Summary

- In June, the growth of Bulgaria's real sector was driven by the expanding industrial sector, whose sales grew by 9.8% year-over-year (yoy), and retail trade, which surged by 12.6% yoy.
- The consolidated budget surplus continued to show positive dynamics and increased in the first half of the year (H1) by 25% yoy, which is equivalent to 3.1% of projected full-year GDP.
- Annual consumer inflation showed some deceleration from 8.2% yoy in June to 7.6% yoy in July.
- Although the trade deficit still remains a significant risk factor for further deepening of the current account (CA) deficit, there was a positive development in June. During the month, the CA deficit grew by only EUR 63.2 million compared with EUR 278.5 million in May, which led to a narrowing of the existing gap. Moreover, the existing net inflow of FDI is able to cover 77.8% of the CA deficit.
- The new Presidential election was scheduled by the Bulgarian Parliament for October 22nd of this year.

Economic Growth

In June, Bulgaria's real sector continued to demonstrate positive developments. Despite some slowdown in the rate of growth of industrial sector sales, the expansion of the real sector still remains significant. During the month, industrial sector sales surged by 9.8% yoy, which is a little lower compared with 11.5% yoy demonstrated in May. However, because industrial output in June grew by 4.9% yoy and sales growth usually has a certain lag, it could be expected that the July indices for sales in this sector will continue to show positive dynamics.

The seasonal adjustment in consumption of electricity, water and gas, along with growing prices for utilities, led to some additional growth in sales prices in the utility sector. In June, it grew by 3.5% yoy up from 0.1% yoy in the previous month. The strongest growth within the utility sector was posted by the water distribution companies, surging at a rate of 5.4% yoy.

In June, retail trade was on an upward trend and posted 12.6% yoy growth. On the other side, wholesale trade increased relatively little and posted 3.2% yoy growth. The significant disproportion in the rates reflects the on-going structural changes in the country’s trade sector and its reorientation towards a retail market.

Fiscal Policy

In January-June, the consolidated budget surplus increased, rising at a slightly accelerated rate as compared to the posted rate of growth in January-May. In H1, the budget surplus reached Lev 1.4 billion (EUR 719.6 million). During the period, its growth rate accelerated to 25% yoy up from 24% yoy in January-May, which can be translated into 3.1% of projected full-year GDP compared with 2.7% posted in the previous month.

There was some slowdown in the rate of growth of revenues. In January-June, budget revenues grew at a rate of 8.3% yoy, which is 1.5 percentage points (pps) lower than in January-May and reached Lev 9.6 billion (EUR 4.9 billion). The greatest contribution to revenue growth came from taxes, which increased by 12% yoy, reaching Lev 7.8 billion (EUR 3.9 billion). Moreover, taxes were the only component of the budget revenues that demonstrated steady growth. Non-tax revenues and grants dropped by 4.5% yoy and 8.5% yoy respectively, constituting Lev 1.6 billion (827 EUR million) and Lev 199 million (101.6 EUR million). When compared to January-May, non-tax revenues demonstrated a slight improvement, increasing by 0.6 pps, while grants decreased by more than 50%.

Similar to revenues, expenditures demonstrated some deceleration in their rate of growth after a slight rebound in the previous period. In H1, expenditures grew by 6% yoy, slowing by 1.8 pps in January-May, and reached Lev 8.1 billion (EUR 4.2 billion). This was due to deceleration in the rate of growth of their major contributors, in particular social expenditures and maintenance, which is included in the expenditure item "other". Social expenditures grew by 14.2% yoy down from 15.7% yoy in January-May, and maintenance dropped by 22.1% yoy, down from a drop of 20% yoy. On a negative note, there was a decrease in the rate of growth of capital expenditures, which dropped by 6.8% yoy during the period after a significant rebound in January-May. At the same time, the weight of this component remained unchanged at around 9% of total expenditures. Public wages and insurance as well as social and health insurance contributions, on the contrary, were growing at a steady rate of 54% yoy and 37% yoy respectively and reached Lev 1.3 billion (EUR 641.7 million) and Lev 402 million (EUR 205.6 million).

In July, the Bulgarian Government approved a draft law that calls for 50% of future privatization receipts and 10% of the central government budget surplus to be used for the formation of a pension system reserve fund. The formation of the fund is in line with the budget law for this year and the fund itself is to be considered a part of the government fiscal reserves at the central bank.

In January-June, the government continued to demonstrate sound debt management. The total amount of public and publicly guaranteed debt has declined by EUR 14.7 million since May and constitutes EUR 6.39 billion, which is 27.4% of GDP. The stock of domestic debt increased by 0.64% month-over-month (mom), reaching EUR 1.55 billion. External debt, on the contrary, continued to decline during the period, dropping by 0.5% mom and constituting EUR 4.845 billion.
The share of US dollar-denominated debt increased slightly to 21.7% up from 21.4% in May. At the same time, shares of Euro and debt denominated in other currencies decreased to 51.8% and 26.5% respectively. The structure of external debt by type of creditor has not experienced any major changes during the period. The IMF, World Bank and European Union remain the largest lenders to the Bulgarian economy. Their shares in the country's total external debt stock constituted 16.6%, 6.54% and 5.3% respectively.

**Monetary Sector**

In July, the consumer prices index (CPI) continued to decelerate and posted 7.6% yoy growth as compared to 8.2% yoy in June and 8.5% yoy in May. As in the previous month, the major reason for the inflation slowdown was food prices, whose growth rate decelerated to 5.5% yoy in July down from 7.2% yoy in June. Another major component of CPI non-foods, demonstrated a slight rebound in growth after some slowdown in the previous month. In July, prices of non-foods grew by 13.5% yoy as compared to 13.4% yoy in July, contributing 4.05 pps to overall CPI growth. Services rates grew by 4.1% yoy, demonstrating steady growth fourth months in a row. The good summer harvest and disinfestations developments on agricultural and food markets are expected to contribute further to deceleration of CPI growth rate through the end of the year.

The producer price index (PPI) of industrial goods grew by 10.9% yoy in June, decelerating by 0.5 pps from the previous month. The major drivers of the PPI growth were equipment, which should create a solid basis for future development in Bulgaria's real sector. In January-June, imports increased by 26.8% yoy down from 29.5% yoy in January-May and reached EUR 7.87 billion. On a positive note, more than a quarter of Bulgarian imports consist of investment goods. Moreover, 8.7% of the country's imports are machines and equipment, which should create a solid basis for future development in Bulgaria's real sector.

**International Trade and Capital**

In January-June, the Bulgarian trade deficit continued to widen. During the period, it surged by 19.3% yoy and reached EUR 2.17 billion, which can be translated into 9% of the country's period GDP. In June alone, the trade gap increased by EUR 35.14 million. The main driving force of the trade gap expanding is a hike in energy prices. Although fast growth in the trade deficit still remains a significant risk factor, the faster rate of export growth compared to imports sends positive signals that further deterioration of the trade balance will be slightly limited. During the period, exports surged by 29.9% yoy, while imports grew by 26.8% yoy. This is the second month in a row when exports posted a faster pace of growth than imports.
lion compared with EUR 278.5 million in May and EUR 356.1 million in April. The positive tendency demonstrated by the CA leads to a narrowing of the existing gap and consequently, to a reduction of risks associated with the CA deficit.

In January-June, the net inflow of FDI reached EUR 1.41 billion, which demonstrates an increase of 86% yoy. The existing net inflow of FDI is able to cover 77.8% of the CA deficit compared with 69.3% in May, and 69.2% in April. The significant amount of FDI allows the BNB to keep foreign exchange reserves at a reasonable level of 5 months of the country’s imports.

International Programs

In August, the IMF finalized the third and last review of the implementation of Bulgaria’s economic program under the precautionary stand-by arrangement. The arrangement was approved in August 2004 and envisioned financing in the amount of $148 million. The IMF Board gave a positive evaluation of the reforms conducted in the country. However, they indicated that further efforts are needed for the country to be able to receive full economic benefit from EU membership and experience faster convergence of living standards to the levels of EU member states.

In an August meeting between representatives of the World Bank (WB) and the Bulgarian Government, the WB expressed its appreciation for the good management of funds and effective implementation of projects by the Bulgarian government. The WB emphasized the progress made in Revenue Administration reforms, Wetlands Restoration and Registration and Cadastre. In addition, the World Bank reviewed the Country Partnership Strategy for future operations and analytical and advisory work that covers 2006-2009, which was approved on June 13th.

In July, the management board of the EBRD approved new credit lines of EUR 10 million for Bulgaria’s second largest bank, Bulbank. In addition to that, EUR 20 million will be directed to the fifth largest Raiffeisenbank. Both credit lines will be used as a part of the energy efficiency program managed by the EBRD. Since the launch of the programme in 2004, the EBRD already arranged credit lines to support implementation of energy efficiency projects in the country with several local banks. The total amount of the arranged funds exceeds EUR 100 million.

A consortium of Bank Austria Creditanstalt and Dexia Bank will launch a program aimed at helping the Bulgarian efficiency service companies (ESCOs) to upgrade facilities and reduce energy costs of their customers. The project envisages allocation of EUR 10 million for renovating 56 hospitals, universities and schools and involvement into the project of 4 ESCOs, which will be responsible for project implementation. The corresponding memorandum was signed in August. A number of companies from several EU member states have already expressed their interest to participate in the implementation of such programs in Bulgaria.

Other Developments and Reforms Affecting the Investment Climate

The Bulgarian Parliament scheduled the new presidential election for October 22nd. The newly elected President will take a 5-year mandate starting January 22, 2007. If after the October 22nd elections, no candidate receives more than 50% of the votes, the second round will be conducted on October 29th. Although not all candidates are officially nominated, yet, it could be expected that incumbent President Georgi Parvanov will be running for a second term.

The Bulgarian State Employment Agency reported that unemployment was on a downward trend. In July, it fell to 8.96% compared with 9.18% in the previous month. This represents significant improvements in job creation. In addition, the nominal monthly average gross wage surged by 9.9% yoy in Q2 and reached Lev 345 (EUR 176).

In July, the market capitalization of companies traded on the Bulgarian Stock Exchange (BSE) reached EUR 5.1 billion, which represents 17% growth compared with the same period of the previous year. As reported by the BSE, more than a quarter of the market capitalization reflects foreign stockholding positions.

In August, the Bulgarian Mine and Geological Chamber announced that around 400 mining and exploration projects, which are currently losing around EUR 10.2 million from related concession and licensing fees, will be stopped. Currently, the annual domestic mining industry turnover is more than EUR 1 billion, with a total number of employees of around 30 thousand workers. Due to the importance of these projects, the Chamber insists on the introduction of a special program aimed to support the country’s mining sector development.