In 2006, Bulgaria's economic growth reached 6.5% year-over-year (yoy), which was driven by the expanding industrial sector, services and trade. The fiscal year ended with a surplus of EUR 897 million, which translates into 3.8% of projected full-year GDP. In January, the consumer price index (CPI) increased by 7.2% yoy as compared to 6.5% in December 2006, which was due to accelerating prices of foods. The current account (CA) deficit remains a significant risk factor, reaching at the end of 2006 16.3% of full-year GDP. On a positive note, the same period FDI inflows were able to cover 111% of the existing CA gap. The 2006 average unemployment rate based on ILO methodology amounted to 9%.

Positive developments in Bulgarian industry were driven by the solid growth of production in manufacturing and mining sectors, where output increased by 7.3% yoy and 1.9% yoy in 2006 respectively. Last year, the growth leaders in the manufacturing sector were the producers of transport equipment, metal products, electrical machinery, and furniture. The monthly average rate of growth posted by these sectors was 39.6% yoy, 26.1% yoy, 24.0% yoy, and 21.9% yoy respectively. On a negative note, the deepest decline was observed in radio, television and communication equipment manufacturing (which has been shrinking at an average contraction rate of 35.2% yoy since January 2006) and in tobacco production, which declined by 26.9% yoy.

At the same time, the expansion of Bulgarian industry was somewhat restricted by the weaker performance of the utilities sector in 2006. The average monthly rate of growth in the utilities sector was 1.6% yoy, which was mainly driven by 4.0% yoy monthly growth in water supply. Relatively warm weather conditions in 2006 and the broad introduction of energy saving technologies, which decreased the demand for energy resources, were the principle reasons for only a modest increase of the utilities sector.

Positive developments in the real sector were supported by the expanding retail sector, whose annual average growth reached 13.3% yoy. Wholesale trade posted a significantly lower rate of growth of 2.5% yoy in 2006.

Fiscal Policy
In 2006, the Bulgarian government continued to conduct prudent fiscal policy. During the year, the amount of collected revenues exceeded expenditures, which resulted in a budget surplus of Lev 1.7 billion (EUR 897 million) or 3.8% of GDP.

In January-December, revenues were growing at a slightly accelerated rate as compared to January-November. During January-December, revenue collections amounted to Lev 20 billion (EUR 10.2 billion), demonstrating a growth of 11.5% yoy, which is 0.14 pps higher than in January-November. At the same time, as compared to the annual revenue collections in 2005, when budget revenues grew by 13.4% yoy, the growth of budget revenues was slower in 2006. The biggest contributor to the budget revenues in 2006, tax revenues, amounted to Lev 16.3 billion (EUR 8.3 billion), which is 12.7% higher as compared to the previous year. The second largest contributor, non-tax revenues, reached Lev 3.0 billion (EUR 1.6 billion) growing at a rate of 2.9% yoy.

On the expenditure side, a deceleration in the expenditure growth rate was registered both in January-November and at the end of the year as compared to the same periods of 2005. In January-December, budget expenditures amounted to Lev 18.3 billion (EUR 9.3 billion), growing by 7.5% yoy, which is 0.03 pps slower than in January-November and 4.4 pps slower than during 2005. Social expenditures, which account for the biggest share in budget expenditures, constituted Lev 7.0 billion (EUR 3.6 billion) in 2006, posting a growth of 13.5% as compared to the previous year. The fastest growing component of budget expenditures was public wages and social insurance, which grew by 54.3% during the year and constituted Lev 2.7 billion (EUR 1.4 billion). On a positive note, there was a growth of capital expenditures. During the year, this expenditure item grew by 4%, amounting to Lev 2.4 billion (EUR 1.3 billion). Finally, the only components that demonstrated negative growth were maintenance, interest and subsidies, which together amounted to Lev 5.2 billion (EUR 2.6 billion) as compared to Lev 6.0 billion (EUR 3.1 billion) in 2005.

In December, the government demonstrated thoughtful debt management. In the last month of the year, the total stock of public and publicly guaranteed debt was reduced to EUR 6,196.8 million, which is EUR 78 million less than in November and Lev 647.6 million less than at the end of 2005. In terms of debt-to-GDP ratio, total debt constituted 25.6% at the end of December, posting a decrease of 1.3 pps since November. At the same time, while domestic debt remained almost unchanged from the previous month's level, the amount of external debt decreased by EUR 77.5 million due to performed repayments. These also affected the foreign exchange debt structure, as the share of US dollar-denominated debt shrunk to 21%, while the share of euro-denominated debt fell to 52.3% and the share of Lev-denominated debt rose to 17.7%. The breakdown of external debt by type of creditor suggests that World Bank, IMF and European Union with shares of 12.7%, 4.18%, and 3.5% respectively, remain the largest lenders to the country.

Monetary Sector
In January, CPI increased by 7.2% yoy as compared to 6.5% yoy in December, according to the National Statistical Institute. Acceleration in the growth of CPI was due to accelerating prices of foods, which
grew by 6.5% yoy, and service tariffs, which grew by 3.7% yoy. Non-foods prices, on the contrary, demonstrated a slowdown in their growth rate, sliding to 11.1% yoy down from 11.3% in December. Starting January 2007, in addition to the usual CPI, the National Statistical Institute started to calculate a harmonized index of consumer prices (HCPI), which uses the consumer weights and standardized product groups of EU member states. The HCPI was introduced to monitor Bulgaria’s compliance for adoption of the euro and its indicators are to play a decisive role in the country’s perspectives to shift to the euro in 2010.

In January, the monetary base and money supply decreased 5.0% yoy by the end of the month. Sector, prices continued to grow at an accelerated rate, 9.1% yoy in the previous month. In the manufacturing industrial goods was registered within the mining and treatment in the growth rate of prices of domestically traded goods. PPI decelerated slightly in December, sliding to 8.0% yoy as compared to 8.1% yoy in November. Deceleration in the growth rate of prices of domestically traded industrial goods was registered within the mining and utilities sectors, where prices grew by 34.1% yoy and 8.8% yoy respectively as compared to 41.1% yoy and 9.1% yoy in the previous month. In the manufacturing sector, prices continued to grow at an accelerated rate, constituting 5.0% yoy by the end of the month.

In January, the Bulgarian National Bank continued to raise base interest rate, which by the end of the month was set at 3.43% p.a. as compared to 3.26% p.a. in December 2006.

In January, there was acceleration in the growth rate of bank credits to the non-government sector, reflecting loosening of the credit restrictions by the Bulgarian National Bank (BNB) at the beginning of the year. During January, the stock of commercial banks claims increased by 27% yoy up from 24% yoy at the end of 2006, and amounted to Lev 23 million. The acceleration was due to faster growth of both household and non-financial corporations’ stock of credits, which increased by 31.8% yoy and 23.5% yoy respectively. At the same time, the BNB is aiming to keep the annual growth rate below 20% in 2007. Shares of household and non-financial corporations in the total stock of bank credits have not changed over the month, and non-financial corporations with the share of 59% remained the largest commercial banks borrowers.

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Despite the significant size of the existing CA deficit, it’s successfully covered by a sufficient amount of FDI inflows. In 2006, the cumulative amount of FDI reached EUR 4.1 billion. This amount is enough to cover 111% of the existing CA gap. Bulgaria’s membership in the EU should serve as an important driver for further increases in FDI, which should soften the existing concern of having a high CA deficit.

The CA deficit remains the most significant risk factor for the Bulgarian economy. As of the end of 2006 it amounted to EUR 3.6 billion, which can be translated into 16.3% of GDP compared with a 12.2% deficit posted in 2005 and 6.7% in 2004. A significant gap in the trade balance remains the main reason for the widening CA deficit.

In nominal terms, Bulgarian imports in 2006 post EUR 17.3 billion compared with EUR 13.9 billion in the previous year. Throughout the year, the rate of growth in Bulgarian imports was decelerating starting from 31.2% yoy in January to 14.8% yoy in December, which brought the cumulative rate of growth in imports to 25.2% yoy. It is very likely that in 2007 this positive trend may continue due to slower growth in prices of imported energy resources.

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In 2006, Bulgarian exports reached EUR 12 billion, which demonstrates 26.6% yoy growth while imports posted 1.4 pps lower growth. Although this trend is positive, demonstrated growth in exports is still not enough to eliminate the existing gap in trade. A geographical breakdown of Bulgarian exports shows that the country is deeply integrated with the EU member states, which consumed more than 55% of the country’s exports. The significant factor of such deep integration was the country’s accession this year to the EU.

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International Trade and Capital

In 2006, the Bulgarian trade in goods and services post a deficit of 22% of GDP, which is 2 percentage points higher than in the previous year. In nominal terms, the trade deficit reached EUR 5.39 billion at the end of 2006. The main reason for the deterioration of the Bulgarian trade deficit was a decrease in world prices for metals along with a parallel increase in energy prices, and increasing domestic consumption.

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International Programs

The IMF executive board completed the fourth and final review of the country's performance under the precautionary arrangement expiring in March 2007. The 2-year programme was enacted as of August 2004 and extended by 6 months at the government's request. The IMF concluded that sound macroeconomic policies and structural reforms have resulted in sustained income growth, broadly moderate inflation and constantly decreasing unemployment. It was also pointed out that a high CA deficit and rising external debt remains a significant risk factor for the country's economy. The Bulgarian government was advised to maintain prudent fiscal and monetary policies, combined with further structural reforms targeted at improving the business environment and labor market.

The European Commission granted EUR 60 million for preparation of investment projects and tender documentation for solid household waste management in 7 local municipalities. A significant portion of this grant will be used for elaboration of projects for water supply and sewage improvements in 10 municipalities. On a later stage the projects will apply for financing by EU cohesion and structural funds. Preparation for this project will be co-financed by the Bulgarian government. The amount of co-financing is defined at a level of EUR 2.8 million.

Under the PHARE program, Bulgaria’s judiciary will receive EUR 15 million as stated by Michael Humphreys, head of the delegation of the European Commission to Bulgaria. The money will be spent on introduction of new information technology in the Bulgarian judiciary (namely, setting up of e-government in Bulgaria, which will be a part of the EU e-Justice portal.) Prior to that, Bulgaria had already introduced a number of IT projects for enhancing effectiveness of its judiciary.

Other Developments and Reforms Affecting the Investment Climate

The 2006 average unemployment rate based on ILO definitions is reported by the National Statistical Institute at 9%. The rate dropped by 1 pps from 10.1% in 2005. It is very likely that increasing demand for labor should put additional pressure on the market and should force employers to raise current wages.

The Bulgarian Cabinet of Ministers announced its decision to raise the funds allocated to exports insurance by one third in 2007. The funds will be used for insurance and reinsurance of export-related risks on account of the state.