

2004-44
December 27, 2004

Bulgaria (the Republic of)

Foreign LT: BBB-/Positive, Local LT: BBB/Positive (Rating outlooks revised on August 11, 2004)

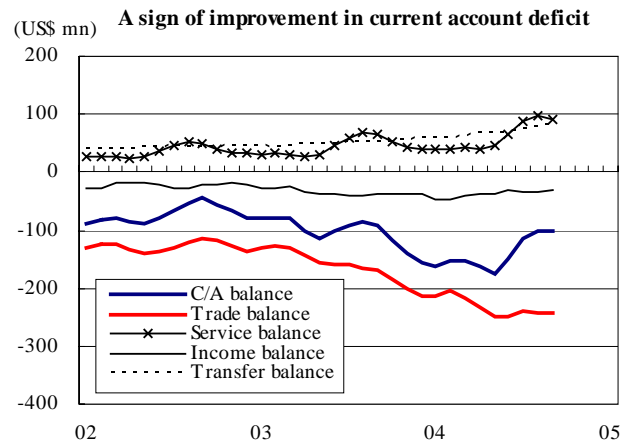
Main Factors for the Ratings

Positive Factors

- Progress on political, economic and budgetary reforms in pursuit of EU entry in 2007.
- Improved fiscal flexibility through budgetary discipline and reduction of public debts.
- Stability of currency and inflation underpinned by the currency board arrangement.
- Expanding production capacity through inflows of foreign direct investment.

Negative Factors

- Transformation of industrial structure still at primary stage.
- High level of unemployment deterring further economic growth.
- High level of external debt of both private and public sectors.



Source: Bulgarian National Bank

Note: Figures are 12 month moving average

Updated: from September 2004 to November 2004

Positive Factors

- In its 2004 Regular Report released on October 6, the European Commission positively evaluated the progress made on economic and fiscal reforms, while pointing to slow progress on reforms of the judiciary system and measures against corruption.
- Current account deficit in the first nine months of 2004 decreased by 12% from the year before to US\$698 million on bigger surpluses of both the service and income balances.
- General government fiscal balance in the first nine months of 2004 registered a large surplus of BGN1.3 billion or 3.7% of GDP. Fiscal reserve balance rose to BGN5, 835 million or 15% of GDP at the end of October.
- Following redemption of a portion of Brady bonds in July, the external public debt shrank by 8% from the year before to US\$8,295 million at the end of September.
- Real GDP in the April–June quarter grew by 6.0% year-on-year, up from 5.3% in the previous quarter.

Negative Factors

- IMF expressed concern over the robust bank lending growth and called for additional measures to check the expansion (9/14).
- Trade deficit in the first nine months of 2004 totaled US\$2,149 million or 9% of GDP, up 40% over the year before.
- Bank lending to the private sector in July continued to grow by 53% from the year earlier.

<Prospects and Noticeable Points>

Possible economic overheating remains a concern, but Bulgaria is steadily headed for EU accession in 2007

Caution needed for economic overheating despite restrained expansion of domestic demand

Bulgaria's real GDP in the April–June quarter grew by 6.0% year-on-year, up from 5.3% in the previous quarter. As compared with the previous quarter, the growth of domestic demand remained flat, but a strong external demand pushed up the GDP growth. On the domestic front, both consumer spending and inventories remained upbeat, making up for a 6.3% drop in gross capital formation. External demand, a negative contributor to overall economic growth previously, was less so in the April–June quarter as exports grew faster. Imports somewhat slowed down but continued expanding faster than exports, registering an 11.3% year-on-year growth. As far as GDP statistics are concerned, it appears that a further expansion of domestic demand has now been brought to a halt. However, no signs of economic deceleration are discernible, with both industrial production and bank lending to the private sector continuing to grow robustly. Meanwhile, inflation picked up 7.6% year-on-year in July due to temporary factors such as a surge in food prices and a tax increase. But the rate slowed down to 5.8% in October as the impact of those factors weakened. The unemployment rate remained high, though it fell to 11.7% in September owing to economic expansion and a set of measures implemented by the government. The general government fiscal balance in the first nine months of 2004 registered a large surplus of BGN1.3 billion or 3.7% of GDP due in part to the maintenance of a prudent fiscal policy and due in part

to increased tax revenues brought by better economic performances. This has added to the possibility that the fiscal balance will register a surplus in 2004 as a whole. The government debt tended to decline with external debt leading the way. The outstanding balance of government debt fell to 43% of GDP at the end of September. In particular, public external debt shrank to US\$8,295 million, an 8% reduction from the end of 2003, following redemption of a portion of outstanding Brady bonds in July. As a result, the ratio of external public debt to exports declined substantially to 58% at the end of September from 85% at the end of 2003.

Current account deficit is sufficiently covered by large FDI inflows

Current account deficit totaled US\$698 million in the first nine months of 2004, down 12% from the year before, on increased surpluses of both the service and income balances. While the bigger service balance surplus was largely attributable to tourist revenues, much of the transfer balance surplus apparently stemmed from increased financial aid from the EU in preparation for Bulgaria's EU entry. Trade deficit, the main cause of the country's chronic current account deficit, grew by 40% to US\$2,149 million or 9% of GDP in the first nine months of 2004. However, trade deficit in the July-September quarter alone showed a marked improvement on increased exports, in particular raw materials, indicating that the pace of deficit expansion may have begun abating. The current account deficit in the first nine months of 2004 was fully covered by large net FDI inflows, which totaled US\$1.3 billion or 1.4 times as big as the deficit. There were no problems about the country's external liquidity given its increasing foreign exchange reserves. JCR considers that growing imports of investment goods and raw materials are unlikely to pose any serious concern over the medium term since they will contribute to expanding the country's production capacity and exports. However, deficit financing needs close monitoring.

EU accession in 2007 will be officially approved

With a parliamentary election scheduled for June 2005, the government has been maintaining a prudent fiscal policy and has taken a set of tightening measures in cooperation with the central bank, such as a moderate fiscal spending cut equivalent to 0.8% of GDP, an increase in the minimum reserve requirement and transfer of government deposits from private banks to the central bank. JCR considers that all these measures will prove effective in curbing the strong domestic demand and gradually narrowing the trade deficit. In its 2004 Regular Report released on October 6, the European Commission positively evaluated the progress the Bulgarian government has made on economic and fiscal reforms, while pointing to slow progress on reforms of the judiciary system and measures to combat corruption. It is highly likely, therefore, that Bulgaria's EU accession in 2007 will be officially approved at the upcoming session of the European Council. Before its actual accession, Bulgaria needs to sign the EU treaty, call a national referendum, ratify the EU treaty and agree with the EU on financial assistance. At the present stage, JCR sees Bulgaria's EU entry in 2007 as a strong possibility. JCR will consider upgrading its ratings when the country's accession becomes a certainty.

Main Economic Indicators: The Republic of Bulgaria

		1999	2000	2001	2002	2003	2004 (f)	2005 (f)
Real GDP growth rate	(%)	2.3	5.4	4.0	4.8	4.3	5.3	4.8
CPI (annual average)	(%)	2.6	10.3	7.4	5.8	2.3	6.5	4.6
Lending rate	(%)	12.8	11.5	11.1	9.3	8.8	9.3	9.0
Unemployment rate	(%)	16.0	17.9	17.3	16.3	13.5	12.6	11.5
General government balance/GDP	(%)	-0.2	-0.6	-0.6	-0.6	0.0	0.0	0.0
General government debt/GDP	(%)	86.7	79.5	70.2	56.0	47.9	42.5	41.9
Current account balance	(US\$mn)	-652	-703	-984	-823	-1,666	-1,231	-1,239
Current account balance/GDP	(%)	-5.0	-5.6	-7.2	-5.3	-8.4	-5.2	-4.4
Trade balance/GDP	(%)	-8.4	-9.3	-11.6	-10.2	-12.5	-12.6	-11.0
Net foreign direct investment	(US\$mn)	8.2	998	803	876	1,398	2,168	1,850
Net foreign direct investment/GDP	(%)	6.2	7.9	5.9	5.6	7.0	9.1	6.5
Import coverage	(months)	5.3	4.9	4.7	5.8	6.1	5.5	5.3
Forex reserves / ST external debt	(times)	2.3	2.2	2.7	2.4	2.5	2.1	1.9
External debt/GDP	(%)	84.3	88.9	78.1	71.8	66.2	64.2	61.7
External debt/ exports (G&S)	(%)	188.3	160.0	146.7	139.6	124.0	110.0	107.5
External public debt/ exports (G&S)	(%)	163.2	133.0	119.2	103.5	85.1	60.9	51.1
Debt service ratio	(%)	18.0	16.7	20.9	16.3	12.4	12.3	11.0

Note: figures for 2004 and 2005 are based on JCR's projection.

Sources: Bulgarian National Bank, Ministry of Finance

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