

THE ECONOMY OF BULGARIA - JANUARY 2012

SUMMARY REPORT

Of the Center for Economic Development

Full text of the report can be found at www.ced.bg

MACROECONOMIC DYNAMICS. Since the second or third quarter of 2010 the real volume of the **gross domestic product** of the Bulgarian economy has started again to grow on an annual basis, i.e. the trend for growth has been recovered. So far, however, this trend is still weak and difficult, although in the third quarter of 2011 it just slightly accelerated compared to the growth in the second quarter.¹ The highest pre-crisis levels of the major macroeconomic aggregates have not yet been reached. Latest data from NSI by the third quarter of 2011 show that the volume of GDP has still to catch up until it recovers to its highest pre-crisis level (from the fourth quarter of 2008), since currently it is by 4.4% below it.² Reaching pre-crisis volume of GDP is likely to be expected in the fourth quarter of 2012. In case the European economy stabilizes faster, the recovery can be expected even in the third quarter. In the event of more complicated international environment the recovery may be delayed and may occur even in 2013.

The slowdown in growth of Bulgaria's key partners continues and this makes us expect short-term slowdown in the country - in the last quarter of 2011, until at least mid-2012. Meanwhile the tendency to balance the structure of growth continues - the contribution of the industry is shrinking at the expense of services (by the production side of GDP), respectively reducing the contribution of net exports, while an increase in the contribution of domestic demand (by the use side of GDP). For the fourth quarter of 2011, growth will not exceed 2% and so for the year it will be around 2%.

In the third quarter of 2011 economic growth was almost as in the second one. On an annual basis GDP increases by 2.3%, value added has increased by a little more – by 2.6%, the pace of remedies³, however, significantly narrowed, and indicates a contraction in the positive effects of foreign trade, which was observed in the initial stages of recovery. Value added in the economy is relatively close to its highest pre-crisis level (by 2.6% below it), and because “Remedies” is lagging behind by 15.8% from its pre-crisis maximum. GDP for the third quarter of 2011 is by 4.4% below the pre-crisis maximum (fourth quarter of 2008).

Separate components of the economy entered the crisis at different times and will exit it at different times. *Sector "Operations with Real estate"* started to shrink first (8.2% share in GDP for 2010). The highest pre-crisis level of value added in the sector is in the last quarter of 2006. For the third quarter of 2011 it was 16.7% below that level, i.e. the sector is far from reaching it, although in the second quarter it started to recover its growth on an annual, and on a quarterly basis. In the third quarter growth dynamics, however, deteriorated, especially given the deep

¹ More specifically, it accelerated by seasonally not adjusted data, and slowed down by adjusted data.

² Rates compared to the highest pre-crisis volume have been calculated from data, based on 2005 prices, seasonally adjusted, and corrected for differences in the number of work days.

³ Remedies consist of taxes on products (excise duties, VAT) less subsidies on products.

decline in the first quarter of 2011, sector *"Operations with Real estate"* is in general expected to demonstrate a decline.

The second sector to start a decrease below its pre-crisis maximum (of the fourth quarter of 2007) was sector *"Professional activities and scientific research, administrative and support activities"* - one year after the peak in the "Operations Real Estate" sector. The significance of the sector for the economy is relatively low with a share of 4.6% of GDP (2010). In the recent few quarters, the actual volume of value added of the sector is trying to shorten the gap to the pre-crisis level. It is expected that for the last quarter of 2011, it is likely to show growth, on an annual, and on a quarterly basis, growth is expected in general for the whole year.

The industry, sector *"Mining and quarrying; manufacturing; production and distribution of electricity, heat and gas fuels; water supply; sewage, waste management and recovery,"* which has the largest share in GDP (20.6% for 2010) had its pre-crisis maximum in the first quarter of 2008. Data show relatively steady trend of reaching to the peak from early 2010 onwards, but for the third quarter of 2011 annual growth slows down, and on a quarterly basis a decline is registered. The downward trend of the business climate and the slowing growth rates of monthly production on an annual basis in the last months of the year are an indication to expect deterioration in the dynamics of value added in the fourth quarter. For 2011 as a whole the sector is expected to show growth due to its better performance in the first half of the year. Reaching the pre-crisis level is unlikely to happen before the end of 2012, or early 2013.

Maximum pre-crisis volume of value added in agriculture (*"Agriculture, forestry and fishing"* with a 4.6% share in GDP for 2010) was in the second quarter of 2008. Since then, the distance from the pre-crisis maximum is significant and deepens periodically. For the third quarter of 2011 it is by 11.5% below it. Decline is expected for the fourth quarter and for the whole year on an annual basis, particularly given the estimate of NSI (*Economic Accounts for Agriculture*) for about 15% smaller volume of real value added compared to 2010.

In the third quarter of 2008 sector *"Creating and distributing information and creative products; communications"* reached its pre-crisis maximum in the volume of value added. Despite its small share in GDP (4.8% in 2010), this sector stands out among all others as the one, which already - in the third quarter of 2011 - has exceeded its pre-crisis maximum. Growth on annual, and on quarterly basis for the second and third quarters are reasons to expect that the sector will report growth both in the fourth quarter, and for the whole 2011.

Sector *"Construction"* (with 6.4% share in GDP for 2010) had its maximum volume of value added in the fourth quarter of 2008. Throughout 2011, it already stands at over 30% below its maximum. Data from business surveys and monthly data on construction output at the end of 2011 show downward trends. For the fourth quarter and for the whole year the sector will end with a decline on an annual basis, although not as deep as in the previous two years.

In the first quarter of 2009 the value added of *"Trade, repair of motor vehicles and motorcycles; transportation and storage; hotels and restaurants"* demonstrates its maximum in volume, followed by sharp and deep drops. Although fluctuating, the sector is going fairly quickly to restore its pre-crisis volume, and in the third quarter of 2011 is only by 4.3% below it. After industry, this sector is second in importance to our economy with a 16.8% share of its value added in GDP (2010). Business surveys and monthly turnover data at the end of 2011 give grounds to expect that *"Trade ..."* will register growth both in the fourth quarter, and on an annual basis.

Sector *"Culture, sports and entertainment; other activities; Activities of households as employers; Undifferentiated activities of households producing goods and services for own consumption;*

Activities of extraterritorial organizations and bodies” has the least weight in the overall economic growth. Its share in GDP for 2010 is only 2%. The sector had a pre-crisis maximum in the second quarter of 2009, and in 2010 it ended with nearly 10% annual decline. In the second and third quarters of 2011, on annual and on quarterly basis it registered growth, which slowed down in the third quarter. For the year it is likely to register growth, but weak, barely enough to cover the deep drop in 2010.

In the conditions of global financial and economic crisis the only *sector in the country which remains unaffected is "Financial and insurance activities."* In the period 2000 – 2007, even in the very crisis in 2009, it grew by double digit rates. In 2010, however, its growth was only 1.2%. The sector's share in GDP was 6.7% (2010). The maximum pre-crisis level of value added of the sector was in the first quarter of 2010. After two consecutive declines on annual and on quarterly basis (until the last quarter of 2010, and the first quarter of 2011), declines relatively deep due to the high base, the value added of the sector continues to grow in the second and third quarters of 2011, but at slow pace. Perhaps the pace will be low both for the fourth quarter and for the year as a whole, and it is quite possible the trend to turn negative. However, in the third quarter of 2011 the sector was only 2.2% below its maximum pre-crisis level and will probably reach it again in the second half of 2012.

The second sector that had a late pre-crisis maximum - just in the first quarter of 2010 - is *"Government; Education; Human Health; and Social Welfare."* In the first half of 2011 the value added of this sector registered declines on annual basis and very weak growth on a quarterly, and its dynamics for the third quarter is about zero. Bearing in mind this, growth can hardly be expected for the whole 2011.

Among the aggregates **on the use of GDP** the furthest back in time - in the first quarter of 2008 - was the pre-crisis level of *Exports of Goods and Services*. It was soon exceeded - in the third quarter of 2010. For the third quarter of 2011 it is by 10.8% above it. This is due solely to the dynamics of exports, which exceeded its pre-crisis maximum early in the second quarter of 2010. For the second quarter of 2011 *exports of goods* is by 17.5% above its pre-crisis peak, while *exports of services* is by 8.5% below its own. For the fourth quarter of 2011 and first half of 2012 we expect relatively low annual growth of exports of goods and services, due to the high base. For 2011, as a whole this component will be the only one with positive growth, and with positive contribution to overall economic growth.

Two of the major components on the use side of GDP - *imports of goods and services* and *investments* registered their pre-crisis maximum in the second quarter of 2008. In the third quarter of 2011 they are respectively by about 16% and 37% below it. The new rates in imports of goods and services on an annual basis (which are positive since the second quarter of 2010) show that in the third quarter of 2011 they have for the first time outpaced those of exports of goods and services. This may be associated with the growth of final consumption, while investments continue to register declines on an annual basis.

The dynamics of *investments* is not improving. For the third quarter of 2011 they decline on annual and on quarterly basis, and the quarterly is quite deep. There is no particular reason to hope that in the fourth quarter of 2011 this decline will turn into growth and thus for the whole year a downturn is expected, albeit weaker than that for 2010.

Final consumption had its pre-crisis maximum in the fourth quarter of 2008. In this period, however, individual consumption had already decreased due to individual consumption of households (the latter had its pre-crisis maximum in the first quarter of 2008). For the fourth

_____, but weaker than in the second and third quarters, and is likely to remain by about 7% lower than its pre-crisis maximum. For the year as a whole, growth will be below 2%.

In the short term the industry will continue to be the growth driver in terms of economy's sectoral structure, and is already joined in this by services such as "*Creating and distributing information and creative communication*" and "*Professional, scientific and research activities; administrative and support activities.*" The latter in turn can be considered an indication of progress in the important for the economy development of innovative economic activity. On the demand side – it is expected that the shrinking contribution of net exports of goods and services will be supported by a sustained growth trend, though weak, in final consumption and a contraction in investment decline, most likely in the second half of 2012.

The current account for the eleven months of 2011 is positive and amounts to euro 1.1 billion, while for the same period a year ago it was negative, though by a small amount (euro 165.3 million). In proportion to GDP, it amounts now to 2.9% of GDP⁴, at a deficit of 0.5% of GDP in January - November 2010. A major factor for the increase of the current account balance continues to be a shrinking in *trade deficit*. The positive *balance on services* improves slightly on an annual basis almost half of the improvement is due to the increase in the positive balance under item *Travel*. The negative balance under *Income* is growing. *Current transfers (net)* continue to show positive value. ***For the whole 2011 the current account will be positive, probably euro 0.8-1 billion. For 2012 it can be expected to remain positive, but much smaller.***

Foreign trade continues to perform surprisingly well against the background of very limited growth in the eurozone and reduced domestic demand in our major economic partners. For eleven months of the year, the total turnover increased nominally by 25%, and the growth of trade with EU countries exceeds that with third countries. Total *exports (FOB)* increase by 30.6% and reach nearly euro 18.5 billion and *imports (CIF)* grow by 20.6%, reaching almost euro 21 billion. The *trade balance deficit (FOB/CIF)* decreases by 23.5% compared to the 11 months of 2010, and amounts to euro 2.5 billion (6.3% of projected GDP, compared to euro 3.2 billion and 8.9% of GDP a year earlier).

Observed trends in 2011 in the *commodity structure* of trade are not particularly favorable. Over 60 per cent of exports consist of raw materials and energy resources, and these exports grow at a much faster pace - 38-40% than the other two product categories - investment (32.4 percent) and consumer (14.3 percent). Among raw materials the fastest growth pace is that of agricultural commodities (by nearly 50 per cent), and of non-ferrous metals (37.7 percent). As to *the geographic structure*, despite signs of slowdown in the economy and the shrinking markets, trade continues its EU orientation. Exports for the EU grow at a higher rate than average (33.1 percent) and imports - at lower (19.7 percent), leading to a decrease in negative trade balance of over 57 per cent just for one year. The main export markets are Germany, Romania, Italy, Greece. In the trade with third countries, the trend is reversed - due to increased prices of fossil fuels the growth rate of exports (26.5 percent) is slower than total, while imports (21.8 percent) are growing faster than the rate of total imports, and the deficit in the trade balance with third countries increases (by 6.6 per cent). Nearly 50 percent of exports to countries outside the EU is oriented to five countries - Turkey, Russia, Serbia, Macedonia and Ukraine.

⁴ With gross domestic product for 2011 – euro 39, 408 million (BNB estimates) and for 2010 (NSI data as of 03/11/2011) euro – 36, 033 million.

The market situation is so unpredictable that it is difficult to make meaningful predictions. Close trade relations with the euro zone, which were at the heart of the booming exports in the last two years, will now have opposite effect. Certainly the pace of export growth will weaken significantly due to declining demand for Bulgarian export products in troubled countries in the euro zone, and the base for comparison is high. Export-oriented businesses are trying to overcome the lack of demand in Europe through reorientation of trade to such traditional markets in the past as the Middle East countries or countries of growing economies, such as Turkey and Russia, but they are also affected by low economic growth in Europe and the uncertainty on the market. In this situation, *even maintaining the position from 2011 would be a success.*

FDI were at the basis of economic growth before the crisis, and although they were mainly focused in three sectors - construction, trade and finance, they were related to the activities of many domestic suppliers and the development of domestic industry. Now they become both the cause and consequence of the slowdown in growth of the national economy. According to preliminary data of BNB *the incoming FDI* in January-November 2011 amount to euro 740.3 million (1.9 percent of GDP). This is a drop of nearly 50 per cent over the same period of 2011 (euro 1.43 billion or 4 percent of GDP). The actual invested equity capital exceeds euro 850 million, but as a result of covered liabilities to foreign investors on loans from abroad, amounting to euro 194 million, the total volume of attracted investments decreases. *Even after all revisions FDI in 2011 is unlikely to exceed euro 1 billion, compared to government expectations for euro 1.5 - 2 billion.*

2011 is characterized not only by a drastic decline in FDI, but also with investors leaving the country (especially in the energy sector). The reasons are varied - some of them are related to the global crisis and the need of companies to readjust investment plans, but most are due to the state of the national economy, to the exhausted potential for growth, the strong shrinkage of the domestic market, the uncertain and unpredictable environment, the deteriorating business climate and corruption index, the unclear laws that can be interpreted in various ways, the burdensome administrative procedures, the shortages of competent personnel. Another feature of the past year is related to the shift of investments from green investment in modernization into the expansion of already established industries to increase productivity, to reduce energy consumption and ultimately – to achieve greater efficiency. *The trend of withdrawal of foreign companies from the domestic market will likely continue in 2012*, although some analysts expect gradual increase in the capital inflows in the second half of the year. Neither the external, nor the domestic environment, however, give reason to expect significant inflows of FDI to the stagnant national economy.

2011 ended with a relatively low **inflation** (December 2011 over December 2010) - measured by the *consumer price index* (CPI) it is **2.8%**, i.e. by 1.7 percentage points lower than that for 2010. The average annual inflation for 2011 (**4.2%**) is higher than in 2010 (2.4%). Since mid 2011 *attitudes of the business* follow downward dynamics for sales price. This trend is best expressed in services and construction. At the same time since October expectations are increasing in for higher sales prices in industry. Uncertain external and domestic environment is reflected in the change of *consumer expectations*, which since October follow an upward movement. For 2012 expectations are for domestic pressure on inflation, except in cases of administratively regulated prices. Its growth will be driven by the influence of international prices, which - in the conditions of stagnation among our most important partners - will hardly bring any surprises, unless unpredictable new political tensions arise, which will have economic response. *Given that our*

European economies intensify during the second half of the year it can be expected that the accumulated inflation for 2012 will reach about 2.5-3%.

Reducing the number of **employed** in the economy continues, although its rate is stabilizing. Recent data for the third quarter of 2011 (*based on national accounts*) show an annual drop of 3.2%, which is a small drop compared to drops by 3.5% for the first two quarters of the year. The deepest decline in employment since the crisis (7.3%) was for the first quarter of 2010.

In the third quarter of 2011 unemployed (*according to Labour Force Surveys*) were 343,000 and the unemployment rate - **10.2%**. On an annual basis the number has increased by 5.0% and the unemployment rate – by 0.7 percentage points. Unemployment among men (11.1%) is almost 2.0 percentage points higher than among women (9.2%). The number of unemployed youth is decreased (15-24 age range), however, the ratio increases from 21.4% to 23.3%. The number of long-term unemployed increases by nearly one-third annually and reaches 207,000, while the number of unemployed for less than a year (136,000) decreases by 20.3%.

Monthly unemployment rate (*according to Employment Agency*) as usual increases in December. In December 2011, job centers registered 342,422 unemployed persons, and the ratio is 10.4%. Since early 2011 monthly registered unemployment has been lower compared to the levels in the months of 2010, but in December, though slightly, it exceeds the level from a year ago.

In the last months of 2011 business expectations for the movement of personnel worsen, according to data from NSI business surveys, since in the summer months from July to August, and in September, they show negative movements - release of labor force – and in services and construction this has worsened, and continues to deteriorate noticeably. The increase in pessimism among consumers is reported with some delay in October.

Stagnant economic activity and deteriorating expectations of businesses and consumers give the grounds to ***expect some rise in unemployment in the winter over 11% of quarterly and 10.5% of monthly registered unemployment.*** 2012 can hardly be expected to show substantial shrinking in unemployment coefficients, such is likely to occur next year when acceleration of economic growth can be expected.

ENTERPRISE POLICY. Investment Policy. The drastic decline in FDI inflow last year led the government to seek ways to stimulate the process of attracting investors. On December 1, 2011 an *advertising campaign* was opened of *Bulgaria Invest Agency*. Within a year and a half 9 international investment forums will be held, where in direct contacts with potential investors the general conditions for investing in Bulgaria will be presented, as well as specific data *on eight priority sectors*. The forums are intended for a narrow range of pre-selected investors with a potential interest in the country.

The decision-makers in power propose *amendments to the Law on Investment Promotion*. Some of the highlights of the amendments affect both the criteria for issuing a certificate and the new incentives. Additional criteria for the certification of classes A and B will be the number of jobs created, along with the required minimum threshold of invested amount, the greater number of jobs can compensate prescribed investment threshold. Investors, who create many jobs in high technology sectors or in municipalities with unemployment above the national average, are provided another incentive - costs for insurance to be covered by the state for a period of time. Increased powers of municipalities are envisaged on investment promotion policy and empowerment of municipal councils to determine the threshold criteria for issuance of certificated in accordance with the needs of the municipality.

Administrative burden on businesses. At the end of 2011 results were presented of a project initiated by the Ministry of Economy Energy and Tourism on *assessing the administrative burden on the business in Bulgaria*. The legislation placed before the business 918 obligations to the state administration, the implementation of which costs BGN 2.7 billion per year. It is expected that after 2013 regulations will be considerably simplified and businesses will pay by BGN 313 million less per year, when communicating with the public administration. 302 proposals have been made in the presented project for reduction of administrative burdens: the Law on waste management contains the most (85), followed by the Energy Act (66), the Clean Air Act (27), the Social Insurance Code(22), and others. Proposals to reduce the administrative burden are related to: providing information electronically, automatic collection of data by the administration, elimination of duplicating information requirements, reducing the frequency of submission of information, simplifying terminology and reducing the complexity of regulations.

Public Procurement. According to the PPA for 2011 17,476 contracts were signed for over BGN 5.72 billion. Increase in the *volume of funds distributed through the public procurement system* (by over BGN 1.72 billion) is significant. It can be expected that this trend will continue at even higher pace this, and next year, since there is an increasing number of procedures of primary funding through EU funds.

In early November, the National Assembly adopted at second hearing *the Law on amending the Public Procurement Law*⁵. In general, the changes aim to simplify legislation, and ease the process of procurement, improving the preliminary control procedures on procurement, financed by EU funds. In early December 2011 the government approved *a draft of the new amendment to the Law on Public Procurement*. The proposed changes⁶ to national legislation introduce requirements of three European Directives, including the coordination of procedures for the award of certain contracts in construction, supplies and services in the defense and security.

Fight against corruption. In 2011 again, despite measures taken at different levels, *the prevalence of corruption in Bulgaria is very high*. Results of national and international studies are indicative of this. Prevailing is the conclusion that more systematic and concerted efforts are necessary from all authorities and activation of the business, the civil society and the media for more effective prevention and combating corruption. The Center for Prevention and Combating Corruption and Organized Crime with the Council of Ministers (BORKOR), whose structure started almost a year ago, should at last start its actual work.

Privatization. The Agency for Privatization and Post-privatization control *does not maintain records reporting on privatization deals*, incomes from them, or reports on implementation of annual work plans for 2010 and 2011. The website of the institution does not provide the Work plan for 2012.

The plan of the Agency for Privatization and Post-privatization control (APPC) in 2011 envisaged the sale of 10 companies with majority state participation, and 30 packages of shares of companies with minority state participation. The expected revenues from privatization sales amounted to BGN 250,100 million, of which BGN 248,600 million cash receipts and BGN 1,500 million non-cash payments. Of the anticipated by the APPC privatization sales in 2011 several *were identified as priority privatization procedures*: the sale of "Bulgartabac Holding," Ltd., "VMZ" EAD - Sopot, as well as minority stakes (up to 33 per cent), owned by the state in the capital of the electricity distribution companies - "E.ON Bulgaria sales 'AD, Varna and" E.ON Bulgaria networks' PLC, Gorna Oryahovitsa. Out of the specified priority transactions a contract was signed

⁵ Some of the significant amendments to the PPL were included in the Center for Economic Development's report "The Economy of Bulgaria – July 2011"

⁶ <http://www.government.bg/cgi-bin/e-cms/vis/vis.pl?s=001&p=0228&n=3074&g=>

in September 2011 for the sale of 79.83 percent of the shares of "Bulgartabac Holding" AD, the buyer being a company registered in Austria - BT Invest GmbH.

In 2011 the government adopted a draft strategy for the privatization of "VMZ" EAD, Sopot, which was approved by Parliament. Given the importance of the deal for development and stabilization of the military-industrial complex of the country, the deadline for development of the privatization procedure will continue in 2012.

През 2011 г. правителството прие проект на стратегия за приватизация на „ВМЗ“ ЕАД, гр. Сопот, която беше одобрена от парламента. Поради важността на сделката за развитието и стабилизирането на военно-промишления комплекс на страната, сроковете за развитие на приватизационната процедура ще продължат и през 2012 г.

Privatization program for 2012. The resources of companies, with which the Agency for Privatization and Post-privatization Control will work in 2012 has increased following recent amendments in Privatization and Post-privatization Control Act. According to them, privatization is allowed of companies with majority state participation: "Military Publishing House" Ltd. "Orpheus Audiovideo" EAD and "ADIS" LTD. The institution will continue its work on the sale of IPK "Rodina," "VMZ" EAD-Sopot, and of minority shares in E.ON and CEZ. The annual Work plan under Privatization and Post-privatization Control Act (PPCA) for 2012 is expected to include privatization of "Technoexportstroy."

Under Decision of APPC as of 30 September, 2011 a procedure was opened for the sale of 100 percent of the shares of "Holding Bulgarian State Railways" EAD in the capital of "Railways - Freight Transport" EOOD. The sales method of the company is not announced. Revenues from the privatization transaction will be received by the company owner - "Holding Bulgarian State Railways" EAD, and will enable funding of liabilities, leverage participation in the requested loan from the World Bank, and to further reforms in the sector.

The state budget for 2012 sets out expected revenues from privatization, amounting to BGN 300 million.

The so called "Prohibited list" has changed. At the suggestion of the government the companies "National Palace of Culture - Congress Center" EAD, and "Fishery resources" Ltd. are not subject to privatization.

Concessions. Government program to attract investment in the transport sector through concessioning of *port facilities, airport and rail infrastructure has not progressed*. The lack of investor interest and the delayed preparation of individual sites did not allow for improving the transport system in the interest of the public and the business. Once again, deadlines have been extended for the concessions of "Civil airport for public use Ruse" – 20 April, 2012, "Cargo area - a separate part of the civil airport for public use Plovdiv" – 7 December 2011, "Airport Gorna Oryahovitsa" - 4 February 2012. No concession procedure is opened for Sofia airport. The intentions of the Ministry of Transport, Information Technologies and Communications for public-private partnership also included the preparation for concessions of two Danube ports - Nikopol and Tutrakan, which is part of Rousse Port Complex. It is expected the selected consultants to prepare concession analyses of the ports. There is no clarity on the state of preparation of concession procedures for the ports of Vidin, Lom, Varna, Burgas or Ruse.

The newly established *single body for management of underground resources* in the Ministry of Economy and Energy reported revenues of BGN 60 million from the concessions. Revenues have increased by 50%, compared to the planned for 2011 BGN 40 million. There is a positive fact that after the amendments to the Mineral Resources Act 50 percent of the concession fees go to municipal budgets. Before the amendemnts this proportion was 30 percent.

The National Concession Register reports 81 procedures for granting concessions for 2011. 77 of these are procedures for municipal concessions, while 4 - for state concessions. For the same period 43 concession contracts were signed, of which one is a state concession and the remaining 42 - municipal concessions. 27 procedures for granting municipal concessions have been stopped. The majority of the concessions in the national register are for concession services - 41, of which 40 – municipal and one - state concession. There are two municipal concessions for constructions. The total value of contracted investments for granted concessions amounts to BGN 8,169,526.57 and Euro 100, 310, 260.00.

PUBLIC FINANCES As usual, in the fourth quarter of the year the budget balance reports weak performance. While the deficit in October is only BGN 16 million - the second lowest for the year, in November it reaches BGN 207 million - third largest after January and February. The accumulated deficit at the end of November amounts to a little below BGN 1.05 billion, which is an increase by BGN 223 million compared to September. Consolidated revenues in the budget for the 11 months of 2011 amount to BGN 22.6 billion, of which BGN 841 million are EU funds. The total costs were BGN 23.68 billion, of which costs less the contribution to the EU budget (BGN 675.6 million) are a little over BGN 23 billion.

Unlike the previous year for the first 11 months of 2011 revenues increase - by 6% or nearly BGN 1.3 billion, while expenditure rises by 1.8% or BGN 405 million. The main groups of revenues - VAT and excise duties are performing significantly better than in the previous year and grow for the 11 months of 2011 by respectively 8.7% and 9.2%. In the for four major groups of expenditures - salaries, ongoing maintenance, capital, social costs and scholarships - changes on an annual basis for the 11 months of 2011 range between -4.8% and 3.9%.

The fiscal reserve amounts to BGN 5.3 billion as of November, which *is above the statutory minimum allowable* of BGN 4.5 billion and is an improvement compared to September, when it reaches BGN 5 billion. The gross government debt as of November represents 14.6% of projected GDP which is by 0.2 percentage points over its value of previous year and by 0.4 percentage points compared to September 2011. The growth is to a great degree due to the increase in domestic debt, which reaches 5.9% of GDP – an increase of 0.3 percentage points compared to September, while external debt reaches 8.7%, an increase of 0.1 percentage points.

The budget adopted for 2012 looks more optimistic than the economic situation itself. It envisages real economic growth of 2.9%, given that the main foreign trade partners of the country are expected to be in recession. Even if the revenue side is calculated for a real growth of 1%, the expected revenues from EU funds seem too optimistic compared to the absorbed in 2011. The budget *needs more buffers* to soften any disappointing revenue performance. However, there are several changes that increase confidence in the fiscal policy. These include changes in determining the salaries of the administration, increasing the retirement age and the years of service for retirement, the introduction of fiscal rules.

Since the beginning of 2012 there are small changes in tax laws, but overall *the tax environment in the country remains stable and predictable.* Higher rates of excise duties on diesel and kerosene are introduced, and a duty on methane. However, *there will not be changes in direct taxes - income, income, insurance.* This keeps the predictability of the government policy, which is good news for the business compared to the uncertainty in the outlook of international and domestic economies.

SOCIAL AND HEALTH POLICY. The end of each year and the adoption of the budget for the next one is traditionally a period of changes in social security and health systems, and sometimes - of heated discussions and social unrest in this regard. This time things developed in the familiar way and the end of 2011 witnessed the launch and discussion of proposed changes in insurance legislation and an intensified debate on health reform. It should be noted that *it is not normal that*

such action is taken only and mainly in relation to the budget procedure for next year. This is a clear sign of lack of vision or coherent policy on the side of decision-makers in the social sphere.

Most acutely discussed in this context is the question for increase of retirement age for the most popular category of work (men and women) by one year as of January 1, 2012, proposed by the government in November 2011. It was done completely unexpected given the achievements of previous year agreements between unions, employers and the government in the area of pension reform.

In the conditions of union grievances and the short timeframe for adoption of the budget of state social security, Parliament voted that from 2012 the retirement age shall be increased by four months each year until women reach 63 years of age (currently 60) and men - 65 years of age (currently 63), and other changes to the Social Security Code. They mean *more restrictive regime for retirement starting from 2012*, limiting the access to social benefits and measures to reduce the expenditures of the National Security Institute.

Indeed, the government and MPs from GERB took a decisive and inevitable step in reforming the pension system, taking advantage of the post presidential election victory tactics of GERB. The question is, however, *should pension reform be done in this way* – in a hurry, with small and hasty steps, without seeking the consent of society and the public, and especially - without long-term strategy that will outline the planned horizon change, and will create confidence and trust in the system. Because on the other hand, little or nothing is being done in other areas of the reform – such as promoting supplementary pensions, measures to increase revenues in the state social security, limiting early retirement and disability pensions, and others.

In practice, without being clarified and agreed upon conceptually for the long-term, the vision for the *health reform, sporadic attempts are observed for changes in separate units of the system* (restructuring of emergency, restructuring of hospitals and others) hoping that this will lead to better management and efficient money spending. This approach should not be denied in general, but at the same time it carries risks of fragmented and slow implementation of reforms. Despite these problems, the search for solutions must continue - with political will, prudent use of foreign expertise and technical assistance in the interest of all stakeholders.

FINANCIAL SYSTEM. In the fourth quarter of 2011 the assets of the BNB continue to follow an *upward trend*, and at the end of the year they reach BGN 26.11 billion, which is the highest value for the last three years. The increase as compared to the previous quarter, and the same period of the previous year, is mainly due to the monetary base. The average volume of the monetary base (notes and coins in circulation and liabilities to banks) continues to increase: the increase compared to the third quarter is 2.4%, and on an annual basis the growth amounts to 6.8%.

At the end of last year the **banking system** as a whole remains stable. Volumes of balance sheet assets and borrowings are relatively unchanged from previous months, but on an annual basis they continue to show an increase. The liquidity of the banks as a whole remains high – the ratio of liquidity of the banking system registers a slight drop compared to August and at the end of November its value amounts to 25.5%. By September the return on equity is 6.8% and goes beyond that of March and June, but on an annual basis, there is a decline of 0.3 percentage points. Return on assets does not change and is at about 0.9%. Capital adequacy remains at stable levels (17.75%) and is similar to that recorded in June, and a year earlier.

Although the overall *banking system remains stable and with high liquidity*, the negative effect of *greatly reduced demand for loans* continues – due to pessimistic expectations of citizens and businesses on the recovery of the economy from the consequences of the crisis (total indicator of business climate remains at the levels of 2001), and due to *continued deterioration of credit portfolios* of banks - a consequence of reduced creditworthiness of borrowers. ***Given the uncertain***

economic environment no improvement of the banking system in the short term could be expected.

For a fifth consecutive quarter the slowing down of decline in **the leasing market** continues, reaching 13.2% yoy. Claims for new businesses continue to grow year on year - by 23.3%, from financing purchases of machinery, industrial equipment and automobiles. Compared to the previous quarter the volume of new business is decreased - by 9.2%, the decline is in all asset classes. The negative trend in non-serviced loans continues in the third quarter of 2011 - their volume reaches BGN 846.6 million, and their share in total receivables increases to 23.2%, compared to 22.3% in the second quarter. The slower decline in the leasing market is due mostly to loans for machinery, industrial equipment, and trucks and vans. For a third consecutive quarter total assets slow down their decrease and as of September are 7.44% on an annual basis. The biggest share is still that of net investment in leasing - 73%.

Weak economic activity and low levels of investment in the country determine the significant reduction in the volume of the leasing market. Given the fragile signs of recovery of the Bulgarian economy and the still weak investor interest, *no significant change can be expected in the state of the sector in the short term, but as a positive factor, which has considerable influence on the sector, the ongoing recovery of the automobile market⁷ should be mentioned.* In the event that the growth in car sales continues, positive changes could be expected in the state of the companies in the leasing branch.

Insurance Market. After four consecutive months of increase in insurance premiums, in August companies in the sector reported a decline on an annual basis, amounting to 0.2%. Since September, however, premiums on the insurance market once again begin to increase - by 0.5% in the third quarter and 0.6% in October.

The general insurance sector continues to decline in gross premiums written in August, but since September a gradual increase in revenues is reported. In the *life insurance segment* there is again a slowdown in growth of gross premiums, and in October they exceed by only 1.3% their level of the same period a year ago. The decline which started in April is maintained in the period August - October, mainly in the general insurance segment. In life insurance the trend of decline continues, but at a significantly slower pace.

The decline in claims with a growth in premiums written reflects on the technical result of non-life insurance companies, which for the first nine months amount to BGN 28.7 million – compared to BGN 12.8 million in year earlier. Consequently, companies in this segment accomplish a positive net result of BGN 40.2 million (which exceeds over 3 times the profit for the same period last year) despite the drop of 18.0% yoy in net income from investments. In the third quarter the technical results of companies in the life insurance market continues to shrink, but the pace of decline slows down to 21.9%, compared to 25.3% for the half year. The net financial result, however, continues to grow, reaching BGN 21.4 million, due to increased income from investing activities.

Albeit weak, *there are signs of recovery on the insurance market.* There is growth in gross written premiums in the significant for the market non-life insurance sector, which is due to the increase in the price of the mandatory "Civil responsibility for vehicles." Positive change comes from significant slowdown in the decline of annual gross premiums under other leading insurances, both in the third quarter of 2011 and in October as well. Given the expected further increase in the price of "Civil responsibility for motor vehicles" and the signs of recovery, seen in the automotive

⁷ According to the ACEA (Association of European Automobile Manufacturers) the annual growth in new car registrations for November is 23.9%.

market, which directly affect the sale of insurance with the biggest share in the portfolio, ***improvement can be expected in the insurance sector in the coming months***, but severely limited by the weak demand for real estate and mortgage loans.

Capital Market. In the last quarter of 2011 *most indices of BSE-Sofia continue to drop* over the previous quarter and the change in levels varies between -1.9% and 7.6%, and only BGREIT rises by 8.2%. Along with this reduced number of transactions on the BSE–Sofia in the last quarter of 2011 they are 4.6% below their level from the previous quarter. However, lots traded increase by 117.17% and the turnover - by 162.35%. The blue chip index *SOFIX* declines by 7.2% between October - December. The broader index *BG40* and *BGTR30* also decrease for the three months which amounts to 1.9% and 7.6%. The only index that increases in the last quarter (8.2%) is the sector index for companies investing in property - *BGREIT*.

In the last quarter the branch structure of stock turnover continues to change - even though the financial and insurance activities still dominate, their share decreases from 54.6% in the third quarter to 50.9%. More significantly decreased are the share of sectors Hotels and restaurants and Trade. *Significantly increased is the share of manufacturing industry*. An increase is observed in the energy sector. The shares of other sectors do not show significant changes.

ENERGY. In 2011 the trend of state-owned enterprises in the energy sector for strong financial results is maintained. Total profits of the major companies as of 30 September 2011 is by 35.54% higher yoy.

In December the Bulgarian Energy Holding announced a procedure for selection of consultant for *the restructuring* of the National Electricity Company (NEK) and ESO, in accordance with the Third Energy Liberalisation Package of EU.

There is still no final decision made on the fate of NPP "Belene." According to the signed in autumn 2011 by NEC and Atomstroyexport Appendix № 14 the duration of the Agreement of 2006 on the construction of NPP "Belene" has been extended until March 31, 2012.

In late November 2011 the Government announced the pipeline "*South Stream*," in the section which will be built on Bulgarian territory, as *site of national significance* (according to the Law on Spatial Planning) and as national site (under the Act on State Ownership). This statute will significantly shorten the time of required administrative procedures for starting and implementing the project.

On December 7, 2011 the Council of Ministers decided *to terminate* the participation of Bulgaria in the tripartite agreement between the Russian Federation, Bulgaria and Greece for cooperation in the construction and exploitation of the pipeline "*Burgas – Alexandroupolis*." Bulgaria offers the tripartite intergovernmental agreement on the oil pipeline to be terminated by mutual consent. Failing such an agreement, the Bulgarian party will withdraw, after 12 months.

In January this year the Council of Ministers approved a *draft law amending the Law on Energy*. The document transposes Directive 2009/72/EU on common rules for the internal electricity market and Directive 2009/73/EU on common rules for the internal market in natural gas. It will assist the achievement of the objectives set out in the Energy Strategy of Bulgaria by 2020.

TRANSPORT. Preliminary NSI data for the third quarter of 2011 show that the goods transported by road and water transport increased by 4.6% over the second quarter. However, performance fell by 8.5%. Passengers carried by road and water transport and urban electrical transport decreased by 0.9% from the previous quarter, while the performance is increased by 2.0%.

Construction companies of three lots of "Trakia" highway were paid over 51% of the value of construction contracts by end December last year. According to estimates by June 30, 2012 the traffic will be placed on Lot 2 from Stara Zagora to Nova Zagora, Lot 3 from Nova Zagora – Yambol, as well as 18 km from Lot 4 (Yambol - Karnobat). The work continues on the "Maritza"

highway - Lots 1 and 2, the “Struma” highway - Lot 1, and two sections of the “Hemus” highway, and others.

The metro construction is executed under schedule. First extension of diameter “Mladost 1” to “Tzarigradsko chausse” blvd. and the construction of a second metro diameter from overpass “Nadezhda” to “Cherni vrah” blvd. are scheduled to start operating in May, and August this year. The procedure for selection of contractors for the subway from “Tzarigradsko chausse” blvd. to Sofia Airport is underway. After three months of public discussions, the third route diameter was approved – “Botevgradsko chausse” blvd. to the railway Sofia – Pernik.

At the beginning of November the Government approved the drafts for the changes of two financial contracts with the European Investment bank for the construction of Danube bridge between Vidin-Kalafat, for which the time for fund absorption of loans was prolonged till 31 December 2012.

In October MTITC presented new guidelines for the development of the *Trans-European transport network* (TEN-T), as well as the specified in Brussels priority directions in the network on the territory of Bulgaria. The preliminary list of projects for Bulgaria by types of transport was presented, including rail and intermodal transport, road transport and the project “Overcoming bottlenecks on the Danube.” These sites are planned to be completed by 2020.

TOURISM. During the period January - October 2011 Bulgaria was visited by 5.8 million *foreign nationals* (excluding transits), by 4.4% more, over the same period of 2010. Increase in visits for vacation is seen - 4.2 million visits and growth of 5.2%. EU countries continue to be the most important market for international tourism of Bulgaria with a share of 68.6%, total 3.9 million tourists and an increase of 1%. The latest figures for November 2011 show that the visits of foreign citizens to Bulgaria increase by 2.4% compared with same month of 2010. The largest increase is registered in visits for holidays and excursions - by 6.2%. According to BNB data *incomes from international tourism in the current account balance increase* – for January-September 2011 they amount to euro 2.5 billion, 3.7% more than the same period of 2010.

The results of the development of the tourism sector in 2011 are favorable. ***Tourism revenues for the whole 2011, from foreign tourists are expected to be 4.5 percent higher than the previous year.*** Estimates are that they will reach euro 2.7 billion. Revenues from Bulgarian tourists are unlikely to exceed BGN 1.5 billion. Experts expect the growth in number of tourists to be within 14% for the whole year.

Estimates for the winter season and for 2012 are optimistic. Experts expect Bulgarian tourism in 2012 to achieve ***4% growth. A slight slowdown in growth is expected,*** however, since part of the tourists in the region may choose to visit Poland and Ukraine, who will host the European Football Championship. However, growth can be around 4% for most of the period. Tourists from Serbia, Macedonia and Hungary will form a significant share of foreign tourists to Bulgaria during the summer and winter season of 2012. According to tourist industry representatives, Bulgaria will be able to rely on tourists from these countries and thus offset the contraction in demand from the English and Russian markets, registered in 2011. Bulgaria continues to be attractive to foreign tourists for one main reason - favorable price-quality of service ratio.

AGRICULTURE. Produce of agriculture in 2011 increases by 13.5 percent on an annual basis, at the expense of increased by 15.9 per cent prices. Since at comparable prices, however, production decreases and, therefore, while intermediate consumption increases (by about 5%), *value added decreases significantly compared to 2010* (approximately by 15%). Agro-meteorological conditions were particularly favorable for sowing of winter wheat and although the area sown more than last year, delayed sowing and lack of moisture in the soil led to a delay in crop development. At this stage it is unclear what yields can be expected. *In 2011 the land has become*

an attractive investment. The market was very active throughout the year, driven by the interests of farmers, land funds and foreign investors. Experts expect 2012 to be characterized by increasing concentration of arable land and increased value added in the sector. Price growth in the long run will remain around 10 percent annually. The expansion of the secondary market will continue. National *policy in agriculture* is dominated by the forthcoming reform of the EU Common Agricultural Policy, which provides for fair and equitable allocation both between countries and farmers. The position of the country on the proposed option for reform is not clear, or how ready is the administration to deal with new challenges. Protests of grain growers from the beginning of December were caused by the news for reductions of previously agreed national payments to EU subsidies per unit area, but one of their main requests was to formulate a long-term state policy in agriculture, with measures and incentives to maintain the balance between subsectors. Nobody denies the need to shift funds to vegetable-growing, farming, organic farming, but to be successful, any business, including grain growers, needs stability and predictability. Without a clear national policy, agriculture will continue to evolve largely chaotically, with strongly shortened horizon for business planning, with periodically occurring imbalances and tensions between representatives of the sub-sector.

REGIONAL POLICY AND EUROPEAN FUNDS. According to representatives of the Government, Bulgaria is moving to the EU average rate of implementation of operational programs. Recent data for approval and payment in the 7 Operational Programmes and the Programme “Rural Development” show that Bulgaria has negotiated 57% of total resources, and has paid out 18% of the allocations. The exact details of the Ministry of Finance indicate that, **as of 30 December 2011, the total budget of the Operational Programs at the amount of euro 6.673 billion, were disbursed euro 1.505 billion.** By the end of 2013 at least 40% of European funds should be absorbed.

Despite the efforts Bulgaria has the second lowest absorption of EU funds. Worse than Bulgaria is only Romania. There remain serious problems in the use of EU funds. There is a *serious difference between the contracted and disbursed resources.* This means that there are processes of indebting and stopping real funds from the treasury and the economy. *Implementation of operational programs is uneven.* Comparison of OPs shows that most successfully implemented is OP “Transport” with euro 718 million. Raising the thresholds for negotiation is seen in OP “Human Resources” – euro 146 million, compared to other programs, where growth is almost imperceptible. The most serious problems are in OP “Competitiveness,” managed by the Ministry of Economy and Energy, where a decrease in absorption from the previous government by euro 293 million (30% of the program budget) and OP “Administrative Capacity,” which was leader in absorption (a drop by euro 37 million). *Inefficient is the work of MIS* (Management Information System for monitoring of funds from the EU Structural Instruments).

Repeatedly addressed so far by the expert community specific proposals to improve the absorption of European funds continue to be relevant:

- Building a competent administration (training and increasing wages)
- Creation of new internal control bodies for each operational program to fight corruption at lower levels of EU funds absorption.
- Creation of new external monitoring bodies to monitor the political process and non-allowing EU funds to flow to the party that is currently in power, or the circles of its companies.
- Defining the power and strengthening the role and the real power of the Ministry for management of EU funds.
- Increasing the efficiency of the MIS system for transparency and fighting corruption.

- Activate the work in sectors that are lagging behind - Program for Rural Development, OP "Competitiveness," OP "Administrative Capacity."
- More active participation of NGOs - redirecting of unabsorbed funds under the annual programs to NGOs and business. European funds are almost unused by NGOs, which have gained significant experience in the period before the accession to the EU (working under the PHARE Programme).
- Strengthening the cooperation between NGOs and local authorities - NGOs have sufficient resources to absorb and manage funds, while municipalities have not yet developed the necessary capacity for this.

In the next programming period, Bulgaria has the ambition to compete for about Euro 14 billion, but it will probably not succeed. The country is very likely to receive about Euro 8 billion.