Bulgaria
Macroeconomic Situation

October 2006

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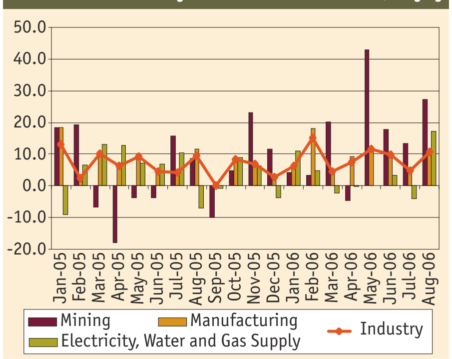
Summary

- In August, the growth of Bulgaria's real sector was driven by the expanding industrial sector, whose sales grew by 10.7% year-over-year (yoy), and retail trade, which surged by 13.3% yoy.
- The consolidated budget surplus posted in January-August was 4.4% of full-year GDP, accelerating in nominal terms by 51% yoy up from 46.3% yoy in January-July.
- The consumer price index (CPI) continued to decelerate for the fourth month in a row and stood at 5.6% yoy in September compared to 6.8% yoy in August.
- The deterioration of the current account (CA) deficit experienced some slowdown. In January-August, the CA deficit deteriorated only slightly and reached EUR 1.9 billion. The existing CA deficit can be translated into 7.9% of the country's period GDP. The current level of FDI inflow is able to cover 92% of the CA gap.
- In the October 22nd presidential election, no single candidate was able to receive a majority of votes; the second round is scheduled for October 29th.

Economic Growth

In August, Bulgaria's real sector demonstrated very positive developments, which were mainly supported by the rapidly growing industrial sector. During the month, industrial sector sales accelerated by a very strong 10.7% yoy compared with 4.9% yoy in July. Moreover, industrial output also posted significant acceleration in its rate of growth. Industrial output statistics were very encouraging in August, posted record high growth for the year of 10.5% yoy, accelerating from 3% yoy in the previous month. Due to the existing time lag between sectoral output and sales, the significant increase in industrial output in August should secure strong growth in industrial sales during September and October.

Economic Growth by Sectors in 2005–2006, % yoy



Source: Bulgarian National Statistical Institute

The increase in Bulgaria's industrial sector was a result of the very good performance demonstrated by all of its components. The growth leader in August was the mining sector, where sales accelerated to an impressive 27.2% yoy up from 13.4% yoy in the previous month. Since output of mining also surged at a significant rate of 10.5% yoy, there is enough evidence to be optimistic about the performance of Bulgaria's mining sector over the next several months. Within the mining sector, the growth leader remains the same as in the previous two months — metal ores — whose sales surged by a very strong 52.8% yoy in August, up from 18% yoy posted in the previous month.

The manufacturing sector, which traditionally drives Bulgaria's real sector growth, posted a 9.6% yoy increase in sales in August and 9.1% yoy growth in output. A structural breakdown of the country's manufacturing shows that the growth leaders in August were machinery products, which grew by more than 30% yoy on average, and manufacturing of metal products, which posted a 17% yoy rate of growth.

Good performance in Bulgaria's real sector was supported by the surging retail sector. In August, its sales surged by 13.3% yoy accelerating from 12.6% yoy in the previous month. However, there was an opposite tendency in wholesale trade, which decelerated to 2.2% yoy in August, down from 3.9% yoy in July.

Fiscal Sector

In January-August, the government continued to conduct prudent fiscal policy. Due to an accelerated increase in revenues on the back of only a moderate increase in expenditures, the fiscal surplus grew at a rate of 51% yoy and reached EUR 1.0 billion (Lev 1.9 billion) or 4.4% of full-year GDP. As a result of excess revenue collections in the first half of the year, the Bulgarian government revised the year-end fiscal surplus up to 3.2% of GDP.

Consolidated Fiscal Program in January–August 2006

	EUR million	% of total	Change, % yoy
Revenue	**6,638.8**	**100**	**10.4**
Tax	5,349.2	80.6	12.2
Non-tax	1,071.9	16.1	–0.7
Grants	217.7	3.3	30.8
Expenditures	**5,621.1**	**100**	**5.3**
Public Wages, insurance	861.9	15.3	53.6
Social and Health Insurance Contribution	276.8	4.9	37.3
Social Expenditure	2,314.1	41.2	12.8
Capital Expenditure	539.4	9.6	–5.1
Other	1,629.0	29.0	–16.7
Balance	**1,017.6**		**51.0**

Source: Bulgarian Ministry of Finance

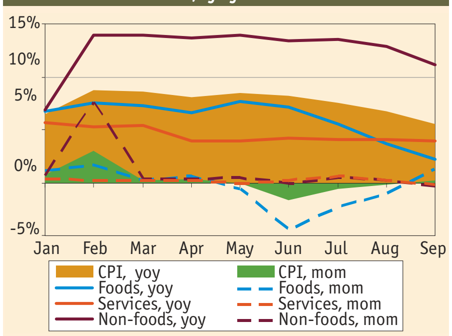
In January-August, fiscal revenues continued to grow at an accelerated rate. They grew by 10.4% yoy during the period and reached EUR 6.6 billion (Lev 12.9 billion). Tax collections, being the largest part of revenues, grew at a rate of 12.2% yoy vs 11.6% yoy in January-July and constituted EUR 5.3 billion (Lev 10.5 billion). On a positive note, there was a slowdown in the decline of non-tax revenues. In January-August, they fell by 0.7% yoy while the decline rate was 2.8% yoy in January-July.

During the same period, expenditures increased at a lower rate than revenues. In January-August, they grew by 5.3% yoy and constituted EUR 5.6 billion (Lev 10.9 billion). The largest increase in expenditures (53.6% yoy) was noted in public wages and insurance, which accounted for 15.3% of total budget expenditures. At the same time, social expenditures, whose share of total budget expenditures is around 40%, experienced some deceleration in their rate of growth. In January-August they surged by 12.8% yoy, down from 13.6% yoy in January-July.

In January-August, the government continued to demonstrate sound debt management. Since July, the amount of public and publicly guaranteed debt declined by EUR 27 million and equaled EUR 6.3 billion, including EUR 1.5 billion of domestic debt and EUR 4.8 billion of external debt. The decline was a result of debt repayments processed during the month. The stock of domestic debt declined by EUR 1.1 million, while the stock of external debt declined by EUR 25.9 million. In August, the debt-to-GDP ratio equaled 27.2%, which is an improvement of 0.1 pps since the last month. The breakdown of debt by currency suggests that all debt is well diversified, with 52.4% being made in Euros, 21.4% in US dollars and 17.4% in Lev.

Monetary Sector

Changes in CPI, its Major Components in 2006, yoy and mom



Source: Bulgarian National Statistical Institute

During September, consumer price inflation continued to decline, driven mainly by deceleration in the growth of food prices. By the end of the month, CPI posted a growth rate of 5.6% yoy, down from 6.8% yoy in August. Food prices demonstrated the lowest price inflation among the CPI components. In September, they grew by 2.3% yoy down from 3.7% yoy in August. Therefore, September became the fifth month in a row with food price deceleration. Although food products are the largest component of CPI, their contribution to overall CPI growth in September was only 0.86 pps. Non-food and service prices demonstrated deceleration in their annual

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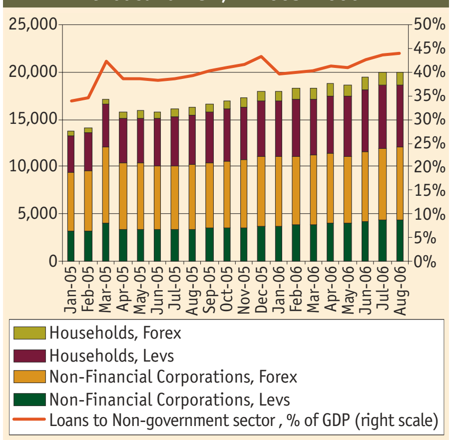
growth rates. In September, the annual growth of non-food products constituted 11.1% yoy as compared to 12.9% yoy in August, and the monthly growth rate fell by 0.3% mom. Prices of services grew at a decelerated rate of 3.9% yoy, after two months of stable growth at a rate of 4.1% yoy.

The producer price index (PPI) remained almost unchanged from its previous month's level. In August it posted a growth of 10.7% yoy as compared to 10.8% yoy in July. The high growth rate of the PPI is driven by the high growth rate in prices for mining products, which surged by 52.4% yoy in August. At the same time, prices in the manufacturing and utilities sector grew at accelerated rates of 7.5% yoy and 8.1% yoy respectively.

In August, money supply grew at an accelerated rate of 22.5% yoy and reached Lev 28.9 million. At the same time, the monetary base shrank from Lev 9.7 million in July to Lev 9.1 million in August, reflecting a deficit in the balance of payments, and its annual growth rate constituted 18% yoy compared to 33.1% yoy in July. As a result, the monetary multiplier stood at 3.2 in August, demonstrating an improvement from the previous month. In September, the BNB raised the interest rate again, setting it at a level of 2.94 per annum (p.a.).

Volume of Loans to Non-government Sector, thousand BGN, in 2005–2006

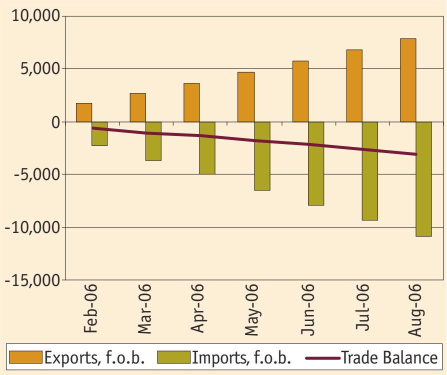


Source: Bulgarian National Bank

The stock of credits issued by banks to the non-government sector during August exceeded July's level only slightly. By the end of the month, the credit volume reached Lev 20.3 million, which is only 0.8% higher than in July. The annual growth rate of loan stock to the non-government sector decelerated and constituted 22.9% yoy compared to 24.2% yoy in the previous month. Loans to non-financial corporations have been issued mainly in foreign currency (64%), while Lev-dominated loans (82%) dominated loans issued to households. As a percentage of full-year GDP, credit volume has been stable at a level of 44%.

International Trade and Capital

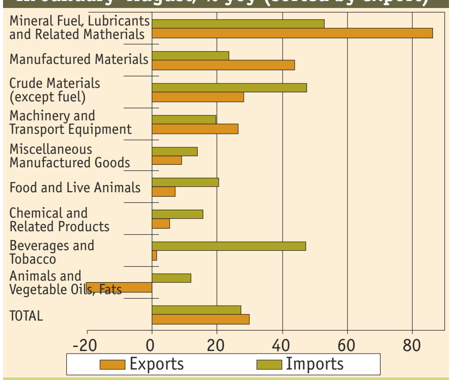
Bulgarian Foreign Trade Indicators, in EUR million (cumulative)



Source: : Bulgarian National Bank, own calculations

In January-August, the Bulgarian trade deficit in goods and services continued an upward trend and reached EUR 3.1 billion compared to EUR 2.6 billion in January-July. The existing trade deficit represents 12.9% of the country's period GDP compared with 10.8% in January-July and 9% in January-June. The upward trend is backed by constantly increasing prices for imported energy resources and relatively stable prices for Bulgarian exported goods. However, due to the recent decline in world oil prices, some improvements in Bulgaria's international trade balance should be expected in the last quarter of 2006.

Change in Bulgarian Exports-Imports in January–August, % yoy (sorted by export)



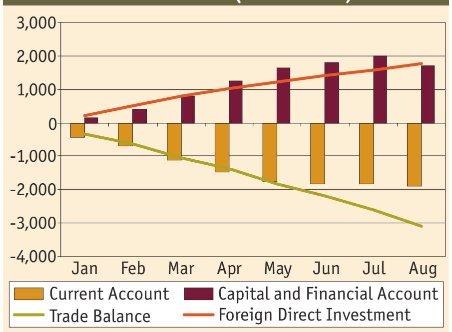
Source: Bulgarian National Bank, own calculations

In January-August, Bulgarian exports grew by 30% yoy, slightly accelerating from the previous month's level when the growth rate was 29.1% yoy. Growth in exports is due to the still favorable situation on the world market for metals and surging world demand for mineral fuels and fertilizers. The geographical breakdown of Bulgarian exports shows that in January-August, the most significant increase was in exports going to Central and Eastern European countries, which grew by 60.5% yoy. The increase in the share of exports to Albania, Bosnia and Herzegovina, Croatia, Romania, Serbia, and Macedonia supports the idea that interregional trade has become more important and economic relations within Central and Eastern Europe are strengthening. Merchandize exports going to Central and Eastern Europe region are mostly represented by relatively high value added products. On the opposite side, a significant portion of exports going to EU countries has a lower value added component.

In January-August, there was some marginal acceleration in the rate of growth of Bulgarian imports. During the period it increased by 27.1% yoy up from 26.6% yoy in the previous month. On a positive note, imports grew by 3 pps less than exports. The relative slowdown in the rate of import growth is largely due to a decrease in energy prices, which started in late August.

In January-August, Bulgaria's CA deficit was on an upward trend and reached EUR 1.9 billion compared to EUR 1.82 billion in the previous month. The existing CA deficit can be translated into 7.9% of the country's period GDP. On a positive note, FDI period inflow is able to cover 92.2% of the CA gap and can ensure the country's long-term macroeconomic stability.

Balance of Payments, in EUR million (cumulative)



Source: Bulgarian National Bank, own calculations

International Programs

On October 5th, the Bulgarian government and the European Investment Bank (EIB) signed a Memorandum of Understanding for the Development and Financing of Infrastructure. The signing of the document was made in the framework of the Bulgarian government's transport and basic infrastructure investment plan (2007–2013).

In October, the new IMF mission started to work in Bulgaria. The main agenda is to discuss Bulgaria's draft budget for next year. The other issues to be discussed include the review of the execution of the precautionary stand-by arrangement between Bulgaria and the IMF and the execution of the 2006 budget. Special attention will be also paid to the planned tax policies for next year, as well as of the overall fiscal stance in 2007 within the framework of the 2007 draft budget.

Other Developments and Reforms Affecting the Investment Climate

On October 22nd, the presidential election had a low turnout, which did not exceed 43%. The first election round was rife with negative campaigns led by most of the candidates and frequent scandals. President Parvanov urged right-wing politicians to take a more constructive and tolerant stance in the future. The next round of elections are scheduled for October 29th.

In October, the Bulgarian parliament passed in final reading a special amendment to the Corporate Tax Law, which will reduce the profit tax rate to 10% down from the current 15%. This amendment will apply to all businesses starting at the beginning of next year. The new profit tax rate will make Bulgaria a country with one of the lowest tax rates in EU.

The household income-expenditure survey conducted by the National Statistical Institute showed that household expenditures grew twice as fast as incomes in August — 9.2% yoy against 4.6% yoy. The existing gap between growth rates in expenditures and incomes is partly explained by strong growth in consumer credit. According to the survey, monthly household income per person was around EUR 109 in August.

In October, the two seminars "The Structural Funds — Opportunities and Challenges" and "The Structural Funds and the Cohesion Fund — the new legal framework" were held with the participation of Bulgarian government officials and representatives of the directorate of DG Regional Policy at the European Commission. During the seminars, the latest trends in European regional policy as well as regulations and requirements of European Funds absorption were discussed. One of the words of advice to the Bulgarian government was to start preparing the projects and have them ready by January 1st, 2007 for application under the structural instruments.