

Bulgaria (the Republic of)

Foreign LT: BBB/Stable, Local LT: BBB+/Stable (Upgraded on May 9, 2005)

Main Factors for the Ratings

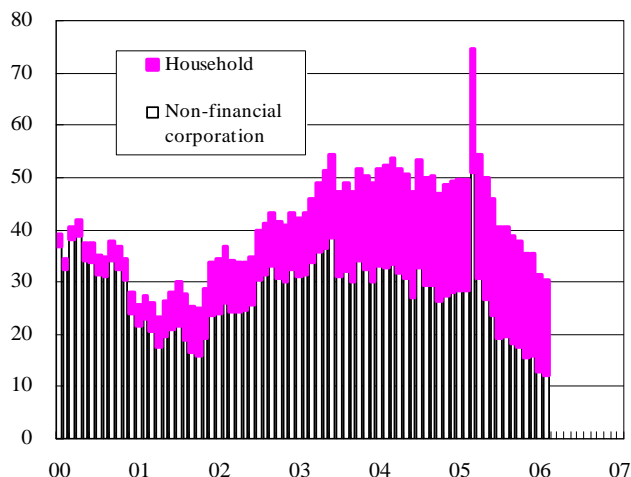
Positive Factors

- Progress on political, economic and fiscal reforms in pursuit of EU accession.
- Prudent fiscal management and considerable reduction of government debt.
- 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.
- Private external debt continues growing due mainly to low-level domestic savings.

(%) **Bank Lending to the Private Sector (YOY)**



Updated: from January 2006 to March 2006

Positive Factors

- The government repaid EUR340 million in debt to the IMF and World Bank ahead of schedule. Consequently, the general government debt was reduced further to 27.9% of GDP in February 2006 from 32.4% at the end of 2005.
- In a bid to get a favorable evaluation by the European Commission for EU accession in 2007, the government and judicial authority tightened measures to fight corruption and amended related legislation.
- The IMF approved the result of the second review based on its stand-by agreement with Bulgaria.
- The government averted an increase in the import price of natural gas from Russia under an agreement with Russian Gazprom.
- The general government fiscal balance in 2005 registered a substantial surplus of BGN990 million or 2.3% of GDP.
- Real GDP growth rate in 2005, though slightly down from the previous year, remained strong at 5.5%.
- Year-on-year growth of bank lending to the private sector decelerated to 30.5% in February 2006.

Negative Factors

- Current account deficit in 2005 swelled 1.2 fold year-on-year to EUR2.5 billion or 11.8% of GDP.
- Consumer price inflation accelerated to 8.8% year-on-year in February 2006 on rises in food prices and excise duties on tobacco and alcohol.

<Prospects and Noticeable Points>

EU accession date due to be decided by this summer

(1) Economic growth strong yet unbalanced

Real GDP growth rate in the October-December quarter of 2005 slowed slightly to 5.5% year-on-year from 6.1% in the first half of 2005. For 2005 as a whole, the economy remained strong as it grew by 5.5%. The growth continued to be unbalanced, however. While domestic demand surged on expansion of consumer spending and gross fixed capital formation, external demand contributed negatively to the economic growth with stronger imports outpacing exports. The rapid growth of bank lending to the private sector, which had pushed up consumer spending, decelerated to 30.5% in February 2006 from almost 50% at the end of 2004, owing to a series of restrictive measures adopted by the central bank. However, real wage increases and improved employment continued to support strong consumer spending. Exports started recovering after remaining slow due to the impact of the flood damage last summer. The consumer price inflation rate rose to 8.8% year-on-year in February 2006, due mainly to rises in food prices caused by the floods and major hikes of excise duties on tobacco and alcohol. JCR expects the Bulgarian economy to return to sustainable growth path with more than 5% annually in 2006 and 2007. Implementation of additional restrictive measures on bank lending by the central bank and price inflation may slow down domestic demand, but the impact will be eased by recovery of exports. Consumer price

inflation, however, is set to rise to around 5.5% in 2006 due primarily to the increases of excise duties in January 2006.

(2) Current account deficit likely to remain large for a while as investment outpaces domestic savings

Due to a widened trade deficit, the current account deficit in 2005 more than doubled year-on-year to a record EUR2.5 billion or 11.8% of GDP. The large trade deficit equivalent to over 20% of GDP stemmed from surging imports driven by strong domestic demand and higher energy prices. In contrast, both services and transfer balances stayed in marginal surpluses on increased tourism revenues and subsidy from the EU. Over the coming years, the annual current account deficit may improve slightly as imports decline on a moderate slowdown of domestic demand, but is likely to remain large as investment outpaces domestic savings. The current account deficit in 2005 was mainly covered by FDI inflows (equivalent to 8.7% of GDP). However, the external debt indicator (excluding public-sector debt) deteriorated slightly on increased private-sector debt.

(3) A restraint fiscal policy to be kept in place; government debt reduced substantially

The general government fiscal balance in 2005 ended with a substantial surplus equivalent to 2.3% of GDP. Much of the surplus stemmed from increased revenues brought by strong domestic demand, although expenditures increased due to rehabilitation measures taken in the wake of the flood damage. The government initially envisaged a balanced budget under its draft budget for 2006. However, it later agreed with the IMF to dampen strong domestic demand with the aim of attaining a fiscal surplus equivalent to 3.0% of GDP. Accordingly, the government is expected to keep a restraint fiscal policy in place under the 2006 budget. The general government debt decreased further to 27.9% of GDP in February 2006 from 32.4% at the end of 2005.

(4) JCR may consider upward revision of the ratings

Since taking office in June 2005, the three-party coalition led by the Bulgarian Socialist Party has adhered to its priority policies — promotion of reforms in pursuit of EU accession in January 2007 and maintenance of a prudent fiscal policy and the currency board regime. Prior to its EU accession, Bulgaria has to win a favorable evaluation by the EC of the progress it has made on the remaining issues (elimination of corruption, combat against organized crime, reform of the judicial system, etc.) as required by the EC. Moreover, the Accession Treaty must be ratified by all 25 EU member countries. There is some progress on the remaining issues as the government and judicial authority tightened anti-corruption measures and amended related legislation. The EC evaluation will be made in the monitoring report due out in May 2006. If Bulgaria wins a favorable evaluation, a decision on a date for its EU accession in 2007 will be made public in the middle of 2006. (Depending on developments, the EC can postpone an accession date to 2008). The Accession Treaty looks likely to be ratified by all 25 EU member countries, though there remains some negative impact of the French and Dutch rejections of the EU Constitution. More than 10 countries have so far ratified the Treaty, following ratification by Netherlands in February 2006.

It is highly likely that the coalition will be able to push through the remaining issues since a two-thirds majority it commands in parliament provides it with a power to amend the Constitution without much difficulty. JCR expects that the government will be able to secure the country's EU accession in January 2007.

Main Economic Indicators: The Republic of Bulgaria

		2001	2002	2003	2004	2005	2006 (f)	2007 (f)
Real GDP growth rate	(%)	4.1	4.9	4.5	5.6	5.7	4.8	5.0
CPI (annual average)	(%)	7.4	5.8	2.3	6.1	5.0	6.8	5.0
Unemployment rate	(%)	17.3	16.3	13.5	12.2	11.5	10.5	9.8
General government balance/GDP	(%)	-0.6	-0.6	0.0	1.7	2.3	2.8	1.0
General government debt/GDP	(%)	69.9	55.8	48.0	40.7	31.7	24.6	20.8
Current account balance	(EURmn)	-1,102	-925	-1,630	-1,131	-2,531	-3,015	-2,998
Current account balance/GDP	(%)	-7.3	-5.6	-9.3	-5.8	-11.8	-12.6	-11.4
Trade balance/GDP	(%)	-11.7	-10.2	-12.5	-15.1	-20.4	-18.8	-18.2
Net foreign direct investment	(EURmn)	895	951	1,827	2,243	1,856	1,950	2,450
Net foreign direct investment/GDP	(%)	5.9	5.8	10.4	11.5	8.7	8.1	9.3
Foreign exchange reserves (excl. gold)	(EURmn)	4,061	4,575	5,309	6,301	6,690	7,300	8,500
Import (G&S) coverage	(months)	5.2	5.6	5.7	5.6	4.8	4.6	4.6
Forex reserves / ST external debt	(times)	3.7	3.0	3.5	2.6	1.9	1.7	1.8
External debt/GDP	(%)	78.6	65.1	60.5	64.2	67.8	71.0	73.7
External debt/ exports (G&S)	(%)	147.4	126.1	112.5	111.8	112.7	112.0	116.4
External public debt/ exports (G&S)	(%)	113.8	87.4	70.0	51.8	34.1	23.1	15.3
Debt service ratio	(%)	20.8	16.4	14.1	23.2	44.3	25.0	16.4

(Note) Figures for 2005 and 2007 are based on JCR projection

(Sources) Bulgarian National Bank, Ministry of Finance

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