

# Bulgaria



## OUTLOOK

While the fundamentals of the Bulgarian economy remain strong, most of the recent data signal aggravation of the existing macroeconomic imbalances. Inflation reached levels unseen since 2001, and the current account (CA) gap continued to expand, although the real size of the deterioration remains unclear as persistent problems plague the quality of foreign trade data collected through the INTRASTAT system. Excessive growth in the

real estate market continued, although the prospects remain uncertain on the degree increased global financial markets turbulence and risk aversion affects Bulgaria. Our baseline scenario envisages another year of strong GDP growth, accompanied by moderate easing of the CA gap and inflation, which remains far from the level needed to qualify Bulgaria for euro adoption.

### MOODY'S LT FC RATING

Baa3/Positive

### S&P'S LT FC RATING

BBB+/Stable

### FITCH LT FC RATING

BBB/Stable

### SPREAD AVG (AUG) 56

EMBI+ Spread on Euro Curve

## Macroeconomic data and forecasts

	2005	2006	2007f	2008f	2009f
Nominal GDP (EUR bn)	21.9	25.1	28.5	31.8	35.0
Per capita GDP (EUR)	2,835	3,268	3,732	4,178	4,623
Real GDP, yoy (%)	6.2	6.1	6.2	6.2	6.0
Inflation (CPI), yoy, eop. (%)	6.5	6.5	6.7	4.6	3.8
Inflation (CPI), yoy, avg. (%)	5.0	7.3	7.4	5.2	4.1
Unemployment rate, eop. (%)	10.7	9.1	7.3	6.5	6.0
Exchange rate BGN/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
1M SOFIBOR, avg. of Dec	2.66	3.68	4.55	4.48	4.46
1M SOFIBOR, avg. of the year	2.71	3.09	4.24	4.50	4.46
Current account balance/GDP (%)	-12.0	-15.8	-17.6	-16.8	-15.0
FDI/GDP (%)	14.2	16.4	15.0	13.0	9.5
General government debt/GDP (%)	31.3	24.7	19.8	18.6	18.4
Budget balance/GDP (%)	2.3	3.6	3.0	2.0	2.0
Total external debt/GDP (%)	69.0	78.4	81.0	86.0	89.5

Sources: Central Bank, Central Statistical Office, Bulbank Research Division, UniCredit Group New Europe Research Network.

## MAIN TOPICS

- GDP grew at a rate of 6.6 % in Q2 2007, still in line with our full-year forecast of 6.2 % real growth. We expect economic growth of similar proportions next year, underpinned by a moderate strengthening in exports and solid growth momentum behind investments, and backed by the start of EU-funded projects as well.
- Healthy fiscal performance enabled a 3 % cut in the social insurance contri-

bution rate in October and bolstered plans for the introduction of 10 % flat tax on personal incomes next year.

- Inflation risks increased under pressure from one-off supply shocks in the agricultural and food sectors, lack of competition in some sectors, wage developments and rapid increase in money and credit aggregates.
- The authorities need to press ahead with reforms geared to increase the

resilience of the labour market, in order to compensate for the lack of flexibility under the currency board arrangement. It will be crucial likewise, to reinvigorated restructuring measures aimed at boosting competition in the sectors where inflationary pressure persists and to improve efficiency in the use of EU funds, to develop human resources and encourage modernization of the economy.

# Economy maintains strong momentum despite rising vulnerabilities and risks

## Economic growth accelerates to real 6.6 % yoy in Q2

The growth pattern also saw some improvement, although it generally remains over-reliant on externally funded investments and consumption appetite in the household sector. Compared to with the previous quarter, the negative contribution of net exports dropped significantly, mostly in response to the gradual recovery in exports. Despite excessive increases in retail credit and wages, individual consumption lost further momentum, slipping to 5.7 % yoy in Q2. Investments continued to expand at an impressive pace compensating for the flagging spending appetite in the household sector, and thereby boosting medium- to long-term economic growth prospects. GFCF including changes in inventories, reached 35 % of total GDP in Q2, still somewhat weaker when compared with the all-time record posted in the previous quarter, when investments edged up to 40 % of GDP. The structure of expenditures for the acquisition of tangible fixed assets also improved. In H1, capital spending in the tradable goods sectors increased by 55 % on an annual basis, boosting its share in total investments to 40 %, from 37 % one year ago. On the supply side, the anticipated contraction in the agricultural sector (-5.3 % yoy), was more than balanced out by industry and services, which exhibited real growth rates of 10.5 % and 9.5 %, respectively.

While the latest national account data bring economic growth to 6.4 % in H1 2007, we think this is still broadly in line with our full-year forecast of 6.2 % GDP growth. Quarterly GDP growth is expected to slow down in the second half of the year, on the back of further decline in agricultural output and a high base effect in the third quarter. Over the mid-term, growth prospects remain favourable. A gradual recovery in exports and solid growth momentum behind investments, also backed by the start of EU-funded projects, will keep GDP growth around 6.2 % in real terms.

Renewed volatility in international markets remains the key downside risk for our baseline GDP growth scenario. A potential deterioration in global financial conditions and a deepening of risk aversion could have a detrimental impact on FDI and the cost of external borrowing, thereby reducing investments and GDP growth, and making it more difficult for the country to finance its large CA shortfall.

## Real estate market provides no evidence of a slowdown, apart from some deceleration in the residential property prices in Q2 2007

Property prices grew steadily, rising by some 12 % in H1 2007 relative to the end of 2006. The combined share of the real estate, construction and tourism sectors in total capital expenditures in the econo-

my remained unchanged at around 20 %, while the same sectors' share of FDI increased slightly to 52 % in H1 2007, compared with 47 % for the previous year as a whole. Likewise, in H1 2007 the number of newly extended retail loans with a single credit size between EUR 25,000 and 250,000 grew 74 % on an annual basis. Next year, we expect to see some slowdown in real estate market activity on the back of slackening external demand and high property prices relative to local incomes, but overall the market will keep its robustness.

## Healthy fiscal performance enabled a 3 % cut in the social insurance contribution rate

With year-to-date revenues in July totalling 62 % of those planned for 2007 as a whole, and expenditures amounting to only 52 % of the planned target, the state budget is looking to be in a very favourable position for meeting its year-end target of a BGN 1.4 bn surplus, equivalent to 2.5 % of projected GDP. The combination of strong economic growth, reduction of the grey sector and very conservative planning made it possible for revenues in the consolidated fiscal programme for the first seven months of the year to outperform the target by 17.1 %. Thus, at the end of July the budget is running a surplus of BGN 2.4 bn which corresponds to a surplus of 4.2 % of GDP for the whole year. Against this backdrop,

## Short-term indicators

	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07
Real GDP, yoy (%)	-	6.7	-	-	5.7	-	-	6.2	-	-	6.6	-	-
Industrial production, yoy (%)	10.6	6.8	5.0	4.2	1.2	3.2	8.9	9.0	11.7	7.0	7.7	13.0	-
Inflation (CPI), yoy (%)	6.8	5.6	5.7	6.1	6.5	7.1	4.5	4.1	4.2	4.3	5.6	8.4	12.0
Unemployment (%)	8.74	8.44	8.38	8.69	9.12	9.67	9.48	8.92	8.38	7.82	7.42	7.25	7.00
Exchange rate, EUR, eop.	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
1M Sofibor, avg.	3.23	3.27	3.43	3.49	3.68	3.74	3.76	3.93	4.02	4.08	4.33	4.43	4.51
Export, (EUR) yoy (%) <sup>1</sup>	37.4	35.8	16.0	17.8	13.5	6.1	2.6	10.9	3.2	11.5	9.8	14.7	-
Import, (EUR) yoy (%) <sup>1</sup>	32.6	23.4	22.7	17.2	32.4	24.1	17.8	16.6	15.6	17.6	20.7	19.6	-
Trade balance, EUR mn <sup>1</sup>	-521.9	-414.8	-590.6	-570.6	-772.9	-585.2	-472.0	-559.0	-523.3	-606.1	-540.1	-600.8	-
Current account, EUR mn <sup>1</sup>	-86.8	-208.5	-546.3	-480.7	-807.5	-631.7	-475.8	-499.9	-556.4	-472.1	-273.4	-131.5	-

Sources: Central Bank, Statistical Office, Bulbank Research Unit

<sup>1</sup>) The Balance of payments data for 2006 and January - June 2007 are revised.

## In line with our previous projections, risks for price stability shifted upward in the H2 2007

The unprecedented spike in consumer prices can mainly be ascribed to soaring food prices. Eurostat data for June showed substantial increase in food and beverages prices across all EU member countries, with new member states hit particularly hard. Year-on-year price inflation was the highest in Bulgaria (14.7 %), followed at a narrow margin by Latvia (12.2 %) and Hungary (10.1 %). Clearly, the spike in food costs witnessed in Bulgaria in the last three months was part of a one-off supply shock of global proportions. However, there are several country-specific factors, some of them structural, which also generated upside pressure on agricultural and food prices in the period under review. First, slow progress in the enlargement of arable land continues to constrain capital spending and competition in the agricultural sector. Second, there was a one-off surge in prices as a consequence of the completion of the process of liberalization of trade after EU accession. Following EU entry some local food manufacturers increased the

share of their output channelled to other EU countries to benefit from the existing price differentials. Supply of foods to the domestic market was reduced, while at the same time imports from non-EU neighbours became more expensive, following the introduction of heavy protection custom duties as part of the Common External Tariff.

Closure of the last two small reactors in the nuclear power plant in Kozlodui rendered the financial situation of the local state energy giant NEK particularly challenging. Falling export revenues caused rapid accumulation of large operational losses, highlighting that NEK is no longer in a position to subsidize prices for domestic consumption at the expense of export revenues. To alleviate the situation, the state-controlled regulator raised prices of electricity for industry by 31 % in July, which in turn elevated costs in energy-intensive sectors as manufacturing of metals, chemicals and construction materials. Last month, Bulgargaz announced demands for an increase in the natural gas prices by 11 %, which seems

justified as quantities supplied from Gazprom costs roughly 20 % more from the beginning of the current year. Further hikes look almost certain, although exact proportions are hard to pinpoint since relevant details in the highly controversial deal with Gazprom remain undisclosed. Water supply and central heating prices were already under pressure earlier this year, when they were raised by 10 % and 5 %, respectively. However, more hikes seem to be on the horizon, as similarly to what we have observed in the energy sector, investments need to be stepped up to cut water leakages back to more tolerable levels.

Elevated pay pressure (average wages increased by 17 % in Q1 2007 and 18 % in Q2, roughly in line nominal GDP growth) and robust expansion of money and credit aggregates were also strong enough to have an impact on prices stability. Lack of structural reforms aimed at boosting competition in railway transport, post services, health care and education sectors is also among the causes of inflation.

the government unveiled plans for another 10 % increase in state-funded pensions on top of the commitment to cut the social insurance contribution rate by 3 %, effective from 1 October 2007.

Likewise, starting from next year the government decided to press ahead with the reduction of taxes on labour by introducing a 10 % flat tax on personal incomes, in order to create more stimuli for the economy to come out from the grey sector. The ratios for social insurance contributions (divided between employers and employees) will shift from 65:35 at the moment to 60:40 next year. The minimum monthly wage will increase by 22 % to BGN 220, while the wage ceiling which is used to form the base for the calculation of social insurance contribution payments will be raised to BGN 2,000, from the current level of BGN 1,400. Fiscal plans for next year include indexation of

pensions by a rate equal to the sum of 50 % of the inflation rate and 50 % of the rate of increase in the actually collected contributions in the first pillar of the pension system. Excise duties on cigarettes will be raised by half of what remains in order to complete the harmonization process, with the last remaining step scheduled for 2009.

We think that fiscal plans for the next year harbour no risks for macroeconomic stability. On the contrary, the cutback in labour taxes will have a broadly based, favourable impact on the economy and therefore deserves acclamation. It will help to reduce Bulgaria's widespread grey sector and will boost collection of social insurance contribution payments, a task which has turned out to be particularly tricky so far. Lower taxation on high-income earners will bring an increase in their disposable income and

consequently will affect positively saving rates. A reduction in personal income tax was also welcomed by the representatives of employer organisations, which in turn agreed to raise the wage ceilings used for the calculation of social insurance contributions in the private sector. Thus, the income base to be used for calculation of contribution payments will increase in between 25 % and 35 %, with rates being highest in sectors such as construction and tourism, where under-reporting of income for tax evasion purposes is most widespread. On the negative side, the government's plans for restructuring of the ailing healthcare and education sectors remain controversial, leaving the impression that there is still a lack of political will to start the process.

### Rising risks for price stability

Rising from 4.3 % at the end of May, 12-month inflation broke through the

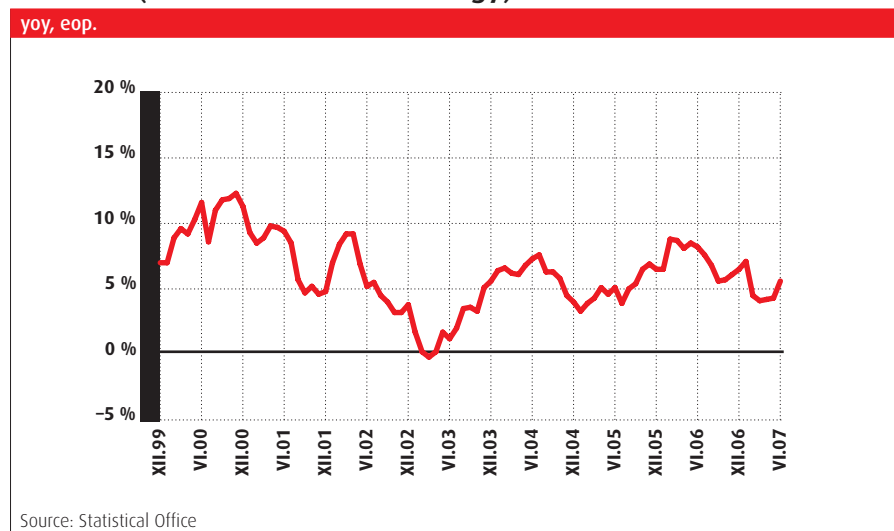
10.0 % mark in just three months to hit 12.0 % in August, its highest level in almost seven years.

Overall, inflation increased under the pressure from one-off supply shocks in the agricultural and food sectors, lack of adequate competition in some sectors, wage developments and rapid increases in money and credit aggregates. We project that inflationary pressure will slacken somewhat towards the end of the current year. However, the causes for unabated prices pressure continue to be broadly based and are often structural in nature, highlighting the fundamental case for persistently high inflation in the forecasting period. We forecast average CPI (measured according to the national methodology) to slow gradually to 5.2 % in 2008 and further to 4.1 % in 2009. Anchoring inflationary expectations will be challenging. It will require sustained fiscal and monetary policy prudence, together with renewed restructuring efforts aimed at expanding the role of the free market and competition in sectors where reforms have lost momentum in the last couple of years.

### External imbalances widened

In July, the year-to-date current account gap expanded by 74 % yoy, reaching 10.5 % of projected GDP for the full year. The deterioration was entirely attributable to the widening of the foreign trade deficit, which increased by 31 % compared to the same period last year. Merchandise exports posted annual growth of 8.6 %, which however was outpaced by

## Inflation (CPI national methodology)



an even stronger increase in imports (+18.8 %). On the positive side, the year-to-date net services balance recorded a 40 % increase, which was attributable primarily to 18 % growth in sales receipts from international tourism. Accordingly, the coverage net services provides for the merchandise trade gap remained little changed, at around 20 %. Net incomes saw marginal deterioration, since improved compensation of employees fell short of compensating for the combined effect of increased profit repatriation and higher debt servicing costs. Net current transfers were almost flat compared with the last year, as rising emigrants' remittances counterbalanced contribution payments in favour of the EU common budget. On the financing side, net FDI edged up by 12 % yoy, reaching 9.4 % of projected GDP, while BNB reserves in-

creased almost in the same proportions as a year ago (plus EUR 933 mn), fuelling money supply and credit aggregates.

This year, we anticipate some further deterioration in the CA balance to 17.6 % of projected GDP. It should be noted though, that the quality of statistical foreign trade data collected through the INTRASTAT system remains questionable. Therefore, the partial data released so far and any projections based on them are subject to potentially sizeable revisions in the months to come. Nevertheless, we remain more optimistic for the CA prospects in 2008. New production capacities added in the tradable goods sectors, fledgling utilization of EU structural funds and the slowly improving business environment will help to ease the CA mismatch to 16.8 % of projected GDP.

Event	Date	Reading
Consumer Prices	12 October, 12 November, 12 December	Following steep food prices hikes in the period June through August some reverse correction seems likely.