Summary

- In August, Bulgaria’s real sector continued to show very good performance, mainly due to significant acceleration in the country’s manufacturing.
- The country’s prudent fiscal policy helped it accumulate a fiscal budget surplus in the amount of EUR 676.0 million over January-August.
- In August, consumer price inflation accelerated further to 4.9% year-over-year (yoy), up from 3.7% yoy in July, driven by adverse supply shocks. The producer price index (PPI) accelerated slightly to 6.6% yoy, up from 6.5% yoy in July.
- Growth of the monetary base slowed to 33.5% in August, down from 35.3% yoy in July, reflecting deterioration in the balance of payments.
- The current account (CA) deficit doubled in August, bringing the cumulative figure to EUR 1.6 billion. The financial account surplus was still sufficient to cover this gap, but FDI inflow, which reached EUR 0.9 billion in January-August, continues to slow down.
- The Human Development Index moved Bulgaria from the group of less developed countries to the developed group, which is due to recognition of the country’s significant achievements made over the last few years.

Economic Growth

In August, the real sector performed extremely well. Rapid expansion of industrial sales grew by 14.9% yoy compared with 8.3% yoy in the previous month, supporting the country’s economic growth. The outstanding performance of the industrial sector supports the idea that Bulgaria will be able to show economic growth of around 5.6% yoy in 2005.

Fiscal Policy

In August, Bulgaria demonstrated prudent fiscal policy. The monthly consolidated budget surplus reached Lev 184.9 million (EUR 94.8 million), which brought the country’s January-August cumulative surplus to Lev 1,318.2 million (EUR 676.0 million). Although the August rate of growth in the fiscal surplus was lower than in June, it is still 10.6 pps higher than in the respective period of last year. Good fiscal performance over the last 8 months suggests that the government has a very strong chance to finish this fiscal year with a significant surplus of no less than 1.5% of GDP, despite the deficit initially forecasted by the government of around 1% of GDP.

Consolidated Fiscal Program

<table>
<thead>
<tr>
<th>Item</th>
<th>Jan-Aug 2005, EUR million</th>
<th>Change, % yoy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>6,030.1</td>
<td>14.0%</td>
</tr>
<tr>
<td>Tax</td>
<td>4,780.8</td>
<td>14.0%</td>
</tr>
<tr>
<td>Non-tax</td>
<td>1,082.3</td>
<td>13.8%</td>
</tr>
<tr>
<td>Grants</td>
<td>167.0</td>
<td>17.5%</td>
</tr>
<tr>
<td>Expenditures</td>
<td>5,354.1</td>
<td>14.5%</td>
</tr>
<tr>
<td>Public Wages, insurance</td>
<td>562.8</td>
<td>10.7%</td>
</tr>
<tr>
<td>Social and Health Insurance Contribution</td>
<td>202.1</td>
<td>2.1%</td>
</tr>
<tr>
<td>Social Expenditure</td>
<td>2,056.8</td>
<td>10.8%</td>
</tr>
<tr>
<td>Capital Expenditure</td>
<td>576.0</td>
<td>67.2%</td>
</tr>
<tr>
<td>Other</td>
<td>1962.3</td>
<td>10.6%</td>
</tr>
<tr>
<td>Balance</td>
<td>676.0</td>
<td>10.6%</td>
</tr>
</tbody>
</table>

In January-August, cumulative budget revenues reached Lev 11.76 billion (EUR 6.0 billion), which represents growth by of 14.0% yoy. Over the period, tax revenues accounted for 79.3% of the total budget revenues, and demonstrated growth of 14.0% yoy. The same growth tendency was observed in non-tax revenue, and grants obtained by the government.

Monetary Sector

In August, consumer price inflation (CPI) accelerated further to 4.9% yoy, up from 3.7% yoy in July and 3.6% yoy in June. This acceleration was mainly driven by adverse supply shocks. Flood damages contributed the upward pressures on food products prices, which grew by 5.1% yoy during the month. Prices for non-food products increased by 5.0% yoy. This is partially due to hikes in fuel prices. On the opposite side, prices for services demonstrated significant deceleration from the average 8.8% yoy in the first half of 2005 down to 4.9% yoy in August. This slowdown reflects the absence of the service tariffs adjustment usually made in July. The adverse supply shocks should continue pushing the inflation rate up through the end of 2005, but the annual figure is not likely to exceed the 6% rate.
In August, producer price index (PPI) growth accelerated slightly. The index increased by 6.6% yoy compared to 6.5% yoy in the previous month.

Further divergence of the country’s export and import growth rates. Over the period, exports increased by 18.8% yoy, which is slightly below the 19.0% yoy growth in January-July. At the same time, imports grew at a faster pace and accelerated to 26.1% yoy compared to 24.3% yoy in January-July. As a result, the cumulative trade deficit in January-August widened by 43% yoy and reached EUR 3.1 billion.

A geographical breakdown of Bulgaria’s international trade suggests that the EU remains the dominant consumer of the country’s exports and the main destination for the import flows. In January-August, exports to the EU-25 grew by 17% yoy, which explains more than half of total export growth. Exports to the neighboring countries of Central and Eastern Europe (CEE) surged by 21.5% yoy. However, its contribution to the overall growth rate of exports was relatively smaller due to the trivial weight of CEE countries in Bulgaria’s exports structure. In January-August, one-third of the overall increase in imports was caused by growing imports from the EU countries. The relatively low contribution of the EU component to Bulgarian import growth (compared to exports) is due to some on-going geographical restructuring in the country’s imports. In particular, this is partly explained by an increase in prices for energy resources imported from the CIS region.

By end-use structure, the increase in exports of raw materials explains about half of all export growth over January-August. One-fourth is attributable to the increase in exports of investment goods. Over the period, the highest rate of growth was registered in vehicle exports, which almost tripled. This positive tendency reflects a gradual reorientation of Bulgarian exports towards commodities with a higher degree of value added. The positive tendency on the imports side is also a steady increase in the share of investment goods, which is largely dominated by machinery and equipment items, and vehicles. Growth of this group explains about one-third of the total import increase. Yet raw materials remain the largest group of imported products, accounting for more than 30% of imports.

The balance of payment (BoP) data from the BNB reveals further deterioration of the current account (CA) balance. In August alone, the CA gap was EUR 115 million, twice last month’s figure. This caused an increase in the cumulative CA deficit to EUR 1.6 billion. Although this figure is much higher than the EUR 0.6 billion cumulative CA deficit registered in the same period of 2004, most of the difference is explained by a lower base effect. The CA deficit continues to be covered by the financial account surplus generated mostly by FDI inflow. Over January-August, net FDI inflow amounted to EUR 1.2 billion. Yet part of this figure is due to a mergers and acquisitions increase, which reflects transfer of shares of Bulgarian MobilTel Company. As a result of all these changes in BoP, BNB foreign exchange reserves increased by EUR 168 million to EUR 7.1 billion in August, which partially offsets the July reduction.

Money supply, measured by monetary aggregate M3, increased by 29.0% yoy in August, up from 26.4% yoy growth registered in July. Most of this acceleration is attributable to the low base effect, namely to technical reduction in M3 in August 2004, as the balance of payments (a fundamental factor fueling monetary expansion) keeps deteriorating. This is confirmed by development of narrower monetary aggregates, specifically the monetary base. In August, the monetary base grew by 33.5% yoy compared to 35.3% yoy in July and almost 40% yoy growth throughout the second quarter of 2005.

The Bulgarian National Bank’s (BNB) efforts to restrain the credit boom seem to have yielded some positive results. The stock of commercial bank credits to non-financial entities grew by 40.1% yoy to Lev 16.3 billion (EUR 8.3 billion) by the end of August. This is only slightly higher than 39.8% yoy growth in July, but significantly lower than 44.8% yoy in June. Of the total growth figure, credit to households increased by 66.2% yoy and credit to non-financial entities by 28.2% yoy. Yet, both types of credit contributed equally to overall growth, due to a smaller share of household borrowings from commercial banks.

The interbank money market was very stable in August. The interest rate on interbank loans was at the same 2.06% p.a. as in July. According, the BNB’s base rate has not been changed as well.

International Trade and Capital

In January-August, the Bulgarian merchandise trade balance deficit kept rising. This is due to the further diversification of the country’s export and import growth rates. Over the period, exports increased by 18.8% yoy, which is slightly below the 19.0% yoy growth in January-July. At the same time, imports grew at a faster pace and accelerated to 26.1% yoy compared to 24.3% yoy in January-July. As a result, the cumulative trade deficit in January-August widened by 43% yoy and reached EUR 3.1 billion.

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Other Developments and Reforms Affecting the Investment Climate

The United Nations’ (UN) Human Development Index (HDI), which is calculated as a weighted average of economic and social indicators and covers 177 countries, has placed Bulgaria in 55th place in the overall ranking. In doing so, the UN moved Bulgaria into the group of developed countries from the less developed group, in which Bulgaria was placed by previous reports. This was due to the recognition of the country’s achievements in economic growth, improvements in life expectancy and child mortality rates, and significant progress in many other living standard indicators. The new published HDI rating placed the country well behind all other new EU member states.

A recently completed comparative analysis by Ernst&Young of investment climates in Europe found that Bulgaria occupies 15th place in its investments attractiveness among other European countries. The study suggests that some 2.2% of the total amount of FDI invested in Europe was made in Bulgaria over 2004. Thus, Bulgaria outranks Italy, Turkey, Greece, Austria and Portugal.

Published in September, the Global Competitiveness Report prepared by the World Economic Forum (WEF), improved its ranking for Bulgaria. The country climbed one place, from 59th in 2004 to 58th in 2005. Two other EU-candidates, Turkey and Romania, were ranked further down (66th and 67th respectively.)