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Bulgarian Odyssey: Economy 2006 and Investment Climate

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Part One: Bulgarian Economy 2006

Overview

In 2000–2005, Bulgaria enjoyed excellent macroeconomic performance. During this period, average GDP growth was 4.9%, which made Bulgaria one of the fastest growing economies in Southeast Europe. Such good macroeconomic performance was mainly due to fast growing domestic consumption and rising investments. During 2005, domestic consumption increased by a significant 11.3% yoy and investment contribution to GDP growth more than twice that of 2002.

During the last several years, Bulgaria's real sector has undergone significant changes in composition with a considerably increasing weight of the service and industrial sectors and a decrease in the weight of agriculture. In 2002–2005, the major driving force of Bulgaria's real sector was industry, and manufacturing in particular, whose average annual growth was the highest within the country's industrial sector. Growing domestic consumption, increasing retail trade, rising construction and services should support successful macroeconomic performance in the coming several years.

During 2004–2005, the Bulgarian government demonstrated prudent fiscal policy, concentrating on facilitating structural reforms, improving the quality of public services, rising standards of living and stimulating investment activity. To a large extent this became possible because of the currency board introduced in 1997. Since 2004, Bulgarian authorities have managed to achieve fiscal surpluses, and this tendency also remains in the first 6 months of 2006 when the budget surplus constituted around 3% of projected full-year GDP. Good budget performance during the period was a result of improved tax revenue collections and prudent management of fiscal expenditures. One of the main features of the public expenditure management was an increase in spending on social development, by gradually reducing subsidies to state owned enterprises and increasing investment expenditures. Bulgaria's EU accession in 2007 should bring additional inflow of new financing to the country, which will help the country to continue with reforms as well as bring additional revenues to the budget.

The last two years of bad harvest, an increase in prices for energy resources along with pre-accession harmonization of prices contributed to acceleration of consumer price inflation (CPI) in 2005-2006. However, during this period its average level was always at a one digit level acceptable for transition economies.

The current account (CA) deficit has been the main risk for the Bulgarian economy over the last few years. Starting from –2.4% of GDP in 2002, the CA deficit widened to 11.8% of GDP in 2005 and posted a 7.6% deficit in H1 2006 of projected full year GDP. In 2005, the government undertook temporary measures to curb rapidly growing private consumption and credit growth, which contributed to the widening CA deficit and threatened the fiscal stability of the country. As a result, tighter reserve requirements and credit expansion limits for commercial banks have been introduced and credit growth has been reduced substantially. The measures were relaxed in mid 2006 as they started losing their effect and created a cost to the banking system.

Bulgaria operates under a currency board arrangement and has its local currency pegged to the Euro at a rate of 1.95583 Lev per 1 EUR. Therefore, foreign exchange reserves serve as an important instrument in maintaining a fixed exchange and therefore should be closely watched. During the last several years, foreign exchange reserves have been rising, mainly due to the high inflow of foreign direct investments. Although the foreign reserve import coverage has been declining slightly since 2004, the continuing growth of foreign direct investments (FDI) will maintain the stock of foreign reserves in the country at a sufficient level.

The main factor for increasing FDI to Bulgaria was improving the country's investment climate. However, some other factors also positively affected FDI inflow in individual years. For instance, the main factor for rising FDI inflow in 2004 was successful privatization, which slowed significantly in 2005 and then renewed in 2006. The largest shares of FDI have traditionally come from the United Kingdom, Austria and the Netherlands, which together accounted for more than half of total FDI stock in Bulgaria at the end of H1 2006.

Bulgaria's foreign trade is characterized by a high degree of openness. Its trade-to-GDP ratio stands at around 130%. The major trading partners for Bulgaria are EU member states, which account for 60% of the country's total international trade. During the last few years, imports have exceeded exports, which led to widening trade and CA deficits.

During the last several years, the Bulgarian government demonstrated prudent debt management. The amount of public and publicly guaranteed debt has been declining and during the first half of 2005, the debt-to-GDP ratio has been maintained at a level below that required for EU-membership. The share of foreign debt in the total country debt has been declining, while the share of domestic debt has been on the rise during the last five years. The currency and maturity structure of government debt has also undergone significant changes, which contributed to a decreasing risk of insolvency. Over the last few years, the major lenders to the country have been the World Bank and the IMF, whose total share in the country's total external publicly guaranteed debt has been slightly above 20% since 2001.

Along with the improving economic situation in the country, Bulgarian authorities have made significant progress in improving the country's investment climate. In particular, government authorities undertook the following reforms and measures over the last couple of years:

- Introduced significant changes in the legislative framework, aiming to improve the country's judicial system and legislation concerning corporate governance;

- Reformed the business regulatory environment by improving the quality of new laws and make existing laws more business friendly;

- Initiated public administration reform by updating the legislative framework and creating a separate body to deal with public administration reform issues;

- Facilitated privatization by using capacity of the Bulgarian Stock Exchange;

- Liberalized and aligned country's trade policy with EU requirements;

- Built a relatively stable and efficient financial sector, capable of attracting investments, mobilizing savings, and allocating resources to their most productive use;

- Undertook significant efforts in fighting corruption by adopting anticorruption legal instruments and institutional mechanisms.

Subsequent sections of Part One present the results of Bulgaria's economic development in 2005-1H 2006 and discuss future prospects. Further sections in Part Two discuss the investment climate and propose specific policy recommendations to improve it. The evolution of key economic indicators for 2001-2007 is provided in the appendix.

1. The Real Economy

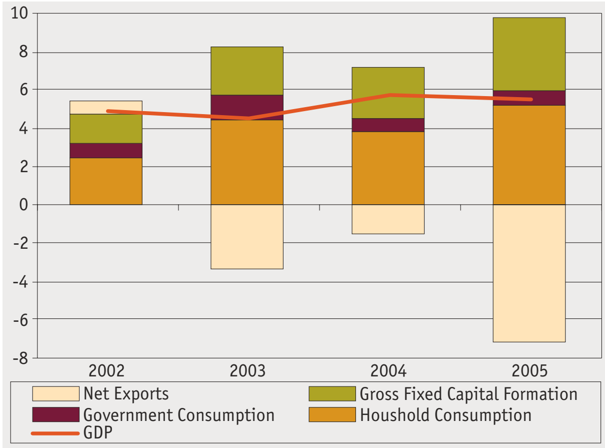
Over the last half a decade, Bulgaria's real sector showed very positive developments. Starting in 2001 from posting 4.1% yoy real economic growth, Bulgaria was able to reach 5.5% yoy in 2005 and will very likely remain at the same rate in 2006 and only marginally lower in 2007. The average annual rate of growth of the country's GDP in 2001–2005 was at strong a 4.9% yoy, supporting the idea that Bulgaria became one of the fastest growing economies in the Southeast Europe region. Moreover, economic growth was significantly higher than in the most advanced EU member states.

GDP Growth of Bulgaria, EU and Southeast Europe in 2001–2005, % yoy

Source: IMF

The main driving force for Bulgaria's surging GDP was sharply growing domestic demand. The historical peak of its growth over the last five years was registered in 2005 when aggregate domestic demand jumped by a very strong 11.3% yoy, while the period historical minimum of 4.1% yoy growth in this component was demonstrated in 2002. The detailed dispersion of Bulgarian domestic demand by different components supports the idea that, as in other fast growing economies, surging individual consumption was among the main contributors to the country's economic growth. Growth in household consumption ensured 5.2 percentage points (pps) growth of the country's GDP in 2005. Although an increase in government consumption has an important role for stimulating a country's overall positive economic performance, it contributed only 0.7 pps to Bulgarian GDP growth in 2005. Additional impulse for growth in the real sector was received from the upward trend in the investment component of GDP, whose contribution to the country's economic growth more than doubled in 2005 as compared to 2002. While gross fixed capital formation contributed 1.55 pps to GDP growth in 2002, this input increased to a significant 3.96 pps in 2005.

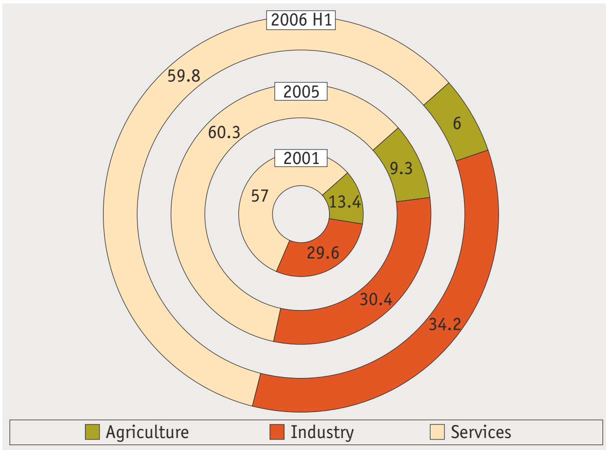
Contributions to GDP Growth, percentage points



Source: Bulgarian National Bank

The structural breakdown of Bulgaria's real sector suggests that there were significant changes in its composition over the last 5 years. The current distribution of the Bulgarian economy bears a closer resemblance to GDP structures of EU member states, where services make up the lion's share of GDP.

Value Added Structure by Sector, %

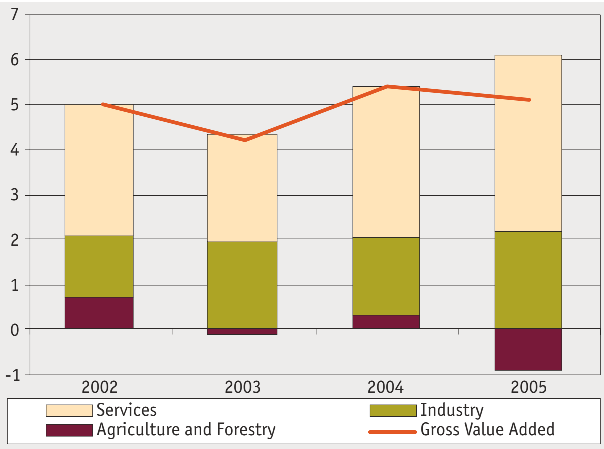


Source: Bulgarian National Statistical Institute

In the first half of 2006 (H1), 59.8% of the country's total value added came from the service sector, which is 3 pps higher than in 2001. In parallel, with the increasing importance of the service sector, the role of industrial production also grew significantly. In H1 2006, industry obtained 34.2% of the country's total value added compared with 29.6% in 2001. The increase in importance of both services and industry was at the expense of Bulgarian agriculture, which shrunk during the same period by more than half, falling from 13.4%

in 2001 to 6% in H1 2006. The existing structural changes in the real sector reflect the common tendencies in the economies of developed countries, where the related weight of the agriculture sector decreases while the weight of the service sector increases. The on-going restructuring of the Bulgarian real sector moves it closer to the EU member states pattern and should secure faster adaptation of the Bulgarian economy to the EU environment.

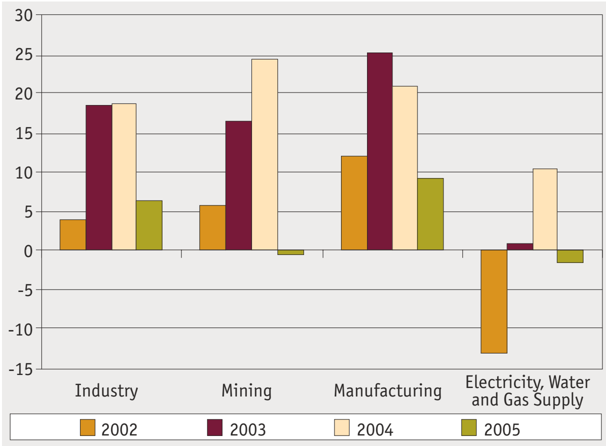
Contributions to Gross Value Added by Sector, percentage points



Source: Bulgarian National Statistical Institute

Growing Bulgarian industry is a significant driving force for the country's real economy growth. A structural breakdown of the industrial sector shows that the highest rate of growth within industry in 2002–2005 was in manufacturing, where output grew at an average annual rate exceeding 16%, while the same indicator for industry as a whole was 5 pps lower. The overall performance of Bulgarian industry could be even better if the rate of growth in utilities had not been declining during two out of the five years during the analyzed period. In 2002-2005, utilities sector growth shrunk on average by almost 8% p.a. The deepest decline in this sector was shown in 2002, when its output fell by around 12% compared with the previous year. The negative rate of growth in utilities is partly explained by decreasing consumption of this sector's products due to the introduction of new energy conservation technologies and partly to the low level of productivity in utility generating companies due to the existing low quality of available technical facilities. However, already implemented projects aimed to fulfill technical modernization of utility production facilities should secure further development of the sector and, consequently, the whole industry.

Industrial Output, % yoy



Source: Bulgarian National Statistical Institute, TBF's calculations

Future Prospects

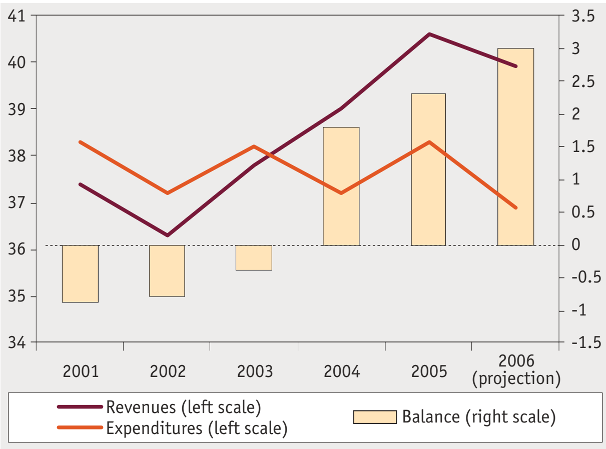
In 2006–2007, real GDP growth is projected at a same range as in 2005, when GDP grew at 5.5% yoy, and even slightly higher in 2006 with a possible minor deceleration in 2007. The growth in GDP will be supported by strong growth in domestic consumption. The positive developments in the real sector will be supported by growing retail trade, expanding construction and surging services. Relatively high prices for metals on international markets, even if the recent upward trend of prices is reversed, should ensure further developments of the country's industrial sector. Aggregate demand will likely accelerate due to recent increases in public investments.

Strong growth of household consumption will remain an important driving force for the country's positive economic developments. Moreover, increases in consumption will be stimulated by the recent decrease in taxes and growing income of the population.

2. Fiscal Policy

In 2004–2005 and H1 2006, the Bulgarian government implemented prudent fiscal policy that was in line with EU requirements to the EU candidate member states. The main efforts of the government were concentrated in supporting a wide range of structural reforms, securing a further increase in efficiency of public services provided by the state, and improving the living standards of the Bulgarian population.

General Government Budget Operations, % of GDP



Source: Bulgarian Ministry of Finance

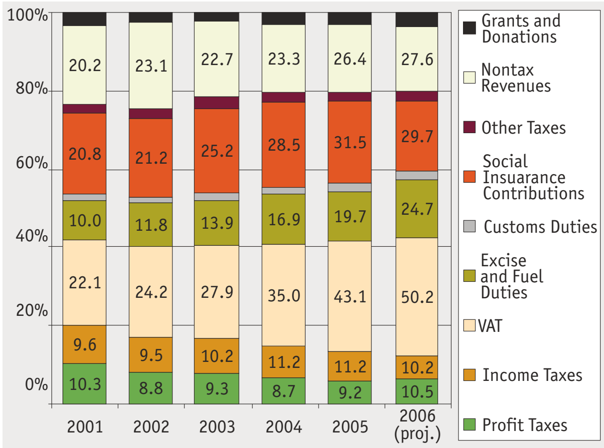
During the last several years, Bulgaria continued to exercise a balanced fiscal policy. Following a budget surplus of 1.8% of GDP in 2004, 2005 ended with a surplus of 2.4% of GDP, and the government was able to keep budget surplus on a level of around 3% of GDP in H1 2006. Existing fiscal surpluses over the last few years have helped Bulgarian authorities in supporting the country's macroeconomic stability, offsetting strong private sector demand, and creating conditions for stable economic growth.

Fiscal Revenues

The growth of fiscal revenues by 13.4% in 2005 was achieved on the back of good macroeconomic performance. At the same time, the increase in budget revenues could only be partially explained by good macroeconomic results. Other important determinants of successful budget execution were improvements in the existing tax system and increased efficiency of tax collection.

In 2005, total budget revenues reached Lev 17.9 billion (EUR 9.2 billion) or 42.9% of GDP, which is in line with the existing EU level of budget redistribution. In 2004–2005, the share of tax revenues in total budget revenues had the most significant weight and remained almost unchanged at a substantial level of around 80%. The 2006 budget also anticipates the same share of taxes in total revenues, and the results of the budget performance in H1 2006 provide additional arguments in favor of this forecast.

Consolidated Budget Revenues, % of total



Source: Bulgarian Ministry of Finance

The stable share of tax revenues in the total structure of budget revenues was ensured by a softening of the Bulgarian tax system. In 2005, the corporate tax rate decreased from 19.5% to 15%. Moreover, in 2006 the Bulgarian Parliament voted that starting 2007 it would be further decreased to 10%, which makes Bulgaria one of the most competitive states within the region and, consequently, more attractive for foreign investors. During the year, there were also some positive changes in the system of personal income taxation. In particular, non-taxable monthly income was increased from Lev 120 to Lev 130.

Fiscal Expenditures

In 2004–2005 and H1 2006, fiscal expenditures were managed prudently. The total amount of expenditures in 2005 increased at a higher rate compared with the previous year. While they surged by 7.9% yoy in 2004, the increase was significantly higher in 2005 and reached 12.7% yoy. On a positive note, the country's level of GDP redistribution was on a downward trend. During the last five years, 40% of the country's GDP was redistributed through budget expenditures, while this number reached 40.5% in 2005 and should be at a slightly lower level of 39% in 2006.

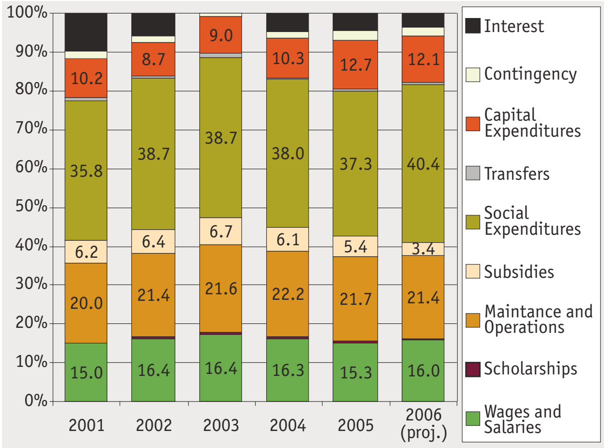
During the last two years, state budget expenditures were mainly directed into programs aimed at supporting the development of social services. In 2005, 14.3% of the country's GDP was spent to support social expenditures, which includes 8.9% for the pension fund, 2.5% for assistance and unemployment, 2.3% for the health insurance fund, and 0.6% for other social support measures. The same emphasis remained in the 2006 budget, where 14.9% of the country's GDP is planned to be redistributed for different social expenditures.

Structural reforms made in the country over the last 5 years along with the massive privatization campaign significantly decrease the amount of subsidies spent by the budget to support state-owned companies. While the share of direct subsidies in the Bulgarian budget was 6.2% in 2001, the weight of such expenditures in the total amount of expenditures is anticipated to drop almost two fold in 2006 and reach EUR 303.6 million.

A significant increase in 2005 expenditures is mainly due to introduction of higher wages and salaries in the budget-supported sphere and an increase in expenditures related to combating unemployment. Starting January 2005, the government raised minimum monthly wages by 25%, which brought its amount from Lev 120 (EUR 62) to Lev 150 (EUR 77). In addition, starting June 2005 there was a 13% increase in the minimum pension. Additional pressure on the state budget was also caused by strong commitments made by the Bulgarian government to combating unemployment. For these purposes, the 2005 budget envisaged EUR 104 million, and this figure increased by about one third in the 2006 budget.

On the positive side, over the last couple of years the Bulgarian government has started to extend its investment activity, in order to create a solid basis for the country's future growth. While the average level of capital expenditures did not exceed 3.6% of GDP in 2001-2004, 4.9% of GDP was spent for these purposes in 2005 and the 2006 budget anticipates 4.5% of GDP to be spent for different capital modernization programs.

Consolidated Budget Expenditures, % of total



Source: Bulgarian Ministry of Finance

Future Prospects

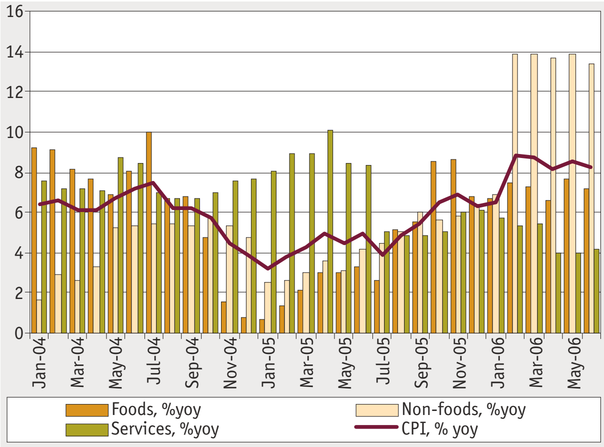
The existing level of vulnerabilities related to the country's current account deficit does not leave room to relax fiscal policy. Therefore, keeping a budget balance in surplus should be one of the government's priorities in 2006 and 2007. Fully realizing this necessity, the government projected the consolidated budget surplus to be around 3% of GDP in 2006, with a slight decline to 0.8% of GDP in 2007. The fiscal performance in the first half of 2006, when the budget was in surplus of 3.1% of GDP, suggests that 2006 budget objectives will be successfully met.

Bulgaria's accession to the EU provides the country with a unique opportunity to benefit from a substantial amount of EU supporting funds. The new transfers will be coming in addition to those funds, which were already received by the country through pre-accession channels including PHARE and ISPA. The amount of post accession funds from the EU to Bulgaria, which can be available upon accession in 2007-2009, can secure up to 2% of GDP of additional revenues for the country's budget. However, EU membership will also require co-financing from the Bulgarian side, which will have an opposite effect on budget. Since co-financing should not exceed 1% of GDP, the net effect of having post accession EU-financing will be positive.

3. Monetary and Exchange Rate Policies

Consumer and Producer Price Inflation

Consumer Price Inflation by Main Components, 2004–2006



Source: Bulgarian National Statistical Institute

Over the last couple of years, the Bulgarian National Bank was able to conduct prudent monetary policy aimed at securing a low level of inflation and stable exchange rates.

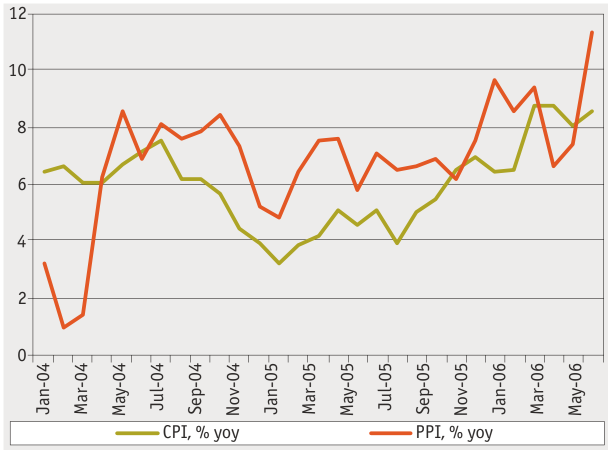
In 2004–2005, the average end of period rate of consumer price inflation was 5.2% yoy. Some acceleration in the rate of growth of inflation appeared in 2005 after a significant slowdown in 2004, when CPI inflation did not exceed 4% yoy.

In 2005, actual end of year inflation posted 6.3% yoy, which slightly exceeded the initially forecasted rate. This excess was due to several factors, the foremost of which was supply side shocks; in particular, flood damages contributed to a poor harvest and caused high prices on domestically produced agricultural products in the second half of 2005. Another additional impulse for acceleration in inflation was an increase in energy prices. The hike in energy tariffs significantly increased domestic prices for services.

An additional factor for acceleration in consumer price index (CPI) inflation was harmonization of domestic prices with EU price levels. As a result, Bulgaria's prices for some groups of goods and services grew considerably. Moreover, those goods and services where harmonization took place posted the fastest increase in prices. In particular, transport tariffs posted 14.9 % yoy growth in 2005, healthcare services increased by 11.4 % yoy, and alcohol and tobacco surged by 10.6% yoy.

The poor harvest of the last year, an increase in steep excise taxes for some non-food products introduced in 2005 along with surging oil prices contributed to the growth of the CPI in H1 2006. During this period, it posted 2.9% yoy growth. Inflation in H1 2006 is in line with the government forecast of year-end inflation at 6.6% yoy.

Inflation and Money Supply Developments, 2004–2006

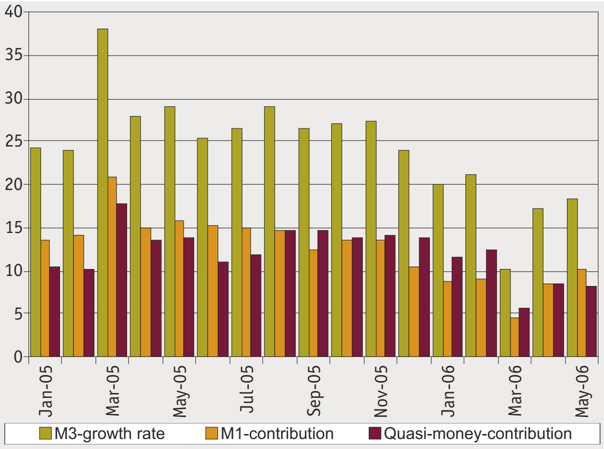


Source: Bulgarian National Statistical Institute

During the last several years, an increase in energy prices was the major factor for the upward trend in producer inflation. Another important driver for increases in the producer price index (PPI) was surging prices for metals. Overall in 2005, the PPI increased by 9.6% yoy. In H1 2006, the PPI demonstrated an upward trend, surging by 10.9% yoy compared with 7.1% posted in H1 2005.

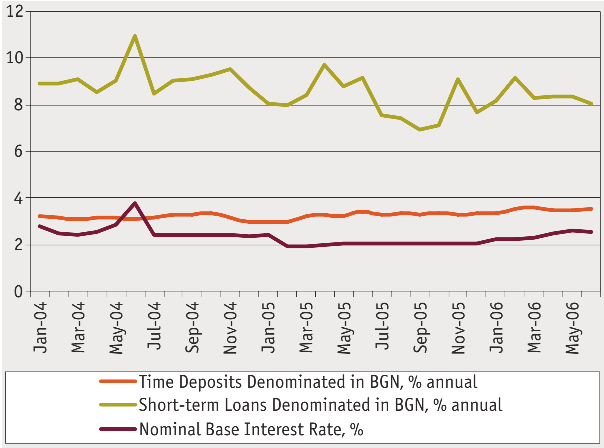
In 2005, the BNB was able to conduct thoughtful monetary policy. During the first two months of 2005, money supply (M3) grew at a stable rate of 24% yoy. At the end of Q1, there was a one-time acceleration in the growth of money supply in view of the BNB's announced credit restrictions, taking effect in April 2005. Since then and through the end of the year, money supply growth was showing a stable trend with the average growth rate in M3 of around 27% yoy. Up until July, the main contributors to money supply growth were deposits with up to 2 years maturity and overnight deposits. During the first half (H1) of the year, both types of deposits grew at a rate of around 45% yoy. In H2 2005, the rate of their growth experienced some deceleration as compared to H1, and year-end growth was around 30% yoy.

M3 Growth Rate, M1 and Quasi-money Contribution, 2005–2006



Source: Bulgarian National Bank, own calculations

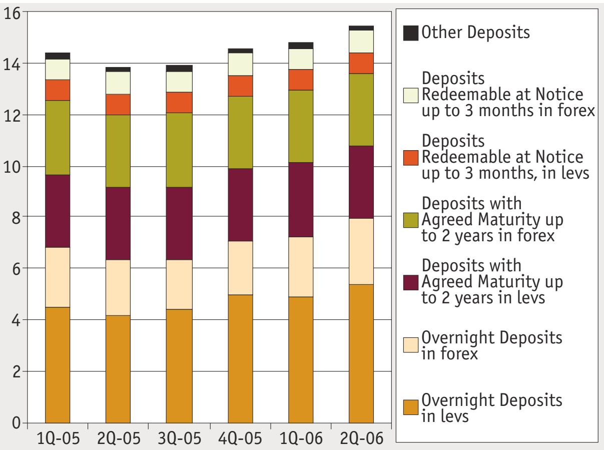
Interest Rate Dynamics, 2004–2006



Source: Bulgarian National Bank

In 2006, money supply growth was decreasing during Q1 and rising again in Q2. However, on average monthly money supply growth in 2006 was slower than in the previous year: 18% yoy compared to 28.1% yoy. Consequently, the rate of growth of deposits in all currencies decelerated as well. The exception has been foreign currency denominated deposits with up to 2 years maturity, where the average monthly rate during H1 of 2006 grew twice as fast as in the same period of 2005 and remained one of the main contributors to money supply growth since H1 of 2005. As a result, foreign currency denominated banking deposits in H1 2006 reached EUR 5.1 billion up from EUR 4.6 billion at the beginning of the year.

Deposit Structure in 2005–2006, BGN billion



Source: Bulgarian National Bank, own calculations

In 2005 and H1 2006, the major part of deposits was comprised of overnight deposits and deposits up to 2 years, which together constituted more than 80% of the overall banking deposits stock. Shares of Lev and foreign currency denominated deposits have been stable since the beginning of 2005 and constituted on average 55% and 45% respectively.

Interest Rate

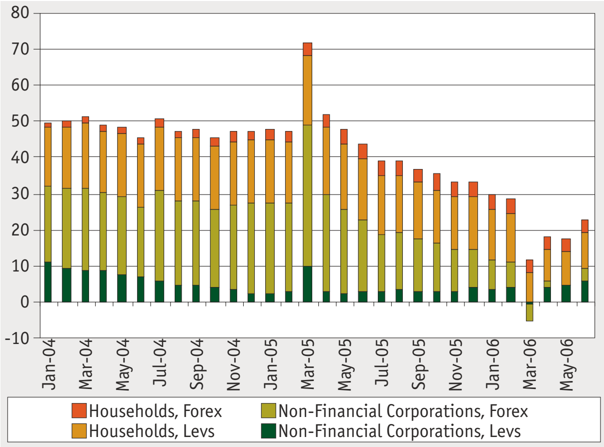
In 2004–2005 and H1 of 2006, the BNB kept the base interest rate at an average level of 2.34 % per annum (p.a.), with a very small fluctuation in its level with a period historical minimum of 1.89% p.a. and maximum of 3.78% p.a.

In December 2004, the BNB announced the introduction of changes in the way the base interest rate would be calculated. In particular, starting February 2005 base interest started to be calculated as an average value of the interbank overnight lending rates (LEONIA) for the previous month instead of being set in accordance with the yield on 3-month government bills. Due to this change, the base interest rate fell slightly in February 2005 to 1.9 % p.a. as compared to 2.4% a month before, which caused a slight decline in interest rates of Lev-denominated instruments. Thus, T-bond yields declined by 75 basis points and the annual interest rate of short term loans fell by 4 basis points. Starting May 2005, the base interest rate was increased somewhat, reflecting the BNB's policy for curbing credit expansion. However, through the end of 2005, the average base interest rate remained lower than in the previous year. At the same time, the interest rate spread for local currency-denominated deposits and loans has been declining on average since the beginning of the year, indicating increased competition on financial markets.

In January 2006, the base interest rate was raised by 16 basis points from its previous month's level of 2.05% p.a. as a response to the European Central Bank (ECB) decision to raise the interest rate on its main refinancing operations at the end of last year. At the end of H1 2006, the BNB continued to raise the base interest rate and in July it was set at 2.56% p.a.

Loans to Non-government Sector

Growth Rates of Banks Credits, 2004–2006, percentage points

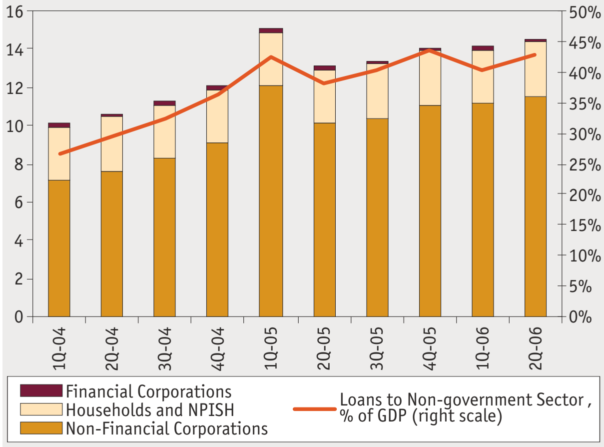


Source: Bulgarian National Bank, own calculations

In 2002–2004, the amount of credit issued to government and non-government sectors was growing at a high rate, sometimes exceeding 50% yoy. In late 2004, fearing that the high pace of credit growth might have a negative effect on the country's economy and cause financial instability (in particular, the rising CA deficit), the BNB started to undertake a range of measures aimed to restrict credit expansion. Among them was the introduction in April 2005 of the system of quarterly credit expansion limits of 6%, upon exceeding of which commercial banks were subject to an additional reserve requirement. In anticipation of the quarterly credit limits, commercial banks accelerated their credit activity and in March 2005 the amount of granted credits increased by more than 75% yoy. Accordingly, broad money supply was increased significantly — the growth rate of M3 constituted 32.4% yoy in March 2005. The undertaken measures, however, had a positive effect and by the end of 2005, credit growth was reduced to 30% yoy, and by the end of the first half of 2006 it constituted 23% yoy.

Quarterly credit expansion limits were introduced on a temporary basis initially until the end of March 2006 and later extended through the end of 2006. However, in view of the country's forthcoming accession to the EU, the BNB decided to relax the lending restrictions starting in August 2006. Indeed, the CA deficit was not improved and commercial banks' loans to the non-government sector as percentage of GDP increased from 36% in December 2004, to 43% in December 2005 and stayed at an average level of 41% during H1 of 2006. All credit restrictions will be eliminated altogether by the end of 2006.

Volume of Loans to Non-Government Sector, 2004–2006, BGN million

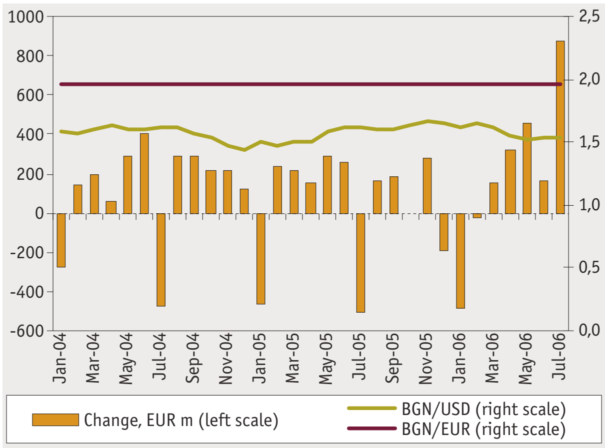


Source: Bulgarian National Bank, own calculations

Non-financial corporations' share in bank portfolios has been decreasing since 2Q of 2005 and constituted 58.8% of total credit in May 2006 against 68% in March 2005, reflecting the reluctance of Bulgarian corporations to take loans from local banks. At the same time, since private individuals have no access to sources of financing other than banks, the share of household loans in total bank loan portfolios increased and constituted 40.2% in May 2006, with mortgage loans growing at the fastest rate among retail loans. However, in June 2006 there was some increase, although slight, in the share of loans to non-financial corporations and a decrease in the share of household loans. This probably is a one-off or short-term occurrence, since local corporations will get even better access to foreign capital with the EU accession and will further reduce their share in Bulgarian's bank portfolios.

Exchange Rate and Foreign Reserves

Change in Official Foreign Reserves and Exchange Rates, 2004–2006



Source: Bulgarian National Bank

Since 1997, the Bulgarian central bank has been operating under a currency board arrangement whereby the Bulgarian Lev has been pegged to the Euro at a rate of 1.95583 Lev for 1 EUR. This arrangement was introduced to establish and maintain macroeconomic stability in the country. With this arrangement, the government has no control over the money supply and has no direct tools to control the inflation; therefore, Bulgaria has been using tough fiscal policy to curb inflation.

Under the fixed exchange rate arrangement, foreign reserves should be closely looked at as the main instrument in maintaining such an arrangement. During the last three years, the level of foreign exchange reserves has been rising on average, despite the deteriorating CA, and amounted to EUR 7.9 billion by July 2006 as compared to EUR 5.0 billion in January 2004. The major negative and positive changes in the stock of foreign reserves had to do with debt repayments, usually done at the beginning and in the middle of the year (July 2004, January and July 2005, January-February 2006), large surpluses in the financial account (November-December 2005), fiscal expansion as in December 2005, and the inflow of foreign direct investments throughout the years. During the last several years, the amount of foreign reserves has been enough to cover several prospective months of imports of goods and services, although import coverage has been decreasing since 2004. In 2004 foreign reserves could cover 6 months of imports, whereas in 2005 import coverage stood at 5.3 months and in H1 2006 decreased to 5 months. Nonetheless, thanks to soaring FDI inflows, which almost doubled during the first half of the year, foreign exchange reserves are expected to grow in the months to come.

Future Prospects

As the next step after joining the European Union, the Bulgarian government sees joining the Exchange Rate Mechanism-2 (ERM-2) as soon as possible and later the Eurozone. The currency board is going to stay in place during the period leading up to joining the Eurozone and the fixed exchange rate is going to stay at the current level of Lev 1.95583 for EUR 1. The targeted year for joining the Eurozone is 2010. The main challenge for Bulgaria on this path is curbing inflation, which is higher than required by Maastrich convergence criteria, according to which inflation should be no more than 1.5 % above the average inflation rate of the three lowest-inflation countries in the EU. During 2005, the average rate was 2.5 % while inflation in Bulgaria for the same period was 6.5%. Moreover, inflation is the only one out of five convergence criteria that is not yet being met. Due to the government's serious intentions to join the Eurozone and, as a result of already adopted measures such as credit restrictions, early harmonization of excise duties and tighter fiscal policy, inflation in Bulgaria is expected to fall in the coming years.

4. Equity Markets

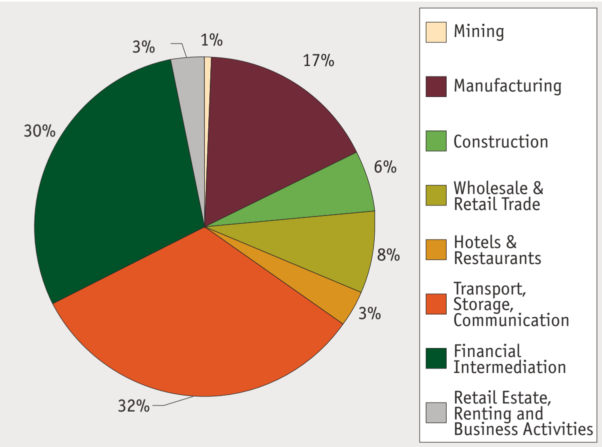
Capital Market Development

	2003	2004	2005	1H 2006
Market Capitalization, EUR million	1,392	2,062	4,312	5,069
Market Capitalization, % to GDP	9%	11%	20%	22%
Volume of Trade on BSE, EUR million	406	816	1300	600
Volume of Trade on BSE, % to market capitalization	29%	40%	30%	12%

Source: Bulgarian Stock Exchange

In 2005, the Bulgarian capital market posted some slowdown after very fast development in 2002-2004. As compared to 2004, when traded volumes and the number of transactions almost doubled, traded volumes fell by 43% yoy in 2005, although the number of trades continued to increase at an accelerated rate of 106% yoy. In 2004–2005, due to price increases in almost all of the actively traded shares on the Bulgarian Stock Exchange (BSE), market capitalization grew significantly. At the end of 2004, market capitalization reached EUR 2.1 billion, which is 48% higher than in 2003, and by the end of 2005 market capitalization had doubled and reached EUR 4.3 billion. This trend continued in 2006 and by mid August market capitalization exceeded EUR 5.1 billion, rising by more than 20% since the beginning of the year. Almost 30% of market capitalization is attributed to Bulgarian Telecommunications Company (BTC), which is the most profitable and largest public company in Bulgaria. Privatization and listing of BTC on the BSE contributed to a large foreign presence on the local exchange market. By August 2006, foreign investors owned about 51% of the shares traded on the BSE. The second and third largest companies in terms of market capitalization were Sopharma AD-Sofia and Interlogic real estate Jsc.-Sofia, which accounted for 6% and 4% of the total market capitalization.

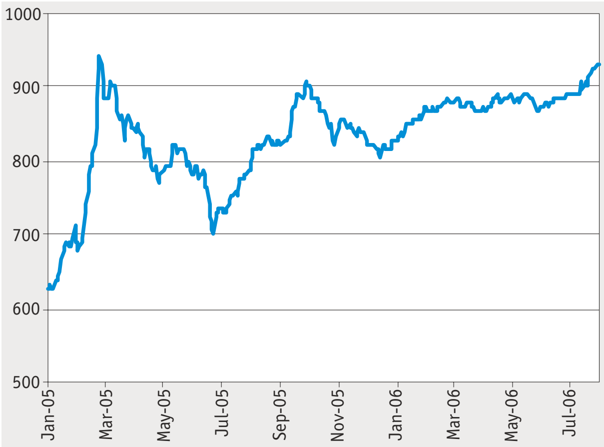
Turnover on the BSE by Sectors in 2006



Source: Bulgarian Stock Exchange

The sale of 35% of BTC in 2005 made compensatory notes, used as the means of payment in privatization deals, the most liquid instruments in H1 2005. However, due to the absence of new major privatization deals, interest in this type of instrument fell in H2 2005. In 2005, the unofficial equity market demonstrated a five fold increase, compensating for the turnover slowdown on the official market. This tendency continued throughout H1 2006. A significant turnover increase — 150% — was also observed on the unofficial bond market, but this was mainly due to new bond issues. In 2005, the highest turnover was in companies in transportation, communications, financial intermediation and manufacturing sectors. In H1 2006, the most actively traded companies remained BTC and Bulgarian-American Credit Bank. By mid August 2006, their turnovers increased by 72% yoy and 11% yoy respectively.

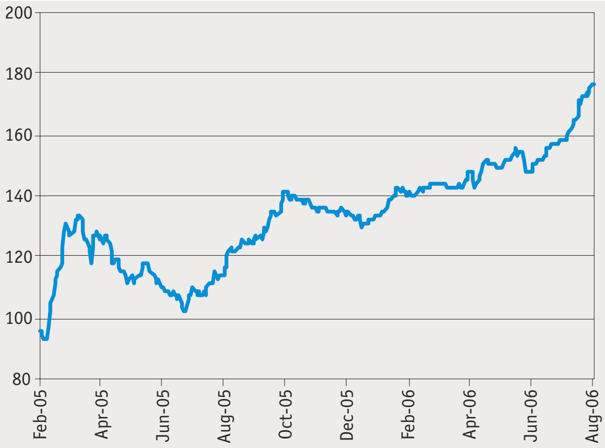
SOFIX Index



Source: Bulgarian Stock Exchange

Blue-chip SOFIX index, which was started in 2000 and includes the most liquid companies traded on the regular markets, continued to demonstrate an upward trend in 2005 and 2006, reaching new records in both years. On December 28th, 2005 the index reached 825.53, which is about 200 points higher than 2004's record high. By mid August 2006, the SOFIX index constituted 942.44 points, rising by 14% since the beginning of the year.

BG-40 Index



Source: Bulgarian Stock Exchange

The broader BG40 Index started in February 2005 initially included 40 companies. The positive development on the Bulgarian equity market is reflected in the growth of BG40 from the initial level of 95.9 to 176.3 in August 2006. The listing of new companies on the BSE should contribute to further growth of the local stock market.

Future Prospects

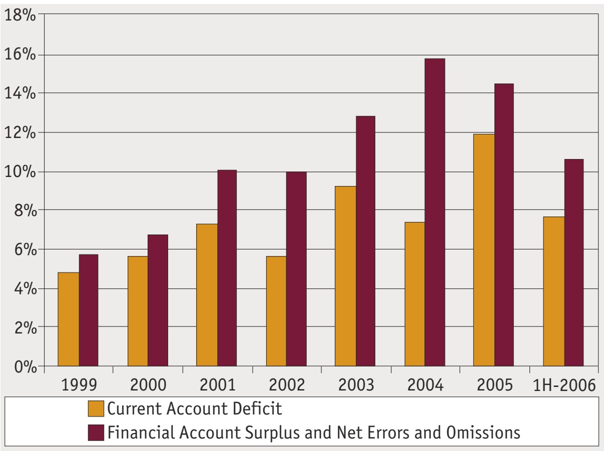
The Bulgarian equity market is expected to continue substantial growth in 2006 as well as in the coming years. With improvements in corporate governance, the legal environment and the liberalization of business regulations, the interest of local and foreign investors in Bulgarian companies will be also increasing. Moreover, accession to the EU will evoke increased inflow of foreign capital to the country, which will contribute to rising activity on the Bulgarian stock exchange and to boosting market capitalization. Furthermore, EU accession will give local companies more opportunities for trading through easier access to stock markets of EU countries. Finally, competition faced from European stock exchanges after joining the EU will stimulate further development of the local stock exchange in order for it to stay competitive on the EU market.

5. International Trade and Capital

Balance of Payments

Over the last several years, the widening deficit in Bulgaria's current account (CA) has been a significant source of concern for the country's macroeconomic stability. The CA deficit was rising during 2005 after some decline in 2004 and reached an exceptionally high level of EUR 2.5 billions, or 11.8% of GDP. This was mainly due to the acceleration of goods imports, which grew by 29% yoy in nominal terms compared to an 18.3% yoy growth rate of exports. As a result, the trade deficit rose by as much as 60.7% yoy and reached EUR 4.4 billions, or 20% of GDP. On a positive note, other components of CA such as trade balance in services, net income and net current transfers increased considerably in 2005, which mitigates the effect of the deteriorating merchandise trade balance. The worsening of the CA has not considerably affected the country's external position yet. Being fully open to cross-border capital movements, Bulgaria managed to attract a lot of foreign capital that came mostly in the form of FDI. Thus, the net inflow of direct investment equaled EUR 1.5 billion in 2005, which constituted about 53% of the total EUR 2.9 billion financial account surplus.

Balance of Payments Components, % of GDP



Source: Bulgarian National Bank

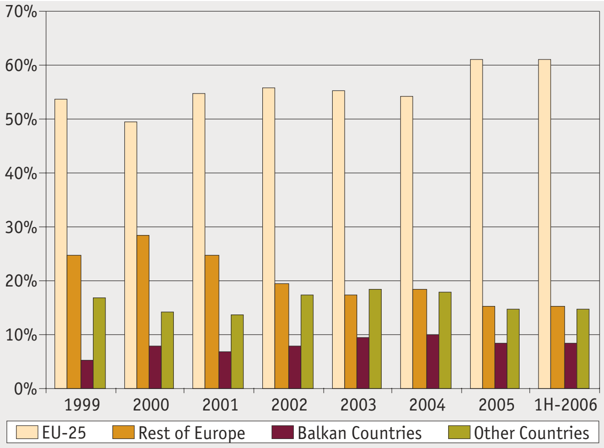
In H1 2006, the CA balance continued to worsen. By the end of June, the current account deficit constituted EUR 1.8 billion or 7.6% of GDP, demonstrating a growth of 63% yoy. The reason was deterioration in cumulative balances of all of its main components, with the largest deterioration registered in the services trade balance, which dropped by 114% yoy during the first half of the year. However, as preliminary data of the BNB shows, the CA deficit was narrowing two months in a row in 2Q 2006 and even dropped by 40% yoy in June 2006. One of the reasons for this was the positive development in the merchandise trade balance, which was decreasing since May on an annual basis and declined by 11% yoy in June. This was due to acceleration in the growth rate of exports, which outpaced the growth rate of imports during 2Q 2006 caused by price hikes of metals, of which Bulgaria is a large exporter. Another reason for some recent improvements in the CA were positive developments in the balance of trade in services, which turned to positive in May and posted a growth of 15% yoy in June. On a positive note, there was a rise in the financial account surplus, pushed by considerable increase in net FDI inflow. By the end of June 2006, the financial account surplus increased by 2.9% as compared to the same period of last year and reached EUR 1.8 billion or 7.6% of GDP, whereas the net inflow of direct investment increased by 76% yoy and amounted to EUR 1.4 billion.

Foreign Trade

The Bulgarian economy is exposed to large flows of trade and capital due to a high degree of border openness. The trade openness, measured as a trade-to-GDP-ratio, averaged 128% over the last seven years with a clear tendency towards an increase. The main trading partners for Bulgaria are EU countries, which altogether account for more than 60% of both inward and outward trade flows. The second largest recipient of Bulgarian goods is the Balkan region, which receives almost one fifth of total Bulgarian exports, whereas the second largest supplier of goods (accounting for almost one fifth of total Bulgarian imports) is the East European region, mostly Russia, and to a lesser extent Ukraine.

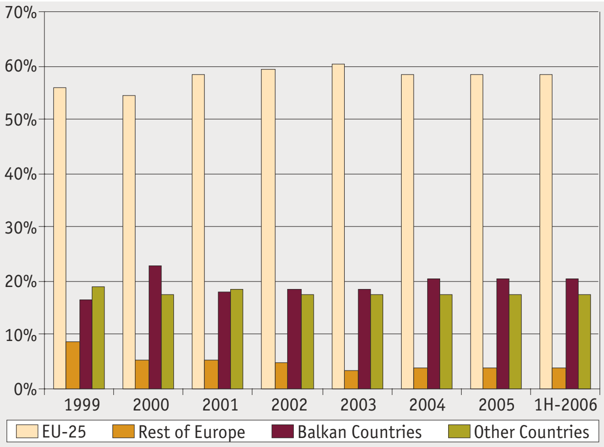
The geographical breakdown of trade flows experienced marginal changes over the years up to 2004 and has remained relatively stable since. In 2004, the share of export to the EU-25 decreased by 2 percentage points since 2003, constituting 58.16% of total exports, and was kept at this level during 2005 and the first half of 2006. At the same time, exports to Balkan countries increased by 2 percentage points in 2004 and stayed stable since then, constituting 20.5% of total export. Shares of the rest of Europe and other countries in total Bulgarian export have increased to 3.7% and 17.6 % respectively and stayed on these levels through 2005 and the first half of 2006. As for imports, shares of the EU-25, the rest of Europe and Balkan countries in total imports have remained unchanged since an increase in 2004 and constituted 54.1%, 18.2% and 9.9% respectively as of June 2006. The inflow of goods from all other regions increased by half a percentage point in 2004 and has stayed at a level of 17.7% since then.

Geographical Breakdown of Merchandise Imports, percentage of total imports



Source: Bulgarian National Bank

Geographical Breakdown of Merchandise Exports, percentage of total exports

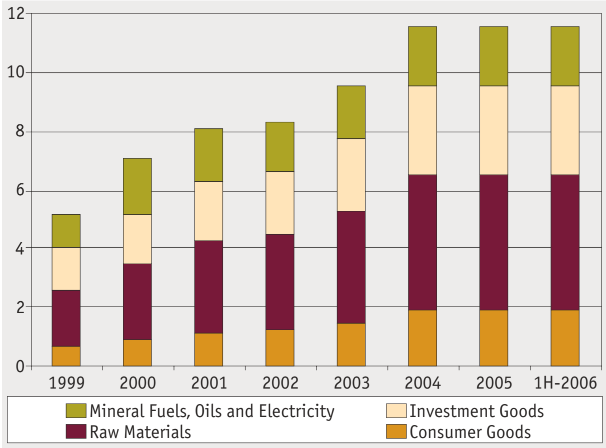


Source: Bulgarian National Bank

As the end-use breakdown of foreign trade shows, the structure of imports has remained unchanged since 2004. The largest shares in total imports have been held by raw materials (39.6%), followed by investment goods (26.5%). Consumer goods and imports of mineral fuels, oil and electricity coming from abroad have occupied almost equal shares of 16.3 % and 16.7% respectively.

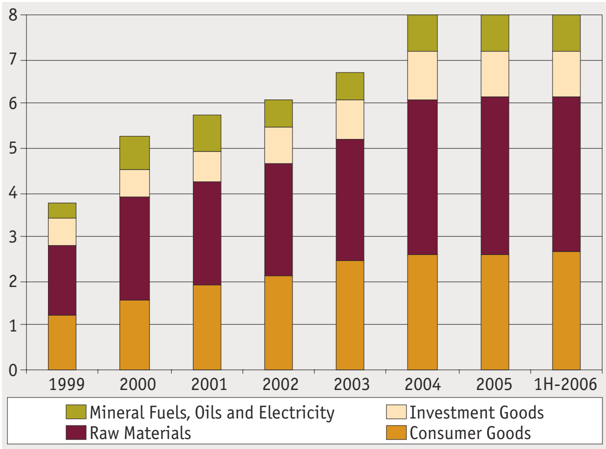
No major changes have been registered in the structure of exported goods over the last several years as well. Raw materials remained the largest component in Bulgarian export, holding a share of 43.6% since 2004. Consumer goods constituted another important group of exports, which after a continuous decline during 2002-2004, remained stable in the following years at a level of 32.9%. The share of investment goods was increasing in 2005--1H of 2006, after a decline by 25 pps in 2004, and constituted 13.5% of total exports at the end of June 2006. Similar to investment goods, the share of mineral fuels, oil and electricity coming from abroad has been rising through 2004-1H 2006 and amounted to 10.17% of total export.

End-Use Structure of Merchandise Imports, EUR billion



Source: Bulgarian National Bank

End-Use Structure of Merchandise Exports, EUR billion

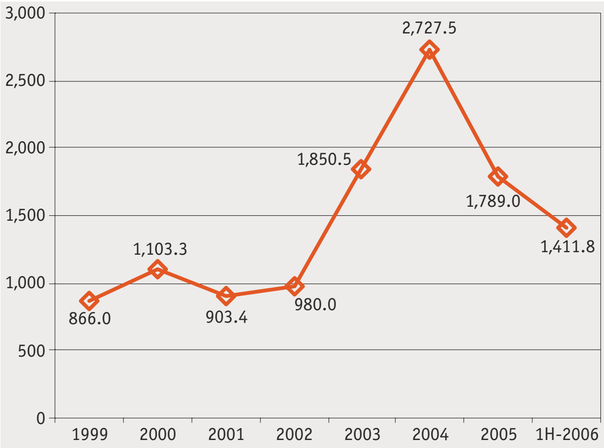


Source: Bulgarian National Bank

Foreign Direct Investment

Thanks to the achieved macroeconomic stability, predictability of the legal environment, and policies directed towards liberalization and deregulation of business activity, Bulgaria became a very attractive country for foreign investors. Large amounts of foreign capital have been flowing into the economy over recent years covering its CA deficit and, more importantly, building a solid ground for sustainable economic growth. In 2004, the inflow of foreign direct investment (FDI) amounted to EUR 2.7 billion or 10% of GDP, reaching a record high since 1999. In 2005, FDI inflow decreased somewhat to EUR 1.8 billion or 8.4 % of GDP, but rebounded again in 2006 when FDI inflows amounted to 1.4 billion for just the first half of the year, 76% yoy higher than during the same period of 2005. By the end of 2005, total FDI stock reached EUR 8.5 billion, which corresponded to EUR 1,105 of FDI per capita.

FDI Inflows to Bulgaria, EUR million



Source: Bulgarian National Bank

An important factor behind FDI growth in 2004 was the successful privatization process. That year, foreign investors acquired seven energy distributing companies for a total amount of EUR 693 million. Privatization of "BTC" EAD Telecommunication Company in the first half of 2004 brought another EUR 230 million of privatization receipts. The privatization deals accounted for about 48% of FDI inflow in 2004, whereas the remaining 52% were attributable to green-field investment projects. In 2005, a slowdown in FDI inflows was observed. Thus, in 2005 FDI inflow dropped by 34% as compared to the previous year and amounted to EUR 1.8 million. The slowdown of FDI inflow was partially caused by the reluctance of the new government to push the privatization process, which resulted in the absence of privatization deals with foreign companies in 2005. Another reason for the decrease in FDI inflow was the high base effect resulting from acquisition of telecom company BTC in June 2004, as well as uncertainties related to general elections held in June 2005. However, FDI inflow rebounded again in the first half of 2006, rising at a rate of 74% yoy, reflecting rising investor interest in the Bulgarian economy. Improvement in FDI inflow during this period came mostly from investments in real estate and construction projects.

The EU-15 members traditionally dominate in the distribution of FDI according to the country of origin. Although the weight of each particular economy fluctuated considerably depending on the results of privatization deals, the biggest share of foreign capital has come from EU countries. As of the end of 2005, the largest contributors to FDI were Austria, Greece, Italy and Great Britain. Their shares in total FDI stock to Bulgaria constituted 34%, 10%, 7% and 7% respectively and the total amount of their investments amounted to EUR 5.6 billion, or 58% of total FDI stock. The only non-EU country with a large contribution to Bulgarian FDI was the US. In 2005, it occupied 9th place in FDI origin, and its total investment to the country amounted to EUR 331.4 million. European investors are attracted to Bulgaria by its proximity and low labor costs accompanied by macroeconomic stability. The forthcoming EU accession and unification of legislation created an additional incentive for European investors.

FDI Stock

Country	FDI Stock in 2004			FDI Stock in 2005		
	EUR million	yoy change, %	% of total	EUR million	yoy change, %	% of total
Total	**6,768.7**	**37**	**100**	**9,674.3**	**43**	**100**
Austria	1,235.1	84	18	3,268.5	165	34
Greece	635.3	19	9	985.1	55	10
Netherlands	625.8	34	9	197.9	−68	2
Germany	520.5	21	8	374.2	−28	4
Italy	482.3	17	7	663.2	38	7
Cyprus	473.3	9	7	390.4	−18	4
Belgium and Luxembourg	460.0	83	7	296.2	−36	3
USA	451.2	24	7	331.4	−27	3
Great Britain	344.1	18	5	659.2	92	7
Switzerland	298.1	0.5	4	392.7	32	4
Hungary	250.6	41	4	560.6	124	6
France	185.4	37	3	304.3	64	3
Other	807.2	38	12	1,250.7	55	13

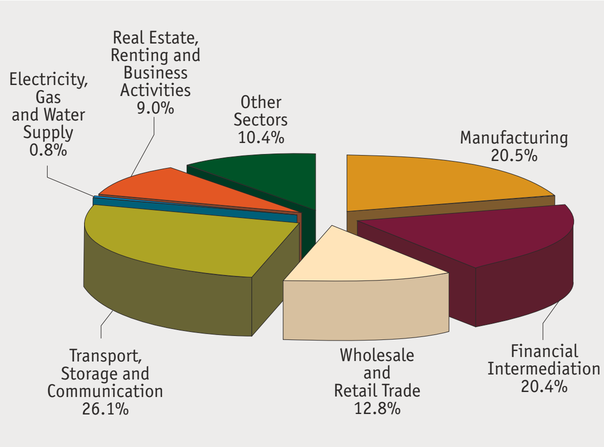
Source: Bulgarian National Bank

A significant portion of FDI coming to Bulgaria has been traditional manufacturing, financial intermediation and wholesale and retail trade, as they usually give investors a high rate of return on investment and lower risk compared to other industries. FDI in manufacturing alone represented about 28.1% of total FDI stock in 2004. 20% of FDI went to financial intermediation and equal shares of 17.8% to wholesale & retail trade and transport, storage & communications.

In 2005, the same industries remained to be the leaders in attraction of FDI; however, their shares in total FDI stock changed. Thus, the share of manufacturing fell by 7.6 pps and almost equaled the share of financial intermediation, which rose to 20.4%. The share of transport and storage, on the other hand, fell by 7.6 pps and constituted 26.1%, while that of wholesale and retail trade decreased to 12.8% down from 17.8% in the previous year. A remarkable development in 2005 was the increase in FDI to the construction industry as well as to real estate, renting and business activities. This development continued in 2006, when foreign investment flows to these industries surged significantly. In particular, the increase of FDI into real estate increased by 3.5 times and by 2.8 times to the construction industry. Such a big increase in FDI into the real estate and construction industries was caused by the initiation of a number of green field projects and large real estate purchases, such as Sofia

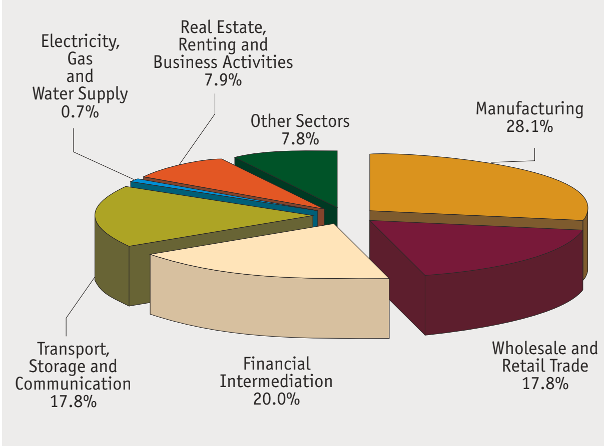
City Center mall, which was sold for EUR 94 million to Equest Balkan Properties.

FDI Stock by Sectors in 2005



Source: Bulgarian National Bank

FDI Stock by Sectors in 2004



Source: Bulgarian National Bank

Future Prospects

Export growth, which accelerated in the last several months of H1 2006, represents a very positive development. However, it will not be enough to bring down trade and the CA deficit that has accumulated over a number of years, and by the end of 2006 the CA deficit is expected to rise from 14% to 15% of GDP. At the same time, higher growth of exports and slower growth of imports is expected to continue in 2007, causing some reduction of the CA deficit. Government projections of FDI inflow for 2006 initially were EUR 2.35 billion, including EUR 150 million of privatization revenues. However, since FDI inflows already totaled 60% of that sum for H1 2006, the actual amount of FDI in 2006 will probably exceed these projections.

6. Public Debt and International Lending

During the last several years, the Bulgarian government carried out thoughtful public debt management. As of the end of H1 2006, public and publicly guaranteed debt had significantly decreased to EUR 6.39 billion from EUR 10.62 billion in 2001. Moreover, the public debt-to-GDP ratio shrunk dramatically from 70.2% in 2001 to 27.4% at the end of H1 2006.

Over the last five years, the structure of Bulgarian total public debt has experienced significant changes. The weight of foreign public debt in the country's total public debt was on a downward trend, shrinking from 91% in 2001 to 75.8% in H1 of 2006, while domestic public debt was on an upward trend surging at the same period from 9% to 24.2%.

The existing size and quality of Bulgarian public debt are appropriate for EU-membership level. Therefore, the risk of the country's insolvency is very low. Strong macroeconomic fundamentals and prudent public debt management contributed greatly to the upgrade of Bulgaria by leading credit rating agencies. The major rating agencies confirmed Bulgaria's sovereign rating as investment grade.

International Credit Ratings for Bulgaria's Long-term Government Securities

	S&P	Fitch	Moody's
Issued in foreign currency	BBB	BBB	Baa3
Issued in local currency	BBB+	BBB+	Baa4
Date of upgrade	Oct-2005	Mar-2006	Mar-2006

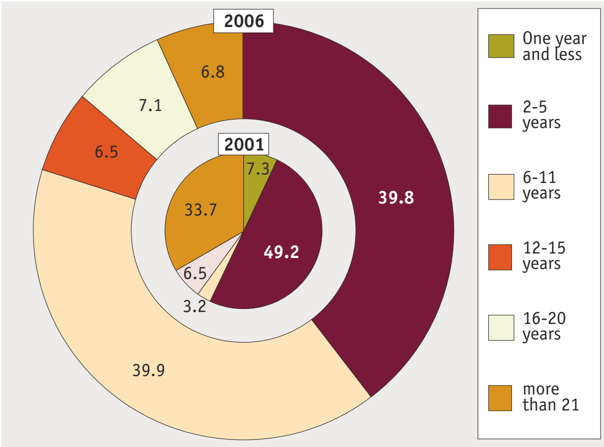
Source: S&P, Fitch, Moody's

Domestic Debt

During the last five years, the total amount of internal public debt has experienced a significant increase. Starting from EUR 0.95 billion in 2001, Bulgarian public domestic debt reached EUR 1.55 billion as of the end of June 2006. Despite more than 60% growth in the size of internal public debt during this period, its GDP-ratio has not been significantly changed and only marginally increased from 6.3% in 2001 to around 7% of full year GDP after H1 2006.

Foreign currency denomination of domestic public debt has experienced significant changes. The share of government securities denominated in levs in 2001 surged from 60.4% to 72.9% as of the June 2006, which reflects an increased confidence of security holders in the national currency and its stability. During the same period, borrowing in foreign exchange experienced both a significant decrease and substantial changes in structure. Structural changes in the foreign exchange composition of Bulgarian domestic debt shifted towards the Euro mainly due to a greater availability of EU funds for the country. During the last five years, the share of Euro-denominated government securities increased more than threefold from 6.4% of the total amount of debt in 2001 to 20.6% as of June 2006. At the same time, the weight of USD-denominated government securities shrank by more than 5 times and as of June 2006 was 6.5% compared with 33.2% in 2001.

Maturity of Government Securities, %



Source: Bulgarian Ministry of Finance

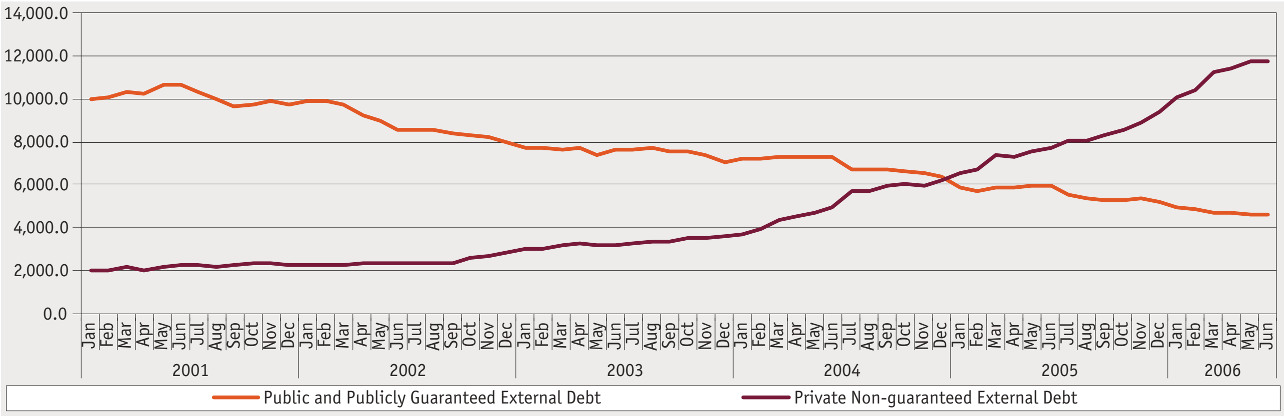
Positive significant changes appeared in the maturity structure of the outstanding government securities. In 2001–2006, there was a sharp decline in the weight of securities with a very short maturity. If in 2001 7.3% of all securities had a maturity of less than 12 months, in 2006 there were no securities with a maturity of less than 3 years. Moreover, 87% of all government securities in 2006 have a maturity exceeding 5 years.

Foreign Debt

Over the last half of the decade, the amount of Bulgarian foreign debt was on an upward trend. By the end of H1 2006, the country's gross external debt totaled EUR 16.3 billion compared with EUR 11.9 billion in 2001. During the same period, the debt-to-GDP ratio decreased from more than 60% to around 25%.

In 2001–2006, the structure of the country's foreign debt experienced significant changes. The main direction of changes was a decrease in the share of foreign publicly guaranteed debt and an increase in the share of private debt, which means that the main burden was shifted from the general public to

External Public and Private Debt, EUR million



Source: Bulgarian Ministry of Finance

private businesses. If in January 2001, publicly guaranteed debt accounted for 83.4% of the country's foreign debt stock, this weight came down to 28.1% in June 2006 reflecting prudent debt management by the Bulgarian Ministry of Finance. The breakdown point for such structural changes appeared at the end of 2005, when there was parity between the country's two types of foreign debt.

The currency structure of Bulgarian foreign public debt has significantly changed over the last five years. In June 2006, debt denominated in Euros reached 61.7%, and in US dollars 26.5%, while in 2001 this composition was strictly opposite and around two thirds of all foreign debt was denominated in US dollars. These changes reflect the country's deeper integration with EU member states.

The growing stability of the country is reflected in the maturity structure of its public external debt. In 2001-2006, the average weighted term of maturity for Bulgarian external debt decreased to 9 years at the end of this period down from more than 12 years at the beginning.

In H1 2006, the structure of external publicly guaranteed debt by type of creditor suggests that the main debt is accumulated in Bulgarian global bonds and Eurobonds. Their total current share comprised around 43% compared with around 60% in 2001. Starting in 2001, the country's main lenders remain World Bank and the IMF with a relatively stable cumulative share in total foreign publicly guaranteed debt of around 23% in H1 2006, which is only marginally increased from its level in 2001 when it comprised 22%.

International Programs

For a number of years, Bulgaria has been cooperating closely with international financial institutions in achieving macroeconomic stability and conducting reforms. Bulgaria has been receiving credit as well as consulting and organizational assistance in various socio-economic fields. Programs financed by such international institutions as the IMF, World Bank, and the European Commission have helped the country achieve a higher degree of economic and social development and ensured accession to the EU.

IMF Program

One of Bulgaria's oldest partners is the IMF, which Bulgaria joined in 1990. Since then, the country has received a number of stand-by credits aimed at eliminating financial crises, restoring and maintaining macroeconomic stability, and implementation of structural reforms. The most recent stand-by arrangement with the IMF was signed in August 2004. With this arrangement, Bulgaria received $148 million for implementation of economic and financial programs 2004-2006 prepared by Bulgarian authorities and approved by the IMF. During the whole period of arrangement, the IMF made several evaluation reviews, which identified the progress made in implementation of the program and developed recommendations for achieving the program's objectives. In their last review issued in August 2006, the IMF praised the Bulgarian government for achieving good macroeconomic results. However, it was noted that reforms should be sped up for Bulgaria to see faster convergence of living standards to the levels of EU member states. The arrangement was supposed to expire in September 2006, but the Bulgarian government and the IMF agreed to extend it through the end of March 2007. It was also agreed that Bulgaria would not apply for any stand-by arrangements after that.

EC-pre-accession Programs

Upon receiving a status of a candidate country for the European Union, Bulgaria became eligible for help from the European Commission (EC). EC pre-accession assistance to Bulgaria is provided through 3 programs — the PHARE programme, ISPA (Instrument for Structural Policies for Pre-Accession) and SAPARD (Special Accession Programme for Agriculture & Rural Development). These programs support Bulgaria's reform through funding for implementation of projects aimed at bringing different aspects of the Bulgarian economy up to EU standards. The PHARE programme, among other things, entails projects targeted to introduce acquis and institution-building in all sectors. The ISPA programme deals with the implementation of large-scale environmental and transport infrastructure projects, and the SAPARD programme is aimed at developing agriculture and rural areas of the country. In addition, EC financial aid to Bulgaria comes in the framework of European Communities' Programmes and Agencies and from different European financial institutions such as the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD).

After becoming a member of the European Union, Bulgaria will be eligible for financing from European Structural and Cohesion funds. In fact, under the agreement signed in 2004 between EU and Bulgaria, Bulgaria will be receiving financing in the amount of EUR 4.6 billion from the European Structural and Cohesion funds during the period of 2007–2009. This funding should promote the country's future development in the post accession period.

World Bank Programs

Since February 2003, the World Bank (WB) has been providing financial assistance to Bulgaria through a series of loans in the framework of the Programmatic Adjustment Loan (PAL) program. The main goal of this program was to support reforms in different sectors of the Bulgarian economy. With the assistance of the PAL program, Bulgaria achieved significant results in conducting large-scale privatization and in reforming such areas as infrastructure, the business environment, financial sector, public governance, education and health service, and social assistance. The total amount of the three loans provided under the program constituted $425 million. The agreement for the third and last loan was signed in June 2005. This loan was intended to advance structural reforms in the country and support accession to the EU.

In a recent meeting between representatives of the World Bank (WB) and the Bulgarian Government, the WB expressed its appreciation for the good management of funds and effective implementation of projects by the Bulgarian government. Moreover, in June 2006, the WB approved a new Country Partnership Strategy (CPS) for Bulgaria. The strategy covers 2006-2009 and envisions four loan operations and analytical and advisory work aimed to continue structural reforms, improve the investment climate, raise employment, reduce social and economic imbalances across the country, and facilitate integration of Bulgaria into the EU. Financial assistance under the strategy constitutes up to $300 million per year.

Future Prospects

Although Bulgaria's fiscal performance was positive over the last couple of years, the existing downward trend in public and publicly guaranteed debt is unlikely to continue throughout 2006 and 2007. Higher social budget spending anticipated in the 2006 and 2007 budget will partially restrict the amount of budget resources that can be channeled to repayment of the country's public debt. As a result, the stock of public external debt will be reduced at a significantly lower rate compared with previous years.

The growth of private external debt could continue throughout 2006–2007. This is due to the limited financial resources available for local companies on the domestic market and better conditions for loans on international markets.

Part Two: Investment Climate

Overview

It is widely recognized that an important component for the country's sustainable economic development is an increasing level of investments. At the same time, although physical and human capital accumulation is crucial for economic growth, their effects became much stronger if combined with increases in the productivity of these factors. In fact, in many countries such as China and Chile, increases in investments explain only a part of the rates of economic growth. The rest is sourced by the increase in total factor productivity that is generated by better management skills, knowledge, information systems, technology and technical change. The increase in total factor productivity can be spurred by welcoming foreign investments, which are an extremely important source of spreading these value-enhancing factors. With the wave of globalization, FDI inflows help countries with emerging markets to better integrate into the world economy by making them more competitive and by improving their living standards. Thus, the policies and efforts directed at improving the country's investment climate can be seen as an indicator of general progress towards achieving sustainable economic growth.

In order to identify the main factors affecting a country's investment climate, SigmaBleyzer embarked on a comprehensive research effort. The level of FDI was considered to be a good gauge of the adequacy of a country's investment climate. The study reviewed 100 countries around the world and carried out statistical analyses to identify the policy measures that have the greatest impact on the flow of FDI. It identified the most important measures that a government can take to improve the business environment of a country and attract foreign direct investments.

Through benchmarking, it also identified best practices in economic reforms in a number of successful developing countries. Also, a model was built to predict the flows of foreign direct investments that a country could receive based on the implementation of these key "policy" investment drivers. Our benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in the group of over 100 developing countries can be explained by nine economic policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flows of FDI, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g., geographical location, country size, population, etc.).

These key investment drivers were the following, in order of priority:

(i) **Macroeconomic Stability**, which includes policies and actions to ensure sustainable economic stability over the medium term.

(ii) **Business liberalization and de-regulation policies** to permit firms to operate freely by removing barriers to market entry, barriers to operations and barriers to exit.

(iii) Policies to create a **stable and predictable legal environment** with well-defined "rules of the game" for all businesses, without discrimination or preferential treatment and with capacity to enforce business contracts.

(iv) Policies to develop sound **corporate and public governance** that would protect ownership rights and shareholders, and avoid excesses of power by Government agencies.

(v) Policies to **liberalize foreign trade and international capital movements** to facilitate the exports and imports of goods and the transfer of capital internationally.

(vi) Policies to **create a healthy financial sector** capable of meeting the financing needs of growing businesses.

(vii) Actions to **minimize corruption** and protect businesses from abuse of power by government officials.

(viii) Actions to minimize the effects of **political uncertainties** on business activities.

(ix) Actions to **promote and inform investors** about business opportunities in the country.

The performance of Bulgaria regarding the above nine investment drivers is discussed below.

Driver 1: Macroeconomic Stability

The basis for sound macroeconomic performance and sustainable economic growth is macroeconomic stability, which is defined as long-term stability in prices (domestic stability) and foreign exchange rates (external stability). Investors need stable prices and currencies since they are the main elements affecting investment profitability. Stable prices and currency are also needed to minimize business risks and reduce the rate of return required by investors. This will increase the range of projects that could be attractive to international investors. Therefore, to encourage investments and enhance private sector confidence in the country, a major pre-condition is that the economy must be stable, which is, the rates of inflation and currency depreciation should be under control. The determinants of macroeconomic stability are sound fiscal and monetary policies, which are achieved through the government's ability to maintain control over the fiscal budget balance, on the one hand, as well as control over the money supply, on the other.

Over the last decade, Bulgaria has made significant progress towards macroeconomic stability. Moreover, the macroeconomic stability maintained in Bulgaria was crucial for the country's economic growth. During the period of transformation to a real market economy, Bulgaria was able to re-establish its growth and reached a significant annual increase in 2000-2005 of around 5% per annum (p.a.), which was driven by increasing domestic demand. During the same period, domestic demand surged by a robust 8% p.a. As a result of the prudent government economic policies, the country was able to maintain low inflation, with an average level in 2000-2005 that did not exceed 5% p.a, and significantly reduced the level of unemployment from more than 17% in 2001 to 10% in 2005 and down to single digits in H1 2006.[1]

During the last decade, almost three quarters of enterprise assets and almost all banking assets were privatized. In addition, the Bulgarian government significantly improved banking supervision according to EU standards, successfully reformed the existing pension system, significantly improved the health care system, and liberalized trade. However, more efforts are needed to reduce inefficiencies in the state-enterprise sector, restructuring the energy sector, and improving the country's investment climate.

Positive developments in Bulgaria's real sector were facilitated by prudent fiscal policy, which kept the government budget in 2004–2005 in surplus of 1.8% and 2.4% of GDP respectively.

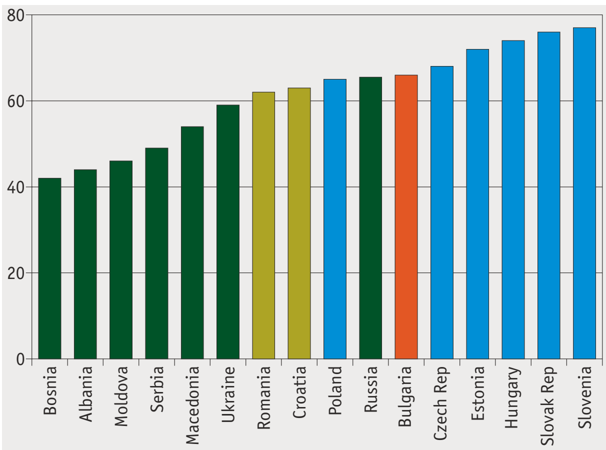
Bulgaria's currency board arrangement continues to have broad political and public support. During the last several years, the interest rate was stable and at a relatively low level, fluctuating between 2% and 3% in 2005 and H1 2006. Bulgarian banks are liquid and fiscal reserves ample. In H1 2006, the overall balance of the fiscal reserve account exceeded EUR 5 billion.

Despite the fact that the Bulgarian economy has experienced positive developments in recent years, some serious external imbalances still exist and should be addressed in the new economic policy measures. In particular, there is an important unresolved issue related to rapid growth of private domestic demand, which negatively affects the current account balance through hikes in imports. At the end of H1 2006, it was equal to 14.6% of GDP, demonstrating significant growth from its lowest level during the last five years it did not exceed 3% of GDP when in 2002. Although the CA deficit continues to be substantially financed by FDI flows, which at the end of H1 2006 were able to cover around 70% of the existing gap, it still remains a significant risk factor for the growing Bulgarian economy. Strong growth in external debt is another argument to solve the problem of external imbalances.

Although the Bulgarian economy showed very positive dynamics over the last five years, important challenges are still in the country's economic policy agenda. Bulgaria should continue to maintain macroeconomic stability and make significant additional efforts in carrying out structural reforms to sustain growth momentum, which should lead to further reductions in poverty and unemployment.

The chart bellow shows that macroeconomic stability in Bulgaria is far above many other countries in the region. However, significant efforts are still needed to propel the country to a higher level of economic stability.

Macroeconomic Stability



[1] Unemployment rate is calculated based on ILO methodology

Public policy recommendations:

- Reduce public debt to a more sustainable level;
- Ensure thoughtful budget management and keep the budget in surplus;
- Accelerate structural reforms in service and industrial sectors through effective privatization;
- Further enhance confidence in the ability of the National Bank to ensure price stability.

Driver 2: Liberalization and Deregulation of Business Activities

This driver includes government policies and actions that reduce government interventions, enabling private businesses to operate freely and make profits in a competitive environment. Favorable conditions must be created for the three major components of business activities: entry, operations and exit.

In 2004–2005, the Bulgarian government made significant progress in reforming the existing business regulatory environment. The government has been working very actively on improving the quality of new laws, making the existing laws more business friendly, and establishing a market-friendly business environment, focusing on entry and exit policies, regulatory costs, delivery of public services, competition, and strengthening market institutions.

The main driving force of the government's further liberalization of the business environment was Bulgaria's forthcoming accession to the EU. Starting in 2002, the Bulgarian government actively worked on reducing the costs of doing business by implementing a two-stage strategy for regulatory reform. In the first stage, which was implemented in 2002–2003, an inter-ministerial working group was formed that was responsible for optimization of regulatory regimes. The task of the working group was to review all national-level regulations, which was successfully accomplished. During this stage, 361 national-level regimes coming up for parliamentary legislation were reviewed as well as decrees from the line ministries. Based on the conducted review of the regulatory acts, the group prepared a program to eliminate 75 and modify 117 existing regimes. Significant legal work was undertaken and at the end of 2005, more than 50 existing regimes were eliminated and almost 100 were substantially simplified.

In the second stage, which started in 2004, significant efforts were undertaken to adopt the new law on Administrative Regulation and Administrative Control of Economic Activities. The law adopted by the Parliament in 2004 ensured that future regulatory regimes will be based on a very clear rationale. Moreover, any new regulatory act proposed for adoption and related to business activity should be a subject of the Regulatory Analysis Assessment (RAA). It was specified that RAA should include a cost-benefit analysis. In addition, the law established principles for the introduction of new regulatory regimes that significantly limited the ability of different line ministries and other government agencies to create their own (not always business friendly) regulations. As a result, the existing regulatory framework was significantly modified and the administrative burden on businesses was also substantially reduced.

Although Bulgaria has made significant progress in business liberalization and deregulation, the regulatory reform agenda is far from complete.

The simplification of **procedures to open a business** was a concern of the Bulgarian government over the last couple of years. The government's efforts were mainly related to the procedures of the new companies' registration. However, the achieved results were insufficient and more efforts are required. Bulgaria's overall rank in the list of 175 countries covered by the *Doing Business Report* is 54.[2] At the same time, based on a number of procedures required to start a new business, Bulgaria is very good compared to other developed and transition countries. The actual number of required procedures is 11, which puts Bulgaria in the very middle of the list by this parameter. The total duration of procedures to start a business is 32 days; this includes 12 days for registering a company in the District Court and 15 days for publishing a required notification in the state gazette. Therefore, even a marginal decrease in the duration of these two procedures should substantially improve the situation in starting business in the country. Removing registration from the district court in parallel with a general simplification and speedy registration procedures will improve the country's overall business climate.

Table. Nature of Procedures for Starting a Business

	Duration (days)
1. Obtain pre-approval of name	1
2. Notarize statutes	1
3. Deposit capital in a bank	2
4. Pay court fee at treasury	1
5. Register at the District Court	12
6. Publish in the state gazette	15
7. Make a seal	1
8. Register with BULSTAT	1
9. Register with the Regional Social Security Institute	1
10. Register for taxes	1
11. Register for VAT	1
Total	**32**

Source: World Bank

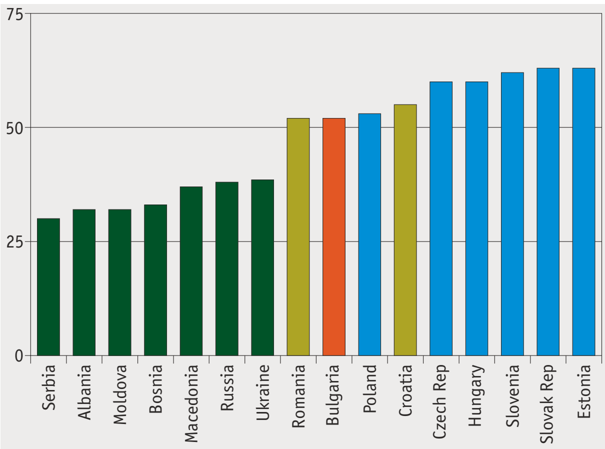
Operating a business in Bulgaria, which includes different parameters such as dealing with licenses, hiring and firing staff, registering property, getting credit, and some others, **has** become much easier

[2] World Bank. Doing Business in 2007: How to Reform

compared with previous years. For instance, Bulgaria had more than 70 types of licensing regimes[3] in 2002, but this number did not exceed 40 at the end of 2006[4]. Certain simplifications were also introduced in registering property, which was mainly a result of increased transparency at all stages of registration and imposing clear requirements during the application process.

Closing a business in Bulgaria is relatively easy. The duration of closing procedures does not exceed 3.3 years, which is good compared to other new EU member states. For instance, the total duration of such procedures in Slovakia is equal to 4.8 years, 3.6 in Slovenia, 3.0 in Estonia, and 2.0 in Hungary. Bulgaria's overall rating is in the very middle of the ranked countries. The World Bank report ranks Bulgaria as 64th out of 175 countries based on this indicator.

Business Liberalization and Deregulation



Public policy recommendations:

- Fully introduce in a system of e-registration for opening new private businesses based on internet resources;
- Decrease the duration of the procedures for opening a business. For this purpose, due to the significant amount of time spent to publish registration information in the State Gazette, this requirement should be withdrawn;
- Reduce the minimum capital requirement for opening private businesses by the introduction of amendments to existing regulatory acts concerning this issue, which should stimulate business activity;
- Simplify the existing procedures required for closing a business by introducing a fully transparent system and avoiding any abuses of power.

[3] World Bank. The Road to Successful EU Integration: The Policy Agenda, 2005.
[4] TBF research.

Driver 3: Stability and Predictability of the Legal Environment

This driver includes policies and actions to enact and implement stable and predictable laws and regulations that would support and encourage private sector businesses in a free market. It calls not only for solid legislation and its effective implementation, but also for a transparent judiciary and recognition of international contracts and agreements.

The Bulgarian parliament has passed many laws to improve the regulatory framework and create better conditions for private businesses, to increase investment incentives and enhance corporate and public governance. However, a properly functioning judicial system is a key precondition to ensure effective implementation and enforcement of the adopted laws and regulations. Unfortunately, the judiciary in Bulgaria remains one of the most problematic areas impeding the accession of Bulgaria to the European Union. In fact, the judiciary was one of the reasons why Bulgaria was not included in the 5th wave of EU enlargement. Thus, there is an urgent need to reform the judicial system with a priority to eliminate corruption in courts and bring the judiciary up to EU standards.

Driven by this requirement, the Bulgarian government has achieved considerable progress in implementing judicial reform, and during the last several years introduced numerous amendments to the legislative framework to advance the functioning of the judicial system. For example, a number of amendments to the Constitution of the Republic of Bulgaria were introduced, including the law passed by the Parliament in February 2006 to reduce corruption in the judiciary and increase its independence, transparency and efficiency. Several measures were undertaken to improve the accountability of the magistracy and reduce corruption in courts, including the requirement for the Prosecutor General and chairperson of the Supreme Court to present regular reports on the activities of courts, prosecutor's offices and investigation authorities to the Parliament. In addition, the immunity mandate of judges was narrowed only to actions involving direct professional duties while stricter procedures were adopted to dismiss corrupt and incompetent judges.

Other amendments to the main Law allow the Minister of Justice to be more actively involved in the development of the budget, appointment, promotion, dismissal and training of judges, prosecutors and investigators. This amendment, however, became a subject of strong critique by the judges of the Supreme Court who opposed the implied strengthening of the influence of the Minister of Justice over the judicial system. Moreover, the judges raised concerns over the amendments that put the Supreme Court and the Prosecutor General under the control of the Parliament, protesting the weakening of the independence of the judiciary. A similar point was articulated by the European Commission, which argued that there was too much interference in the functioning of the judiciary.

A number of key laws governing the judicial system were amended as well, including several important modifications to the Law on the Judiciary in April 2006 that introduced the competitive appointment of magistrates, random allocation of cases in courts, prosecution offices and investigation services. The European Commission, however, insisted that further steps be taken to insure more effective implementation and enforcement of the amended procedures.

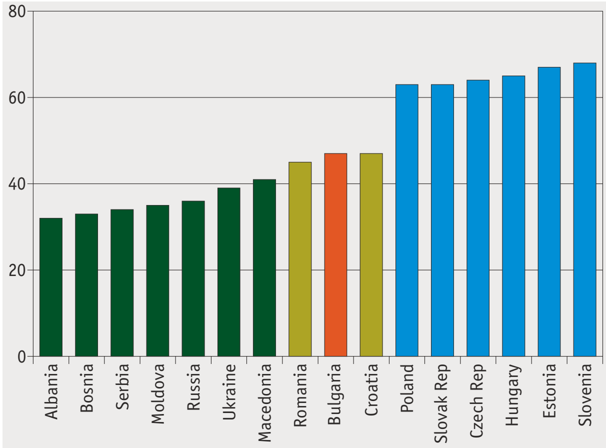
In October 2005, the new Penal and Procedural Code was adopted which, despite being a target for sever critique, put forth the reform of the pre-trial phase of the criminal proceedings. Since reforming this area was of central priority and represented one of the main issues on the agenda of judicial reform, adoption of the new code is a positive signal reflecting the accelerated speed of institutional transformations in the judiciary. To insure adequacy and implementation of the Code, the monitoring mechanism was established and the action plan for judges training is being implemented.

A draft of the new Civil Procedures Code was developed in 2005 and is expected to be adopted soon. This law was drafted jointly with the Federal Ministry of Justice of Austria and is intended to speed up the proceedings of trials, improving the investment climate through the reduction of the duration and costs incurred by local and foreign businesses to settle commercial disputes. With the assistance of USAID, the Mediation Law was developed and adopted in December 2004 establishing a legal basis for mediation as an alternative mechanism for dispute settlement, thus reducing time and costs for solving commercial conflicts and providing a low-cost settlement tool for businesses. Despite slow implementation and the postponed adoption of the secondary regulation for the Association of National Mediation, this regulatory initiative is an important step to equip Bulgarian businesses with modern legal procedures that are effectively applied in EU member states and other developed market economies.

All previously listed regulatory transformations will have a considerable positive impact on the effectiveness of the judicial system in Bulgaria in the medium-term. In the short-term, there is still an urgent concern expressed by the European Commission that these measures are not sufficient to ensure adequate speed of harmonization of Bulgarian legislation with EU guidelines. The Commission calls for more active steps to amend the legislation, enhance the independence of the judicial system, fight corruption in the courts and advance the capacity of the judiciary to process trials and enforce rulings by reducing the duration of trials and improving the internal consistency of courts' decisions. Judicial reform, the fight against corruption and organized crime are the top priorities that require immediate attention from the government to ensure frictionless accession of Bulgaria into the EU.

Bulgaria has achieved notable progress in improving its legal environment, however further efforts are necessary to reform the country's judicial system and strengthen independence and efficiency of courts. Therefore, the development of Bulgaria's legal environment is still below the level of legal practices enforced in the new EU member states.

Stability and Predictability of the Legal Environment



Public policy recommendations:

- Ensure proper implementation of judicial reform and advance the development of the legislation necessary for this reform;
- Further improve administration and financing of the courts to enhance independence in the decision making process;
- Advance public awareness of the legislation by encouraging the development of legal advice and consulting centers available for the public free of charge;
- Introduce special educational programs for judges and court personnel with an emphasis on contemporary issues.

Driver 4: Corporate and Public Governance

This driver includes policies and actions aimed at improving the governance of private companies and public administration, to support private sector activities in a free market economy. They include policies related to corporate governance, public administration and privatization.

a. Corporate Governance

The objective of corporate governance policies is to establish appropriate rules that would guide the activities of businesses in the best interest of their shareholders, protecting ownership rights. Key elements here include disclosure of information about corporations, shareholders' rights protection, public reporting requirements, and the use of transparent accounting practices.

Considerable efforts of the government and international organizations were devoted to the development of good corporate governance principles in Bulgaria. An extensive legal framework regulating relationships between the shareholders, stakeholders and company management, as well as defining their rights and responsibilities and establishing disclosure processes has been developed in Bulgaria. These efforts were designed to incorporate advanced international and EU practices in building domestic high quality corporate governance. Furthermore, corporate governance regulations in Bulgaria have been energetically amended to enhance its capacity in enforcing adequate incentives for public companies to act in the best interest of their owners. However, further key improvements are pending, including the strengthening of the legal extensiveness of corporate governance and more vigorous reform of the judiciary system.

In Bulgaria, corporate governance is regulated by two principle pieces of legislation: The Law on Public Offering of Securities (LPOS) and Commercial Code. These laws set the rules for corporate activities of the public and joint stock companies, including shareholders rights protection, equal treatment of shareholders, prohibition of insider trading, information disclosure, and responsibilities of the board members.

All public companies should register their shares with the Central Depository, and joint stock companies should maintain a shareholders' register, which secures shareholders' right for ownership. Shareholders have the right to participate in shareholders meetings, which are to be convened at least once a year and all major issues must be approved only through voting procedures. The list of issues requiring shareholder voting includes transactions between associated and third parties, transactions with financial companies exceeding legally defined limits, as well as distribution of company profits. Shareholders, excluding minority shareholders, can add items to the meeting's agenda as well as during the meeting request from management and information on business and financial conditions of the company even if these questions are not on the agenda.

A considerable improvement to the law is a provision that demands that the shareholders' meeting be held at the company's headquarters. Prior to this amendment, companies were able to restrict the participation in the meeting through the selection of a location that was difficult to reach by all shareholders in order to approve the decisions that favored a narrow group of shareholders. The important new provision stipulates that shareholders are entitled to pre-emptive rights to subscribe to new shares, while prior to this amendment it was legal to increase the company's capital through private placement by designated persons at an agreed upon price, thus restricting the rights of shareholders to maintain their share in the company. However, the principle weakness of the law is the absence of a specified minimum quorum (percentage of capital) required for the approval of important decisions at shareholders meetings. The provisions are usually defined in the company's statute, which creates the opportunity for a small number of shareholders to monopolize the decision making process and weakens the protection of minority shareholders.

Shareholders are granted procedural rights to ensure that the company acts in compliance with the law and observes shareholders' rights. According to the LPOS, any shareholder with a stake of over 5% in a public company has the right to file a lawsuit against the management and supervisory board to obtain compensation for losses incurred by the company. Shareholders also have the right under the Law on Obligations and Contracts to sue the directors who have caused damages to the company. However, the long duration of trials and inefficient proceeding of cases frequently restrict successful protection of shareholders' rights in courts.

Corporate governance legislation also provides for equal treatment of shareholders and prohibits insider trading. However, insider trading is treated as an administrative violation and not as a criminal offense. A cap in the amount of Lev 200,000 (EUR 100,000) placed on sanctions against the violations of the LPOS has failed to be an effective deterrence against insider trading, while the absence of a clear definition of insider trading leaves numerous loopholes for insiders to abuse the rights of other shareholders. The Ministry of Finance has recently drafted a law prohibiting insider trading on capital markets and circulated it for public discussion with institutions and industrial associations. Although the new law will continue to treat insider trading as administrative offense, it will nevertheless conceptualize the definitions of insider trading and market manipulations and will specify when these violations jeopardize investor interest. Moreover, the new law obligates managers of public companies to declare and disclose to the Financial Supervision Commission the details of any transaction within 5 days after they were concluded. This information is supposed to be further disclosed to the public by the Commission. However, many investors demand all information on transactions involving company's shares to be disclosed with the minimum time lag and preferably on a spot basis.

Public companies are subject to stringent rules concerning the disclosure of information. They are obligated to publish corporate brochures, submit annual and quarterly reports to the Financial Supervision Commission (FSC) and the stock exchange where company's shares are listed, and notify these institutions about any price-sensitive information. In addition, annual reports should contain a program of implementation of the internationally recognized standards of good corporate governance. The FSC closely monitors all the disclosed information to detect violations of competition and urges companies to resubmit their reports if mistakes are found or insufficient information is disclosed. Unfortunately, numerous minor technical mistakes or inconsistencies restrict the FSC capacity to address more serious violations such as the provision of misleading or untrue information.

Notably, LOPS ensures cheap and easy access to disclosed information and is effectively enforced by regulators. The dissemination of information is done through the stock exchange, supporting simultaneous access by all shareholders and investors to the same information. However, several improvements are still necessary. Access to disclosed information and all price-sensitive data online is provided for a fee, which is often too high for small investors or the general public. Moreover, not all of the disclosed information is available online and some of the non-financial part of annual reports and of notifications of major corporate events cannot be found online due to technical reasons. Fortunately, all information received from companies and major shareholders is available through the FSC's public register and is free of charge. In addition, shareholders can receive all disclosed information from investor relations officers by phone, letter or in person at the company's headquarters.

Bulgaria has made considerable efforts to harmonize disclosure procedures with international standards. For example, new prospectus legislation was adopted in 2003 and is based on the EU Prospectus Directive. Moreover, in 2003 and 2005, the international financial reporting standards (IFRS) were introduced in Bulgaria as obligatory accounting standards for all companies, excluding small and medium size enterprises (SMEs), which can apply National Accounting Standards (NAS).

Special attention was devoted to the development of the functional capacity of the company's supervisory board. Responsibilities of the board embrace monitoring and management of potential conflicts of interest within the company, including misuse of corporate assets and abuses through related party transactions, ensuring the integrity of the company's accounting and financial reporting systems and control and enforcement of sound governance practices. Board members are also in charge of selecting, compensating, monitoring and replacing key executives, reviewing remunerations of top executives as well as developing and guiding corporate strategy, setting performance targets, and overseeing mergers and acquisitions. Responsibilities of board members, however, do not extend to the supervision of disclosure and information communication. The board is not required to establish a special committee to supervise financial reporting, board nomination and remuneration of the top management and board members. There is no restriction for the participation of managers on boards as well as no explicit qualification requirement to become a board member. However, to minimize conflicts of interest and strengthen the independence of the board, there is a requirement that at least one-third of the board members should not be affiliated with the company.

The board of a public company is obligated by LPOS to prepare a program of the implementation of internationally recognized standards of good corporate governance (OECD Principles of Corporate Governance as stated by FSC) and to report the application progress to the general meeting of shareholders. However, since the program is an internal instruction of the company and its unsatisfactory fulfillment does not involve any administrative punishments, the incentives to introduce OECD standards of governance are still weak.

Public policy recommendations:

- Establish a minimum quorum for all joint stock companies, taking an example from other transition countries where the first quorum is usually set at 40% or 50% of capital, and the second at 30% of capital;

- Empower minority shareholders with the right to add items and questions on the general shareholders' meeting agenda;

- Provide legal basis for shareholders' voting outside of the general shareholders' meeting such as by Internet, mail, telephone or other means;

- Encourage public companies to put all disclosed information on their websites, which will further facilitate access of the public and investors to the company's information and improve the level of corporate transparency;

- Increase the number of independent directors, which would allow inclusion of independent professionals on the board, thus increasing the level of the board's competence and creating additional guarantees for protection of interests of all shareholders;

- Establish specialized committees on the board that would deal with the nomination of board members, remuneration of top executives, collection and provision of information to the board about company activity.

b. Public Governance

The objective of public administration policies is to redefine the role of the government to support the private sector and secure the provision of sound and efficient government services without corruption. Progress in this area is achieved through implementation of transparent public administration procedures, sound procurement policies, and redefining the roles of government agencies.

Under pressure from the European Commission, the Bulgarian government has notably intensified efforts to reform public administration. The legislative framework was updated, a profile committee to deal with public administration reform was created, and new priorities for the coming years were laid down. Significant measures have been undertaken to increase the capacity of public administration through the development and enhancement of professional skills of civil servants; the advancement of the transparency and accountability of state administration activities, the fight against corruption and development of e-government. Moreover, a clear distinction has been outlined between political and administrative levels of public administration — a step that was frequently suggested by the European Commission, Furthermore, the decentralization of the state administration has been considerably advanced.

Legislation Framework

In 2006, improvements of major legislative acts regulating functions of state administration were developed and adopted by the Bulgarian government. For example, the Administrative Procedure Code replaced a number of laws on state administration and accelerated the process of preparation and issuing administrative acts. New amendments to the Law on Administration established clear distinctions between the political and administrative levels of public administration and strengthened the role of the Inspectorates as the internal administrative units for control and prevention of corruption. Limits on governmental regulations and control of business activities were enforced by respective law, which was also amended in 2006. Adequate implementation of these and other adopted pieces of legislation is the major challenge to successful public administration reform.

Government Strategy

The government's strategy on public administration reform was developed based on public expectations and recommendations of the European Commission and other international organizations, and is embedded in a number of strategic documents. The introduction and implementation of e-government, training of state administration employees, improving human resource management, enhancing the quality of provided services through introduction of one-stop shop offices are among key items of this strategy. An important step was the adoption of the strategy for transparent government and prevention and fight against corruption 2006-2008, and the establishment of the Combating and Prevention Corruption Committee for implementation of the strategy.

Civil Servants

Civil servants play a major role in the activities of public administration, so increasing their competence and improving their skills advances the operational capacity of public administration. For this reason, the government created the Institute for Public Administration and European Integration (IPAEI) as an executive agency within the Ministry of State Administration and introduced compulsory training for all civil servants as well as specialized training. Since 2000 when this Institute was opened, the number of employees who passed training has been increasing and the total number of employees who passed compulsory and specialized training in 2005 amounted to around 7,300. According to the new strategy for training of state administration employees, 87,000 more civil servants are going to receive training by the end of 2006 in English, information technologies, professional ethics and corruption prevention. In addition, the new strategy envisions the development of training programs designed to increase the quality of services provided by public administration and to prepare civil servants to work with EU structural funds.

To increase the efficiency of human resource management, a Uniform Information System for Human Resource Management was developed and is to be implemented by August 2006. Until now, the capacity to undertake a comprehensive analysis of the human resources in all of the administrative units was weak, restricting evaluation and monitoring of the effectiveness of public administration human resource policies, the availability of vacant positions, and the training needs of employees.

Several steps have been undertaken to enhance the motivation of the civil servants, raise their responsibility, increase clarity in goal setting and objectivity of the evaluation criteria to ensure a stronger link between civil servants' remuneration and performance.

The introduction of competition procedures for recruitment of new civil servants is a positive achievement, implying that the selection of applicants and appointments should be based on applicants' professional qualifications. This step would encourage the inflow of motivated and professional personnel into public administration. However, a number of improvements should be made to the legislation and procedure itself to advance the competitiveness of the recruiting process.

E-government

The development of e-government and information and communication technologies is considered to be a major step to modernize state administration and fight corruption. Its implementation would create better coordination of activities among the various administrational units, municipal and central branches, enhance efficiency, improve delivery of administrative services to citizens and businesses, and increase access to public information. Moreover, the provision of services through electronic technologies would reduce the personal contact of state officials with the public, thus decreasing the opportunity for corruption.

Although the strategy for e-government was developed and approved in 2002, its implementation has been delayed for a number of reasons. In 2006, the Ministry of the State Administration and the Administration Reform (MSAAR) declared the introduction of e-government as its top priority. According to the State Administration Minister, there are three steps that have to be taken to launch e-government in the country: building infrastructure, training of personnel, and development of software solutions. Tenders have already been announced to select the company that will design e-government software. According to the Economic Intelligence Unit, Bulgaria ranks 44th out of 68 countries in the world in its readiness to implement electronic governance.

Decentralization

One of the major developments in decentralization was the adoption of the Municipal Debt Law in 2005, which allowed local governments to issue debt to finance local infrastructure and capital projects. This step increased local governments' access to resources. Another major development was the adoption by Government of the Decentralization Strategy (2006–2015) and the Program for Implementation of the Decentralization Strategy (2006–2009). The strategy, among other things, envisions transfer of public services from the central government to local authorities, which, according to international experience, should improve cost recovery at least for basic services. In addition, constitutional amendments improving the independence of local budgets by granting them the right to set new taxes and change tax rates are expected to be adopted by the end of 2006.

Other Developments

In 2004, the Public Procurement Law was passed; this paved the way for the creation of the Public Procurement Agency (PPA) subordinated to the Minister of Economy and Energy and called upon to facilitate the public procurement process, namely, to ensure publicity and transparency of the process, free and fair competition and equal opportunities for all candidates. Although, the law still has to be improved and brought in line with EU requirements for public procurement, bidders argue that public procurement procedures are now better and more transparent. Upgrading the regulation and implementation of the procurement process would help to reduce corruption and allow foreign suppliers to participate in Bulgarian public procurement. Recently a Law on Amendments and Supplements of the Public Procurement Law was adopted, which is in full compliance with the requirements of the European regulations for public procurement and establishes a basis for the management of all payments from the EU Cohesion and Structural Funds.

On January 3, 2006, under the World Bank's Revenue Administration Reform Project (RARP), the National Revenue Agency (NRA) was launched, which operates in accordance with modern, EU-compatible legislation. The adoption of the NRA procedural code in December 2005 established a legal framework for the new agency, which is to implement a unified collection of domestic taxes and social contributions. The creation of the agency is supposed to reduce the compliance cost for businesses and provide better services for taxpayers. Improved revenue administration will reduce tax evasion by private domestic and state owned firms, thus ensuring equal opportunities for foreign investors.

The introduction of the institution of the Ombudsman, which is one of the key options for citizens to defend their rights from actions or lack of actions of the public administration, marked a significant step toward strengthening human rights protection in the country as well as toward improvement of the work of public administration. Moreover, since the ombudsman concept was developed in the framework of the anticorruption initiative, the adoption of ombudsman legislation and election of the Ombudsman is a significant step to fight corruption.

Public policy recommendations:

- Although the legislative framework has been extensively developed, its inadequate implementation hampers the reforms and modernization of the state administration. Thus, the enforcement of the legislation should be strengthened.

- Implementation of e-government is seen by the government as the main driving factor for the modernization of state administration, but a large share of the population is still unaware of e-government benefits. Popularization of e-government and explanation of its essence, working principles and benefits should be performed more actively.

- Increase capacity of the Ombudsman as well as the awareness of citizens about their own rights and the ways to protect them.

c. Privatization

The objective of privatization-related policies is to improve the efficiency of resource use through private ownership, minimize the possibilities of undue market power by the authorities, and concentrate government resources on public goods. Key elements here include sound legislation to ensure a competitive privatization process, an independent agency in charge of privatization, along with private ownership of land.

Since 1992, when the Transformation and Privatization of State-Owned and Municipal Enterprises Act was adopted, most of the state-owned enterprises and enterprises with a state share have been privatized. Sectors with the largest number of privatized enterprises are industry (1,634) and trade (1,172), followed by agriculture (620), construction (535) and tourism (523). In the rest of the sectors, the number of privatized enterprises is 744. At the same time, the total quantity of enterprises privatized by foreign investors amounted to 170. Among the foreign investors are Viva Venture Ltd. (Austria), E.ON Energie (Germany), Interbrew (Belgium), Lukoil Petrol (Russia), and others. Total financial receipts from privatization of state property for the entire period of privatization amounted to $10,604.683 million in May 2006.

Privatizations deals that had a significant impact on the economy include the sale of Bulgarian Telecommunications Company (BTC). Being at a standstill after the ban of the sale of BTC to Advent International, the privatization successfully concluded with the sale of the 65% stake to Viva Ventures for EUR 1.1 billion[5] and a placement of 35% of the shares on the Bulgarian Stock Exchange for EUR14 million. Other large privatization deals involved the sale of a 67% state stake in seven electricity distribution companies, which generated EUR 693 million, as well as the privatization of state-owned banks, including the sale of state shares in Bulbank to Unicredit, Italy for EUR 360 million.

During the first 5 months of 2006, the Privatization Agency concluded 54 privatization transactions, including Bulgaria's Varna power station, sold to a Czech state-run energy company. Another large state enterprise that is being prepared for privatization is "Bulgaria Air" EAD sold to local career Hemus Air through public tender. Companies that are being prepared for privatization in 2006 include 5 district heating companies, 2 thermal power plants, 1 coal mining company, 3 transport companies, 2 subsidiary companies of "Balkancar Holding" EAD, Vazovski Mashinostroitelni Zavodi EAD operating in the machine building sector and others. Cash payments from concluded privatization transactions in 2006 are expected to total Lev 600 million.

The Bulgarian government established an effective legal framework for organizing the privatization process. Thus, the adoption of the Privatization and Post-Privatization Control Act (PPCA) in 2002, which replaced the Transformation and Privatization of State-Owned and Municipal Enterprises Act, set forth two separate privatization authorities: the Privatization Agency, responsible for administering the privatization of all state-owned companies, and the Post-privatization Control Agency, responsible for the supervision of the fulfillment of buyers' obligations under privatization contracts. PPCA eliminated the method of negotiation with potential buyers and established other more transparent methods of privatization, including most frequently applied publicly announced tenders and public auctions. Moreover, amendments and supplements to secondary legislation of PPCA in 2003 led to the creation of the Bulgarian Stock Exchange-Sofia, which in turn significantly accelerated the privatization process. Since the enactment of PPCA, the number of sales of state-owned shares concluded at BSE-Sofia reached 1,640.

In 2006, the Privatization Agency continued to sell state stakes in companies through BSE-Sofia. Since the beginning of the year, 2 remote public auctions and 1 centralized public auction have taken place, where 48 packages of shares and interests in companies were sold.

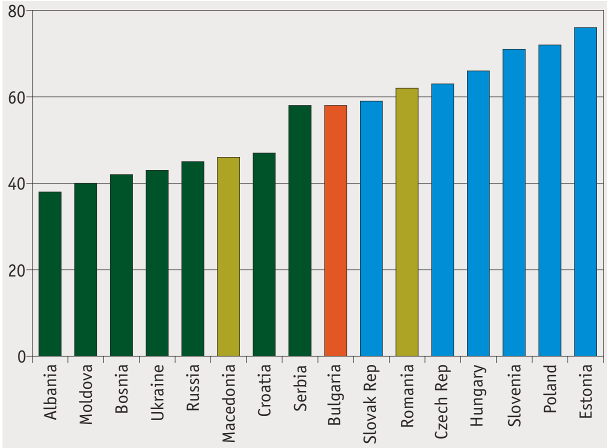
[5] Viva Ventures paid EUR 230 million for a 65% stake in BTC and would invest additional amounts of up to EUR 700 million into the company.

Although few companies with sate ownership are left for sale, privatization is not expected to be completed in 2006. State shares are still present in 487 commercial companies; however, specific privatization plans were not developed for all of them. Thus, the completion of privatization is anticipated by the end of 2007.

Public policy recommendations:

- Advance privatization of state property;
- Develop a detailed and specific privatization plan for all state owned companies that can be privatized in 2006–2007.
- Increase public awareness of the government's plans concerning privatization by informing the public through state controlled media resources.

Corporate and Public Governance



Driver 5: Liberalization of Foreign Trade and Capital Movements

This driver includes policies and actions to facilitate the exports and imports of goods and transfer of capital internationally. This includes the following actions: removal of restrictions to both exports and imports, including non-tariff restrictions, streamlining customs procedures and certification requirements, and liberalizing the foreign exchange regime.

The current shape of Bulgaria's foreign trade regulations was essentially influenced by the country's membership in the WTO, the European Union's Association Agreement, future accession to the EU, and numerous free trade agreements with other European and neighboring countries. Upon joining the WTO in 1996, all tariffs were aligned with GATT 1994 requirements, while their bound rates were reduced in accordance with the Schedule of Concession and Commitments developed for Bulgaria. In addition, Bulgaria has granted most-favored-nation treatment to all WTO Members and undertaken measures to bring its trade-related legislation into compliance with WTO provisions. Tariffs on industrial imports and some agricultural imports from the EU as well as customs duties on goods from the EU, EFTA, CEFTA member countries, Macedonia and Turkey have been eliminated following the conclusion of the Association Agreement with the European Union. Preferential regional trade agreements and reciprocal trade agreements established free trade regimes for industrial and selected agricultural products with CEFTA and EFTA countries and several other countries that have Association Agreements with the EU. Moreover, adhering to the General System of Preferences, recommended by the UNCTAD, Bulgaria imposes lower tariffs on imports from developing countries. As for exports, no tariffs, duties or taxes are applied to exported goods, while export quotas are only applied to goods that are subject to international agreements.

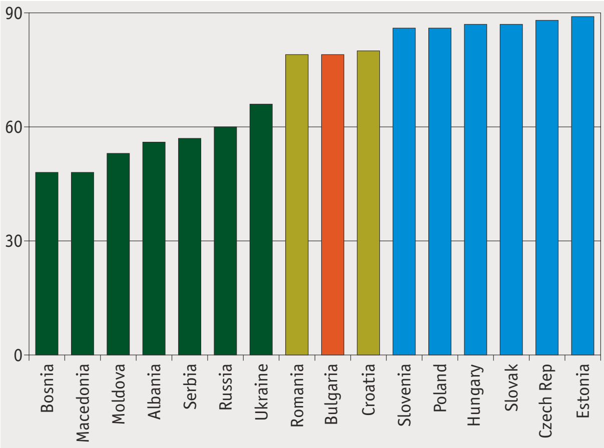
Upon accession to the EU, import tariffs and customs duties in Bulgaria will have to be reduced to the level of tariffs applied within the EU. For example, the average custom duty on industrial goods in the country is currently at 8.55%, whereas in the EU it is only 3.7%.

In general, Bulgaria has been aligning its trade policy with EU regulations, which is reflected in the completion of the negotiations on chapter 1 "Free movement of goods", Chapter 25 "Customs Union", Chapter 26 "External Relations" and the adoption of a number of laws in the areas of free movement of goods and customs policy. In particular, the Law on Technical Requirements for Products, the Law on National Standardization, the Customs Law, Bulgarian Customs Tariff and other laws have been adopted. The Customs Law is based on EU Customs Code, while the Bulgarian Customs Tariff is based on the international Harmonized Commodity Description and Coding System and on the EU Combined Nomenclature. Moreover, the customs declaration that is required at the time of customs clearance of goods closely resembles the Single Administrative Document used in the EU.

Although Bulgaria has been working on improving its trade regime, significant non-tariff barriers arising from inadequate customs regulation and policy are still present. The US Department of Commerce identifies "excessive documentation requirements, slow processing of shipments and corruption" as major non-tariff barriers in Bulgaria.

Capital movement in Bulgaria has been extensively liberalized; therefore, effective legislation complies for the most part with the requirements of the EU. A number of laws has been adopted that established a legal framework for capital movement as well as for payment systems. Among them are the Foreign Investment Law (last amended in 2002), the Foreign Exchange Law (last amended 2003), the Law on Public Offering of Securities (last amended 2003), the Law on Banks (last amended 2003), the Law on Funds Transfers, Electronic Payment Instruments and Payment Systems (2005). In addition, the Law on Measures against Money Laundering (LMML) has been adopted, defining the measures that should be taken against money laundering. According to the legislation, foreign currencies can be used for carrying out domestic transactions, and a number of licensing requirements for capital transfers abroad have been replaced with registration procedures. An adequate and effective redress procedure for the settlement of disputes between banks and customers has been established. Foreign investors have been granted the same treatment as local investors: there are no limitations on the amount of foreign participation in a company and no restrictions on transfer of funds abroad. In addition, Bulgaria has committed to eliminate existing restrictions on the acquisition of secondary residences by EU nationals not resident in Bulgaria within five years after accession and on the acquisition of agricultural land and forests within seven years after accession.

Liberalization of Foreign Trade and Capital Movements



Public policy recommendations:

- Undertake adequate measures for effective implementation of legislation in the field of money laundering. Provide sufficient training in all bodies dealing with money laundering;

- Stimulate development of export-oriented sectors of the economy and provide them with needed consulting services;

- Develop concrete measures for effective organization of the market for land, which will allow foreign residents to purchase land.

Driver 6: Financial Sector Development

This driver includes policies and actions to develop a healthy financial sector capable of meeting the financing needs of growing businesses. To achieve this, a country needs an independent central bank capable of effective bank supervision, a large number of private commercial banks, including foreign ones, functioning lending and deposit markets with liberalized interest rates, along with a developed stock market and an effective insurance system in place.

Banking Sector

Following the financial crisis of 1996–1997, the Bulgarian banking sector has gone through an impressive process of stabilization. Bulgaria can now boast a stable and efficient financial sector that is able to attract investments, mobilize savings, and allocate resources to their most productive use.

The legal system sluggishly adjusted to the new environment. The Law on the Bulgarian National Bank came into effect in June 1991, and the Law on Banks and Credit Activity was passed in 1992. Some additional improvements to both laws were introduced after the financial crisis, which corrected the shortcomings of earlier regulations.

These efforts demonstrated many positive results. By the end of 2005, the total asset' size of Bulgarian commercial banks increased to some EUR 16.85 billion, which is 31.84% more than the previous year. Lending rates and asset restructuring of Bulgarian banks is on the average EU-level. The number of state-owned banks has gradually declined from 6 in 1999 to 2 in 2005. The asset share of private-owned banks increased from 53% in 1999 to almost 99% in 2005. These positive developments enhanced competition in the Bulgarian banking sector.

Structure of Banking Sector, 2000–2005

	2000	2001	2002	2003	2004	2005
Number of Banks	35	35	34	35	35	34
Number of banks' Branches	717	738	744	755	714	653
Asset Share of Private Banks, %	80	80	86	98	98	98
Asset Share of Foreign Banks, %	75	73	75	83	82	80
Asset Share of 5 Largest Banks, %	60	57	55	53	52	51

Source: Bulgarian National Bank

The country's banking sector is a well developed system that includes both domestic and foreign banks operating within the country. Although during the last seven years the number of banks has remained stable at around 35, the quality of the Bulgarian banking system has improved significantly. Foreign banks operating in the country are present in the form of subsidiaries of their parent banks, registered abroad. These include 3 banks from Greece — National Bank of Greece C. A, Piraeus Bank, Alpha Bank; ING Bank N. V. (Netherlands), Citibank N. A. (USA), and T. C. Ziraat Bank (Turkey). The share of total banking assets held by these foreign-owned banks surged from around 20% in 1999 to almost 80% in 2005. This also means that Bulgaria's largest banks are owned by foreigners.

The top 10 Bulgarian banks based on the size of their assets includes Bulbank, DSK Bank, United Bulgarian Bank, HVB Bank Biochim, First Investment Bank, Raiffeisenbank, Bulgaria, Bulgarian Post Bank, Societe Generale Expressbank, Economic and Investment Bank, and DZI Bank. The second tier includes around 20 commercial banks, whose assets are significantly smaller compared with the first group.

The stability of the country's banking sector is reflected in the steady growth of deposits with Bulgarian banks. The existing banking system is backed by public trust in its stability and efficiency. As a result, deposits with Bulgarian banks showed steady growth during the last several years. Over 2005, deposits with financial institutions grew by 48.9% yoy and reached almost EUR 1 billion, while growth in loans posted significantly a lower rate of growth, which was about 30%. Deposits of households are the largest liability of Bulgarian commercial banks, accounting for around 50% of total liabilities.

Banking Sector Performance, 2000–2005

	2000	2001	2002	2003	2004	2005
Total Assets, % to GDP	36.5	41.1	45	50.3	65.6	78.3
Credit to Private Sector, % to GDP	12.6	14.9	19.8	27.6	37.1	44.5
Total Domestic Deposits, % of total liabilities	66.7	72	71.4	71.1	64.1	66.9
Deposits of Households, % to total deposits	48.9	54.9	54.5	53.4	54.5	51.4

Source: Bulgarian National Bank

Over the last several years, significant credit growth was a major challenge for the country's economy. Due to this reality, the Bulgarian National Bank (BNB) issued several regulations in 2005 aiming to restrict such growth. In particular, measures were introduced to restrict growth of credit to the private sector. As a result, the annual growth rate of claims on the private sector significantly decreased and reached around 30% yoy as of the end of 2005 compared with almost twice as much in 2003.

Non-banking Financial Sector

The Bulgarian non-banking financial sector still remains relatively small, which negatively affects the country's overall economic performance. The insignificant size of the existing non-banking financial institutions (NBFI) limits their actual involvement into providing domestic businesses with the needed financial services and resources.

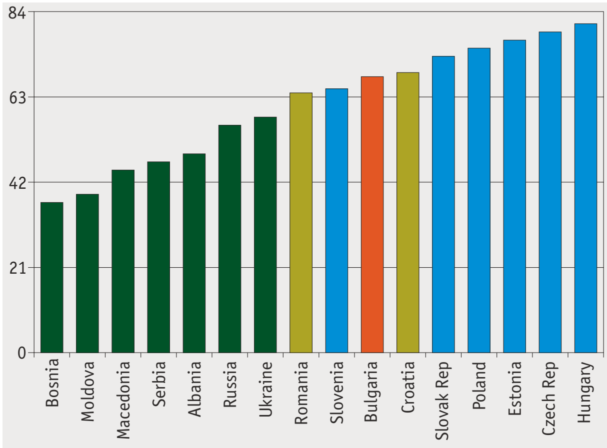
Over the last several years, the Bulgarian capital market experienced significant positive developments. In 2005, Bulgarian market capitalization reached EUR 4.32 billion up from EUR 2.06 billion in 2004, which translates into 109% yoy growth. A significant upward trend in market capitalization was due to increases in prices of most traded companies and the listing of Bulgarian Telecom, which is one of the country's largest public companies.

In 1999, the Bulgarian Parliament passed the new Law on Public Offering of Securities. According to this law, investors were granted a high level of protection of their interests while working on the country's capital market. By this step there were ensured principles of equal access to information. This law also requested a high level of transparency and irrevocability of all transactions made on the country's capital market by all individual participants. As a result, the activity of the Bulgarian capital market institutions became more efficient.

In 2005, the number of companies traded on the Bulgarian Stock Exchange (BSE) was 389. As a result of some changes in the legal framework, which regulates activity of the country's capital market, it became possible to carry out centralized public auctions and remote public auctions at the BSE. These auctions are mostly identical to the privatization market for public offering of securities owned by the state. The only difference between the two is that in the remote public auction, the state sells stakes of limited liability companies, while at the centralized public auction the state sells shares. In 2005, there were 3 centralized and 4 remote public auctions organized on the BSE.

Over the last several years Bulgaria has made significant progress in the area of financial services, notably in banking and insurance. However, in order to be more prepared for EU-accession and during the first years of the post-accession period, additional efforts are still required in the banking sector. In particular, all issues related to capital requirements should be resolved. The same is true for the state regulations on the insurance market.

Financial Sector Development



Public policy recommendations:

- Secure further development of the country's financial sector in the area of non-banking financial services;
- Clearly define capital requirements for different types of companies operating on different financial markets of the country.
- Stimulate development of private pension funds, for which different new instruments should be available.

Driver 7: Corruption Level

This driver includes policies and actions to minimize corruption and protect businesses from abuse of power by government officials. Key measures here range from creating the legal framework to ensure better enforcement of anticorruption measures, to measures to prevent corruption and raise public awareness of the problem.

Corruption still remains a significant barrier for further improvements in Bulgaria's business environment. According to Transparency International's most recent Corruption Perception Index 2005, Bulgaria ranks 55th and it shares the same spot with Columbia, Fiji and the Seychelles Islands. The individual index for Bulgaria, which may range between 10 (highly clean) and 0 (highly corrupt), is set at a level of 4.0 points. This score incorporates the perception of the degree of corruption as seen by representatives of the business community and country analysts. By placing the country at this position, Transparency International recognized significant progress made by the country over the last several years and especially during the process of preparation for EU accession. Romania, which is another candidate member state, was ranked 85th, which put it in the same spot with the Dominican Republic and Mongolia.

Over the last several years, Bulgaria has implemented a set of anticorruption reforms in the public sphere, which resulted in reducing the level of corruption in the country. As a result of an extensive process initiated by civil society in the middle of 1990s and with significant support from international institutions, Bulgaria was able to build a relatively well-established anticorruption infrastructure. Several anticorruption legal instruments and institutional mechanisms were adopted. In particular, specialized anticorruption commissions/counsels with each of the three branches of power were established. Additional positive impulses for increasing efficiency while fighting corruption were received from the country's accession to NATO and from the progress in bilateral negotiations for EU membership.

The Bulgarian government implemented a set of measures to combat the level of low-ranked-corruption. However, fewer efforts were invested into fighting high-ranked-political corruption. Such a disproportion in efforts is mainly due to the limited efficiency of anticorruption measures against high-ranked-political corruption practices.

Bulgaria made significant progress in adopting modern penal provisions concerning corruption-related offenses. However, practical enforcement was largely hampered by the inconsistent and inadequate reform of the penal process and inefficiency in the existing judiciary system.

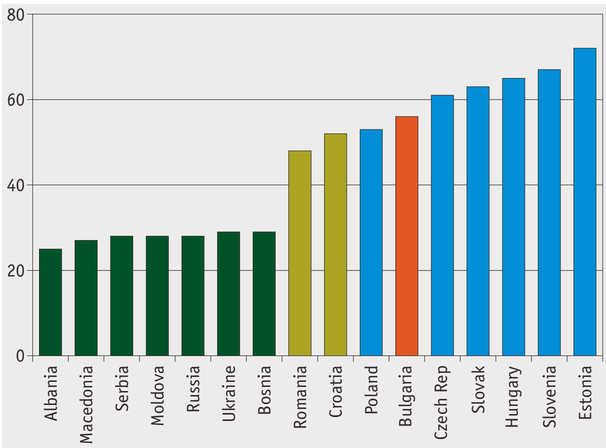
The creation of a legal and institutional environment that is unfavorable to corrupt practices was one of the important tasks to help achieve approximation of Bulgarian civil and commercial laws to EU standards. However, the issue of increasing efficiency of the practical implementation of the accepted changes is still on the agenda of the Bulgarian government.

The gradual introduction of e-governance in Bulgaria created favorable conditions for decreasing corruption. However, the existing system of public administration should be modernized. In particular, significant potential for combating corruption lies in reducing the regulatory and administrative burden of the state.

The inefficiency of the existing practices of public procurement is one of the major sources for corruption. According to the data of the Corruption Monitoring System (CMS) of Coalition 2000, up to one third of the awarded government contracts involves corrupt payments.

Despite significant progress made by Bulgaria in fighting corruption, its overall level is still significantly higher than in many new EU-member states and there is considerable room for improvement in this area.

Corruption Level



Public policy recommendations:

- Effectively implement programs to combat corruption in all areas of the country's public sector, including public procurement and public health;
- Widely introduce features of e-governance into public services;
- Stimulate development of public awareness programs concerning all issues of public administration.
- Actively advise with non-government organizations working in the field of anti- corruption practices and closely monitor the latest developments in this area.

Driver 8: Political Risks

This driver includes policies and actions to minimize the effects of political uncertainties on business activities. This is achieved through effective functioning of the authorities unimpeded by vested interests, elimination of power abuses by the authorities, and minimizing the risks of civil disturbances that may affect businesses.

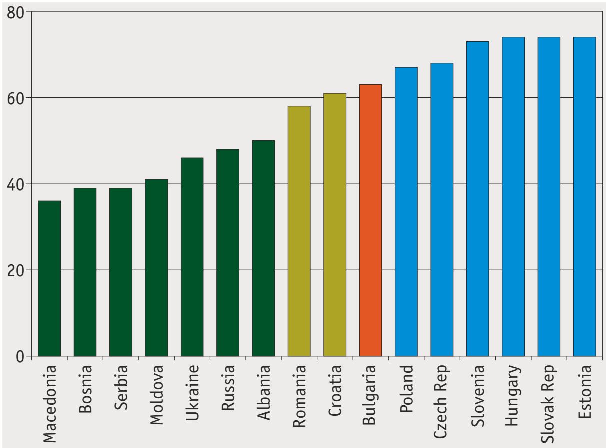
Since the collapse of the communist regime, Bulgaria persistently moved forward on the road of democracy and market economy and achieved considerable results. Having applied for EU membership in December 1995, Bulgaria's efforts to integrate into the western community intensified, supplemented with the efforts of fighting corruption and organized crime, eliminating bureaucracy, maintaining sustained economic growth and rising standards of living. Thus, formed in 1997 government of Stefan Sofianski, UDF (Unified Democratic Forces) party member, started persecution of corruption and organized crime, as well as sought to eliminate bureaucracy. Moreover, it curbed inflation and stabilized the Lev after its 6-fold depreciation in December 1996-February 1997. Under the guidance of the next (since May 1997) Prime Minister Ivan Kosov, the UDF leader, Bulgaria saw establishment of a currency board arrangement, stabilization of the economy and privatization of most industries. A low budget deficit, sustained economic growth, sharp falls in unemployment, a rise in foreign investment and substantial progress on the way to EU accession was achieved with the government of the former king Simeon Saxe-Coburg, leader of Simeon II National Movement (SNM), heading the government since 2001.

Notwithstanding all these achievements, crime and corruption in high ranks of power and connected with that judicial inadequacy remained one of the major problems in the country. These problems were passed on to the present government, headed by the leader of the Bulgarian Socialist Party and formed after the parliamentary elections in June 2005. The remarkable thing about the present government is that it was created out of a three-party coalition, which is an unprecedented case in Bulgaria's political life. The formation of this coalition was met with great public support since the new coalition was formed based on compromise and was able to avoid confrontation.

The EC report on Bulgaria, which was published in the middle of May 2006, pointed out that the EU community gave good grades to the current performance of Bulgaria. At the same time, the report also expressed concern with inadequate measures undertaken in problematic areas. Since EU membership is the only thing that holds three-party coalition and government together, the ease of EU and public pressure and the absence of an urgent common goal may weaken the party's desire for compromise, thus leading to tensions inside the government and finally to collapse. However, with or without the collapse of the present government, policy decisions are expected to be in line with EU policy, thus predictable and expected.

The common goal of entering the EU serves as a directive for Bulgaria's government policies. For the last several years there were no examples of civil disturbances and transmission of power has always been done in a peaceful way. Therefore, political risk remains low, which is confirmed by the placement of Bulgaria in the middle of the graph.

Political Risks



Public policy recommendations:

- Continue reforms in the country's judicial system and energize its efforts in fighting corruption and organized crime as indicated in the European Commission report;
- Parliamentary opposition and the coalition should concentrate their efforts on resolving those problems that hamper EU accession;
- Political parties in coalition and government should strive for government stability no matter when and how EU accession will result.

Driver 9: Country Promotion and Image

This driver includes policies and actions to promote the country and improve its image as perceived by foreign and domestic investors. Key measures include a consistent and detailed government action plan on country promotion, support to current investors in resolving problem issues, and the country's active position internationally.

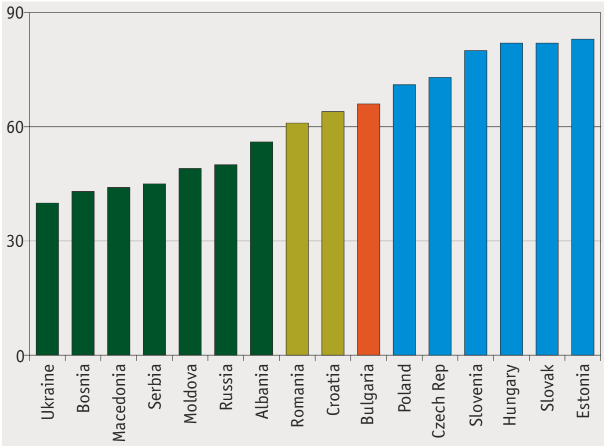
Over the last several years, Bulgaria made significant progress in improving its image as a democratic country with a free market economy. The main efforts in this direction were undertaken after 1999 when the European Union invited Bulgaria to start negotiations on its membership in this organization. The negotiations had a great effect on all areas of the Bulgarian economy. It significantly helped the country to harmonize the existing economic legislation and regulatory practices with the best western standards, improved the system of public administration by introducing effective institutions oriented for the country's further development.

The excellent performance of Bulgaria on its way to an open and democratic society was recognized and highly appreciated by the international community. The EU Accession treaty was signed on April 25, 2005 and after significant work Bulgaria should join the EU on January 1st, 2007.

Considerable improvements made by Bulgaria are reflected in the Human Development Index (HDI) calculated by the United Nations Development Program. In 2005, Bulgaria received the highest score in the last decade and was placed in the group of highly developed societies.

According to UNCTAD's World Investment Report 2005, Bulgaria is the fifth largest recipient of FDI inflow in South East Europe and CIS countries.[6] Moreover, based on the indicator of the country's share in the global FDI market (Inward FDI Performance Index) Bulgaria was classified as number 12. This index placed the country ahead of several other countries that have already become EU-member states including the Czech Republic, Slovakia, and Estonia. Besides prospects of EU membership, FDI to Bulgaria was boosted by a stable macroeconomic situation and incentives' framework.

Country Promotion and Image



Public policy recommendations:

- Use high-level political summits, meetings, conferences, etc. to educate representatives of other countries on Bulgaria's achievements in building a strong democracy and a functioning market economy;
- Ensure a high level of transparency of all incentives granted to foreign investors operating on the domestic market;
- Secure broad circulation of the regular reports issued by the Bulgarian state agencies among existing and potential investors.

[6] World Investment Report 2005. www.unctad.org

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Appendix

Key Economic Statistical Indicators

	2001	2002	2003	2004	2005	2006*	2007(f)**
GDP							
GDP nominal (EUR billion)	15	17	18	20	21	24	26
GDP per capita (EUR)	1,919	2,101	2,258	2,515	2,771	3,088*****	3,385*****
Real GDP (% yoy)	4.1	4.9	4.5	5.7	5.5	5.6	4.7***
Final Consumption (% yoy)	4.4	3.6	6.6	5	6.8	4.6	—
Gross Fixed Capital Formation (% yoy)	23.3	8,5	13.9	13.5	19	13	—
Agricultural Output (% yoy)	0.5	5.1	−1.3	2.2	−8.6	—	—
Industrial Output (% yoy)	4.2	3.5	7.1	5.3	7.3	—	—
Public Finance							
Consolidated Fiscal Balance (% of GDP)	−0.6	−0.8	0	1.8	2.4	3.2	0.8****
Revenues & grants (% of GDP)	—	38.4	40.7	41.4	42.9	40******	41.7****
Expenditures (% of GDP)	40.7	39.2	40.7	39.7	40.5	36.8******	40.9****
Monetary Statistics							
Consumer Price Index (% yoy, eop)	4.8	3.8	5.6	4	6.3	6.6	3.1****
Monetary Base (% yoy)	34	11	18	34	18	—	—
Money Supply-M3 (% yoy)	25	12	21	21	30	18	—
Average Exchange Rate (BGN/$)	2.2	2.1	1.7	1.6	1.6	1.56***	1.44***
Average Exchange Rate (BGN/Euro)	1.96	1.96	1.96	1.96	1.96	1.96	1.96
External Sector							
Merchandise Exports (EUR million)	5,714	6,063	6,668	7,994	9,454	12,367	13,858
Merchandise Imports (EUR million)	−7,493	−7,755	−8,868	−10,712	−13,823	−17,340	−19,539
Exports of Goods & Services (EUR million)	8,441	8,784	9,459	11,347	13,041	16,253	18,168
Imports of Goods & Services (EUR million)	−9,592	−9,879	−11,135	−13,352	−16,591	−20,530	−22,965
Net Foreign Direct Investment (EUR million)	895	951	1,827	2,561	1,533	2,300	2,288
Gross International Reserves (EUR billion)	4	5	5	7	7	8	9
Gross International Reserves (months of imports)	5	4.9	4.8	5	4.3	4.3	4.4
Current Account Balance (EUR million)	−1,102	−402	−973	−1,132	−2,531	3,657	−2,178
Debt							
Gross External Debt (EUR billion)	11.9	11	10.6	12.6	14.5	16.7	18
External Public Debt (EUR billion)	1	8	7	6.4	5.1	5.3	5.7
Domestic Public Debt (EUR billion)	1	1.1	1.2	1.4	1.5	—	—

* *Preliminary data*

** *Unless specified, forecasted indicators are from Bulgaria: 2006 Article IV Consultation, Third Review Under the Stand-By Arrangement, and Request for Rephrasing, Waiver of Applicability and Nonobservance of Performance Criteria and Extension of the Arrangement-Staff Report; Staff Statement; and Public Information Notice and Press Release on the Executive Board Discussion*

*** *Economic Intelligence Unit forecast*

**** *Bulgarian Ministry of Finance forecast*

***** *The Bleyzer Foundation Forecast*

****** *Projections for general budget*

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