Summary

- In the first quarter (Q1), the Bulgarian economy posted 5.6% year-over-year (yoy) growth, which was backed by 8.8% yoy growth in the industrial sector and a 6% yoy increase in services.
- After some slowdown, the consolidated budget surplus rose to 3% of the full-year GDP in April, up from 0.9% in the previous month.
- Annual consumer inflation posted some acceleration from 8.1% yoy in April to 8.5% in May.
- The widening of the current account (CA) deficit in January-April is backed by an increasing trade gap. Although the CA deficit has reached 6.1% of estimated full-year GDP, it is fully covered by an EUR 1.16 billion surplus in the financial and capital accounts item of the balance of payments.
- The treaty of Bulgaria and Romania's accession to the EU has been ratified by 20 parliaments out of 25 member states.

Economic Growth

In Q1, the Bulgarian real sector continued its expansion posting a 5.6% yoy rate of growth. This demonstrates insignificant acceleration from the 5.5% yoy posted in the previous year. The industrial sector, which surged over the period by 8.8% yoy, remains the main driving force of the country's economic growth. Significant growth of industry heavily benefited from increasing volume of foreign direct investments (FDI), a significant part of which was absorbed in manufacturing. A 6% yoy increase in the service sector also contributed to the country's overall growth.

On the revenue side, there was some rebound in their rate of growth. In January-April, revenues increased by 7.2% yoy as compared to 5.1% yoy in January-March and stood at Lev 6.2 billion (EUR 3.2 billion). Revenues from taxes continued to grow; however, their share in total revenues dropped slightly from 84.5% to 82.6%, which is mostly due to an increase in budget inflows from grants. During January-April, the amount of grants increased by almost 90% yoy compared to a drop of 12.2% yoy in the previous period and constituted Lev 114 million (EUR 58.1 million). Although non-tax revenues continued to shrink, their rate of decline in January-April was lower than in January-March: -8.6% yoy vs. -10.8% yoy.

In Q1, growth of expenditures decelerated and constituted 4.2% yoy, which is in accordance with the government's course toward tighter fiscal policy. A decrease in growth was observed in almost all items on the expenditure side, except for capital expenditures. The growth of capital expenditures demonstrated an increase of 6.6 percentage points. Although the growth of other budget expenditures demonstrated some deceleration, they are still high. In particular, growth of public wages and social security contributions constituted 55.5% yoy.

To improve fiscal budget performance, the Bulgarian government adopted a decentralization strategy, which transfers a significant portion of public services from the central government to local authorities. The new strategy should seriously improve the independence of local budgets by granting them more autonomy while forming local budgets.

In January-April, the government demonstrated sound debt management. Government debt continued to decline during the period. The total amount of public and publicly guaranteed debt decreased by 0.74% month-over-month (mom) and constituted EUR 6.4 billion or 27.5% of GDP by the end of April. The stock of the state's external debt decreased by 1% yoy, and the stock of domestic debt decreased by 0.13% mom, constituting EUR 4.9 billion and EUR 1.5 billion respectively. The structure of external debt by type of creditor changed slightly. The European Investment Bank took the place of the European Union in the list of the three largest lenders to the country, and at the end of April the most significant lenders to Bulgaria were the World Bank, the IMF and the European Investment Bank. Their shares in the total external debt stock constituted 16.7%, 7% and 5.4% respectively.

Monetary Sector

In May, driven mainly by the growth of food prices, consumer price inflation accelerated again after a slight deceleration in April and constituted 8.5% yoy. Prices of food products increased by 7.7% yoy in May compared to 6.6% yoy in April. However, with the coming harvest, inflation of food products should experience some deceleration in the next few months. Prices of non-food products grew by 14.1% yoy, showing only slight growth compared to the previous month's level. At the same time, growth of service tariffs remained stable at 4% yoy, suggesting that inflation growth will mostly depend on the growth of prices of food and non-food products through the end of the year.

Changes in CPI and its Major Components in 2006, yoy

- Foods
- Non-foods
- Services
- CPI

Source: Bulgarian National Bank, own calculations
The PPI on domestic markets showed a rebound in April, growing at a rate of 7.4% yoy up from 6.5% yoy in March. The biggest price increase — 11% mom and 39.6% yoy — was observed in the mining sector, which was driven by doubled prices of metal ores extraction. In both the manufacturing and utilities sectors, prices rose at lower rates (4.7% yoy and 6.4% yoy), remaining relatively stable as compared to the previous month. Major price increases in these sectors were observed in manufacturing of basic metals, machinery, electricity, gas, steam and hot water supply, while deflation was observed in manufacturing of tobacco products. The broader producer price index, which includes prices of exported goods, reflected the dynamics of the common PPI growing at a rate of 10.4% yoy in April up from 9.5% yoy in March.

Money supply growth accelerated in April and constituted 17.12% yoy in contrast to 10.1% yoy growth in March. This was immediately reflected in the acceleration of deposits growth, which almost doubled compared to the previous month. In April, deposits grew by 19.2% yoy up from 10.1% yoy in March. On a monthly basis, however, money supply growth slowed somewhat and constituted 0.83% mom.

The Bulgarian National Bank (BNB) continued to raise the base interest rate, which was set at 2.57% per annum (p.a.) in May. At the same time, the interbank rate for Lev-denominated deposits stayed almost the same as in the previous month, decreasing only slightly by 0.01 percentage points.

In April, growth of commercial banks claims on the non-government sector accelerated considerably and constituted 17.5% yoy, which is more than 4 times higher compared to the previous month's growth. However, as percentage of projected GDP, the stock of commercial bank credits to the non-government sector demonstrated only a marginal increase to one percentage point from the previous month's level, which is in line with the BNB's policy of limiting credit expansion. In August, the BNB is going to start the process of removing barriers to private lending by commercial banks. In particular, additional minimum reserve requirements applied to banks that have exceeded growth limits of their lending will be reduced. So far, banks that have exceeded their quarterly limit of lending growth by more than 1% were subject to an additional minimum reserve requirement of up to four times the amount by which the lending growth limit was exceeded.

International Trade and Capital

In January-April, Bulgaria's foreign trade gap continued to expand. During the period, the cumulative trade deficit in goods and services reached EUR 1.37 billion, which demonstrates a 36.4% yoy rate of growth. This represents some deceleration in the rate of growth from the January-March level, when the trade deficit grew by 47.4% yoy. This slowdown of growth of the cumulative trade deficit was a result of a relatively small increase in April, when this indicator increased by 10.6% yoy, while in March alone it grew by 58.9% yoy. Some slowdown in the growth of the trade deficit is backed by a higher rate of growth in Bulgarian exports compared with imports, which appeared for the very first time at the beginning of this year. In April, exports grew by 32% yoy while imports increased by a lower pace of 26% yoy. The main reasons for the latest increase in exports are the growing prices for metals and chemical products.

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International Programs

In April, the trade balance in services posted a deficit of EUR 99 million, which is more than three times the deficit in the previous year period. This acceleration is due to some decrease in tourism revenues and increasing prices for energy transportation importing to Bulgaria. In January-April, Bulgaria showed a steady increase in net FDI inflows. During the period, the net inflow of FDI surged by 55% yoy and reached EUR 834 million. The existing amount of FDI inflow is able to cover more than 50% of the CA deficit. A sector breakdown of FDI inflow shows that almost half was directed into real estate and construction. In January-April, FDI in the form of private equity had the largest share in the total structure of FDI, equal to 61%.

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The existing trade deficit in goods and services remains the main driver for the widening of the current account (CA) deficit. In January-April, the CA gap reached EUR 1.47 billion compared to EUR 1.05 billion in January-March. The existing CA gap can be translated into 6.1% of estimated full-year GDP. Although this number seems high, the CA deficit is fully covered by a large surplus in the financial and capital accounts item of the balance of payments, which amounted to EUR 1.16 billion at the end of April.

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In June, the World Bank (WB) announced that it would continue its assistance to Bulgaria in obtaining EU membership. The WB Board of Executive Directors recently launched a new Country Partnership Strategy (CPS) for Bulgaria for 2006-2009. The CPS assumes that in 2007, Bulgaria will be a member of the EU and will need significant support during the first years of its membership. It was noted that the WB is not just a funding source for a series of projects, but also a very reliable partner. The CPS envisages a lending program to the country of up to USD 300 million per year.

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The Bulgarian application to the European Investment Bank (EIB) was approved by the executive board of the bank. This approval should allow Bulgaria to join the shareholders structure of the EU; the country will now participate in the Bank's share capital with a quota of EUR 296 million. The defined amount will be paid in eight separate installments over 2007-2011. The Minister of Finance is the official representative of the country in EIB structures.

Other Developments and Reforms Affecting the Investment Climate

By the end of June, the treaty for Bulgaria and Romania's accession to the EU had been ratified by 20 parliaments out of 25 member states. It is very
likely that some of the remaining EU members will wait for the final EC progress report in October and then will vote for the treaty.

Moody’s upgraded the ceilings for Bulgaria. The rating for long-term instruments was raised to A1 level from Baa3; the outlook remains stable. The recent upgrade is a result of recognition of positive achievements made by Bulgaria in its economic development. At the same time, the ratings for government bonds and the foreign currency ceilings for bank deposits stay unchanged at Baa3.

In June, the Bulgarian State Energy Commission confirmed that the prices charged by electricity producers would be raised by an average of 5–6% starting July 1st. However, the increase will not immediately affect prices for households. The Commission expects that both industrial and household prices are likely to pass another upward adjustment of around 10% at the beginning of next year. The undertaken steps are needed to compensate energy-generating companies for increasing prices of their input.