

2008-19  
July 30, 2008

## Bulgaria (the Republic of)

Foreign LT: BBB+/Stable, Local LT: A-/Stable

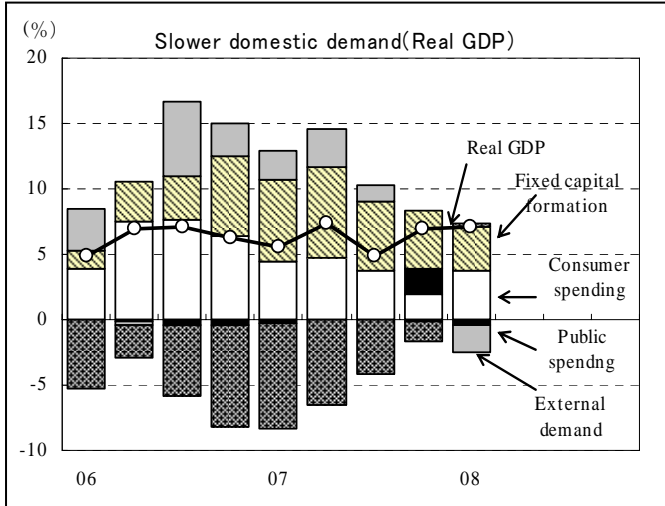
### <Rating Perspective>

#### Positive Factors

- Solid fiscal structure underpinned by continued fiscal surplus and substantial reduction of government debt
- The maintenance of the currency board arrangement
- Expanding production capacity rendered by robust investment following massive inflows of FDI and EU subsidy

#### Negative Factors

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



### <Updated: from April to June, 2008>

#### Positive Factors

- Real GDP in the January-March quarter of 2008 accelerated slightly to 7.0% year-on-year from 6.9% in the previous quarter, but domestic demand slowed to 4.7% year-on-year from 6.7% in the previous quarter
- The general government fiscal balance in the first five months of 2008 registered a substantial surplus equivalent to 5.6% of GDP from 3.7% the year before
- The unemployment rate (Eurostat) fell to 5.5% in April 2008, the lowest in history
- Further deterioration of the current account deficit seems to be halted as the ratio of the deficit to GDP in the first four months of 2008 resulted in 7.3%, the same level from the year earlier
- Bank lending to the private sector in May fell to 54.4% year-on-year from 62.5% in December 2007

#### Negative Factors

- The consumer price inflation (Eurostat) surged to 14.0% year-on-year in May 2008 on higher food and energy prices
- Gross external debts rose by 42.8% year-on-year to EUR 30.7 billion at the end of April 2008

## <Outlook and Points to Watch>

### Rising inflation and financing to the C/A deficit

#### (1) The economy to return to balanced growth sustained by both domestic and external demand amid marked slowdown of domestic demand

Following the EU accession in January 2007, the Bulgarian economy has kept growing by more than 6% annually for four consecutive years from 2004, led by strong private-sector demand bolstered by the progress on structural reforms and the maintenance of prudent fiscal and monetary policies as well as the massive FDI inflows. However, the current account deficit widened significantly to reach 21.5% of GDP in 2007 on increased imports driven by private domestic demand. Against this background, the government pursued tighter policies in collaboration with the Bulgarian National Bank (BNB) with the aim of reining in the deficit. As a consequence, a slowdown of domestic demand has become more pronounced and a further deterioration of the deficit has apparently come to a halt. The labor market tightened as the unemployment rate (Eurostat) fell to yet another record low 5.5% in April 2008 amid increased employment and higher real wages brought by the strong economic expansion. Consumer price inflation (Eurostat) accelerated to 14% year-on-year in May 2008 due primarily to the higher food and energy prices as well as added inflation pressure stemming from wage increases.

#### (2) As deterioration of the current account deficit comes to a halt, there is little immediate concern over its refinancing

The widening current account deficit was largely due to increased imports of raw materials and investment goods spurred by robust domestic demand. Lately, however, exports have been growing faster than imports despite the worsening external business climate. A further deterioration of the deficit has apparently come to a halt, with the deficit

in the first four months of 2008 standing at 7.3% of GDP, little changed from the same period the year before. Bulgaria needed a large external financial requirement to finance the large current account deficit. However, refinancing of the deficit was mainly covered by FDI inflows. In the first four months of 2008, it began to rely more on bank loans as net FDI inflows declined. But there is little immediate concern over refinancing risks. The country's foreign liquidity remains at sufficient levels, with the foreign exchange reserves standing at well over EUR12 billion, enough to cover five months of imports. The external debt exceeded 90% of GDP at the end of March 2008, with much of the growth led by the private sector. However, the ratio came to just over 60% when corporate loans were excluded.

### (3) Tighter fiscal and monetary policies to be kept in 2008 and 2009

The government and the BNB have taken a tighter fiscal policy and prudent measures with the aim of reining in the current account deficit. The general government fiscal balance has been in surplus for four years running since 2004 and ended up with a surplus equivalent to 3.4% of GDP (ESA95) in 2007. The government plans to keep the annual surplus at 3% of GDP in 2008 and 2009 (over 4% barring its contribution to the EU budget). Although a 10% flat personal income tax rate was put in force at the beginning of 2008, the general government fiscal balance in the first five months of the year was in surplus by 5.6% of GDP, up from 3.7% the year before on higher-than-expected revenues and restrained expenditures. The ratio of government debt to GDP halved to 18.2% (ESA95) at the end of 2007 as compared with three years before thanks mainly to advanced repayments of IMF loans and Brady bonds. The BNB has raised the reserve requirement ratio and implemented demand-control steps with the aim of curbing the growth of bank lending to the private sector, one of factors that had spurred domestic demand. It has also stepped up supervision of banks in a bid to prevent possible deterioration of bank assets. These steps have helped to keep the banks' balance sheet sound even amid a slower growth of their lending to the private sector.

### (4) Rising inflation and execution of the 2008 budget ahead of general elections in 2009 need to be watched

JCR holds that the current account deficit will continue improving moderately as the economy returns to a balanced growth of around 6% in 2008 and 2009, led by domestic and external demand. Risks of refinancing the deficit continued to be eased by the massive inflows of FDI and financial capital from abroad amid the prospects of sustainable economic expansion and continuation of prudent policy management. In view of the deteriorating global financial situation, however, JCR will continue to watch how the country's external finance will evolve in the months ahead. Inflation will decelerate only slightly in 2008 and 2009. While food prices may fall and the currency may appreciate, inflationary pressures are likely to remain little abated given the planned hike of excise duties and rising wages amid a tighter labor market. Faced with its poor approval rating following its setbacks in the European parliamentary and local elections in 2007, the coalition government may choose to boost budget spending ahead of the general elections scheduled for mid-2009. JCR will closely monitor how the government will steer its fiscal policy in the coming months.

## Main Economic Indicators: The Republic of Bulgaria

		2003	2004	2005	2006	2007	2008 (f)	2009 (f)
<b>(Convergence criteria for adopting the euro)</b>								
1. CPI (annual average)	3.5%(note)	6.2	6.1	7.5	7.3	8.4	11.0	7.5
2. 10 year government bond yield	5.7%(note)	6.4	5.4	3.9	4.2	4.5	5.1	4.8
3. General government balance / GDP	Below -3.0%	-0.5	1.4	1.8	3.0	3.4	3.5	3.3
4. General government debt / GDP	Below 60%	45.9	37.9	29.2	22.7	18.2	14.3	11.0
Real GDP growth rate	(%)	5.0	6.6	6.3	6.3	6.2	6.0	6.0
Unemployment rate	(%)	13.7	12.0	10.1	9.1	7.0	5.5	5.0
Current account balance / GDP	(%)	-5.5	-6.6	-12.4	-17.8	-21.5	-19.0	-18.0
Trade balance / GDP	(%)	-13.7	-14.9	-20.2	-22.0	-25.5	-24.5	-23.8
Net foreign direct investment / GDP	(%)	10.3	14.6	13.3	23.1	20.5	14.0	12.6
Net foreign direct investment / C/A balance	(%)	190.2	209.4	116.5	132.8	98.2	77.6	76.7
Forex reserves (excl. gold)	(EURmn)	4,791	6,301	6,690	8,193	11,179	13,250	15,300
Forex reserves / monthly imports	(months)	5.1	5.6	4.8	4.7	5.5	5.7	5.8
Forex reserves / ST external debt	(times)	3.1	2.6	1.8	1.3	1.2	0.9	0.8
Gross external debt / GDP	(%)	60.1	63.8	69.8	73.7	97.3	107.4	113.4
Gross external debt / exports (G&S)	(%)	113.2	112.5	117.2	114.8	155.4	171.2	179.7
Gross public external debt / exports (G&S)	(%)	70.5	53.2	33.7	23.4	16.7	13.2	10.3
Debt service ratio	(%)	14.2	23.3	44.3	26.4	6.6	7.1	7.4

(Note) Figures for criteria 1 and 2 are annual average between July 2007 and June 2008. Figures for 2008- 2009 are projection made by JCR

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

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