Summary

- During the first months of 2008, robust internal demand and high world metal prices boosted industrial growth. Machinery-related sectors and metallurgy led the growth.
- The government continued to carry out prudent fiscal policy. In Q1 2008, budget revenues outpaced expenditures, and the quarter ended with a surplus of Lev 1.08 billion.
- Consumer prices accelerated, increasing by 4.2% year-to-date (ytd) in January-April 2008. Food inflation reached 6.0% ytd during this period.
- Producer prices increased by 4.4% ytd in Q1 2008. The highest PPI growth was observed in metal ore mining and basic metal manufacturing.
- Both exports and imports of goods and services were dynamic in Q1 2008. FDI inflows totaled 740 million. Negative values of trade and current account (CA) balances increased as compared to Q1 2007, but the financial and capital account surplus was still enough to cover the CA deficit.

Economic Growth

This year, Bulgarian industry started out on a solid note. In February 2008, industrial sales increased by 11.4% year-over-year (yoy). The mining sector demonstrated the highest growth, gaining 14.5% yoy. This accelerated performance was driven by high international prices for iron ore, which stimulated an increase in production by almost a third. Manufacturing was also actively developing (12.9% yoy). One of the reasons for this was surging domestic consumption and investment. In particular, robust investment activity has led to brisk growth in the production of manufacturing goods, such as radio, television and communication equipment (36.0% yoy), medical, precision and optical instruments, watches and clocks (33.0% yoy), machinery and equipment (29.0% yoy), and electrical machinery and apparatus (23.8% yoy). At the same time, an increase in production of vehicles by almost a fifth and transport equipment by more than time, an increase in production of vehicles by almost a third.

Prices of foods and non-alcoholic beverages, miscellaneous goods and services, including transport, grew at the fastest pace, gaining in the range of 5.3% ytd to 6.1% ytd. Of the four components of the CPI, inflation was the highest in foods (6% ytd) and catering (5.2% ytd), being more moderate in non-foods (3.2% ytd) and services (2.6%).

Fiscal Policy

According to the Budget Law, budget revenues are expected to grow by 25.9% yoy in 2008 and expenditures and transfers should increase by 18.7% yoy. The budget is expected to be in surplus of Lev 1.3 billion, which is 2.0% of annual GDP. During the first quarter of 2008, budget revenues grew faster than anticipated — 32.8% yoy, while expenditures and transfers did not keep pace with initial projections and went up only by 14.3% yoy. All told, the budget surplus stood at Lev 1.08 billion in January-March. Dynamic growth of revenues was mainly due to brisk VAT receipts, which surged by 62.6% yoy, twice as rapidly as expected. Excise receipts, having risen by 26.6% yoy, also surpassed expectations. High growth of VAT and excise receipts is explained by strong domestic consumption. At the same time, receipts from profit and income taxes grew more slowly than planned — by 30% yoy and 15.3% yoy respectively.

Under-execution of budget spending was observed on the back of slower growth of current expenditures; while its anticipated growth was set at 16% yoy, it increased by only 3.6%. The areas that were financed less than planned are maintenance, interest, and social expenditure and scholarships. At the same time, capital expenditures grew by 18.1% yoy, which was close to plan. This dynamic budget capital expenditure will add support to investment activities in the country.

By the end of the first quarter of 2008, the stock of government debt and government-guaranteed debt totaled €5.3 billion, which is 7.2% less than at the end of 2007. The government and government-guaranteed debt to GDP ratio dropped by 3 p.p. from the end of 2007 and reached 16.8%. Since the beginning of 2008, payments on government debt totaled €732 million, out of which €573 million was spent to repay external debt and €159 million to reduce domestic debt. In March, the largest share of payments was made on domestic debt and as prepayment of a portion of the debt to the World Bank.

Monetary Sector

In the first four months of 2008, the consumer price index (CPI) rose by 4.2% ytd. Price hikes were observed for all groups of consumer goods and services, except for telecommunication services. Prices of foods and non-alcoholic beverages, miscellaneous goods and services, including transport, grew at the fastest pace, gaining in the range of 5.3% ytd to 6.1% ytd. Of the four components of the CPI, inflation was the highest in foods (6% ytd) and catering (5.2% ytd), being more moderate in non-foods (3.2% ytd) and services (2.6%).

On the positive side, consumer inflation was decelerating throughout Q1 2008 as the CPI slowed to 0.8% month-over-month (mom) in March from 1.4% mom in January. In April 2008, the CPI accelerated only marginally to 0.9% mom. However, despite the registered improvement in inflation dynamics, the CPI still remains high. Above all, prices of food products, which constitute 36.7% of the consumer basket, are still growing rapidly. In April, food prices became dearer by 1.3% as compared to the month before. And though prices of non-foods (constituting 32.0% of the consumer basket) went up significantly less (0.8% mom), price growth of some non-food items was impressively high. In particular, clothing and footwear became more expensive by 1.6% mom.

In Q1 2008, producer prices increased by 4.4% ytd. Prices in mining grew by 6.0% ytd, and those in manufacturing rose by 4.8% ytd. The price increase in electricity, water and gas supply was the slowest, approaching only 1.4% ytd. Metal ore mining and manufacturing of basic metals were among the industries with the fastest growth of producer prices, which soared by 8.4% ytd and 7.6% ytd respectively. A price jump (6.6% mom) in metal ore mining took place in February, leading to a similar hike (6.4% mom) in manufacturing of basic metals in March. By and large, the major reason for this is the rapid growth of world iron ore prices. Furthermore, price trends in metallurgy were decisive for the overall price dynamics in mining and manufacturing. While prices in the mining industry climbed by 4.5% mom and increased by only 0.7% mom in manufacturing in February, prices in the mining sector grew by only 1.1% mom and in manufacturing they rose by 3.3% mom in March.

At the same time, the price trend was descending in electricity, gas and water supply. After increasing...
by 1.9% mom in January, prices decelerated to 0.4% mom in February and dropped by 0.8% mom in March.

International Trade and Capital

In Q1 2008, the current account deficit reached €1.7 billion, having increased by €96.7 million or by 6.1%, yoy. The existing CA deficit is equivalent to 5.1% of projected full year GDP. The trade balance deficit worsened to €1.93 billion, having risen by €295 million from the year before. 71% of this increase came from deterioration of trade in goods and 29% due to the shrinking balance of trade in services. Notably, trade grew rapidly both in goods and in services. However, while exports of goods outpaced imports (25.7% and 21.3% yoy respectively), in services a reverse trend was observed (11.4% and 21.5% yoy respectively). Still, the deficit in trade of services constituted only a marginal share of the overall trade deficit, as it was twelve times less than the negative balance of trade of goods.

The rest of the CA balances — the income and current transfers accounts — improved. Favorable dynamics both on credit side, due to rising employee compensation, and due to reduced investment income payments on the debit side, made it possible for the income account to turn positive (€124 million), while it was slightly negative in the corresponding period of the previous year. Growth in inflows of current transfers significantly exceeded the rise in outflows, so net current transfers almost doubled yoy to €135 million.

The financial account improved less than the CA deteriorated. It rose by only €65.7 million (or by 3.8% yoy), reaching €1.79 billion. Growth in the financial account was hampered mainly by negative dynamics of net foreign direct investments. First, Bulgarian investments abroad rose briskly to €391 million. Second, investment in the domestic economy shrunk by 17.5% yoy to €740 million. As a result, net foreign direct investments (FDI) shrunk by €556 million in January-March to only €348 million. At the same time, portfolio investment assets and liabilities and other investment assets more than compensated for this decline in FDI and other worsening financial accounts (those of other investment liabilities and financial derivatives). Other investment assets reached €963 million, advancing by €492 million. Also, portfolio investment assets and liabilities in sum turned slightly positive after considerable negative values (-€216 million) in the first quarter of the previous year.

Despite the narrowing difference between the financial and current accounts compared to the corresponding period of the previous year, the overall balance of payments improved due to the brisk dynamics of the capital account, which gained €157 million. The overall balance and respective increases in reserves stood at €1.43 billion in the first quarter of 2008, which is almost three times more than in the corresponding period of 2007.

Other Developments and Reforms Affecting the Investment Climate

Growing commodity prices and labor costs will represent one of the main challenges for the Bulgarian economy in 2008. In particular, enterprises will have to bear significantly higher labor expenses. In 2007, growth in labor costs was 16.9% yoy compared to 4.7% yoy in 2006. What's more, labor costs accelerated throughout 2007 and reached impressive growth of 19.6% yoy in Q4 2007.

In 2008, tightness on the labor market is expected to continue. Additional labor will be needed to satisfy robust internal and growing export demand, and attracting new employees will become ever more difficult as unemployment has been approaching its natural level (in the fourth quarter of 2007, unemployment was at 6.1%). According to the NSI business survey in March 2008, 19.3% of industrial enterprises believed that labor shortages limited their activity.

At the same time, consumer inflation, which has been troublesome since 2007, is expected to calm down in the second half of 2008, when the favorable impact of the new harvest will ease upward pressures on food prices. However, the situation on the energy market is likely to remain tight, which will adversely affect both producer and consumer prices and contribute to a widening CA deficit through higher energy costs.