Bulgaria
Macroeconomic Situation

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Summary

- In H1 2007, economic growth accelerated to 6.4% from 6.1% in 2006 driven by strong investment and consumption.
- In July, industrial sales growth rebounded to 11.7% yoy after deceleration to 5.1% yoy in June.
- In January-July, the fiscal surplus accounted for 4.6% of projected full-year GDP against 4.1% as of the end of June and reached EUR 3.76 billion (Lev 7.35 billion).
- The government approved a fiscal framework for 2008-2010. The consolidated budget surplus is targeted at 2.5% of GDP in 2008, economic growth is forecasted at 6%, and consumer price growth will slow down to 3.7% next year and 2.6% in 2010.
- In July, external government and government guaranteed debt slightly increased to EUR 4.21 billion from EUR 4.09 billion in the prior month.
- In August, consumer prices as measured by the Consumer Price Index (CPI) surged 3.1% mom driven by a one-off shock in agriculture and related industries after drought damage in the region. In the first eight months of the year, CPI growth reached 7.5% (12% yoy).
- In January-July, the current account (CA) deficit widened to EUR 3.04 billion (11.4% of GDP). Foreign direct investment covered 87.7% of the CA deficit.
- The financial account surplus reached EUR 4.4 billion as compared to EUR 3.2 billion in the same period last year.

Economic Growth

The National Statistical Institute released preliminary data on GDP growth for the first 6 months of 2007. The GDP data shows that real GDP growth accelerated to 6.4% from 6.1% in 2006.

Real GDP Breakdown (%, yoy)

	2002	2003	2004	2005	2006*	1H 2007*
GDP	**4.5**	**5.0**	**6.6**	**6.2**	**6.1**	**6.4**
Consumption:	4.2	5.9	5.4	5.3	6.5	6.0
Investment:	8.5	13.9	13.5	23.3	17.6	29.6
Exports:	8.1	10.7	12.7	8.5	9	4.1
Imports:	5.0	16.4	14.5	13.1	15.2	11.9
By sector:						
Agriculture:	4.7	-2.3	2.3	-9.5	-1.9	-2.3
Industry:	4.7	5.7	4.1	4.8	8.3	9.1
Services:	5.9	4.7	5.7	8.2	6.1	8.8

*Preliminary data by the National Statistical Institute

In the first half of 2007, investment expressed by gross capital formation reached EUR 4.5 billion (Lev 8.8 billion) or 36% of GDP compared to 24.7% of GDP a year earlier. Investment continued to be the fastest growing component of GDP with a growth rate of 64.8% yoy. Consumption growth slowed to 6% yoy from 6.5% yoy in 2006 and reached EUR 11 billion (Lev 21 billion). The increase in consumption is driven primarily by individual consumption, which grew 11% yoy; its share in total consumption increased to 90%. The share of final consumption in GDP increased slightly to 87.6% from 86.6% in 2006.

Underpinned by increasing investment and robust consumption, industry and services growth accelerated to 9.1% yoy and 8.8% yoy respectively. The share of industry in GDP increased to 27.5% from 26.3% in H1 2006. The services sector increased its share in GDP to 50.2% from 49.3% in H1 2006. The services sector has the greatest share in Gross Value Added (61% in H1 2007, down from 61.1% in H1 2006). The industry contribution to value added increased to 33.4% in H1 2007 from 32.7% in H1 2006.

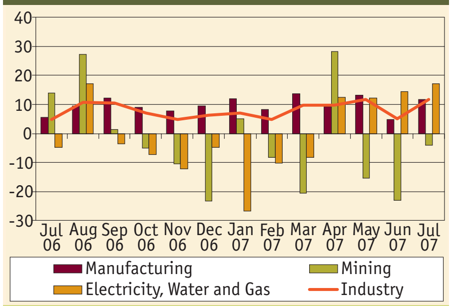
The agricultural sector dropped 2.3% yoy in H1 2007 (compared to a 3.2% yoy decrease in H1 2006) as a result of insufficient investments, small agricultural land parcels and an undeveloped agricultural distribution infrastructure, as well as unfavorable weather conditions. The agricultural contribution to value added is down to 5.6% (6.2% in 2006).

The National Statistical Institute (NSI) released final data on industry growth in June 2007 and preliminary data for July 2007. Industrial sales growth rebounded to 11.7% yoy after deceleration to 5.1% yoy in June. Manufacturing sales expanded strongly by 2.2% mom in July and 1.6% mom in June. On an annual basis, manufacturing sales surged 11.9% in July compared to 5% in June. Utilities posted strong growth of 14.3% yoy in June and 17.3% yoy in July. Sales in the mining sector recovered to 12.8% mom growth in July after a contraction of 12.5% mom in June; as a result, mining sector sales are down 4.2% yoy (23.2% yoy in June). The mining sector is highly dependent on external demand and world prices, and seasonal factors affect demand in the utilities sector.

Industrial production surged 13.2% yoy in July and 7.7% yoy in June. The growth in industrial production outpaced growth of industrial sales for the second month in a row. Output in manufacturing and utilities sectors in July increased 13.2% yoy (6.9% yoy in June) and 22.9% yoy (20.4% yoy in June) respectively. Production in the mining sector continued to recover for two consecutive months with growth rates of 11.4% mom in June and 4.6% mom in July. On an annual basis, output in the mining sector is down 12.4% in July (13.1% in June). Industrial sales in food and beverages, textiles, paper and paper products, mineral products, basic metals, fabricated metal products and machinery and equipment sectors are major contributors to industry growth.

In July, retail trade grew 2.5% mom, a considerable decrease from 4.4% mom growth in June. In January-July, retail trade growth slightly decelerated to 8.6% yoy from 9.1% yoy in the prior month. Wholesale trade growth decelerated to 3.5% mom in July from 4.1% mom in June. In the first seven months of 2007, wholesale trade expanded 2.9% yoy as compared to 3.5% yoy in the prior month. The margin between retail and wholesale growth rates is a result of the structural changes of trade. In January-July, sales growth of electrical household appliances and food decelerated slightly to 10.5% yoy and 9.3% yoy respectively, while sales growth of pharmaceuticals/cosmetics and textiles/clothing accelerated to 6.8% yoy and 8.3% yoy respectively.

Index of Industrial Sales by Sector, % yoy



Source: National Statistical Institute

According to an NSI survey, managers in industry, construction, retail trade and service sectors confirmed either optimistic or "preserving the same" expectations on growth in their sectors. In August, the composite business sentiment indicator (CBSI) decreased by 1.9 pps compared to July. Industrial managers were more optimistic about production activity due to the current amount of orders from abroad, and indicated higher inflationary expectations. Construction managers' expectations shifted toward "preserving the same" situation. The shortage of labor along with intentions to hire additional personnel in the next 3 months was cited among factors impeding growth in the sector. In retail trade, 61.2% of respondents expected the same trade sales volume while 36% of respondents expected improvement. In construction and retail sectors, managers indicated higher inflationary expectations. In the service sector, managers' expectations remained favorable regarding growth in the sector for the next 6 months; their expectations about employment in the sector improved, and expectations on selling prices indicated "no change".

Fiscal Policy

In July, the government's fiscal reserve increased by EUR 137 million (Lev 268 million) to EUR 3.76 billion (Lev 7.35 billion). Fiscal reserve coverage of government and government-guaranteed debt reached 65.3%. In January-July, the fiscal surplus accounted for 4.6% of full-year projected GDP compared to 4.1% at the end of June. Given the strong year-to-date revenue performance, the year-end fiscal surplus could reach 4.5% of projected GDP (excluding contributions to the EU budget) if the government maintains its restrictive fiscal policy.

In January-July, consolidated fiscal revenues reached EUR 6.76 billion (Lev 13.22 billion), an increase of 17.1% yoy (17.4% yoy in June). The revenue growth was driven primarily by corporate and individual tax collections. Tax revenue amounted to EUR 5.54 bil-

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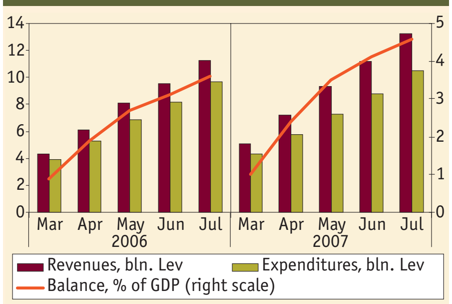
lion (Lev 10.83 billion), an increase of 19.3% yoy. Non-tax revenues reached EUR 1.05 billion (Lev 2.05 billion), a growth of 11% yoy. The government continues to implement gradual tax reforms. After reduction of the corporate income tax to 10%, the mandatory contributions to the State Pension Fund and Unemployment Fund will be reduced by 1 pps and 2 pps respectively as of October 1st.

In January-July, consolidated budget expenditures growth accelerated to 8.9% yoy from 7.9% yoy in the prior month and amounted to EUR 5.4 billion (Lev 10.5 billion). The consolidated budget allocated EUR 2.13 billion (Lev 4.16 billion) to social expenditures and EUR 0.63 billion (Lev 1.24 billion) to capital expenditures. Wages and salaries and maintenance allocations increased to EUR 0.84 billion (Lev 1.64 billion) and EUR 1.05 billion (Lev 2.05 billion). Capital expenditures posted the highest growth rate of 39.4% yoy while wages and salaries, maintenance and social expenditure allocations increased 11.7% yoy, 5.6% yoy and 4.8% yoy respectively.

Consolidated Budget Flows



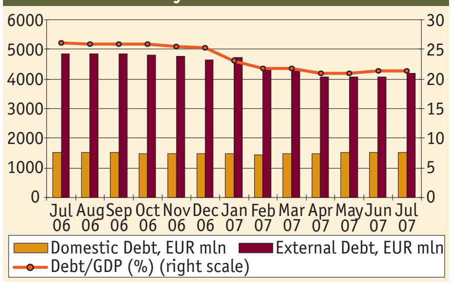
Source: Bulgarian Ministry of Finance

The government approved a 3-year fiscal framework (2008–2010) that incorporates government plans to continue tax and social insurance adjustments. The 2008 budget will be based on the fiscal framework and required changes will be introduced to the tax legislation. According to the framework, the consolidated budget surplus is targeted at 2.5% of GDP in 2008, economic growth is forecasted at 6%, and consumer price growth will slow to 3.7% next year and 2.6% in 2010. The tax legislation will be amended to implement the following policies: i) personal income tax will be reduced to a 10% flat rate, ii) the monthly wage floor will be raised to EUR 112 (Lev 220) from the current EUR 92 (Lev 180), iii) the monthly income ceiling subject to social insurance charges will be increased to EUR 1,022 (Lev 2,000) from the current EUR 715 (Lev 1,400), iv) pension adjustments will be equal to 50% of forecasted consumer price (CPI) growth and 50% of insurance income growth in the prior year (pensions were raised by 10% in July and will be further increased by 10% as of October 1st), and v) the excise tax on cigarettes will be increased by 50% for two consecutive years and the excise tax on fuel will go up by EUR 0.026 (Lev 0.05) per liter in 2008.

The government continues to implement its public debt management strategy, which targets reduction of government and government guaranteed debt and service costs. According to the Ministry of Finance, government and government guaranteed debt increased slightly over the month to EUR 5.76 billion (Lev 11.262 billion) from EUR 5.75 billion (Lev 11.256 billion) at the end of July. On an annual basis, government and government guaranteed debt decreased by 9.6%. The debt to GDP ratio was 21.6%, unchanged from the previous month.

In July, external government and government guaranteed debt slightly increased to EUR 4.21 billion from EUR 4.09 billion in the prior month. The average weighted residual term to maturity of external debt was nine years and six months. In the debt structure, global bonds and euro bonds accounted for 41.9%, debt to the World Bank was 21.1%, government investment loans and guaranteed loans accounted for 14.6% and 13% respectively, and obligations to the EU and Paris club stood at 7.8%. Domestic government debt decreased slightly to EUR 1.54 billion from EUR 1.55 billion in June. The share of government securities denominated in Lev decreased to 74.3% and securities denominated in EUR and USD stood at 25.7%. The maturity structure of government debt slightly changed. Long-term securities grew to 65.2% and medium-term securities dropped to 34.3%.

Dynamics of Domestic and External Public and Publicly Guaranteed Debt



Source: Bulgarian Ministry of Finance

The Bulgarian National Bank (BNB) released preliminary data on gross external debt as of the end of June. Gross external debt increased by EUR 467 million (2.25% mom) to EUR 21.18 billion. On an annual basis, gross external debt increased 22.5% and reached 79.2% of GDP. Short term liabilities accounted for 31% of total debt (EUR 6.57 billion). After a 7.2% mom decline in May (transfers of reserve funds released by the BNB after abolishment of credit restrictions on January 1, 2007), liabilities in the banking sector increased 6.2% mom to EUR 3.67 billion. Inter-company lending (direct investment liabilities) grew 0.7% mom to EUR 6.48 billion, and other sectors debt increased 1.3% mom to EUR 7.8 billion. Since the start of the year, inter-company lending showed the highest growth rate of 15.8% (EUR 885 million), banking sector liabilities increased by 8.4% (EUR 282 million) and third sector external debts posted growth of 11.6% (EUR 814 million).

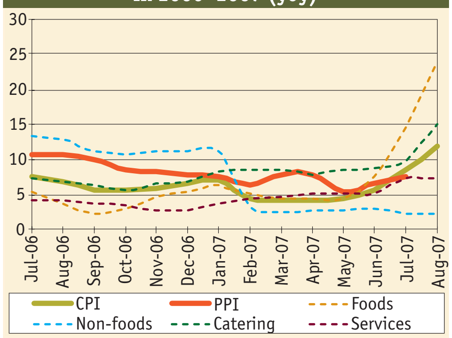
Monetary Sector

In August, consumer prices as measured by the Consumer Price Index (CPI) surged 3.1% mom while CPI posted growth of 2.2% mom in July and 0.4% mom deflation in June. The consumer price hike is driven by a one-off shock in agriculture and related industries after drought damage in the region. In the first eight months of the year, CPI growth reached 7.5%, which is already far above the government inflation target of 4.4% for 2007. On an annual basis, the consumer price index posted a 12% increase. Given the strong economic performance, inflation remains the greatest challenge in meeting the Maastricht criterion for European Monetary Union (EMU) membership. The rebound in price growth delays the BNB's plan to access the Exchange Rate Mechanism (ERM II) as soon as possible.

In August, consumer prices in foods, catering and service sectors increased 7.3% mom, 4.8% mom and 0.3% mom respectively while consumer prices in non-foods have not changed for the second month in a row. On an annual basis, food prices grew 24.1%, prices in services and catering grew 7.5% and 15% respectively, and prices in the non-foods sector edged up 2.1%. Besides the drought this summer, the increasing wage demands due to the shortage of qualified labor, foreign financial inflows as well as price adjustments to EU average levels all exert inflationary pressure on the economy.

The harmonized index of consumer prices (HICP), calculated on the basis of consumer weights and standardized product groups of EU countries, increased 9.3% yoy in August (6.8% yoy in July). The difference between the HICP and the national CPI is attributed to the larger weight of catering and services in the consumer basket of the EU. The HICP is used to measure the country's performance toward meeting the price stability criterion for joining the EMU.

Changes in CPI, PPI and CPI Major Components in 2006–2007 (yoy)



Source: Bulgarian National Statistical Institute

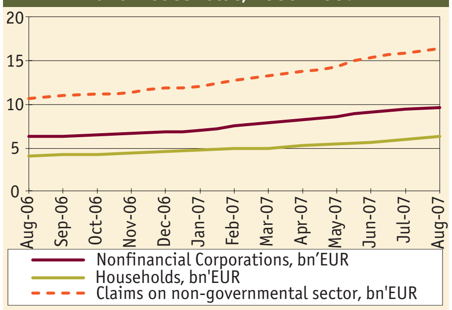
In July, producer prices measured by the producer price index (PPI) increased 7.7% yoy, up from 6.5% yoy growth in June. The growth of producer prices accelerated from 0.7% mom in May to 1.2% mom in June to 2% mom in July. While producer price growth was driven primarily by the mining sector in June, producer prices in the utilities sector contributed most to the increase in PPI in July. Prices in the utilities, manufacturing and mining sectors posted growth of 3.6% mom (0.2% mom in June), 1.2% mom (1.2% mom in June) and 4.2% mom (4.5% mom in June) respectively.

In August, broad money (M3) increased to EUR 19.3 billion (Lev 37.8 billion), a growth of 30.4% yoy (29.1% yoy in July). Narrow money (M1) grew to EUR 9.7 billion (Lev 18.9 billion), an increase of 30.3% yoy (28.9% yoy in July). The monetary base increased 2.7% mom to EUR 5.44 billion (Lev 10.6 billion). The money supply multiplier increased to 3.55 from 3.52 in July. The ratio of money supply to GDP increased to 72.3% from 69.6% in July.

Deposits with a maturity of up to 2 years increased to EUR 7.98 billion (Lev 15.61 billion), a growth rate of 30.6% yoy (29.6% yoy in July). Deposits redeemable at notice of up to 3 months amounted to EUR 1.67 billion (Lev 3.27 billion), an increase of 30.9% yoy (28.5% in July). Overnight deposits reached EUR 6.17 billion (Lev 12.06 billion), up 39% yoy (36.9% yoy in July).

The Bulgarian National Bank (BNB) decreased its base interest rate to 4.09% p.a. in September after an increase from 4.01% p.a. to 4.10% p.a. in August.

Growth of Loans to Nonfinancial Corporations and Households, 2006–2007



Source: Bulgarian National Bank

In August, claims on the non-government sector surged to EUR 16.43 billion (Lev 32.14 billion) from EUR 15.78 billion (Lev 30.86 billion) in the prior month. On an annual basis, claims on the non-government sector grew 54.1% (49.3% in July). Loans to non-financial corporations were the fastest growing component of the claims. As of the end of August, loans to non-financial corporations had expanded 57.9% yoy to EUR 9.72 billion (Lev 19.3 billion). Loans to households grew 50.2% yoy to EUR 6.15 billion (Lev 12 billion). The share of claims on the non-governmental sector in foreign currencies decreased slightly to 48.4% from 48.7% in July.

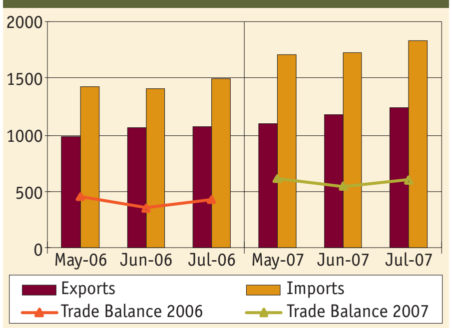
As of September 1st, the Bulgarian National Bank increased the minimum reserve requirement (MRR) of banks from 8% to12% to slow down bank credit growth.

International Trade and Capital

In July, the balance of trade in goods posted a deficit of EUR 601 million according to preliminary data from the National Statistical Institute. In January-July, the trade balance deficit reached EUR 3.89 billion (14.5% of GDP), an increase of 44.4% yoy. Data on foreign trade will be revised since it is now based on customs reports for non-EU countries and incomplete INTRASTAT files for EU states.

Export growth slowed to 4.3% mom in July from 7.4% in June and 7% mom in May. In January-July, Bulgarian exports grew to EUR 7.38 billion worth of goods, a growth of 8.6% yoy. Imports growth accelerated to 6.5% mom in July after a considerable slow down to 0.9% mom in June and strong growth of 9.9% in May. In January-July, Bulgarian imports grew to EUR 11.27 billion, an increase of 18.78% yoy. The share of exports to EU countries decreased slightly to 62.2% and the share of imports from EU countries in total imports fell slightly to 59.3%*.

Balance of Trade in Goods, EUR million



Source: Bulgarian National Statistical Institute

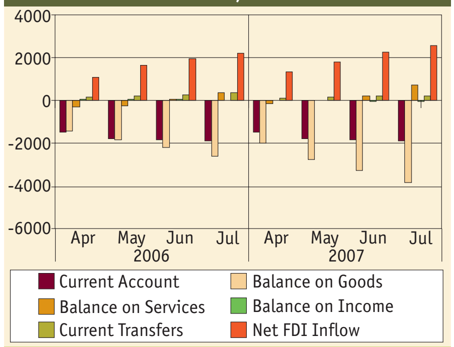
In January-July, the current account (CA) deficit widened to EUR 3.04 billion (11.4% of GDP). In July, the CA deficit narrowed to EUR 131.5 million from a deficit of EUR 273.4 million in June and EUR 472.1 million in May. The CA balance improvement is a result of seasonal improvement in the balance of trade in services. In July, the surplus of trade in services increased to EUR 457 million from EUR 278.4 million in June and EUR 91.6 million in May. In January-July, the tourist sector contributed EUR 1.35 billion, up 16% yoy.

In July, the growth of the foreign direct investments (FDI) slowed to EUR 301 million from EUR 488 million in June and EUR 492 million in May. In January-July, FDI reached EUR 2.67 billion (10% of GDP), an increase of 14.2% yoy. Equity investments increased by EUR 667 million to EUR 1.61 billion or 60.3% of all FDI inflow. In the first seven months of the year, foreign direct investment covered 87.7% of the CA deficit. The financial account surplus reached EUR 4.4 billion compared to EUR 3.2 billion in the same period last year.

The Ministry of Finance revised its forecast of the CA deficit for 2007 to 18% of GDP. In 2006, the CA deficit was 15.7%.

In August, the Bulgarian National Bank (BNB) reserve assets increased by EUR 471 million to EUR 10.3 billion, a growth of 26.9% yoy.

Current Account Components and Net FDI Inflow, EUR million



Source: Bulgarian National Bank

Other Developments and Reforms Affecting the Investment Climate

In July, basic unemployment dropped to 7.25% from 7.42% in June as a result of strong economic growth and increased seasonal demand in construction and tourist sectors.

On September 26th, The European Commission approved the national operational program "Development of the Competitiveness of the Bulgarian Economy" for 2007–2013. The program complies with the EU "Community Strategic Guidelines on Cohesion 2007–2013", which sets priorities linked to the Lisbon strategy. The budget of the program is close to EUR 1.16 billion, including EUR 988 million in European Regional Development Fund (ERDF) funds. The objective of the program is to increase sustainable economic growth and improve the competitiveness of the Bulgarian economy. Improving the business environment, introduction of new technologies, assistance in development of innovations, transitions to a knowledge-based economy and increasing productivity are the priorities of the operational program.

* Preliminary data of the NSI.

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"Eolica Bulgaria", a Spanish-Bulgarian company, plans to invest EUR 85 million in a wind farm with a capacity of 60 Mwt near Varna in Northeast Bulgaria.

The KBC Bank and Insurance Group (Belgium) will acquire a 75% interest in the Economic and Investment Bank (EIBank) for EUR 295 million. EIBank is the ninth-biggest lender by assets in Bulgaria. The acquisition will be finalized after the approval by regulatory authorities in Bulgaria.

In privatization of the shipping company "Navigation Maritime Bulgare", twenty three companies bought tender documentation and three of them submitted letters of interest to buy a majority interest. The tender bids were submitted by Chartworld Shipping Corporation (Greece), Essar Shipping&Logistics Ltd (India) and a consortium of KG Maritime Shipping (Bulgaria) and Martrade Shipping Transport (Germany). The deadline for submitting preliminary bids is November 8th. Navibulgar employs over 4,000 people and owns 77 cargo ships. In 2006, company revenues were EUR 200 million.