Summary

- Following very good performance in the first five months of the year, real sector growth slowed down slightly in June, mainly due to a decline in the extracting industry and deceleration of industrial sector sales.
- Following prudent fiscal policy, the fiscal budget surplus reached EUR 578.1 million over January-June.
- In June, the consumer price index (CPI) decelerated to 3.6% year-over-year (yoy), down from 4.6% yoy in the previous month, while the producer price index (PPI) accelerated to 7.1% yoy, up from 5.9% yoy in May.
- The rapidly increasing size of the current account (CA) deficit remains a significant risk factor; widening by 42.6% yoy in January-June, it reached EUR 1.37 billion.
- Concerns over the increasing CA deficit are rising even more considering the 14.7% yoy decline in FDI over January-June.
- The Bulgarian Parliament elected new Premier Sergey Stanishev, a chairman of the Bulgarian Socialist Party (BSP) and approved a new Cabinet.

Economic Growth

In January-June, the Bulgarian real sector performed relatively well, although economic growth decelerated slightly compared to January-May. Driven by robust growth in industry and utilities, GDP should expand at a pace of more than 5% yoy for the first half of the year.

In June, industrial sector sales grew by 8.7% yoy compared to 14.3% yoy in May. This increase was secured by 9.7% yoy growth in manufacturing. The overall performance of the industrial sector would be even better if there had not been a 9.8% yoy decline in the Bulgarian extracting industry during June, after a 4.4% yoy decline in May. However, the observed decline in the extracting sector reflects the ongoing process of re-orientation in the industrial sector towards higher value added products. Within the extracting industry, the steepest decline was observed in mining of metal ores, which dropped by some 19.3% yoy, and in coal extraction, which shrunk by 15.0% yoy.

The breakdown of Bulgarian manufacturing shows that the growth-leaders in June were companies producing electrical machinery, motor vehicles, and communication equipment. The rate of growth in these sectors reached 40.5% yoy, 31.4% yoy, and 42.7% yoy respectively. The deepest decrease was observed in office machinery manufacturing (where sales dropped by 51.4% yoy) and the tobacco industry (shrinking by 45.5% yoy). In general, performance of the country's manufacturing sector supports the idea that Bulgarian production has been reorienting towards sectors producing high value added products.

In June, the country's utility sector demonstrated similar performance as in the previous month, expanding by 8.3% yoy. The growth is mainly attributed to the increase in gas consumption, which grew by 9% yoy in June.

Fiscal Policy

In June, Bulgaria demonstrated prudent fiscal policy. This month's consolidated budget surplus amounted to Lev 132.5 million (EUR 67.9 million), bringing the cumulative January-June surplus to Lev 1,127.3 million (EUR 578.1 million). The substantial registered budget surplus significantly exceeds the initial government forecast, and is 28.4% higher than in the respective period last year. Nevertheless, the outstanding budget performance in the first six months suggests that the 2005 fiscal year may end with a surplus exceeding 1.5% of GDP.

The growth in budget revenues accelerated from 15.4% yoy in January-May to 15.7% yoy in January-June and reached Lev 8.85 billion (EUR 4.5 billion). Over the period, tax revenue, which accounts for three quarters of total budget revenues, grew by modest 5.3% yoy; the second largest group, non-tax revenue, surged by a substantially higher 16.8% yoy. In January-June, the amount of grants received by the Bulgarian government increased by an impressive 97.5% yoy compared to 28.5% yoy in January-May. However, since the weight of this source does not exceed 5% in the total budget revenues, there is no reason to think that the budget is becoming more dependent on foreign aid. At the same time, this source of budget revenues cannot be considered sustainable in the medium- and long-run.

In January-June, budget expenditures grew at a slower pace of 14.0% yoy compared with a 15.7% yoy growth in revenues. On a very positive note, capital expenditures demonstrated considerable 60.8% yoy growth over the period despite elections, while social expenditures grew by a moderate 9% yoy. Cumulative capital formation expenditures reached EUR 400.4 million. This increase will build a solid platform for Bulgaria's economic growth in the future.

In June, Bulgaria's external debt increased by some EUR 27.6 million and reached EUR 6.09 billion. This increase is due to fluctuations in the nominal exchange rates. The structure of debt by type of creditor shows that the highest weight is concentrated in Global Bonds and Eurobonds, which account for some 28.4% of total external debt. However, some changes in the structure of lenders appeared over the period. The largest lenders are the World Bank (12.4%), the International Monetary Fund (11.1%), and the European Union (8%).

Monetary Sector

In June, consumer inflation decelerated to 3.6% yoy, down from 4.6% yoy in May and 5.1% yoy in April. June's deceleration is mainly attributed to some decrease in prices for services, which accounted for 28% of the total consumer basket. Unlike in the previous two months, when CPI decel-
In June, the Bulgarian National Bank (BNB) continued to increase money supply (M3), which accounted for services grew by 6.8% yoy in June, while food prices grew by 1.1% yoy.

The producer price index (PPI) accelerated by 7.1% yoy in June compared with 5.9% yoy in May. This increase was mainly due to some increase in prices for energy resources, which is an important component of the producer basket. However, it is very likely that CPI inflation will accelerate during the next few months. The reason for this forecast is the time lag between PPI and CPI dynamics.

In June, the BNB’s official foreign reserves remained almost unchanged from the previous month. In any case, the existing amount of foreign reserves is sufficient enough to cover more than 7 months of the country’s imports, which should secure its stability.

Merchandise Export Structure in June 2005

Yield for Lev-denominated Instruments, %

Source: Bulgarian National Bank

Merchandise Import Structure, by countries in June 2005

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International Trade and Capital

In June, the merchandise foreign trade deficit (FOB-CIF) grew by EUR 482.2 million, which brought the January-June cumulative trade deficit to EUR 2.22 billion. The widening of the trade deficit accelerated in January-June to 28.9% yoy compared with a 22.3% yoy increase in January-May, which should be attributed to growing world prices for importing fuel and decreasing prices for exporting metals.

In June, the merchandise exports grew at a solid 17.43% yoy, reaching EUR 820.1 million. This brings January-June cumulative exports to EUR 4.4 billion, which demonstrates growth of 21.1% yoy compared to 22.0% yoy in January-May. As in the previous three months, the highest rate of growth in the country’s exports was observed in a group of high value added products. The value of exports in investments goods, which account for almost one fifth of the country’s total exports, grew by 41.7% yoy in June. EU countries are the biggest consumers of Bulgarian exports. In June, 59.3% of total exports went to the EU-25, compared to 58.2% in May, and 57.1% in April. This very solid growth in the export of investment goods along with the geographical reorientation of exports towards EU countries makes Bulgaria more competitive on the world market in the long run.

In January-June, the current account (CA) deficit continued to accelerate. Over the period, its size widened by 42.6% yoy compared to 37.4% yoy in January-May, and reached EUR 1.37 billion. This negative tendency will continue in the next several months since the country’s trade deficit is forecasted to deepen further.

The consequences of a rapidly widening CA deficit are exacerbated by the decline in foreign direct investment (FDI) inflows. In January-June, the total amount of FDI inflows reached EUR 723.2 million, which represents a drop by 14.7% yoy. However, ongoing structural improvements in the economy may accelerate FDI inflow to Bulgaria.

International Programs

In July-August, the World Bank’s (WB) Third Programme Adjustment Loan (PAL-3) continues to assist Bulgarian economic reforms. PAL-3 aims to support the country’s accession to the EU in 2007. The WB representatives declared that this is the last in a trilogy of loans in the total amount of $450 million. The loan signed for PAL-3 is to be repaid over 17 years, including a 5-year grace period.

In August, the International Monetary Fund (IMF) announced that it would insist on a quick passage of bills drafted by the previous government. The IMF also claimed the necessity to start full-scale operations of the National Revenue Agency (NRA) at the beginning of next year. The NRA will be integrated into the tax administration and the revenue department of the social security institute. The new IMF mission will take place in late September or early October. However, a short mission aimed to meet with the new cabinet may arrive in late August.

The European Bank for Reconstruction and Development (EBRD) announced in late July that Bulgaria would receive EUR 85 million in grants to decommission units 1-4 of the Kozloduy nuclear power plant. This grant will be provided under a special Phare Programme 2004, which reflects the agreement of the financing memorandum between the Bulgarian government and the European Commission. The financing will be utilized according to a 2001 framework agreement.
Other Developments and Reforms Affecting the Investment Climate

On August 16, the Bulgarian Parliament confirmed the new center-left Cabinet of Ministers led by BSP leader Mr. Sergey Stanishev with the votes of all 169 lawmakers of the new ruling partners BSP, NMS-II, and MRF. However, all opposition members in the 240-seated parliament voted against the cabinet. The new ruling partners stated that the composition of the government fully reflected the will of the voters given that the best-ranked parties in the general elections on June 25 would govern the country.

In his speech before the Parliament, the new Premier Sergey Stanishev pointed out the following policy objectives for his Cabinet:

- Joining the EU as was initially planned on January 1, 2007;
- Rapid economic development, including annual GDP growth of 6-8%, to accelerate convergence to the EU living standards;
- Acceleration of ongoing judicial reforms;
- Building a knowledge-based economy;
- Continuing ongoing social programs;
- Reducing regional disparities within the country;
- Fighting against corruption and crime.

In August, the Bulgarian Foundation for Local Self Government Reforms announced it would support the setting of the 15 regional investment agencies. The project aims at (i) establishing regional offices for registration of regulated industrial land, (ii) maintaining contacts with potential investors, and (iii) promoting business opportunities at the local level. The regional agencies will be designed in such way that they follow the model of the State Investment Agency. However, it is expected that they would seek more direct relations with businesses without mediation from the side of the central administrative bodies.

Following the significant damage caused by the summer floods, the Bulgarian Cabinet approved additional transfers of Lev 170 million (EUR 87 million) to help local authorities and line state institutions in rebuilding major infrastructure units destroyed by bad weather conditions. Although this financing is necessary for regional recovery, it was not foreseen in this year’s fiscal budget and may decrease the forecast for this year’s budget surplus.