2006-32
October 30, 2007

Bulgaria (the Republic of)

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

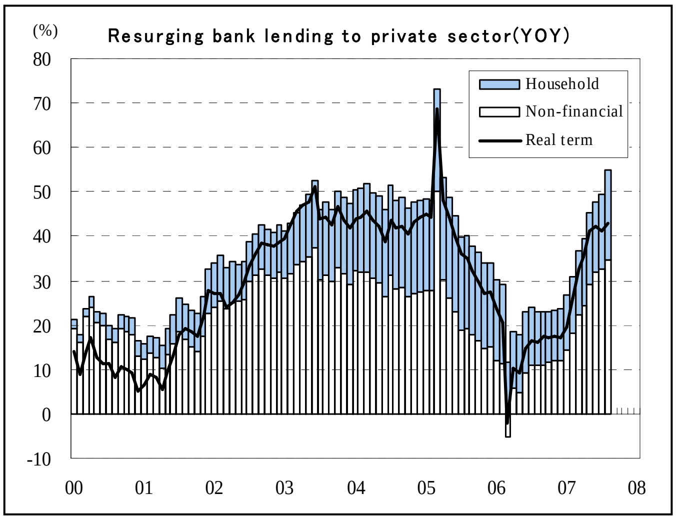
<Rating Perspective>

Positive Factors

- Sounder fiscal structure underpinned by continued fiscal surplus and substantial reduction of government debt.
- Stability of the currency and inflation supported 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 July 2007 to September 2007>

Positive Factors

- The government envisaged a fiscal surplus equivalent to 2.8% of GDP in the budget plan for 2008.
- In response to the surging bank lending to the private sector, the central bank raised its minimum reserve ratio to 12% from 8% in September.
- The general government fiscal balance in the first eight months of 2007 registered a substantial surplus equivalent to 5.1% of GDP (BGN2,874 million).
- The ratio of government debt to GDP declined further to 20.0% at the end of July 2007 from 24.7% at the end of 2006.
- Unemployment rate (Eurostat) hit the lowest on record at 6.5% in September 2007.
- FDI inflows in the first seven months of 2007 totaled EUR2,667 million, covering 88% of the current account deficit in the same period.

Negative Factors

- Consumer price inflation (Eurostat) surged to 9.3% year-on-year in August 2007 on higher food prices caused by unfavorable whether conditions.
- The current account deficit in the first seven months of 2007 widened to 10.5% of GDP (EUR3,041 million) from 7.2% in the same period of 2006.
- Bank lending to the private sector swelled by 54.1% year-on-year in August 2007.

<Outlook and Points to Watch>

Central bank resumes credit tightening

(1) BNB resumes credit tightening to stem economic overheating

The Bulgarian economy continued accelerating on strong investment and consumer spending, with real GDP posting a 6.6% year-on-year growth in the April-June quarter of 2007, up from 6.2% the previous quarter. Investment remained robust on increased construction and business investment triggered by massive inflows of FDI and subsidy from the EU in recent years. Consumer spending stayed brisk on improved employment and higher wages. Net exports continued contributing negatively to the whole economic growth as imports grew faster than exports amid a strong expansion of domestic demand. Bank lending to the private sector has been on the rise again since the tight money policy was lifted at the beginning of 2007, posting a 54.1% year-on-year surge in August. In September, the Bulgarian National Bank (BNB) resumed credit tightening to rein in the swelling bank lending to the private sector. With its ability to raise its interest rates independently restricted under the currency board arrangement, the BNB raised the minimum reserve requirement ratio to 12% from 8%.

Meanwhile, increased employment amid the strong economic expansion has contributed to a marked reduction of the unemployment rate. The unemployment rate (Eurostat) hit the lowest on record at 6.5% in September. Consumer price inflation (Eurostat) climbed to 9.3% year-on-year in August on higher food prices (24% year-on-year) caused by

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unfavorable whether conditions.

(2) Ample external liquidity and FDI inflows mitigate risks of financing large C/A deficit

The current account deficit, which widened to 15.8% of GDP in 2006, continued to deteriorate, with the deficit in the first seven months of 2007 already reaching 10.5% of GDP (EUR3,041 million), up from 7.2% in the same period of 2006. The trade deficit widened substantially to 13.5% of GDP in the first seven months on strong imports of energy and FDI-related capital goods and raw materials, which were to be turned later into export products. However, risks of financing the deficit have been largely mitigated by strong FDI inflows which covered 88% of the deficit. Furthermore, net financial inflows centering on bank loans helped the foreign exchange reserves swell to a record EUR9,663 million at the end of August, equivalent to around five months of imports.

(3) The government maintains restrictive fiscal policies

The government has kept a restrictive fiscal policy with the aim of curbing domestic demand. The general government fiscal balance in the first eight months of 2007 registered a substantial surplus equivalent to 5.1% of GDP (BGN2,874 million). While tax revenues grew markedly on economic expansion and tightened tax collection following a full-fledged operation of the National Revenues Agency, expenditures stayed largely in line with the levels projected in the budget. There had been concern that the coalition government, which faced a weak approval rating, might loose its fiscal policy prior to the October local elections. However, no such action has been taken so far. The favorable fiscal developments boosted the fiscal reserves to BGN7,908 million (14.1% of GDP) at the end of August. The ratio of government debt to GDP declined further to 20.0% at the end of July from 24.7% at the end of 2006 thanks mainly to advanced loan prepayments. Given the current fiscal development, the projected fiscal surplus equivalent to 2.0% of GDP under the 2007 budget plan is highly likely to be achieved.

The government envisaged a bigger fiscal surplus equivalent to 2.8% of GDP in the budget plan for 2008 while pledging to maintain a restrictive fiscal policy. The budget plan called for higher tax rates on alcohol, tobacco and energy and adopting a unified 10% rate on personal income in lieu of the current progressive tax rate.

(4) JCR retains the ratings and watches the effectiveness of the fiscal and monetary policies

While the fiscal surplus has continued widening, both the economic growth and inflation rates have been accelerating faster than the government's projection. The economy looks unlikely to slow down and is expected to grow around 6% in 2007 on robust domestic demand. Inflation will decelerate only slightly as falls in food prices will be neutralized by inflation pressure resulting from higher wages amid a tighter labor market. The economy is likely to slow down from the middle of 2008 due mainly to the impact of the government policy to increase a fiscal surplus and the BNB decision to raise the minimum reserve requirement ratio. JCR will continue to monitor the effectiveness of these policies. Barring drastic fluctuations of the domestic and international financial markets, there will be no serious concern about the Bulgarian economy at least for a while, as risks of financing the widening current account deficit are largely mitigated as the deficit is covered by FDI inflows amid growing foreign exchange reserves.

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)	2.4%(note)	5.8	2.3	6.2	6.1	8.7	7.5	6.0
2. 10 year government bond yield	5.4%(note)	n.a.	6.4	5.4	3.9	4.2	4.5	4.3
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	6.2	6.1	6.5	5.5
Unemployment rate	(%)	18.4	14.0	12.1	10.2	9.4	7.2	6.0
Current account balance / GDP	(%)	-2.4	-5.5	-6.6	-12.0	-15.8	-19.0	-16.4
Trade balance / GDP	(%)	-11.3	-13.7	-14.9	-20.2	-22.2	-26.0	-24.3
Net foreign direct investment / GDP	(%)	5.7	10.3	14.6	13.0	16.8	15.3	12.0
Net foreign direct investment / C/A balance	(%)	243.1	190.2	209.4	118.4	112.2	82.3	76.1
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	5.0	5.1
Forex reserves / ST external debt	(times)	3.0	3.5	2.8	2.0	1.5	1.4	1.7
Gross external debt / GDP	(%)	65.0	60.1	63.8	69.0	77.6	81.8	78.3
Gross external debt / exports (G&S)	(%)	126.4	113.2	112.5	115.8	120.5	135.9	127.8
Gross public external debt / exports (G&S)	(%)	87.7	70.5	53.2	33.9	22.7	17.9	15.3
Debt service ratio	(%)	16.5	14.2	23.3	44.3	25.3	26.0	25.0

(Note) Figures for criteria 1 and 2 are annual average between September 2006 and August 2007. Figures for 2007 and 2008 are projection made by JCR
(Sources) The Bulgarian National Bank, Ministry of Finance, Eurostat

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