

## Macroeconomic Situation

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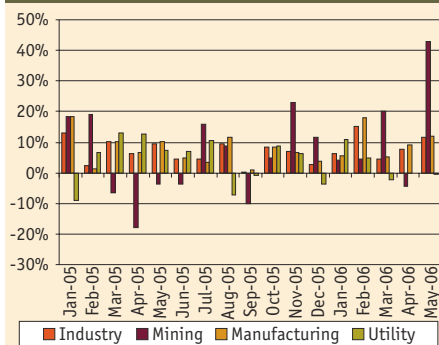
### Summary

- In May, the growth in Bulgaria's real sector was driven by the expanding industrial sector and trade, where sales grew by 11.6% year-over-year (yoy) and 14.2% yoy respectively.
- The consolidated budget surplus continued to show positive dynamics and increased in May by 24% yoy, which is equivalent to around 3% of full-year GDP.
- Annual consumer inflation posted some deceleration from 8.5% yoy in May to 8.2% yoy in June.
- The increasing trade gap still remains the main driving force for the widening of the current account (CA) deficit, which surged in January-May by 27.6% yoy. This amount was almost fully covered by the existing surplus in the financial and capital account item of the balance of payments and the remaining gap was insignificant.
- In August, the Bulgarian Parliament passed in a final reading the Law on Credit Institutions, which brings regulation in this sector into full compliance with EU requirements and standards.

### Economic Growth

In May, Bulgaria's real sector continued to demonstrate substantial growth, which was supported by the expanding industrial sector and trade. During the month, industrial sales surged by a strong 11.6% yoy up from 8% yoy in April and 4.5% yoy in March. The rate of growth in retail trade posted in May was even higher and reached 14.2% yoy compared with 10.2% yoy in April.

**Economic Growth by Sectors in 2005–2006, % yoy**



Source: Bulgarian National Statistical Institute

A breakdown of industry by sub-sectors shows that the considerable growth was supported by rapidly increasing manufacturing. In May, it grew by a substantial 12% yoy, up from 9.2% yoy in April and 5.2% yoy in March. Within manufacturing, the growth leaders were companies producing office machinery and computers, transport equipment, and fabricated metal products. During the period they surged by an impressive 82.5% yoy, 48.5% yoy, and 43.9% yoy respectively. On the negative side, some sub-sectors posted a sharp decline. For instance, medical, precision and optical instruments production posted a 28.4% yoy decline, while radio and television equipment shrunk by 24.5% yoy.

The seasonal adjustment in consumption of electricity, water and gas led to a decrease in the amount of total sales in the utility sector, which drop in May by 10.3% month-over-month (mom). However, the overall effect of this one month decrease on annual indicators was insignificant and can be translated into 0.4% yoy.

In May, retail trade surged by a strong 14.2% yoy up from 10.2% yoy in the previous month. This increase brings the cumulative rate of growth in retail trade in January-May to 10.6% yoy. The main reason for this acceleration is the rapidly growing consumption backed by surging real income of households.

### Fiscal Policy

In January-May, the consolidated budget surplus continued to increase. However, its growth rate slowed somewhat. During the first five months of the year, the budget surplus reached Lev 1.2 billion (EUR 628 million), growing at a rate of 24% yoy,

**Consolidated Fiscal Program in January–May 2006**

	EUR million	Change, % yoy
<b>Revenue</b>	<b>4,127.3</b>	<b>10%</b>
Tax	3,317.9	13%
Non-tax	709.5	(-5%)
Grants	99.9	45%
<b>Expenditures</b>	<b>3,498.8</b>	<b>8%</b>
Public Wages, insurance	531.2	53%
Social and Health Insurance Contribution	170.9	38%
Social Expenditure	1,446.7	16%
Capital Expenditure	304.7	3%
Other	1,045.3	(-15%)
<b>Balance</b>	<b>628.5</b>	<b>24%</b>

Source: Bulgarian Ministry of Finance

which is 6 percentage points slower than in January-April. As a percentage of projected full-year GDP, the budget surplus reached 2.7%, suggesting that at the end of the year it could exceed the planned 3% target.

On the revenue side, there continued to be a rebound in their rate of growth. During the period, revenues grew at an accelerated rate of 10% yoy and reached Lev 8.1 billion (EUR 4.1 billion). The highest increase among revenue components was observed in grants, which grew by 45% yoy, constituting Lev 195 million (EUR 99.9 million). However, this rate of growth is almost 2 times lower than in the previous period, when grants grew by 88% yoy. On the other hand, the growth of tax revenues accelerated during January-May, with the rate being 3.1 percentage points higher than in the previous month, and reached Lev 3.3 billion (EUR 6.5 billion). On the negative side, non-tax revenues continued to post a decline, which reached January-May 5% yoy. At the same time, the weight of non-tax

and grants components in the total amount of budget revenues have been slightly increasing and reached 17.2% and 2.4% respectively.

In January-May, the growth rate of expenditures accelerated sharply after some slowdown a month before. During the period, expenditures grew by 8% yoy, which is almost 2 times faster than in January-April and constituted Lev 6.8 billion (EUR 3.5 billion). Items that contributed the most to the acceleration were maintenance and subsidies, which are included in the item "other" and together constitute 24.3% of total budget expenditures. The acceleration in the rate of growth was also observed with capital expenditures. In January-May, they grew by 3% yoy after a drop of 6.6% yoy in January-April. Moreover, their weight in total budget expenditures also grew, constituting 8.7% compared to 4.1% at the beginning of the year. Public wages together with social and health insurance contributions showed some deceleration in their rates of growth compared to the previous month and amounted to Lev 1.0 billion (EUR 531.2 million) and Lev 334 million (EUR 170 million) respectively. The public wage increase of 6% passed by the Cabinet and effective July 1 will increase public wages expenditures during the second half of the year. However, since the rise is consistent with the budget program, this should not affect the targeted budget surplus. Social expenditures, which constitute the largest share in total budget expenditures, continued to grow at a steady rate of 16% yoy and reached Lev 2.8 billion (EUR 1.4 billion).

In January-May, the government demonstrated sound debt management. Government debt continued to decline during the period, although the decline was insignificant in absolute terms.

The total amount of public and publicly guaranteed debt decreased by EUR 18.2 million compared with the previous month and constituted EUR 6.4 billion or 27.5% of GDP. The stock of domestic debt increased by 1.3% month-over-month (mom) and reached EUR 1.5 billion. At the same time, the stock of external debt declined by 0.8% mom and amounted to EUR 4.8 billion. However, as compared to the previous year, public debt demonstrated strong improvement. As a result of regular repayments and early retirement of loans and securities from international financial institutions, the total amount of debt declined by 14.4% yoy as of the end of May 2006. The structure of external debt by type of creditor remained unchanged from the previous month. The World Bank is still the largest lender to the country, followed by the IMF and the European Investment Bank. Their shares in the country's total external debt stock are 16.8%, 6.8% and 5.6% respectively.

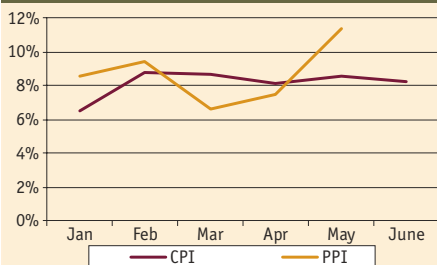
### Monetary Sector

In June, the consumer price index (CPI) increased by 8.2% yoy, slowing from 8.5% yoy in May. The main reason for the decrease of the CPI is the better harvest. In June, prices of food products, whose

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weight in the consumer basket is 37.2%, grew at a decelerating rate and constituted 7.2% yoy as compared to 7.7% yoy a month before. The expected higher production volumes in most agricultural sectors will contribute to further deceleration in the growth of food prices and total CPI. This should make CPI development in line with the government forecast for year-end inflation, which is 6.4% yoy. Prices of non-food products remained stable in June and even decelerated by half a percentage point as compared to the previous month, suggesting that one-off effects of excise hikes for tobacco, alcohol and fuel are fully absorbed. The growth rate of service tariffs accelerated slightly in June, constituting 4.2% yoy up from 4.0% yoy in May.

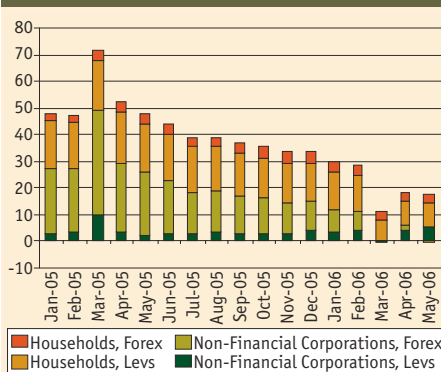
**Price dynamics in January-June 2006, % yoy**



Source: Bulgarian National Statistical Institute

Growth of the producer price index (PPI) on the domestic market continued to increase at an accelerating rate and constituted 11.4% yoy in May as compared to 7.4% yoy in April. The major driver of PPI inflation in May, as in the previous month, was the mining industry, where prices increased by 54% yoy driven by the 135% yoy growth in prices of metal ores. Prices in the manufacturing sector rose by 9% yoy as compared to 4.7% yoy in the previous month, mainly due to steep acceleration of prices for basic metals. Since most of the metal production is exported, the price increase in the extraction and manufacturing of metals had an effect on the broader PPI, which grew by 15.3% yoy in May up from 10.4% yoy in April.

**Growth Rates of Bank Credits, % yoy**



Source: Bulgarian National Bank, own calculations

The Central Bank continued to increase money supply (M3), which by the end of May constituted Lev 26.6 billion. The increase in money supply was driven mainly by the increase in the most liquid monetary aggregate M1, which grew by 21.3% yoy in May or by 5.3% mom. Banking system deposits also increased by 21.2% yoy

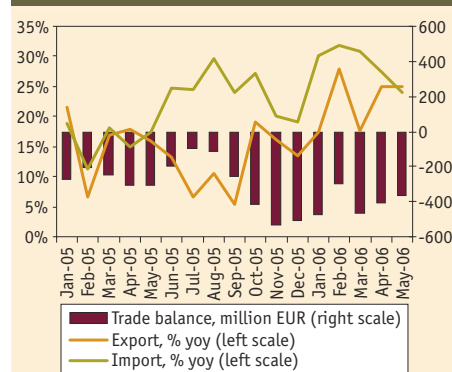
In June, the Bulgarian National Bank (BNB) slightly lowered its base interest rate, which was set at 2.59 per annum (p.a.).

In May, the growth of the commercial banks' credit portfolio decreased by 0.7 percentage points and constituted 16.8% yoy, being in line with BNB expectations for credit growth of 20% yoy. As a percentage of projected full-year GDP, the stock of commercial banks' credits to the non-government sector did not change and remained on the same level of 41 % as in the previous month. Non-financial corporations' share in the banks portfolio 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 banks loan portfolio increased and constituted 40.2% in May, with mortgage loans growing at the fastest rate among retail loans.

### International Trade and Capital

In January-May, the Bulgarian foreign trade deficit continued to increase. During the period it surged by 27.6% yoy and reached EUR 1.8 billion, which is translated into 7.3% of period GDP. However, foreign trade expanded by 6.6% yoy in May alone, which is significantly lower compared with the previous month when it grew by 10.6% yoy. To a great extent, the current deterioration of the country's foreign trade balance can be explained by the hikes in energy prices.

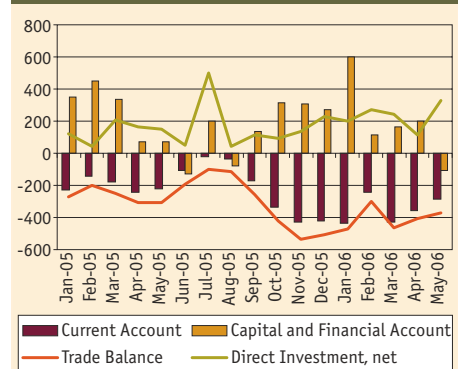
**Trade flows of goods and services in 2005-2006**



Source: Bulgarian National Bank, own calculations

In May, exports of goods accelerated to a significant rate of 33.7% yoy up from 32.4% yoy in April. The increase in exports is backed by growing prices for metals. In particular, the world market for steel and copper posted strong growth over the first half of the year. Since this trend is expected to continue in the second half of the year, it should positively affect the country's merchandise exports.

**Balance of payment in 2005-2006, million EUR**



Source: Bulgarian National Bank, own calculations

On a positive note, imports grew at a slower pace compared with exports in May. During the month, imports increased by 29.5% yoy, which demonstrates some deceleration in the rate of growth from the previous month's level of 31.1% yoy growth. As in previous months, the rise in Bulgarian imports was driven by energy prices.

Although the level of the CA deficit still remains the major risk factor for the country's economy, so far it has been fully covered by the existing surplus in the financial and capital account of the balance of payments. However, it dropped by 7% yoy to EUR 1.5 billion in January-May. This is slightly below the required amount for full coverage of the existing CA gap. On the positive side, the increase in the net inflow of FDI almost doubled during the period and reached EUR 330.5 million in May alone.

### International Programs

The Management Committee of the EU PHARE Program approved the financial proposal of the 2006-PHARE National Program for Bulgaria, which entails investing EUR 26.3 million in Bulgaria. The funds will be distributed among 8 projects in the areas of justice and home affairs, economic and social cohesion, democracy and social integration, and harmonization of the Bulgarian legislation with the EU in the field of transportation. However, the remaining part of the Program, which contains other important projects, will be discussed in October 2006. The Management Committee also approved two multinational programs for funding municipalities and administrative reform in European countries in transition, including Bulgaria.

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In June, the Bulgarian government signed two agreements for awarding grants from the European Union Solidarity Fund. According to the agreement, the EC will grant Bulgaria EUR 20.4 billion. The funds will be used for covering flood damages from the spring and summer 2005 in energy, water supply and sewage, telecommunication, transport, health and education sectors.

### Other Developments and Reforms Affecting the Investment Climate

The survey conducted by the World Bank found that the level of corruption in the country has significantly declined over the last 3 years. Although the spread of corruption remains relatively high, it has significantly declined compared with its level in

2002. In particular, corporate expenditures for corrupt practices dropped to 1.6% of the overall revenues from 2.5% in 2002. A higher level of bribes is reported in only 2 out of 10 fields covered in the survey. Those are (i) public procurement and (ii) health and labor inspections. State procurement is at the top of the ranking of the most corrupt areas. According to the survey, 21% of all respondents stated that bribes are a must for winning the state contracts. Although licensing and customs administration still remain the most corrupt public activities, some improvements were also demonstrated.

The Bulgarian State Labor Office (BSLO) reported that at the end of June, the unemployment rate dropped to 19.18%, which is 1.9 percentage points lower than the corresponding period of the previous year. The highest level of unemployment is ob-

served in small settlements, where business activity is relatively low. This fact forced the BSLO to refocus some of its projects to stimulate job creation in the defined depressed regions.

In August, the Bulgarian Parliament passed in a final reading the Law on Credit Institutions. The new law harmonizes regulations in the country's financial sector with EU standards and practices. The law comes into force starting January 1<sup>st</sup> 2007.

The Ministry of Economy announced its plans to finance between 15 and 30 economic clusters in various regions of the country. Two pilot projects were already successfully implemented and demonstrated significant positive results. The maximum amount of the government's aid will be limited to EUR 1 million per cluster.

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