

## Bulgaria (the Republic of)

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

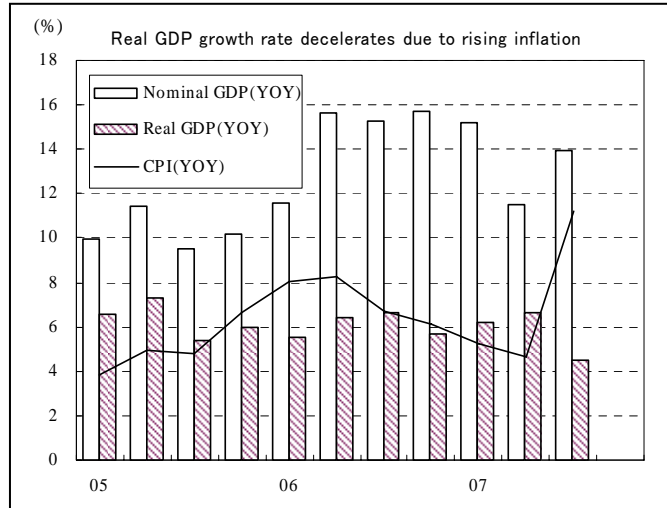
### <Rating Perspective>

#### 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 FDI inflows 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 October to December, 2007>

#### Positive Factors

- The parliament approved the 2008 budget plan envisaging a fiscal surplus equivalent to 3.0% of GDP (Dec. 20)
- The government unveiled its convergence report, pledging to keep a fiscal surplus equivalent to 3.0% of GDP through 2010.
- The general government fiscal balance in the first eleven months of 2007 registered a substantial surplus equivalent to 8.0% of GDP (BGN4,503 million)
- The ratio of government debt to GDP declined further to 20.4% at the end of October 2007
- The unemployment rate (Eurostat) fell to 5.8%, the lowest on record, in November 2007
- FDI inflows in the first eleven months of 2007 totaled EUR4,524 million, covering more than 100% of the current account deficit in the same period

#### Negative Factors

- The consumer price inflation (Eurostat) surged to 11.4% year-on-year in November 2007 on higher food prices caused by bad weather conditions
- The current account deficit in the first ten months of 2007 widened to 15.9% of GDP (EUR4,554 million) from 10.5% in the same period of 2006
- Bank lending to the private sector swelled by 58.4% year-on-year in October 2007
- Fifteen MPs left the ruling coalition partner, the National Movement for Stability and Progress, and formed the Bulgarian New Democracy faction

### <Outlook and Points to Watch>

#### FDI inflows in excess of C/A deficit

##### (1) The economy remains strong

Bulgaria's real GDP growth rate decelerated on the negative effects from last summer's drought, posting a 4.5% year-on-year growth in the July-September quarter of 2007, down from 6.6% the previous quarter. The economic momentum remained strong as the growth of nominal GDP in the same quarter accelerated to 14.5% year-on-year from 11.5% the previous quarter. The surging bank lending to the private sector showed no sign of deceleration. Its year-on-year growth rose further to 58.6% in October 2007, despite the Bulgarian National Bank's increase of the minimum reserve requirement ratio to 12% from 8% in September. Meanwhile, increased employment created amid the strong economic expansion has contributed to a marked reduction of the unemployment rate. The unemployment rate (Eurostat) dropped to 5.8%, the lowest on record, in November 2007. The consumer price inflation (Eurostat) climbed to 11.4% year-on-year in November 2007 on higher food prices brought by the unfavorable weather conditions.

## (2) Ample external liquidity and FDI inflows ease 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 ten months of 2007 already reaching 15.9% of GDP (EUR 4,554 million), up from 10.5% in the same period of 2006. The large current account deficit was primarily attributable to the widening trade deficit which grew substantially to reach 20.2% of GDP in the first ten months on strong imports of energy as well as 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 more than 100% of the deficit. Furthermore, net financial inflows centering on bank loans helped the foreign exchange reserves swell to a record EUR 9,198 million at the end of October 2007, equivalent to nearly five months of imports.

## (3) The government maintains restrictive fiscal policy

The government has been keeping a restrictive fiscal policy with the aim of curbing domestic demand. The general government fiscal balance in the first eleven months of 2007 registered a substantial surplus equivalent to 8.0% of GDP (BGN4,503 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 in line with the levels projected in the budget. The projected fiscal surplus equivalent to 2.0% of GDP under the 2007 budget plan is highly likely to be achieved. The favorable fiscal developments boosted the fiscal reserves to BGN9,445 million (16.9% of GDP) at the end of November 2007. The ratio of government debt to GDP declined further to 20.4% at the end of October 2007 from 23.0% at the end of 2006 thanks mainly to advanced loan prepayments.

The government envisaged a bigger fiscal surplus equivalent to 3.0% of GDP in the budget for 2008 while pledging to maintain a restrictive fiscal policy. The budget called for higher tax rates on alcohol, tobacco and energy and a unified 10% rate on personal income in lieu of the current progressive tax rate. Given the coalition government's weak approval rating as it lost both the European parliamentary and local elections in 2007, there is the possibility of budget spending being increased ahead of the general elections scheduled in 2009. JCR will closely watch how the government will steer its fiscal policy.

## (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 2008 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, with the deficit covered by FDI inflows and the foreign exchange reserves steadily expanding.

### Main Economic Indicators: The Republic of Bulgaria

		2003	2004	2005	2006	2007 (f)	2008 (f)	2009 (f)
<b>(Convergence criteria for adopting the euro)</b>								
1. CPI (annual average)	2.3%(note)	6.2	6.1	7.5	7.2	7.4	6.5	5.0
2. 10 year government bond yield	5.6%(note)	6.4	5.4	3.9	4.2	4.5	4.3	4.0
3. General government balance / GDP	Below -3.0%	-0.9	2.2	1.9	3.3	5.0	3.0	3.0
4. General government debt / GDP	Below 60%	45.9	37.9	29.2	22.8	19.5	18.2	17.5
Real GDP growth rate	(%)	5.0	6.6	6.3	6.1	6.5	6.0	6.0
Unemployment rate	(%)	13.7	12.0	10.1	9.0	6.9	5.9	5.0
Current account balance / GDP	(%)	-5.5	-6.6	-12.0	-15.5	-19.8	-20.5	-18.7
Trade balance / GDP	(%)	-13.7	-14.9	-20.2	-22.2	-24.2	-25.5	-24.7
Net foreign direct investment / GDP	(%)	10.3	14.6	13.0	16.8	18.7	14.9	11.9
Net foreign direct investment / C/A balance	(%)	190.2	209.4	118.4	112.2	97.2	76.0	67.3
Forex reserves (excl. gold)	(EURmn)	5,309	6,854	7,370	8,926	10,000	10,000	10,500
Forex reserves / monthly imports	(months)	5.7	6.1	5.3	5.2	5.0	4.4	4.1
Forex reserves / ST external debt	(times)	3.5	2.8	2.0	1.5	1.4	1.0	1.1
Gross external debt / GDP	(%)	60.1	63.8	69.0	77.6	85.7	88.9	89.6
Gross external debt / exports (G&S)	(%)	113.2	112.5	115.8	120.5	136.9	141.3	136.8
Gross public external debt / exports (G&S)	(%)	70.5	53.2	33.9	22.7	16.8	13.8	10.7
Debt service ratio	(%)	14.2	23.3	44.3	26.5	28.5	20.8	15.4

(Note) Figures for criteria 1 and 2 are annual average between December 2006 and November 2007. Figures for 2007- 2009 are projection made by JCR

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

(Toshihiko Naito, Senior Analyst)