Bulgaria

Macroeconomic Situation

October 2007

Summary

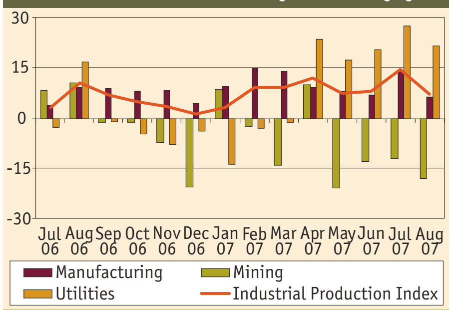
- The annual GDP growth in 2007 is likely to reach 6.0% yoy, which is supported by growing industrial and service sectors.
- In January-September consumer price inflation (CPI) accelerated to 13.1% yoy up from 12% in the previous month.
- The fiscal surplus for 8 months reached 5.5% of GDP.
- Due to prudent government debt management the level of country's debt decreased from 25% to GDP in January to 22.1% in August 2007.
- The rapid growth of current account (CA) deficit remains the main concern for the country's economy, reaching in January-August almost 12% of GDP. However, it is successfully covered by strong foreign direct investments (FDI) inflows.

Economic Growth

Among the key factors stimulating economic growth in Bulgaria in January-August 2007 was increased private consumption and investments. Private consumption in Bulgaria was driven by increasing real household income, which grew 21.7% yoy in January-August 2007, and private credit, which posted growth of 54.1% yoy. Consumer expenditures increased by 18.6% yoy and savings by 12.3% yoy. Consumer demand expansion and investments into economy continued to stimulate growth of industrial production in Bulgaria.

According to preliminary statistical data from the National Statistical Institute (NSI), the cumulative growth in January-August was lower than in January-July. Industrial production growth dropped to 6.2% yoy from 12.6% yoy in the prior month mainly as a result of deceleration of mining production by 19.6% yoy. The main reason of decreasing in mining is a high dependency on external market conditions. Sales in mining of metal ores, which is one of the export product, were down due to lower prices for similar products on the world market, mostly from China, Kazakhstan and Russia. Nevertheless, general growth in industrial production was driven by utilities and manufacturing, which helped to offset negative trends in mining during May-August. Growth of production in utilities reached 21.3% yoy. Robust performance of food processing, which increased by 9.3% yoy in January-August, continues to add a notable contribution to the sustainable growth in manufacturing. In January-August 2007, production in manufacturing grew 6.2% yoy, but compared to the previous month (due to a broader statistical base) the cumulative growth in manufacturing production in January-August was lower by 7.6 percentage points than in January-July 2007. The same trends existed in industrial sales, which surged 6.2% yoy. As a result of deceleration in rate of growth industrial production and the same trends in sales, the general growth rate for Bulgarian's exports dropped to 8.3% yoy. At the same time, the import of goods and services to Bulgaria strongly grew by 17.3% yoy. This widened the current account deficit in January-August 2007.

Index of Industrial Sales by Sector, % yoy



Source: National Statistical Institute

The NSI released its monthly "Business Conjuncture". The total business climate indicator (CBSI), which is calculated as a weighted average of four branch business climate indicators in industry, construction, retail trade and the service sector, was down 1.4% in September 2007 from August. The worse expectations are related to more moderate manager opinions about decreasing sales due to inflation pressures and increasing imports (the opinion was changed from "better" to "the same").

However, the strong accumulation of investments in 2007 as well as growth in industrial production set favourable expectations for the medium term. It is likely that GDP growth in Bulgaria will accelerate to about 6% yoy in 2007, driven by investments. The forecast for 2008 is slightly lower at to 5.9% yoy. It corresponds to the general GDP growth of 6.0% yoy in Southern and South-Eastern Europe for the same period.

Fiscal Policy

Bulgaria's fiscal policy was focused on budget expenditure containment because of high inflation in 2007. In January-August, **consolidated** expenditures amounted to EUR 6.1 billion (Lev 12.0 billion) while revenues reached EUR 7.8 billion (Lev 15.2 billion) or 29.2% of GDP.

The general revenues growth in the budget reached 18.3% yoy and was mainly driven by increasing tax revenues, due to a corporate income tax reduction to 10%, the widening tax base thanks to industrial production and import growth. In January-August, the profit tax was almost fully collected (99.6% of the amount approved by the Budget Law). It could be a result of higher company profits, lower unemployment (which continued to decrease in September and stood at 6.78%, down 0.22% mom and 1.66% yoy) and also a possible underestimated annual forecast for profit tax because of the fiscal impact of tax legislation changes.

In January-August 2007, consolidated budget expenditures amounted to EUR 6.1 billion (Lev 12.0 billion), increasing by 9.2% yoy. Budget expenditure execution was equal to 23% of GDP. The general expenditures structure (current and capital expenditures) was changed. These changes on 2.9 percentage points were concerned with increasing the share of capital expenditures (capital expenditure, state reserve gain and purchases of agricultural production, subsidies) from 15.3% to 18.2%. The growth rate of capital expenditures in comparison to the previous year was 26.7% yoy.

Current expenditures (wages and salaries, social and health insurance contributions, maintenance, interests payments and other social expenses) in January-August 2007 amounted to EUR 5.2 billion (Lev 10.2 billion). The growth rate for those expenditures was 6.5%, with the growth rate for wages and salaries at 12.2% yoy and maintenance at 5.6% yoy (which has an impact on household incomes increasing.) The share of current expenditures is 81.8%, while it was 84.7% in the same period of 2006. These changes in the structure of budget expenditures show a well designed social policy and good management of current liabilities. It allows for investment of budget resources into long-term programs, including structural reforms. Structural reforms that are aimed at raising the efficiency of the public sector have to be taken into account for development and achievement of public policy, aimed at promoting sustainable economic growth and improving the business climate.

As a result of revenues increasing and tight control over expenditures, the fiscal surplus in January-August was equal to EUR 1.5 billion (Lev 2.9 billion) or 5.5% of GDP. According to the Bulgarian "National Reform Programme (2007–2009)", one of the medium-term goals is to maintain a budgetary sur-

Republican Budget	8 Months 2006		Share %	8 Months 2007		Share %	%, yoy
	Lev billion	EUR billion		Lev billion	EUR billion		
Revenues	**8.9**	**4.5**	**100.0**	**10.5**	**5.4**	**100.0**	**18.3**
Profit tax	0.9	0.5	10.3	1.3	0.7	12.5	43.4
Personal income tax	0.8	0.4	9.5	1.1	0.6	10.5	31.3
VAT	3.6	1.9	41.0	4.2	2.1	39.8	14.8
Excises	1.6	0.8	17.7	2.1	1.1	20.1	34.1
Expenditures	**6.9**	**3.5**	**100.0**	**7.5**	**3.8**	**100.0**	**8.2**
Instalment for the EU Budget				**0.4**	**0.2**		
Fiscal surplus/deficit	**1.9**	**1.0**		**2.6**	**1.3**		**36.0**

Where Opportunities Emerge.

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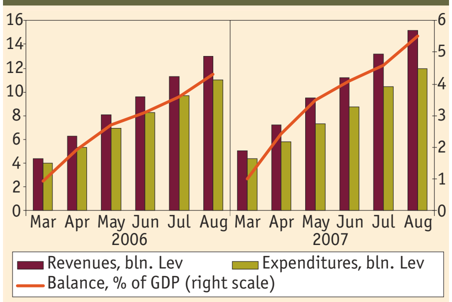
plus in the range of 1.5-2.0% of GDP over 2007-2009. If current tendencies were continued the year-end fiscal surplus will likely to be above the government quantitative target and reach 5.5-6.0% of GDP.

Consolidated Budget Flows

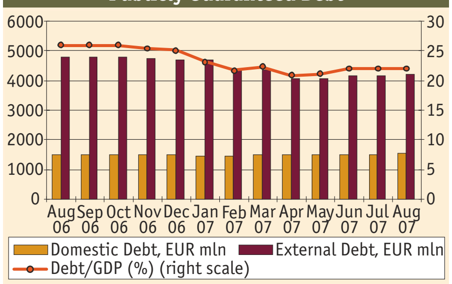


Source: Bulgarian Ministry of Finance

Bulgaria's debt policy is focused on debt reduction, which is why the public debt to GDP ratio decreased from 28.2% in January 2006 to 22.1% in August. The low level of public debt in Bulgaria and good credit rating ensure easy access to foreign financial markets. It helps to have a well-presented debt structure by residual maturity: long-term securities (7–10 years) dropped to 63.5% and medium-term securities (1–5 years) grew to 36.3%. The share of short-term securities (up to 1 year) totalled just 1.12%.

According to statistical data from the Ministry of Finance, the share of external debt in the debt structure was 73.1% at the end of August, while domestic was 26.9%. This proportion shows that external borrowings are more accessible and cheaper than domestic borrowings. But it could also have a negative impact on domestic market development. Public debt repayments in January-August were higher than new government borrowings (Lev 0.3 billion) which was one of the factors limited currency flows into the economy.

Dynamics of Domestic and External Public and Publicly Guaranteed Debt



Source: Bulgarian Ministry of Finance

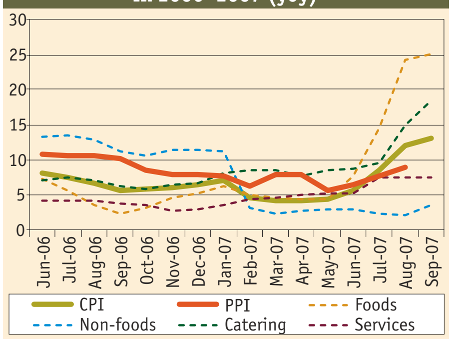
The Bulgarian National Bank (BNB) released preliminary data on gross external debt as of July 2007. In January-July, gross external debt increased by EUR 1.89 billion (9.4%) to EUR 22 billion. The share of gross external debt in GDP reached 82.3 %. On an annual basis, gross external debt increased by EUR 3.97 billion or 22% yoy in comparison to January-July 2006. Since the start of the year, the banking sector has the highest growth rate at 27.2% (EUR 795.1 million) which was caused by strong demand for credit resources from the private sector.

Monetary Sector

The inflation level in Bulgaria has increased to the maximum monthly rate for the last 2 years. In January-September 2007, the CPI surged 13.1% yoy. The high CPI rate was driven by price increases on foods and catering, which is a concern with unfavourable weather conditions this spring and, as a result, a lower yields of basic crops in Bulgaria. The prices for foods grew faster than other CPI components. For the first 9 months of 2007, food prices increased 25.1% yoy, catering prices increased by 18.3% yoy, while prices for non-foods and services grew 3.7% and 7.6% yoy respectively. The highest level of prices for food and catering was in July and August. During these months, food prices increased 3.9% mom in July and 7.3% mom in August, while catering prices grew 1.3% mom in July and 4.8% mom in August (due to heightened demand due to the tourism season's peak, when restaurant and hotels prices showed the highest growth rate of 17.7 % yoy).

In general, CPI in January-September 2007 is three times higher than the government inflation target for 2007 (4.4% yoy). The high CPI shows a problematic situation with monetary instruments, which are used for the inflation control in Bulgaria. Monetary policy in January-September shows a faster growth of monetary aggregates. In September, broad money (M3) increased to EUR 19.5 billion (Lev 38.2 billion), a growth of 29.1% yoy, as a result of the credit boom in Bulgaria. This has an impact on the acceleration of consumer inflation. Narrow money (M1) grew to EUR 9.8 billion (Lev 19.2 billion), an increase of 30% yoy. This state of affairs could influence or delay the process of access to the Exchange Rate Mechanism (ERM II).

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



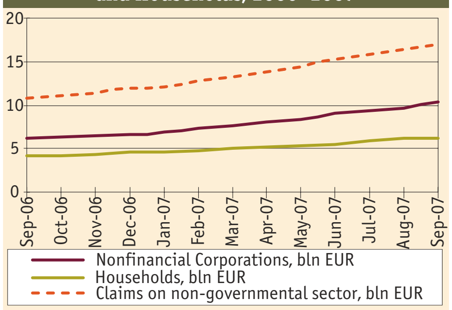
Source: Bulgarian National Statistical Institute

The CPI forecast by international experts for Bulgaria in 2007 is 8.2 % on an annual basis (and 7.9 % for 2008). But taking into consideration the current macroeconomic situation during the first nine months of 2007, this forecast could be too optimistic. It is likely that the CPI may reach 14–15 % yoy before the end of the year if the monetary policy remains unchanged.

The Producer Price Index (PPI) accelerated to 9.1% yoy. In January-August, the PPI growth was a result of price growth in utilities (14.2% yoy) and mining (12.3% yoy). Taking into account world demand for metal production, the price level in mining (metal ores) strongly increased in June (4.5% mom) and July (4.2% mom). In August, prices in mining slightly rose by 0.7% mom. Producer prices in manufacturing were rising gradually (1.2% mom in June-July and 1.4% mom in August) as a result of internal demand and high prices for energy resources.

As a result of the bank credit boom, the Bulgarian National Bank increased the minimum reserve requirement (MRR) of banks from 8% to 12% (as of September 1st, 2007). This was done to slow down bank credit growth, which also further stimulates inflation. In August, loans to the non-government sector (more than 50% of general loans) increased to EUR 16.96 billion (Lev 33.16 billion) or 56.4% yoy. Loans to non-financial corporations were the fastest growing component of loans and expanded 66.4% yoy to EUR 10.39 billion (Lev 20.33 billion). Loans to households grew 48.3% yoy to EUR 6.26 billion (Lev 12.24 billion). According to this data, the banking sector seems well-positioned to absorb adverse shocks. However, the true underlying credit risk is difficult to gauge in a rapidly developing economy, and the quality of credit portfolios needs to be carefully monitored, especially credit structure (short-term and long-term credit).

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



Source: Bulgarian National Bank

International Trade and Capital

Strong consumer demand and the domestic industrial slowdown negatively affected net export flow in August. The deficit during January-August 2007 stood at EUR 3.2 billion (12% of GDP), resulting

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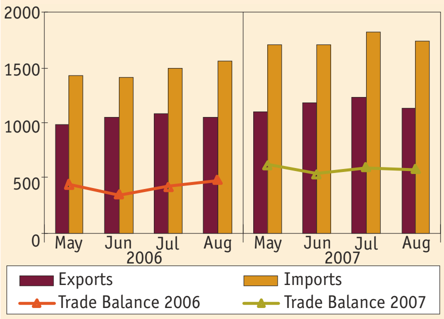
from a large deficit of trade balance. During the first eight months of 2007, the trade balance deficit reached EUR 4.47 billion (16.7 % of GDP).

Balance of Trade in Goods, EUR million

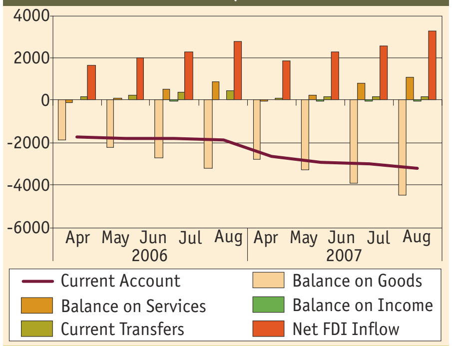


Source: Bulgarian National Statistical Institute

As expected, import growth in January-August 2007 was higher than exports and accelerated to 17.3% yoy compared to 8.3% yoy. Bulgarian exports grew to EUR 8.53 billion worth of goods; imports grew to EUR 13 billion. In contrast to balance of goods, the balance of trade in services in August was positive and reached EUR 1.1 billion.

Based on macroeconomic indicators the Current Account Balance (CAB) in 2007 should accelerate to

Current Account Components and Net FDI Inflow, EUR million



Source: Bulgarian National Bank

19%. It could be slightly lower (18.0%) in 2008. In general, these expectations are absolutely appropriate for the current trends in Bulgaria (in 2006, the annual CAB deficit was 15.7%, while the Ministry of Finance's forecast for 2007 is 18% of GDP).

Nevertheless, the financial and capital account, helped by foreign debt accumulation by the private sector, managed to fully cover the CA deficit in January-August 2007. The total amount of FDI reached EUR 3.4 billion (12.7% of GDP for the first eight months of the year), an increase of 21.7% yoy. As a result, net FDI inflow covered 102.4% of the CA deficit in the first eight months of the year. The financial account surplus reached EUR 5.4 billion (70.3% yoy) compared to EUR 3.2 billion in the same period last year. Thanks to robust FDI inflow and external crediting, the Bulgarian National Bank reserve assets increased by EUR 1.4 million in August to EUR 11.7 billion, a growth of 38.7% yoy.

Taking into account Bulgaria's increasing gross external debt, the larger share of debt-financing of the CA gap makes the economy more dependent on external shocks in world financial markets (like the mortgage crisis in the US). Because of this, the Government should attract the FDI flow at modernization in industrial and service sectors.

Other Development and Reforms Affecting the Investing climate

The World Bank recently released "Doing Business 2008". The report noted that Bulgaria is in the top 10 reforming countries from 178 total countries, which helped take the country from 56th to 46th place in the total rankings. The strong economic growth during last few years and effective fiscal policy facilitated the investment climate improvement.