

Economy

Sound fiscal policy has maintained budget surpluses

Labour shortage for skilled and unskilled workers

Current account deficit driven by trade gap

Foreign investment expected to remain buoyant

Eurozone membership now scheduled in 2012





EU funds in 2008 are expected to support infrastructure projects

Holding steady

Strong domestic demand is helping the economy

The general consensus among economic analysts is that Bulgaria could see a growth rate of over 6% in 2008 as a result of a high level of investment and EU funding for infrastructure.

Despite hitting a rough patch in the third quarter of 2007, Bulgaria's economy still ended the year at a rate of 6.2% growth due mainly to fixed capital investment and strong domestic demand. A strong fourth quarter showing of 6.9%, following a slowdown in the previous three months, somewhat mitigated the negative effects of a severe drought that wreaked havoc within the agriculture industry. Indeed, agricultural output, mainly grains, plunged in year-on-year (y-o-y) value added terms by 43%. This drop also caused a severe rise in food prices, pushing inflation at year-end up to 12.5%.

POWERING THE ECONOMY: Otherwise, manufacturing and services continued to lead the economy. Economists say that if agriculture were stripped from the equation, the growth rate for 2007 was around 10% in real terms, as manufacturing, construction and services grew at double-digit rates.

Services currently make up around 60% of GDP, of which financial intermediation services are playing an increasingly stronger role, registering a 40% y-o-y rise in the first nine months of 2007 and a 54% growth in value added against the same period in 2006.

The industrial sector, which contributes 31% to GDP, is also growing at a brisk pace. In March 2007 industrial sales grew by 9.8% and production jumped 8.7% compared to March 2006, according to the National Statistics Institute. Construction, which has grown 10% in the last two to three years, rose 16% by the third quarter of 2007, stated the state Agency for Economic Analysis and Forecasting (AEAF). Further, the manufacturing and processing industry grew by 15% in real terms despite the restructuring of one of the country's largest copper plants, Cumerio.

Meanwhile, exports grew at double-digit rates in the last two quarters of 2007. However, the country's seemingly unquenchable thirst for investment goods and raw materials caused the trade deficit to widen further, which in turn has driven up Bulgaria's current account deficit. Yet Dimitar Chobanov, chief economist at the non-governmental Institute for Market Economics

(IME), told OBG he believes output of Bulgarian manufacturing companies will remain competitive and their shares of EU markets are growing. He said that despite the slowdown of the EU economy, Bulgarian companies' export capacities would not be strongly affected.

While the turmoil on international markets has not yet affected Bulgaria, many local economists have not discounted the possibility it still could. Bulgaria is a very open country so there are chances of a spillover effect but to what magnitude is hard to say. The country's ballooning current account deficit has made Bulgaria more vulnerable to external developments.

That said, barring any major fallout from the international credit crunch or another bad year for agriculture, the consensus is that a growth rate of over 6% is achievable for 2008 due to a continued high level of investment and EU funds for infrastructure and human capital development. The third quarter drop in 2007 is seen as a one-off as a result of a regional drought and the resulting devastated harvests. Although it is impossible to make a safe long-term prediction about the weather, there have been encouraging signs for 2008, such as more snowfall in the winter of 2007-08 than the previous year, meaning more runoff for irrigation.

EU FUNDING: Officials have pinned their hopes on EU funds in 2008, which if put to good use would substantially shore up the country's ailing infrastructure and flagging agriculture – though questions remain over the country's ability to successfully absorb the money.

Nonetheless, EU money is expected to have a major impact, especially for the country's infrastructure. The funds are expected to give a huge boost to the transport sector by financing new infrastructure like motorways and railways. This will also have a knock-on effect for the burgeoning tourism industry, which has received a shot in the arm with the arrival of low-cost airlines. According to Stanislav Novakov, deputy-chairman of the state agency for tourism, international tourism accounts for 9.3% of GDP. When coupled with services, this reaches a total of 14% of GDP. The tourism industry also

Excluding agriculture, the economic growth rate in Bulgaria in 2007 was about 10% in real terms with manufacturing, construction and services rising at very high rates.

makes up 2.3% of employment, he said. Elsewhere, agriculture will receive about €500m. The money will help the sector but there are still a bevy of problems to overcome that have dogged the industry for years, such as a severe shortage of milk in the dairy sector.

Looking to the state's own coffers, the government says it will continue to run a tight fiscal ship in 2008.

SITTING ON A SURPLUS: Prudent fiscal policies led to a budget surplus of 3.8% of GDP in 2007. This is well above the initially budgeted 2% of GDP and slightly higher than the 3.6% seen in 2006. The IMF has cited growing economic activity, increased employment, higher imports and higher inflation, as well as improved tax collection to explain the revenue windfall.

The official goal for 2008 is 3.5%. However, the AEF has lowered its target to 3% due to revenue reasons, namely the three-percentage-point cut in social contribution rates implemented in October 2007.

Economists say the budget surplus should be stable for the next three years. The government is working to restructure spending, putting more emphasis on capital expenditures, with an eye to expected EU funds. In its 2007 annual report, the IMF said, "Authorities have decided to use part of the revenue windfall to step up the investment programme in the most-needed sectors. The bulk of the supplementary fiscal expenditures is mainly for infrastructure projects which includes road construction and construction of water purification stations and sewerage systems. Most relates to co-financing EU-financed projects for regional development, environment, rural development and transport."

With elections scheduled for 2009, there is a concern politicians will be tempted to use the surplus to engage in populist spending policies. However, Chobanov told OBG he does not expect any loosening of fiscal discipline in 2008, saying European Commission monitoring will keep the local authorities in line as a diminished surplus would put the country at risk of breaching the EU's stability and growth pact.

The introduction of a flat 10% corporate and income tax is also expected to bring in more revenue, Chobanov said, as lower taxes generally help root out the grey economy. To counter any potential shortfall, a hike in indirect taxes has broadened the tax base.

The tax cuts are seen as an incentive for attracting more foreign investors, said Chobanov. The institute is lobbying the government to eliminate minimum reserve requirements for setting up firms in Bulgaria and to reduce the red tape that currently inhibits the easy start-up of a business. The implementation of a single electronic business register is seen as a big step forward in improving the business environment, he said. In another move to attract more investors, the government has introduced legislation that will include incentives to encourage investments in underdeveloped areas. Bulgaria is awaiting the green light from the EU to offer incentives to attract investments in equipment and plants as well as for training employees.

A double-tax treaty with the US that is awaiting US ratification is expected to take effect in 2009. When it does, it is anticipated to have a major impact.



Prudent fiscal policies led to a budget surplus of 3.7% in 2007

INVESTMENT DRIVE: Foreign direct investment (FDI) has grown considerably for the third consecutive year. In 2006 investment reached a record high of €4.4bn, a 40% increase on 2005. Bulgaria has attracted 20% of overall investments in South-eastern Europe and ranks first in Central and Eastern Europe in terms of FDI to GDP (16.4%), according to the state's investment arm, InvestBulgaria Agency. Foreign capital investment reached 32% of GDP in 2006 compared to 28% in 2005.

Stoyan Stalev, executive director of InvestBulgaria, told OBG there were 25 big investors coming through the agency in 2006. This shot up to 62 in 2007. He said that he expects total investment for 2007 to reach €5bn, which is an almost 20% jump over 2006 figures.

That said, he noted that a breakdown in investment sectors shows a huge imbalance. Namely, 60% of FDI has gone into real estate, tourism and commerce and about 30% into production. "This must change in order to have sustainable growth," Stalev said. Towards this end, in 2006 the investment law was amended so that only investments in production will receive state support. Those areas include energy, education, high-tech industries and medicine, among others. State initiatives include accelerating the administrative processes and giving individual services for local support. "We are also supporting the municipalities in terms of infrastructure upgrades in order to meet investors' needs," he said. "I expect this will reduce the number of investors coming through our agency but we are trying to forge a

Due to a cut in social contribution rates, the AEF has targeted a 2008 budget surplus of 3%, which is slightly lower than the government's official mark of 3.5%.

Main trading partners & investors, 2005 (\$ m)

Exports		Imports		Trade balance		FDI stock	
Italy	1407	Russia	2850	Germany	3637	Austria	4061
Turkey	1231	Germany	2483	Italy	3045	Greece	1224
Germany	1154	Italy	1638	Russia	3002	Italy	824
Greece	1107	Turkey	1104	Turkey	2335	UK	819
Belgium	701	Greece	913	Greece	2021	Hungary	697
Total	11,762	Total	18,224	Total	29,986	Total	12,020

SOURCE: Bulgarian Central Bank, New Europe Research Network



While annual average inflation stood at 8.4% in 2007, the government expects it to slow to 4.5% in 2008

Credit grew by 60% in Bulgaria in 2007. However, rising interest rates are making it more difficult for banks to borrow overseas, thus easing domestic demand for credit.

more competitive market. We must focus on new production possibilities and new niche fields for production as simply relying on services and tourism will not underpin durable growth. For example, we are eyeing producing automotive parts to export regionally as well as high-tech, software and electronics products.”

He said that despite a shift in focus, tourism would always contribute a significant amount to GDP. However, the main reason behind efforts for production-linked investments is to keep the skilled workforce in the country. “There are about 40,000 Bulgarian students in EU universities and we want them to come home and apply the knowledge they have gained,” Stalev said.

Although industry has attracted a meagre share of FDI, it has seen the bulk of overall fixed capital investment. According to the AEA, the sectors that drew in the largest investments in the first half of 2007 were the processing industries (20.6%), followed by electricity-producing companies (17.3%) – as a result of environmental and expansion programmes, construction (14%) and transport (12.3%).

Still, Stalev said it is imperative Bulgaria attract more production-linked investments and increase exports in light of the country’s current account deficit, which was 21.6% of GDP in 2007. The World Bank said in its EU8+2 regular economic report in January 2008 that current account deficits “represent the greatest vulnerability to deteriorating international conditions”, with little prospect of turnaround in Bulgaria in the near future. Net FDI covered 92% of the current account deficit as of November 2007, according to local reports. Keeping investment flows high throughout 2008 will be the main challenge in light of global inflationary pressures and drying liquidity. Local authorities will also have to wrestle with inflationary woes of their own.

HOTTING UP: The 2007 summer drought caused food prices to soar, pushing inflation up to 12.5% y-o-y in December, the highest level seen since 2000. Annual average inflation stood at 8.4%. Higher energy prices and excise duties in 2008 are expected to maintain infla-

tionary pressures but authorities have said the sharp rise in consumer prices was a one-off due to poor grain crops. They expect inflation to slow to 4.5% at the end of 2008. AEA officials said they expect a 5% increase in electricity prices and a 10% increase in heating in 2008 as a result of the rise in natural gas prices.

But while supply-side problems were the main instigators of rising prices in 2007, stronger demand from rising wages is expected to exacerbate the problem this year. The IMF has weighed in on the situation, saying that wage growth needs to be tamped down to keep inflation in check. This will prove to be difficult as there has been increasing pressure coming from doctors, teachers and social workers. The expected growth in nominal wages for 2008 is 15% in both the public and private sectors, according to the IMF.

Rising credit growth and consumption are also factors. Credit rose by around 60% last year. Most of the growth was generated by companies seeking financing to upgrade equipment. Basically the factors spurring inflation are the same as those behind the current account deficit. The evolution of money creation is growing faster than the production of goods and services, meaning there is the danger of overheating. The savings rate is poor in Bulgaria compared to other EU states where the average savings rate to GDP is around 20% as opposed to 16% in Bulgaria.

State officials are optimistic though that building up production capacities to bolster the supply side, as well as high investment rates, will help cool down the economy. Officials say that they expect to see consumer demand steadily met over the years and perhaps go into the negative by 2010. In addition, rising interest rates have made it somewhat harder for banks to borrow as easily from abroad, thus easing domestic pressure that stems from cheap credit.

For now the central bank has been urged to take measures to slow down credit growth, but as the monetary policy is constrained by the currency board, the bank has little room to manoeuvre. Its only real tool is to set minimum reserve requirements (MRRs) and some administrative measures. The bank has increased MRRs for local commercial banks from 8% to 12% of deposits, though credit continued to accelerate as banks continued to easily borrow from abroad, as returns are still high in the country. A central bank official told OBG the institution will wait to see whether the market takes care of the situation with higher interest rates in 2008 before it decides to take further action. The central bank expects about 35% to 40% credit growth in 2008.

OUTLOOK: The leading economic concern in 2008 is the world financial situation, which some believe will inevitably affect Bulgaria. State officials have said if there is a long-term global economic downturn Bulgaria’s growth rate would fall to about 5.5%, but if it is short the economy will continue to grow at 6% and above. The main economic issues for Bulgaria in 2008 are the current account deficit and inflationary pressures that are coming to bear on the market. Investment is expected to stay mostly buoyant although not as high as in 2007, which was a very strong year in terms of FDI.

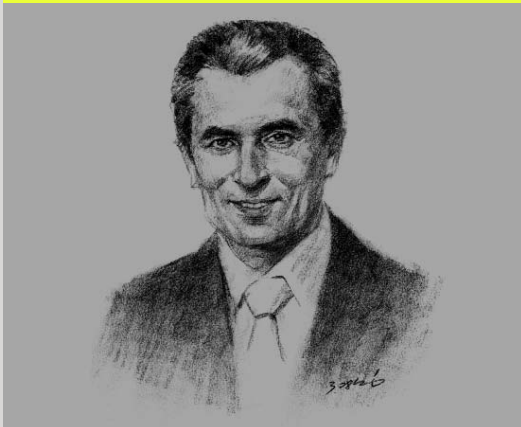


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Plamen Oresharski

Holding the line

Plamen Oresharski, Minister of Finance, on Bulgaria's economic and fiscal policy in 2008

The fiscal policy challenge this year is to assist in deepening the country's macroeconomic stability despite volatile financial market conditions and liquidity stagnation. At the same time, we have to work to preserve the conditions that have provided for relatively good economic growth rates in recent years. The factors specific to the Bulgarian economy are the existing monetary regime based on a currency peg established by the currency board and the low price and income levels in Bulgaria compared to average European levels. Additional issues include the current account deficit, which has widened to around 20% of GDP, and the higher level of inflation in 2007. In this context, the fiscal policy objectives include maintaining macroeconomic equilibrium, encouraging economic growth, continuing reforms in key public sectors such as education and health care, reducing the number of public sector staff, and improving the quality of public services.

Mainly as a result of large-scale foreign direct investment, the current account deficit is continuing to increase and is expected to reach around 20% for 2007. The ensuing high domestic demand in combination with the unfavourable price trends for oil and basic foodstuffs has led to an increase in inflation to 11.6%. This preconditions the necessity to continue to base our fiscal policy on positive budget balances. After the budget surpluses of 3.3% in 2006 and 3.8% in 2007, we have planned for a 3% budget surplus in 2008 and an additional 0.5% special reserve in the expenditure part of the budget for the purposes of fiscal sustainability. We continue to limit the total amount of public expenditure to below 40% of GDP, which is a budget rule that guarantees development in the private sector. We are anticipating a gradual reduction in foreign investment in the medium term, which will reverse the trend in domestic demand and in some economic imbalances. We expect the current account deficit in 2008 will not increase and inflation to be limited to 6.9%.

As a result of the significant investments made in recent years, a favourable business environment has

been created thus increasing economic activity. We expect economic growth to continue to be above 6% as it has been in the last three to four years.

The sustainability of the monetary regime and the currency peg are supported by the country's increasing foreign exchange reserves. The sources include the inflows of foreign investment, which finance the current account deficit at over 100%, and the budget surpluses realised in the last couple of years.

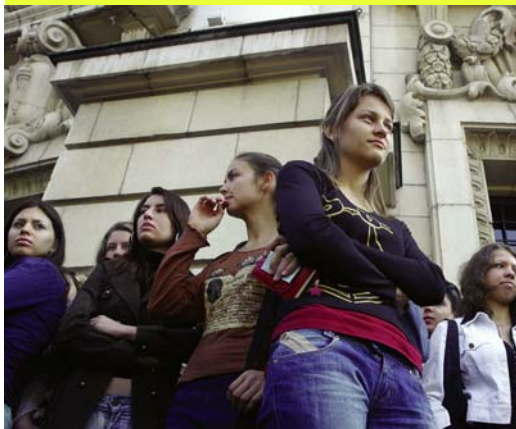
The 2008 budget continues the tax policy – adopted in recent years – of reducing direct taxes. After reducing the total level of social security contribution to 33% from 43% and establishing a 10% corporate income tax rate, we have also reduced the personal income tax to the same level – a single rate of 10%. We expect this policy to bring additional revenue as a result of the widened tax base and to contribute to reducing the share of illegal and non-taxable income.

The reforms in the administrative system are expected to include a planned 12% reduction of staff in the public sector. Besides the fiscal savings and the reserves for improved remuneration of key specialists, this measure will help us to meet the emerging shortage of qualified specialists in the labour market.

In 2008 municipalities will have the opportunity to determine, for the first time, the level of local taxes. This is an important step in the process of fiscal decentralisation that has been carried out in recent years.

Deepening the programme nature of budgeting and improving control over public expenditures will further contribute to raising the public sector's effectiveness.

In summary, the current fiscal programme maintains the positive direction adopted in recent years – a policy of budget surpluses, controlling public expenditure and containing it within economically acceptable limits, and decreasing direct taxes thus making for greater overall collection. What is different is the focus on the public investment programme for the sectors most directly related to human capital – education and health care, and on a process of fiscal decentralisation.



There is an acute labour shortage for skilled and unskilled workers

Understaffed

A labour shortage creates a bonanza for job seekers

During the days of communism workers who landed jobs in Bulgaria would hang on to their positions without question until they were ready to retire. In those times, it was normal for 10 candidates to apply for a single job vacancy. Currently a complete reversal is being witnessed and it is now the employee who is in the driver's seat on the back of a fast-moving economy and plunging unemployment rates, especially in the cities. Today one job-seeker can choose from among 10 job vacancies, according to a local recruitment agency.

LABOUR SHORTAGE: This also reflects the fact that the country is facing an acute labour shortage for skilled and unskilled workers, as Bulgarians are heading to higher paid jobs elsewhere. This has, in turn, created pressure to increase wages at home.

"The unemployment rate is about zero in Sofia but it is approximately 7% nationwide. It is rare to meet an applicant who does not already have a job," said Elitsa Yankova, a permanent placement executive at the local recruiting agency Manpower. According to government data, the unemployment rate in the country as of January 2008 was 7.37%, down from 9.67% a year earlier. The National Statistics Institute reported in September 2007 that workers' average monthly pay increased 20% year-on-year while 17.6% of industrial enterprises said they were understaffed.

Yankova noted workers are overpaid in all sectors, especially at the managerial level within the IT and finance industries. "IT jobs are seeing wages rising 30% to 35% and overall wages rising by 20%. Many weak Bulgarian companies will disappear and only the big ones that have the financial muscle to pay for skilled workers will stay in the market," she said.

The IMF and the European Commission (EC) have sounded the alarm over salary hikes, saying further increases need to be tamped down to keep inflation in check. An IMF official in Sofia said this would be difficult considering the number of qualified people who have left the country for jobs elsewhere in

Europe and North America. Meanwhile, doctors, teachers and social workers are increasing pressure on the government for better pay. The expected growth in nominal wages for 2008 is 15% in the public and private sectors, said the IMF official.

In a report on Bulgaria's convergence programme for 2007-10, the EC stated: "Fiscal institutions and public sector wage policy need to contribute to overall wage moderation in line with productivity gains."

The state's Agency for Economic Analysis and Forecasting said the labour shortage, for certain types of qualifications, was one of the reasons why wage increases in 2007 were slightly higher than labour productivity. Agency officials said the problem will persist in 2008 but they do not expect it will last. The agency said it anticipates wages will increase by 4% to 5% a year over the next few years, in line with productivity. "This is our expectation, but we will see what happens," an agency economist told OBG.

EDUCATION IS KEY: The government needs to step forward and begin revamping the country's aged educational system so students can gain the skills required in the fast-moving job market. Calls have been made for the government to draft an outline showing which sectors will need industry-specific skills and then adapt school curricula to match. Often new employees are in need of about three to six months of training that the employer has to pay for.

"The government needs to listen to businesses and invest in research and development," a member of a local recruiting agency said. "A lot of government officials still do not recognise the problem but will face reality if a raft of businesses pack up and leave the country in two or three years."

There have also been complaints that Bulgarian legislation restricts employers from bringing in qualified workers from abroad. There have been some talks on introducing a "green card" system to allow foreigners to live and work in the country but the project has not moved beyond the discussion stage.

More people are leaving the country in search of better-paying jobs elsewhere. As a result, Bulgaria is facing an acute labour shortage, which is coupled with rising wages, especially in the IT and finance industries.

The government anticipates that wages will increase by 4% to 5% a year over the next several years. These are expected to be in line with overall labour productivity.



André Bergen

New opportunities

OBG talks to André Bergen, CEO, KBC Group

Following the acquisition of Bulgaria's DZI Insurance and EIBank, what kind of role does the country now play in your overall global strategy?

BERGEN: In 1997 KBC decided to develop what we call the second-home market. Initially we bought up banks and insurance companies in the Visegrad countries and the original EU countries. In 2007 we decided to expand our business to the new EU countries by playing the convergence game. The acquisition of EIBank in September 2007, in addition to our majority stake in DZI, offers an ideal opportunity to start developing the bancassurance model in the high-growth Bulgarian market. We have already made the decision to focus on the countries in which we are already present and not to make any further expansion into new countries for the duration of 2008. The focus now is to further develop the concept of bancassurance with DZI and EIBank.

Given the strong competition in Bulgaria, is there a risk that margins will shrink or that the rate of NPLs (non-performing loans) will increase?

BERGEN: Regarding margins, I think ultimately that you will see in Bulgaria what you see in all central and eastern economies. The more they grow the more financial intermediation develops and you will see margin pressure appear, which is quite normal. However, we have significant experience in other emerging European markets and we reckon this margin erosion in our modelling and pricing before we decided to enter the market. Although it didn't appear in 2007, I think we will see some convergence in credit margins. How long it will take is open to speculation. I do not think that the rate of NPLs is a major concern, as today we see a robust environment in Bulgaria, but you really can never ignore that with a weakening economy you can see an increase in provisioning levels. However, right now we are still looking at a robust environment and we do not see any evidence of deterioration in NPL levels in our bank.

Is the relatively low purchasing power of Bulgarian citizens one of the major obstacles to the growth of the life insurance market?

BERGEN: It probably is, but having said that, it's a question of time. Purchasing power levels will increase as you see in all new EU countries and looking further back, at Spain, Portugal and Ireland when they first joined the EU. Bulgaria will follow this path. We should also take into account that the first pillar, the pension system, is relatively moderate and people will increasingly invest in pillar two and three systems, leading to a growth in life insurance products. This may take a number of years, but when we invest in a country, it is never for the short term. Today life premium income is approximately 0.3% of GDP. That will increase. The insurance market was at first essentially a car insurance market. Then wealth levels increase and people start to buy houses with mortgages and start to reinsure their property, which is the second wave. In the third, wave rising wealth levels will lead people to start thinking about retirement and start investing in pension schemes and life insurance products. The same thing should happen in Bulgaria.

Do you consider the country's widening current account deficit to be a threat to the economy?

BERGEN: It is not currently a problem, but it needs to be addressed. On the one hand there has been rapid credit expansion and a widening deficit and a rising external debt. This is something you see in the early stages of the development of emerging economies. However, the rising external deficit due to increased internal consumption is an issue that needs to be addressed. For now this has been covered by foreign direct investment (FDI), but it needs to be viewed in the context of an increasingly challenging international economy and FDI could slow down, leading to a widening external deficit. The authorities should be wary. It is not an issue currently, but if it were to slip, it could become a major one.



Exports have been growing at 8% to 11% a year since 1997

A balancing act

Capital levels are low and returns are high

A major issue facing Bulgarian authorities is the country's ballooning current account deficit that is being driven by an ever-widening merchandise trade gap. The central bank reported that the country's current account deficit increased in 2007 to a preliminary 21.6% of GDP (€6.18bn) against 15.7% in 2006. While the deficit had been predicted to be 18.5% at the end of 2007, an upswing in year-end holiday consumption and a rise in fuel imports caused a sudden surge.

Kalin Hristov, advisor to the central bank's governor, told OBG the current account deficit is certainly an issue. He said it is not driven by uncompetitive exports, as they have been growing at 8% to 11% in real terms every year since the introduction of the currency board in 1997. Causes for the deficit include a low savings rate, about 16% of GDP, a steady inflow of capital, and high returns of 30% to 36% that are enjoyed by investors.

STRUCTURAL ISSUES: "It is not about monetary policy, but rather it is structural: capital levels are low and returns are high," Hristov said. "We are going to have a high current account deficit until internal capital is high here. Over time returns will lower and capital inflows will slow." He added that it is investment goods like machinery and raw materials that are driving the deficit. Along with energy resources for production, these items constituted some 85% of total imports, estimated at about €20bn, for the first 11 months of 2007, according to the National Statistics Institute.

"A lot of investment is going into real estate, retail and offices, which creates a problem for the trade balance," Hristov said. "For example, we have three factories for steel production and five factories for cement production yet we are still importing steel and cement. There are also worries about the deficit because Bulgaria is not borrowing in its own currency. However, by adopting the euro, payment balances will improve. We have to reduce profits here and make the capital/labour ratio much higher to reduce the return on capital."

Officials at the state's Agency for Economic Analysis and Forecasting have attributed the growing deficit

to the high level of investments in the country over the last three to four years. The floods in 2005 and the drought in 2007 also had a negative impact on exports.

A process of export restructuring is underway, with many plants closed and expansion plans kicked off. An agency official told OBG, "The main driver is the merchandise deficit. So, in light of the large amount of investments over the years, the deficit is basically not a concern. Fundamentally, it is due to market forces and the strong role played by the private sector."

IMF CONCERN: Still, the IMF has said the government needs to take measures to get the deficit below 20% of GDP within three years. The IMF does not expect the economy to suffer a hard landing, but global financial events have made that seem more likely. The IMF said that despite the deficit rising above sustainable levels, external competitiveness has remained adequate. "But, underscoring growing external vulnerabilities, the net international investment position is projected to deteriorate to about 65% of GDP, while gross external debt could soar to about 88% of GDP," the report added.

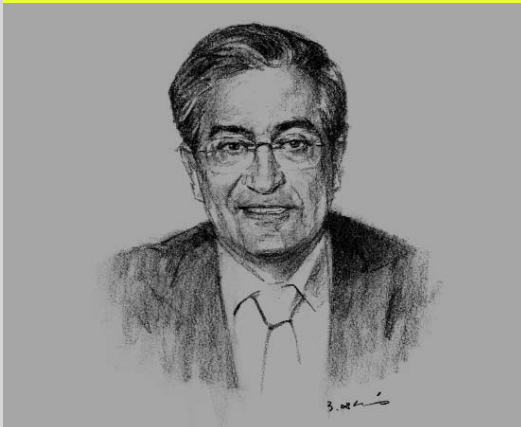
Local economists say the gap has most likely reached its peak and 2008 will see a slight narrowing.

Narrowing the trade gap will hinge on a recovery in agricultural production, the development of industries based on export and an expected drop in imports, say economists. Consumption may see a decrease as the central bank has moved to rein in lending by raising minimum reserve requirements. Commercial banks have been more cautious in handing out credit as a result of dropping global liquidity. While the country's currency is pegged to the euro, under the currency board the central bank has no real monetary tools to deal with the issue. However, the government's fiscal policies have been prudent as the country recorded its fourth consecutive yearly budget surplus in 2007.

Foreign direct investment will continue to cover a large portion of the deficit in 2008. A slight drop in inward investment is expected owing to the international credit crunch but coverage is expected to remain above 90%.

Bulgaria's rising current account deficit is not a major concern to local officials who say it is mainly due to a widening merchandise trade gap.

While local analysts believe the trade gap has reached its peak and will slightly decrease in 2008, the IMF is still raising concerns about external causes.



Anand Seth

Natural reformer

OBG talks to Anand Seth, Director for Bulgaria, Croatia and Romania, World Bank

You worked closely with the government on EU accession. What were the major challenges and how satisfied are you by the way they were resolved?

SETH: Bulgaria was already a natural reformer by the time the EU accession process picked up steam. The country was coming out of a financial meltdown in 1997 and the whole of society wanted to avoid any hint of a repetition of this phase. It was not difficult for the World Bank and the IMF to convince people why reform was necessary. And like most reform processes, once the reasons “why” have been accepted, the “what” and the “how” of reform become easy. People realised they could not continue to pump money into various loss-making state enterprises; they had to get their fiscal house in order. The percentage of economic activity in private hands in Bulgaria was 60% four years ago, but when it entered the EU it was already at 75%, which is where the Czech Republic and Poland are now. While many of the main challenges revolved around the EU’s political criteria, such as public governance, judicial reform and anti-corruption, there were also challenges such as education that were not part of the accession agenda but were very important to society.

The IMF’s “Doing Business” report ranked Bulgaria one of the world’s top-10 reformers in 2007. In what major areas has the country seen improvements?

SETH: Bulgaria’s strong showing in the report was based on the particularly successful reform of the country’s revenue and tax administration. It is almost a textbook model for other developing countries. Not only has the revenue base increased, the collection systems are friendly to the taxpayers. Because the revenue base is solid it has been possible to reduce labour and corporate taxes. Over the last three years corporate tax revenues have risen by 3.7% while the taxation rate has declined. Other measures taken in the last 12 months and the introduction of flat rate personal income tax last year will mean further improvements in the future. However, there are other weaknesses. Whenever the

justice system has to intervene in the process of doing business, things slow down and confidence in the system is reduced. There is still much that remains to be done on regulatory reforms and judicial system support in order for Bulgaria to become a top performer.

What practical measures can be undertaken by the government to make it easier to set up and run a company in Bulgaria?

SETH: The non-judicial part of making it easier to set up a company has largely been done but the results will only show in a year or two. The simplification of the tax forms and system, and the introduction of e-filing are well underway. The issue is the interface between business and the judicial system, which need significant strengthening. At the urging of the EU and support of the government, we have a major collaborative exercise underway, which will hopefully result in a clear five-year action plan for the modernisation of the judicial system. We believe the government will keep us involved through the implementation phase as well.

What are the major obstacles to Bulgaria’s future convergence with EU economic standards in the long term? How can they be resolved?

SETH: The bottom line is Bulgarian incomes are only 40% of the EU25 average and productivity is 37%. The two are related. There was a period two or three years ago when productivity growth rose to 4% but it is back to the trend line at 2%. At this rate real income convergence is some sixty years away. The main agenda has to be to work on reforms areas that affect labour force productivity such as the freedom of labour markets, the skills of the workforce, investment in research and development and also on demographic issues. Experts in these fields can help define the reform agenda. However, the beacon that existed when the whole society was focused on EU accession, when policymakers could make tough choices in pursuit of this goal, is no longer there now that EU accession has been achieved.



The government is keen to find its place at the ECB table

Euro inflation blues

Inclusion in the single economic union is still a ways off

Bulgaria's inclusion in the eurozone, originally scheduled for 2010, has been set back. It is now hoped to take place some time around 2012, with eventual entry into the single economic zone being conditional on continued fiscal prudence and lower inflation. The government and the central bank, the Bulgarian National Bank (BNB), have dropped their original deadline for adoption of the European single currency. In fact, Bulgaria has yet to join the Exchange Rate Mechanism II (ERM II), the "waiting room" for euro membership, amid worries about its inflation rate and external trade imbalances. Reluctance by other EU member states to expand the eurozone due to political and economic concerns may also be a factor in the delay, with stricter enforcement of membership criteria being applied.

Bulgaria applied to join the ERM II when it signed the EU accession treaty in January 2007, with inclusion expected by the end of that year, possibly within the first half of the year. However, as of February 2008 the country remained outside the mechanism. As there are no specific requirements for entering ERM II, other than EU membership, this has caused no little frustration, particularly as the Bulgarian currency is already hard-pegged to the euro through the currency board, which was initiated in 1997 as a response to the financial crisis then taking place.

MEMBERSHIP BENEFITS: One benefit of joining the eurozone would be the elimination of transaction costs with member businesses, with which Bulgaria currently conducts 60% of its trade. Beyond that, the government is keen to make the symbolic move of adopting the euro and taking its place at the European Central Bank (ECB) table, finally locking it into the world's largest economy. The real advantage would be to underline the country's economic stability and thus encourage continued investment.

There have been recent rumblings in the press – swiftly and unequivocally quashed by the BNB and the government – that a devaluation of the lev, in

part to reduce the deficit, may be on the cards. The potential chaos this could cause, with capital flight from lev-denominated assets, would likely be a blow to the country's economy and its euro ambitions. Once in the eurozone, Bulgaria will have removed the possibility of its currency coming under speculative attack, lessening the chances of such a crisis.

RULES OF THE GAME: In order to become a full member of the eurozone, Bulgaria must fulfil five convergence criteria laid out in the Treaty on European Union, signed in Maastricht in 1992. This includes price stability such that inflation must be no higher than 1.5% above the average of the three eurozone members with the lowest non-negative rates. The government's deficit must be no higher than 3% of GDP at the end of the fiscal year preceding entry. The gross government debt must not exceed 60% of GDP. The country's currency must have been locked into the ERM II for two years without devaluation or exchange rate fluctuations outside a specified band around the euro. Finally, the country's long-term nominal interest rates must not exceed those of the three member states with the lowest inflation.

While these broad criteria, there are additional specifications and allowances. Most importantly, Bulgaria does not necessarily have to have achieved the budgetary goals set, but it must be close and making clear progress towards them. On the other hand, not only must the inflation target be met, the country's price stability must be sustainable. Bulgaria is well within the fiscal boundaries given the government's policy of running surpluses. It is also within the interest rate band as a result of the currency board. However, the inflation rate is well above the EU target – and looks set to stay there for some time to come. Not only must Bulgaria significantly reduce inflation, the ECB will have to be convinced it will not spike after the country joins the eurozone.

While the original ERM members were allowed to overshoot the criteria outlined at Maastricht at times

Despite applying for eurozone membership upon EU accession in January 2007 and hoping to join by 2010, new estimates place the entry date for some time in 2012.

Eurozone membership would underline Bulgaria's economic stability, encourage investment and remove the local currency from wild speculative fluctuations.



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prior to the adoption of the euro, the ECB appears to be taking a considerably more stringent approach with applicants from Central and Eastern Europe. In March 2006, Lithuania registered inflation that was 0.03% above the ECB's then 2.6% maximum. Its application for eurozone membership at the beginning of the next year was rejected. Similarly, in early 2008, scepticism surrounded Slovakia's ability to sustain its low inflation, despite the Bratislava government's confidence in its ability. As Kalin Hristov, advisor to the BNB's governor, told OBG, joining the eurozone now will be "much more difficult than for the first wave, as the ECB is more conservative".

Most observers, including the IMF, say the delay in Bulgaria joining the ERM II is largely due to worries in the ECB and European Commission about Bulgaria's inflation and current account deficit, both of which grew considerably last year. By the end of 2007, year-on-year inflation had hit 12.5%, up from 6.5% in 2006, and the current account deficit in the first 11 months of the year was 18.5% of GDP, up from 15.8% in the same period of 2006, according to the BNB. The current account is not a criterion for eurozone membership, let alone joining ERM II, but it has added to fears about the sustainability of Bulgaria's growth, as have rampant credit growth and a possible real estate bubble, according to Gabriella Rozenova, a researcher at ING Bulgaria.

POLITICAL CONCERNS: A September 2007 report by the global ratings agency Fitch suggested the issue of inclusion in the eurozone might be further complicated by political questions surrounding Bulgaria's 2007 accession to the EU. "The topic of ERM II membership is very sensitive," Rozenova told OBG. "Some thought that Bulgaria had been let into the EU too soon and the decision to let the country enter ERM II appears to have been delayed by politics, even though European finance ministers themselves have all expressed their strong support."

Despite the setbacks in 2007, Bulgaria seems likely to join ERM II at some stage in 2008 as inflation eases, according to analysts. Progress from then on will focus on continuing to bring inflation down and keeping it low before the unofficial date for eurozone membership, which is in 2012. No new official date has been set as there are concerns about the damage to Bulgaria's standing that could result from missing another "deadline" for monetary union. The general expectation is that membership could happen between 2011-13 without triggering serious worries about further slippage. However, the path is far from clear of obstacles.

The forecast for 2008 and the next few years is cautiously optimistic. The inflation figures for 2007 are likely to have been just a temporary spike. Global food and fuel costs rose significantly during the year, and wage pressures have added to demand and supply shock throughout the country. However, according to Hristov, core inflation in 2007 was around 5.5%. Bulgaria has one of the tightest fiscal policies in Europe and plans a 3% budget surplus this



Bulgaria's inclusion in the eurozone is now scheduled to take place some time around 2012

year to counter risks arising from its current account deficit.

The current government says it is committed to running fiscal surpluses, and, despite its rhetoric, the opposition would be very wary of a loosening, according to Rozenova. The global credit crunch and the slowing of US demand may do Bulgaria a favour by draining liquidity and easing commodity prices. A few domestic factors may also lend a hand. The government's hiking of alcohol and tobacco duties early in 2006, rather than steadily over several years, in the expectation that the inflationary effect would fade by 2010, is likely to pay off. Similarly, price increases that have followed the liberalisation of the electricity market should have dissipated.

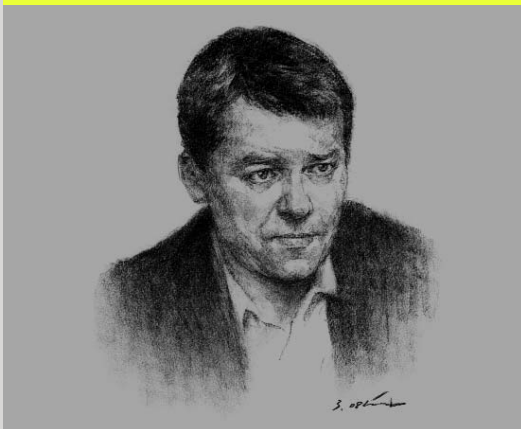
FLAT TAX: Furthermore, while the IMF has been sceptical about the 10% flat tax on individual income that was introduced in January 2008, Rozenova said she believes it will have a disinflationary effect by benefitting more affluent people who are likely to invest the money and by delivering more money into workers' pockets, easing wage demands.

Nonetheless, pressures remain. On the supply side, productivity and workforce participation are relatively low. Meanwhile, dampening demand is more difficult, due to a dearth of monetary levers for the BNB, high growth and EU funds pouring in. In September 2007 the central bank increased banks' minimum reserve requirements but is unlikely to increase them further due to the disproportionate effect it would likely have on small Bulgarian banks, which find it harder to access credit abroad.

However, given the political dimension of the single currency and jitters over the sustainability of Central and Eastern Europe's growth, an easing of the membership criteria now seems very unlikely. According to the current rules, Bulgaria will have to have a measured pace in its progress towards joining the eurozone, keeping its tight fiscal stance and hoping that external pressures on inflation ease.

Year-on-year inflation reached 12.5% in 2007, up 6% from the previous year. The current account deficit hit 18.5% of GDP in the first 11 months of 2007 – causing concern about the sustainability of Bulgaria's growth.

The government says it plans to have a budget surplus of 3% in 2008 in an effort to mitigate the risks posed by the country's current account deficit.



Milen Ivanov

Situations vacant

OBG talks to Milen Ivanov, Managing Partner, Jordan Sheppard

Which sectors are most affected by human capital shortages and in which skill category?

IVANOV: Basically, there are problems of human talent at every level in Bulgaria. At first the shortage was most keenly noted in the lack of good managers, as the socialist system had not equipped people with the necessary experience to run a business. This shortage then spread to IT workers and engineers, but it has become a feature of every sector of the economy – there is currently a particular shortage in experienced project managers. Five years ago a job advert would be met with 50 good CVs, now it might receive one or two. Unemployment in Sofia is effectively zero and this means that companies frequently have little option but to hire staff without the requisite experience or to mould positions to suit their candidates. In many cases, a company can have an efficient supply chain and strong demand from customers, but its growth is held back due to a lack of human resources. Right now, Bulgaria is an employees market, dictated by the candidates. The biggest challenge is to establish a corporate culture able to retain and motivate the people, and that could take quite a few years to implement.

What reforms need to be made to the education system so that it can better suit the business world and the needs of employers?

IVANOV: Education should not only be designed for an initial stage of when people start to work, but also adopt the concept of life long learning and target educational programmes to older people as well. We are an ageing country, but some of them could be educated and trained to different jobs and include them in a corporate environment.

We should also be more open to external talent. Being a gate to Asia, we should position ourselves as a strategic country in order to attract people from different places, not only to come to Bulgaria for vacation, but we should also promote ourselves as a good

country to work in. This would solve problems in different areas where we lack human resources.

There is also a lack of business education. There is a big difference between what students learn at university and a real business environment.

How can managers curb the rising cost of labour?

IVANOV: They can't avoid paying more money for their staff, but what they can do is focus more on money for value. To be competitive you have to raise salaries, but you should be careful to whom you employ. There are other things that also motivate people to work. For example, the sense of appreciation you get from the employer, the personal attitude they might get from their direct manager. When people can make a choice, they will opt for the place where they feel happier. Nowadays people want a good balance between work and their personal life. It is a world trend that is also true here in Bulgaria.

Is brain drain still a problem for Bulgarian business, and how can Bulgaria retain and attract its talent back to the country?

IVANOV: I don't think that is such a problem now, even with Bulgaria in the EU. I think that the people that wanted to leave have left already. I assume there will be a normal immigrant-emigrant balance now.

We are actually seeing an interesting trend now. A lot of people that have been out of Bulgaria for the last four or five years are currently looking for an opportunity to come back. They are cautious and not in a hurry; they're looking for the right thing for themselves. They want to come back and be somebody in Bulgaria, and I think they have experience and a lot of knowledge to give to the market.

And they have a better chance of getting a job in Bulgaria than an expatriate, because the companies also look for people that know the Bulgarian market. So I think we are actually going to see a lot of skilled Bulgarians coming back to settle down.