining to 26.6% yoy from 36.5% yoy as compared with January, and 0.2 pps from the previous month's level. The main reason for such deceleration is a relative decrease in (i) domestic consumption of some imported consumer goods, which declined during one month by 1.7 pps, (ii) investment goods, which declined by 3 pps, and (iii) some other non-energy commodities, which shrunk by 4.4 pps. Although it is very likely that the share of investment goods has declined only temporarily, the downward tendency in the weight of other imported commodities could continue within the next couple of months, which should limit the growth of Bulgarian imports and, consequently, positively affect the trade balance.

In January-July, Bulgaria's CA deficit deteriorated only marginally and reached EUR 1.82 billion, which is almost at the same level demonstrated in January-June. The existing deficit in the CA can be translated into 7.6% of the country's period GDP. The existing positive tendency demonstrated by the CA over the last two months leads to a narrowing of the existing gap and, consequently, to reduction of risks associated with the CA deficit.

In January-July, the net inflow of FDI reached EUR 1.59 billion, up from EUR 1.41 billion in January-June. This increase can be translated into a 21.2% yoy rate of growth. The existing inflow of FDI is able to cover 87% of the current CA deficit.

International Programs

During the latest meeting of Bulgaria's Minister of Finance with the World Bank (WB) in September, it was mentioned that Bank's support to Bulgaria would be based on a three-year loan program consisting of 2 or 3 operations per year and amounting to $900 million. The loans will be granted in the form of a consequent series. These loans will be directed to the facilitation of trade, further development of infrastructural projects including transport, road and municipal infrastructure, social inclusion and regional development. Program implementation is to be accompanied by analytical and consulting activities.

Some of the projects supported by the EBRD that were planned to be launched next year have already been started. In September, the Ministry of Finance reported that the Bulgarian government approved projects for Struma motorway and the waste dump of Sofia has been already prepared with the participation of different international institutions. Moreover, there are several other projects that are also ready for actual implementation.

Other Developments and Reforms Affecting the Investment Climate

According to the recently released annual periodic report by the World Bank, Doing Business 2007 — How to Reform, Bulgaria was ranked 54th, which is 5 points higher compared with the previous year's ranking. Most notable improvements were reported in the area of cross-boarder trading and getting credit — 9 and 8 points respectively.

Bulgaria has continued its efforts in fighting corruption. In September, the Parliament passed special amendments to the law on publicity of properties of high ranked civil servants. This step should meet the policy recommendations developed by the EU report for Bulgaria's further progress in EU integration. According to the law, around six thousand civil servants will be required to make information on their properties and income publicly available. If a property and income declaration is not submitted or contains untruthful information, special procedural measures such as inspections and audits will be in place.

Doing Business in Bulgaria 2007

Ease of...	2006 rank	2005 rank	Change in rank
Doing Business	54	59	+5
Starting a Business	85	91	+6
Dealing with Licenses	140	144	+4
Employing Workers	100	106	+6
Registering Property	65	66	+1
Getting Credit	33	41	+8
Protecting Investors	33	33	0
Paying Taxes	107	104	–3
Trading Across Borders	104	95	–9
Enforcing Contracts	52	52	0
Closing a Business	64	66	+2

Source: World Bank

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