

2006-17
 July 25, 2007

Bulgaria (the Republic of)

Foreign LT: BBB+/Stable, Local LT: A-/Stable (Affirmed on June 27, 2007)

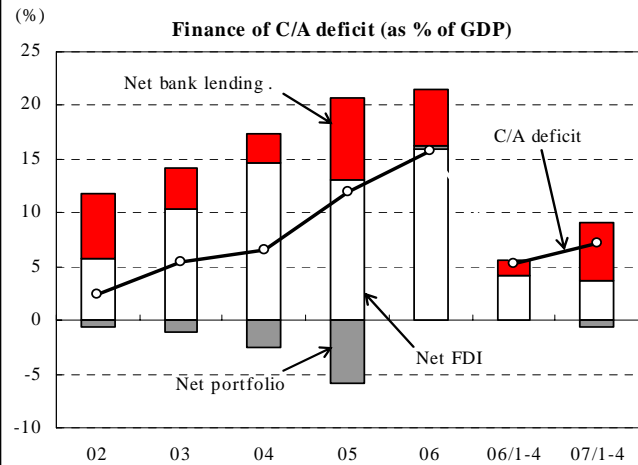
<Rating Perspective>

Positive Factors

- Sounder fiscal structure underpinned by a continued fiscal surplus and a substantial reduction of government debt.
- Stability of currency and inflation underpinned by the currency board arrangement.
- High economic growth prospects mainly bolstered by massive inflows of FDI and EU subsidy, as well as the prudent fiscal and monetary policies.

Negative Factors

- Widening current account deficit on robust domestic demand.
- Transformation of industrial structure still at primary stage.



<Updated: from April 2007 to June 2007>

Positive Factors

- The European Commission (EC) concluded in the report that Bulgaria made some progress on judicial reform and the fight against corruption and organized crime, while urging Bulgaria to speed up the reforms (June 27).
- The general government fiscal balance in the first five months of 2007 continued to registering a substantial surplus equivalent to 3.9% of GDP (BGN 2,099 million).
- The ratio of government external debts to GDP declined further to 15.6% at the end of May 2007 from 18.7% at the end of 2006.
- Unemployment rate in April 2007 fell to 7.8%, the lowest on record.

Negative Factors

- Current account deficit in the first four months of 2007 widened to 7.7% of GDP (EUR 2,136 million) from 5.8% in the same period of last year.
- The inflows of foreign direct investment (FDI) in the first four months of 2007 was EUR 1,115 million, only covering 52% of the current account deficit for the same period.
- Bank lending to the private sector resumed accelerating to register a 45.2% year-on-year growth in May 2007.
- Real GDP growth rate in the January-March quarter of 2007 resumed accelerating moderately to 6.2% year-on-year from 5.7% in the previous quarter.

<Outlook and Points to Watch>

Refinance of the growing C/A deficit

(1) JCR has affirmed the ratings in annual review

On June 18, 2007, JCR retained its ratings with stable rating outlooks on foreign (BBB+/ Stable) and local currency (A-/Stable) long-term senior debts of the Republic of Bulgaria. The affirmation of the ratings is mainly supported by Bulgaria's sounder fiscal structure underpinned by a continued fiscal surplus and a substantial reduction of government debt, and stabilization of prices and its currency under the currency board arrangement. Also supporting the ratings are the country's high economic growth prospects mainly bolstered by an expanding production capacity rendered by massive foreign direct investment (FDI) inflows in recent years and a substantial amount of subsidy from the EU, as well as the continued prudent fiscal and monetary policies. On the other hand, the ratings remain constrained by a deteriorating current account deficit resulting from strong imports caused by robust private-sector demand and the fact that industrial transformation is still at a primary stage, with per capita GDP (in PPP terms) estimated around 35% of the EU25 average.

The rating outlooks are stable. The tripartite coalition, which led Bulgaria to EU membership in January 2007, is expected to pursue a tight fiscal policy and the economy is highly likely to return to sustainable growth in the years ahead. While the government has yet to decide when to apply for euro adoption, it is set to join the ERM2 at an early date by maintaining the currency board arrangement.

(1) Robust economic expansion led by private-sector demand

Following the EU accession in January 2007, The Bulgarian economy keeps growing robustly led by strong private-sector demand underpinned by the progress on structural reforms and the maintenance of prudent fiscal and monetary policies as well as the massive FDI inflows in recent years. It continued expanding to 6.2% year-on-year in real GDP terms in the January-March quarter of 2007 on strong investment and consumer spending. Increased employment amid the strong economic expansion has contributed to a marked reduction of the unemployment rate. The unemployment rate (Eurostat) in April 2007 fell to 7.8%, the lowest on record. Consumer price inflation (HICP) accelerated to 6.3% in 2006 due primarily to the hikes of excise tax rates and the surge of energy prices, but slowed down significantly to 5.0% year-on-year in the January-June 2007 as the impact of those special factors wore off.

(2) Strong external liquidity position mitigates the risks of refinancing the large current account deficit

The current account deficit widened to 15.8% of GDP in 2006 from 12.0% in 2005 on increased imports of raw materials and investment goods spurred by robust domestic demand. The deficit in the first four months of 2007 widened to 7.7% of GDP (EUR 2,136 million) from 5.8% in the same period of last year. Although the external imbalance has been largely financed by FDI inflow, the FDI inflow in the first four months of 2007 was EUR 1,115 million, only covering 52% of the current account deficit for the same period. However, there is little concern for the foreign liquidity as the foreign exchange reserves over EUR 8.0 billion at the end of May 2007 was enough to cover almost five months of imports.

(3) In a bid to narrow the current account deficit, the government and the central bank maintained restrictive fiscal and prudential policies

As the government has kept a tight fiscal policy in place, the fiscal balance has been in surplus for three years running since 2004.

The general government fiscal balance in the first five months of 2007 continued to registering a substantial surplus equivalent to 3.9% of GDP (BGN 2,099 million). While tax revenues grew markedly on economic expansion and tightened tax collections by the operation of National Revenues Agency, expenditures stayed largely in line with the levels projected in the budget. The favorable fiscal developments boosted the fiscal reserve to BGN 6.5 billion at the end of 2006 or equivalent to 12.1% of GDP. The ratio of government debt to GDP declined further to 21.5% at the end of May 2007 from 24.7% at the end of 2006 thanks mainly to advanced loan prepayments. The BNB has adopted a series of administrative and prudential measures since 2004 with the aim of cooling down the growing bank lending to the private sector, one of factors that had spurred domestic demand. The measures included an increase of the reserve requirement ratio and tighter restrictions on bank lending.

(4) Current account deficit to improve on prudent fiscal and prudential policies

JCR continues to watch the effectiveness of government policies to curb strong domestic demand. If the government continues prudent fiscal and monetary policies, the current account deficit is likely to improve as the economy returns to sustainable growth of around 5% in 2007 and 2008. The BNB continues its strict supervision in a bid to prevent possible deterioration of bank assets, though year-on-year bank lending to private sector resumed accelerating since the BNB removed its administrative measures in January 2007. There is the possibility that the fiscal policy may be eased in 2007 as the government has projected the fiscal surplus for the year to decrease to 2.0% of GDP (on a cash basis) from 3.5% the previous year. However, the fiscal estimate includes Bulgaria's contribution to the EU budget equivalent to more than 1% of GDP. Given the fiscal development of the 2007 budget so far, a fiscal policy aimed to curb demand will in effect be maintained in 2007.

Main Economic Indicators: The Republic of Bulgaria

		2002	2003	2004	2005	2006	2007 (f)	2008 (f)
(Convergence criteria for adopting the euro)								
1. CPI (annual average)	2.6%(note)	5.8	2.4	6.2	5.0	7.3	4.5	3.5
2. 10 year government bond yield	5.4%(note)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3. General government balance / GDP	Below -3.0%	0.1	-0.9	2.2	1.9	3.3	2.5	2.0
4. General government debt / GDP	Below 60%	54.0	45.9	37.9	29.2	22.8	18.5	16.9
Real GDP growth rate	(%)	4.5	5.3	6.6	6.1	6.1	5.5	5.0
Unemployment rate	(%)	16.3	13.5	12.2	10.7	9.5	8.0	7.2
Current account balance / GDP	(%)	-2.4	-5.5	-6.6	-12.0	-15.8	-14.2	-12.7
Trade balance / GDP	(%)	-11.3	-13.7	-14.9	-20.2	-21.5	-19.6	-18.8
Net foreign direct investment / GDP	(%)	5.7	10.3	14.6	13.0	15.9	12.3	9.5
Net foreign direct investment / C/A balance	(%)	235.8	187.8	222.1	108.9	100.1	86.8	74.9
Forex reserves (excl. gold)	(EURmn)	4,575	5,309	6,854	7,370	8,926	10,200	11,500
Forex reserves / monthly imports	(months)	5.6	5.7	6.1	5.3	5.2	5.1	5.1
Forex reserves / ST external debt	(times)	3.0	3.5	2.8	2.0	1.5	1.4	1.5
Gross external debt / GDP	(%)	65.0	60.1	63.8	69.0	78.4	81.9	83.8
Gross external debt / exports (G&S)	(%)	126.4	113.2	112.5	115.8	123.1	119.3	115.5
Gross public external debt / exports (G&S)	(%)	87.7	70.5	53.2	33.9	22.9	17.4	13.8
Debt service ratio	(%)	16.5	14.2	23.3	44.3	25.3	23.8	23.0

(Note) Figures for criteria 1 and 2 are annual average between May 2006 and April 2007. Figures for 2007 and 2008 are projection made by JCR

(Sources) The Bulgarian National Bank, Ministry of Finance, Eurostat

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