

2004-30
September 22, 2004

Bulgaria (the Republic of)

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

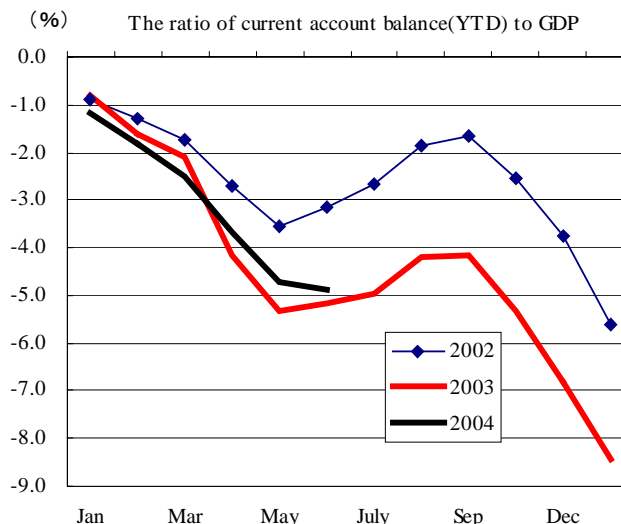
Main Factors for the Ratings

Positive Factors

- Progress in 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 due to the expansion of private-sector debt.



Updated: from June 2004 to August 2004

Positive Factors

- Negotiations for EU entry were completed on June 14.
- Consolidated fiscal balance for the first six months of 2004 registered a large surplus of Lev878 million or 2.3% of GDP.
- Some progress has been made in the privatization of seven state-owned electricity distribution companies and Bulgarian Tobacco.
- Foreign direct investment (FDI) in the six months to June 2004 totaled US\$1,179 million, a 1.6-fold increase year-on-year.
- Unemployment rate dropped to 12.06% in June, the lowest level since December 1998.

Negative Factors

- The current account deficit in the six months to June 2004 totaled US\$1,591million, or 4.9% of GDP.
- Bank lending to private sector in June continues to grow by 50.9% from the year earlier.
- Inflation picked up 7.6% year-on-year in July.

<Prospects and Noticeable Points>

Rating outlooks revised to positive in August

JCR revised rating outlooks from stable to positive in August, primarily in consideration of a stronger provability that Bulgaria's EU entry may materialize in 2007 as envisaged by the government, following the conclusion of negotiations over the *acquis communautaire* (the laws and rules adopted on the basis of the EU founding treaties). In order to attain EU accession, a country must have its political, economic and budgetary systems in tune with those of the EU through *acquis communautaire* negotiations. If Bulgaria implements what has been agreed in the negotiations, it will be able to establish systems that ensure economic and corporate activities to the extent the EU does. Such systems will not only enhance economic and corporate activities but also promote a further inflow of FDI. In addition, after its EU accession, Bulgaria will be able to receive more financial assistance from the EU, which will contribute toward accelerating its economic development.

Expanding domestic demand and current account deficit

Bulgaria's real GDP grew 5.3% year-on year in the January-March quarter of 2004, up from 4.9% in the previous quarter. While consumer spending growth declined to 5.2%, gross capital formation showed strong growth, rising 21.4%. Imports surged 17.7% year-on-year, surpassing the growth of exports. The economy showed signs of excessive demand amid strong consumer spending spurred by a 50% gain in consumer credits and accelerating investment triggered by massive inflows of FDI. 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. The unemployment rate remained high, though it fell to 12.06% in June, the lowest level since December 1998, amid economic expansion and the policies

implemented by the government. As the government maintained a prudent fiscal management, the consolidated budgetary balance registered a large surplus in the six months to June on increased tax revenues. The current account deficit in the six months to June narrowed marginally from the year before, reaching US\$1,591 million or 4.9% of GDP.

Current account deficit fully covered by FDI inflows

Bulgaria's large current account deficit stems from strong imports of FDI-related investment goods and raw materials, which are to be turned later into products for export. In the six months to June, the deficit narrowed modestly due primarily to a larger transfer account surplus and a reduced income account deficit. However, the trade deficit during the six-month period continued to expand as much as 50% year-on-year. JCR considers that increased 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, short-term financing of the deficit needs close monitoring. In the first half of 2004 alone, the deficit was fully covered by large FDI inflows totaling US\$1,179 million, mainly driven by the privatization of Bulgarian Telecom. Furthermore, liquidity remained sufficient as the foreign exchange reserves rose to US\$7 billion at the end of June.

Current account deficit expected to improve moderately after mid-2005

The surging bank lending to the private sector needs to be monitored since it could lead to economic overheating. However, given the country's stable financial system and the banking industry's sound financial position, the ongoing development can be positively evaluated as indicating recovery of the financial intermediary functions played by banks. To cope with the swelling bank lending, the government and the central bank have taken measures such as a moderate fiscal expenditure 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. All these measures are expected to prove effective in curbing the strong domestic demand and bank lending, and gradually narrowing the current account deficit after the middle of 2005.

Focal point is coalition government's fiscal management prior to general election

The government maintains a prudent fiscal policy and has already adopted measures to contain the current account deficit. Furthermore, the privatization of state-owned Bulgarian Telecom was accomplished in June and there has been some progress in the privatization of seven electricity distribution companies and Bulgarian Tobacco. JCR holds the view that there is little possibility of the current reform path being abandoned before the country's planned EU accession in 2007. However, considering the possibility of parliament being dissolved and an election called well before the next general election scheduled for June 2005, JCR will closely watch if the government can hold fast to its policy of sound fiscal discipline.

Main Economic Indicators: The Republic of Bulgaria

		2001	2002	2003	2004 (f)	2005 (f)
Real GDP growth rate	(%)	4.0	4.8	4.3	5.0	4.5
CPI (annual average)	(%)	7.4	5.8	2.3	6.8	4.9
Lending rate	(%)	11.1	9.3	8.8	9.2	8.8
Unemployment rate	(%)	17.3	16.3	13.5	12.7	11.5
General government balance/GDP	(%)	-0.6	-0.6	0.0	0.0	0.0
General government debt/GDP	(%)	70.2	56.0	47.9	43.4	40.7
Current account balance	(US\$m)	-984	-823	-1,666	-1,815	-1,733
Current account balance/GDP	(%)	-7.2	-5.3	-8.4	-7.7	-6.5
Trade balance/GDP	(%)	-11.6	-10.2	-12.5	-12.2	-10.2
Export good & service		7,236	8,053	10,602	13,521	15,725
Import good & service		8,415	9,164	12,476	15,626	17,658
Net foreign direct investment	(US\$m)	803	876	1,398	1,800	1,350
Net foreign direct investment/GDP	(%)	5.9	5.6	7.0	7.5	4.7
Import coverage	(months)	4.7	5.8	6.1	5.9	5.7
Forex reserves / ST external debt	(times)	2.7	2.4	2.5	2.3	2.3
External debt/GDP	(%)	78.1	71.8	66.2	63.7	58.5
External debt/ exports (G&S)	(%)	146.7	139.6	124.0	111.7	106.8
External public debt/ exports (G&S)	(%)	119.2	103.5	85.1	69.5	63.0
Debt service ratio	(%)	20.9	16.3	12.4	11.8	10.8

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

Sources: Bulgarian National Bank, Ministry of Finance

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