

THE ECONOMY OF BULGARIA - April 2012

SUMMARY REPORT

Of the Center for Economic Development

The full text in Bulgarian is available at www.ced.bg

MACROECONOMIC DYNAMICS

Economic growth. The latest annual NSI data confirm that after the decline in GDP by 5.5% in 2009, our economy is growing again in the last two years (by 0.4% and 1.7%). Although the growth trend in the Bulgarian economy started recovering in the second-third quarter of 2010, growth is still weak, and slows at the end of 2011 by more than the expected up to 0.3% for the last quarter of 2011. Short-term data for the first 2-3 months of 2012 do not seem encouraging for a positive economic growth in **the first quarter. We expect a decline, albeit weak.**

Due to the uncertain and slowing recovery in Bulgaria's main foreign partners and the slow adjustment of our economy to the conditions of the crisis, it is more likely to expect reaching the pre-crisis volume of GDP not by the end of 2012, but in 2013.

Undoubtedly, the recovery of our economy depends on the international conditions, but the domestic market and resources should not be underestimated. It is high time that Bulgaria's economy turns to itself - to its domestic potential (resources and markets). The Bulgarian economy should be geared more towards the opportunities to meet its consumption with its own goods and products (both intermediate and final) and to grow through it, and not just to follow international processes. Meanwhile, 2012 has put more strongly before the global economy, Europe and Bulgaria the need for implementing a new economic paradigm. Sustainable economic recovery and growth are now possible if only a better mutual economic responsibility and integrity is introduced – which are foundations of confidence in the economy.

In its latest Interim forecast (developed according to express GDP data for the fourth quarter of 2011) the [European Commission](#) says explicitly that the delay in the recovery of European economies at the end of 2011 was **unexpected**. The EC envisages the slowdown to continue in the first two quarters of 2012. The recovery to a moderate growth is expected to happen in the second half. The forecast is reduced to zero growth for the EU for 2012. The forecast for Bulgaria is also reduced compared to the EC autumn forecast – a slowdown of growth to **1.4%**. In its previous report [of January](#) CED shared its similar expectations as those of the EC – for a slowdown in the first two quarters of 2012 and a recovery to a moderate growth in the second half of 2012. What turned to be unexpected both for us and for the EC experts was not so much the profile of dynamics, as the extent of the delay - it is obviously more significant than what was expected.

Compared to the February EC expectations of global and EU development – which put the international frame for the open Bulgarian economy, and after reading the latest data for Bulgaria (according to national accounts in March), we also revise our expectations towards a lower growth for 2012 and expect that pre-crisis economic levels will be reached in the end of 2013.

In the updated draft of the [National Reform Programme 2012 - 2020](#), published in March, the Ministry of Finance also decreases its forecast for the macroeconomic development of the country - to **1.4%** growth for 2012. At the end of March the [Institute of International Finance](#) publishes forecasts for a lower - **1.3%** growth - of the Bulgarian economy in 2012. In early April [BNB](#) announced that "based on current forecasts for a recession in the euro zone a slowdown in growth is expected of the Bulgarian economy in 2012 of about **0.7%**." Spring forecast of the [International Monetary Fund](#) for GDP growth in Bulgaria in 2012 are also lowered to **0.8%**.

Against this background, *our expectations for growth in 2012 also decrease for the time being to about 1%*. But are slightly more optimistic, compared to those of BNB and IMF, which is based on our confidence that there are still opportunities for domestic responses and for mobilizing the business and Government for achieving higher growth.

On March 6, 2012 NSI published final data for 2010 and preliminary data for the fourth quarter of 2011 and for the whole 2011. Details of the annual comparisons are available in the full text of the report.

Quarterly data for 2011 indicate that economic growth on an annual basis is delayed - for the fourth quarter GDP grows by only 0.3 % from a year ago. GDP at current prices for the last quarter is less than a year ago, which is disturbing. **Monthly data** for January and February in industry, construction and trade are also disturbing.

On the **production side of GDP** by quarters, let us first discuss quarterly dynamics of the sectors with best performance in 2011 according to annual data. There are three sectors, which demonstrate an annual growth. The three sectors together have created nearly 31% of GDP for the last year.

The fastest growing sector in 2011 (by a 9.1 % growth) was "*Mining and quarrying; manufacturing industry; production and distribution of electricity, heat and gas; water supply; sewerage, waste management and remediation.*" The industry has the largest share in GDP (21.2% for 2011, which already exceeds its share of the pre-crisis year 2007 - 20.4%). For the third and fourth quarters of 2011, annual growth slows significantly compared to the first half of the year, even when double digit. For the third quarter a decrease on a quarterly basis is registered, which is not entirely offset by the growth in the fourth quarter.

A decline may be registered on an annual basis for the first quarter of 2012 both due to the high base in the first quarter of 2011, and also due to unfavorable developments in the early months of 2012. In the first three months of 2012 the business climate in the sector suffered stagnation and is well below its level of a year earlier. **Monthly data** of industrial production point to a deepening of the process which started in November last year of a deepening decline on a monthly basis, and on an annual basis in January and February. *Expectations for 2012 are that the sector will finish the year with a growth* again due to expected positive development accelerating in the coming quarters of the year.

The second sector with highest growth in 2011 (by 8.1%) was "*Professional, scientific and technical, administrative and support activities.*" The significance of the sector to the economy, however, is relatively low (4.7% share of GDP for 2011 which is already higher than the pre-crisis share of 4.2% in 2007). In the last quarter of 2011 with a double digit growth in value added on

annual and quarterly basis, the sector has already exceeded its pre-crisis maximum. ***We expect it to continue growing in the future, too.***

The third, and last sector of growth for 2011 (1.9%) is "Creating and distributing information and creative communication". Despite its small share in GDP (4.8% in 2011), this sector is characterized among others by being the only one, which first went above its pre-crisis maximum, even in the third quarter of 2011, by volume of value added. The growth on annual and quarterly basis for the second half of 2011 is the reason to ***expect that the sector will continue to register growth in 2012.***

Let us now look at the quarterly dynamics of the remaining 7 sectors, ranked by increasing rate of their decline in 2011 and for the year as a whole.

In terms of a global financial and economic crisis the only sector in Bulgaria untouched by it is "Financial and insurance activities." Its share in GDP is 7% for 2011 (highest since 2006). The sector growth slowed in 2010 and for 2011 registers a decrease, albeit minimal (0.1%). After two consecutive declines on annual and quarterly basis (only in the last quarter of 2010 and first quarter of 2011), which were 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 lower rates. For the fourth quarter annual growth is minimal, and the quarterly shows a decline. ***For the first quarter of 2012 a decline or slower growth may be expected to be registered. Growth activity may be expected in the second half of 2012.***

After revision of data for 2010 it appears that the sector, which first started to contract in early 2007 – "Real Estate" - shows a growth (3.4%). In 2011 though, a decline is registered again, albeit weak (0.6%). The sector has 8.1% share in GDP for 2011. For the last two quarters in 2011, the sector is growing with increasing speed both on annual and quarterly basis. ***For the first quarter we expect growth, though weaker, and forecast for acceleration since second quarter.***

Sector "Government; education; health and social work" slightly slows its decline in 2011 (from 1.2% to 1%). Its share in GDP is 10.8% for 2011. In the first half of 2011 the value added in this sector registers annual declines and only a slight quarterly growth, and the growth in the third quarter is followed by a decline in the fourth. With the quarterly decline in the fourth quarter, ***the first quarter of 2012 may also register declines.***

There are three sectors with equal drops for 2011 (by 1.1%). Let us look at them quarterly in a descending order according to their share in the economy for 2011.

Sector "Trade, repair of motor vehicles and motorcycles; transportation, storage, and postal; hotels and restaurants" comes second in importance to the economy, after industry, with 17% share of its value added in GDP for 2011 (with a maximum share in the past six years recorded in 2006 – of 19.9%). In the last two quarters of 2011, the sector shrinks on an annual basis. There are many reasons to expect growth in the first quarter of 2012, as business surveys indicate a sharp deterioration in the business climate in *retail trade* at the end of 2011 and slight improvement in the first months of 2012. **Monthly data** of turnover continue to fall both on monthly and annual basis and the declines in February increase. However, in the last quarter the value added for the sector shows quarterly growth and ***might not have a deeper drop for the first quarter, its dynamics will be close to zero or slightly above,*** due to the winter season.

Sector "Construction" (with 5.6% share in GDP for 2011, the lowest in the last 6 years, at the maximum 7.9% in 2009) is growing in three consecutive quarters and this is a symptom that it returns to growth trend on an annual basis, but probably not earlier than in the second or third quarters of 2012. The business climate in the sector deteriorates sharply at the end of last year, but the first three months does not deteriorate further. **Monthly data** on construction output in January and February show declining trends, both on monthly and annual basis, especially in February. ***In the first quarter of 2012 a drop is expected again on an annual basis, though weaker than the last quarter of the previous year.***

The agricultural sector ("Agriculture, forestry and fisheries" with 4.8% share in GDP for 2011, at 6% for 2008) declines in 2011 due to drops in the second quarter, while in the last two quarters its dynamics is around zero, rather too weak, but yet growing on a quarterly basis. ***For the first quarter of 2012, due to the unfavorable weather, drops are expected as well. It is likely to expect growth for the year.***

The final sector to be discussed is "Culture, sport 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." This is the sector with the largest decline in 2011 (8.1%). This sector has the least weight in the overall economic growth. Its share in GDP is the lowest among the 10 sectors of the economy - in 2011 it is only 2.1%. After a deep drop on an annual basis and another decline on a quarterly basis for the last quarter of 2011, ***it is quite possible that a decline is registered again in the first of 2012.***

Among the aggregates on **the use of GDP** the exports of goods and services exceed their pre-crisis maximum (of the first quarter in 2008) in the third quarter of 2010, and continue to grow compared to it. For the fourth quarter of 2011, their growth on an annual basis accelerates, compared to the third quarter, but on a quarterly basis are of almost the same size. ***In the first quarter of 2012, however, a much lower growth can be expected, more significant in the second half of 2012.*** In contrast to exports in the last quarter of 2011, imports of goods and services slow their growth on an annual basis and are below exports. ***Their slowing down is expected to continue in the first quarter of 2012, so net exports of goods and services is expected to maintain a positive contribution to overall economic growth.***

In investment, after a contraction of the quarterly declines on an annual basis (in the fourth quarter of 2010 and first of 2011), in the third and fourth quarters of 2011 they deepen. But in the fourth quarter there is a quarterly growth, albeit very small, which gives some grounds to ***expect that the decline in the first quarter of 2012 will be weaker compared to the previous.*** We would like to draw attention to data from the investment survey in the industry, carried out twice a year - in March and October. A positive sign for the current 2012 in our view are expectations in October last year for investment growth in 2012 and this March - for investment growth in 2012 are of similar magnitude, thus confirming the registered attitudes for investment growth in industry for this year. This is the reason, in our opinion, ***to expect in the course of the year, intensification of investment dynamics in industry, and for the country as a whole.***

Final consumption after the weak growth in the second quarter of last year and relatively more significant growth in the third, at the end of the year has a fluctuating dynamics – according to seasonally unadjusted data it decreases (by 1.3% yoy), and according to adjusted data - increases, albeit slightly (by 0.5% yoy and 0.2% on a quarterly basis). According to NSI survey of household

budgets for 2011 a positive change should be noted in that the main component of household income - wages, accounting for 51.8% - increases on an annual basis both in nominal and real terms. According to data deflated by the CPI from 2002 to 2009 there is an annual growth in wages both per household and per person, with a decline only in 2010. Second by share in the structure of household income is the component "Pensions" (30.1% for 2011). Deflated figures for it register growths from 2003 to 2010, while in 2011 however, a decline is registered. Changes should be mentioned in the third component of household income by its share, which is income from entrepreneurship, with 6.4 % share in 2011. After three consecutive years of decline, it rises in 2011, with double-digit growth and this is *encouraging for future developments in the dynamics*, both of final consumption and of domestic investments. *For the first quarter of 2012 it is possible however, that the dynamics of final consumption may drop even below zero. More significant movement towards growth is to be expected in the second half of the year.*

Data for last year, on quarterly and annual basis, show that despite the difficulties in early 2012, the industry will continue to be the driver of growth in terms of the economy sectoral structure, especially in its interrelation with innovative activities of the steadily growing sectors "*Professional scientific and technical activities; administrative and support activities*" and "*Creating and distributing information and creative products; telecommunications.*" In terms of demand, a decrease in the drop in the investments is expected to continue, and in general the shrinking contribution of net exports of goods and services will be supported by a steady growth trend in final consumption, which is more likely to be expected to start in the second half of 2012.

Current Account. 2011 ended with a positive **current account** (Euro 361 million) for the first time in years. However, for the first two months of 2012 it again turns to negative (Euro 388.2 million or 1% of GDP), a year ago it was a surplus, albeit modest (Euro 11.1 million or 0.03% of GDP)¹. *Exports (FOB)* is now in nominal terms lower by 6.1% over the same period of 2011, when the export growth on an annual basis was 62%. However, *imports (FOB)* continue to grow nominally, although at a slower pace (now by 7.1%, an increase yoy of 41.5% over the same period last year). The balance of *services* is positive, and almost in the volume from the first two months of 2011. This is due to item "*Travel.*" Income balance improves, although remaining negative. Positive net current transfers contract - for the period January-February 2012 they are Euro 52.2 million compared to Euro 219.4 million for the same period of 2011. **2012 is likely to result in a relatively small negative account.**

Foreign trade ended in 2011 with a 30 percent increase in exports and 21.3 per cent increase in imports (nominal). It was clear that such rates could not be maintained, since the base has already been very high, but the results from the first two months of 2012 prove to be much more disturbing. For the first time a decline in *exports (FOB)* is registered by 6.1 percent down to Euro 2.9 billion over Euro 3.1 billion of a year earlier. Two reasons for this – the severe winter impeded transport links and limited movement of goods, and the slowdown in EU economies. And if the first reason could easily be overcome, and in February trade with third countries began to grow, the second one will continue to impact the economy in the near future. As a supplier of raw materials and components for machines and vehicles for west European enterprises, Bulgarian

¹ With a GDP of Euro 39,821 million for 2012 (BNB estimates) and Euro 38, 482.6 million for 2011 (NSI data as of 6/03/2012).

exports will be influenced by reduced consumption, and by declining industrial production in Europe. *Imports (CIF)* grow in both directions with a total of 7.1 per cent, reaching Euro 3.37 billion over Euro 3.15 billion for the first two months of 2011. All this leads to an increase in *negative trade deficit (FOB / CIF)* to Euro 640.4 million (1.6 percent of expected GDP) over a deficit of Euro 214.9 million (0.6 percent of GDP) for the same period last year or the increase is almost three times big.

With stagnant European economy and the unstable positions of export companies to third markets we could not expect a substantial increase in exports by the end of the year, unless the recession withdraws quickly. Expected recovery of export growth is in quite smaller frame (up to 10 % by year-end). Unfavorable structure of exports is a well-known problem, but while exports grew by violent pace, it was not paid sufficient attention. Now with reduced growth rates the problem with structure stands out very clearly. Bulgaria has good positions on the markets for certain goods (metals, spare parts for machines and vehicles, agricultural produce), but they cannot compensate for the lack of products of high value added, which can ensure stability and good prospects. Unless conditions for investments are created in such productions, the comfort is that international prices of our current export goods are growing and our presence on the market is certain. Hopes are associated with expected improvement in the economic situation in Europe in the second half of the year and with increased activity of capital flows, which could defreeze some investment projects in the country, and provide security for future economic growth and exports stability.

According to BNB preliminary data the incoming **foreign direct investments** in January-February 2012 amount to Euro 84.6 million (0.2 per cent of GDP). This is just a quarter of the investments attracted in the first two months of 2011 and confirms the trend of continuing decline. The big difference is in the breakdown by type of capital. The volume of investments in equity is not much different and the difference can disappear completely in subsequent revisions. More alarming is the deterioration in the structure of these investments - nearly 40 percent are for purchase of real estate by foreign persons compared to 15 per cent a year earlier. The other significant difference is the outflow of capital which amounts to Euro 19.8 million, for covering debts to foreign creditors, while the first two months of 2011 there was practically an influx of over Euro 200 million under "other capital." Reinvested earnings in January and February this year (Euro 8.9 million per month) is the largest in the past 14 months.

All government promises to improve the business environment and to provide investment incentives, to reform the judiciary and education, to reduce licensing regimes and red tape are still in the sphere of good wishes. In this situation, with the ongoing recession in the euro zone, we can hardly expect a substantial increase in investment by the end of the year, and without increasing the levels of FDI we cannot expect even a moderate GDP growth with the limited domestic resources. Investments made are rather for expanding existing business than for starting new productions that could increase exports. The only hope lies in outsourcing services - financial, accounting, computer services, which do not involve large investments, but at least bring movement on the domestic market.

2011 ended with a relatively low annual **inflation** (according to CPI it is **2.8%**). According to the *Consumer Price Index* for March 2012 inflation since the beginning of the year (March 2012 over December 2011) is **1.4%**, according to the *Harmonised Index of Consumer prices* it is **1.1%**, and according to the *Price Index of the Small Basket* it is **1.8%**.

Data until March 2012 show a continuing trend of slowdown in monthly inflation on an annual basis. This downward trend is similar to the trend in the attitudes of the business to the dynamics of sales prices, which in mid-2011 was also downward, but since the beginning of 2012 sharp fluctuations are seen in services, and the March expectations in all four observed sectors are aggravated.

For 2012 due to the weak movement in final consumption no pressure can be expected in consumer price inflation, except for administratively regulated prices. Inflation growth will be driven under the influence of international prices, which - in the conditions of stagnation in Bulgaria's most important partners - will hardly cause any special surprises, unless predictable new political tensions arise which have economic impacts. Expectations are for the usual seasonal deflation. *Given that EU and Bulgaria's economies are more active in the second half of the year, it could be expected that accumulated inflation for 2012 will not exceed 2.5%.*

Reduction in number of **employed** in the economy (*according to national accounts* as of 06/03/2012) continues, although its rate for the last quarter of last year it has shrunk – to 2.3% yoy. The unpleasant finding is that in the ten major economic sectors a decline in number of employed is observed in the fourth quarter of last year on an annual basis (between 0.1% in agriculture and 15% in construction). Although very slightly, the number of employed reduces in "Creating and distributing information and creative products; telecommunications" whose value added is growing, and for the third quarter only this sector registers growth in employment.

The total number of **unemployed** (age range 15 years and above) in the fourth quarter of 2011 is 380.9 thousand (*according to the Labour Force Survey*). *Good news is* that for the first time since the crisis the number of unemployed decreases year on year (by 1.5 thousand), nevertheless, the *overall unemployment rate* increases - from 11.2% to 11.4%. The number of unemployed youth and *youth unemployment rate* continue to grow. *Long-term unemployed (for a year or more)* are 55.7% of all unemployed. Compared to the fourth quarter of 2010 their number increases by 6.3%. The year started with **registered monthly unemployment** at levels above 11%. While since early 2011 until its end monthly registered unemployment is lower compared to its monthly levels of 2010, **since December its coefficient is higher yoy**. Rows of **harmonized unemployment rate (Eurostat)** show a tendency of keeping unemployment rate at same levels until October 2011, and **a stronger deterioration since November**.

The improved business expectations for movement of staff in the next three months, registered in the NSI business surveys in February and March is the reason to *expect that since April onwards harmonized unemployment will not continue to grow at the rate which was registered since November, in the spring it will remain near the high levels of the first months of 2012 (i.e. over 12%), while since the summer months a reduction is expected, be it weak.*

ENTERPRISE POLICY. Innovation policy. In February, the Foundation "Applied Research and Communications" presented its latest report "Innovation BG" 2012. The positive findings in the report are that the business increases costs for business research and development. Another positive change is related to the fact that there is a more equitable distribution of funds for innovation in different regions in the country. In recent years there has been growth in patent activity, which is also a positive sign of innovative development. Growth is mostly among foreign patent holders. The biggest patent activity is in pharmaceuticals (28% of issued patents) and chemical industry (16%). The main problem is that there is no focused policy for the promotion of

innovative business development. The Innovation Strategy of Bulgaria (2004) is outdated, and there is no funding for the National Innovation Fund.

Investment Policy. The government has repeatedly declared as a priority the attraction of more investments (both foreign and domestic) in industries of high value added, but practically nothing is done to achieve this objective. No sensible ideas have appeared to attract strategic investors in the high technology sectors. Expected changes in the Law for investment promotion are delayed, but they are consistent with the need for changing the structure of investments in the country and for redirecting them in areas different from construction, trade or finance, towards export-oriented production.

Public Procurement. For the period January - March 2012 4,101 contracts have been signed for just over BGN 970 million, compared to 3,397 awarded contracts for nearly BGN 996 million a year ago. The Government has made *changes in Council of Ministers' Decree (CMD) 55/2007* which regulates the procedures for selection of contractors by beneficiaries of agreed grants from the Structural and Cohesion Funds, the Joint Operational Programme for Cross-border Cooperation "Black Sea 2007-2013," and the Financial Mechanism of the European Economic Area. The changes are made so that the legislative act reflects the new rules on public procurement entered into force in late February this year with amendments to the Public Procurement Act. The Cabinet also approved *changes in CMD 112/2010*, which creates a Central Public Procurement Authority. In April the National Assembly approved at second reading the Law on Amendments to the Public Procurement Act. The document introduces the requirements of Directive 2009/81/EU, which regulates public procurement in the defense and security, and specifies some provisions to simplify reward procedures.

Fight against corruption. Despite the efforts and measures taken at different levels, the level and spread of corruption in Bulgaria is still quite high, and this directly affects the business environment and economic development. This is confirmed by findings from a number of authoritative reports and surveys, including Eurobarometer report titled "*Corruption*," Report for the *International Strategy for Drug Control in 2012*, published by the U.S. Department of State, traditional annual poll of the German-Bulgarian Chamber of Industry and Commerce among leading German and Bulgarian investors in the country on the business environment in Bulgaria. Several recommendations for improving the fight against corruption have been made in the *Interim Report on Progress under the Cooperation and Verification in Bulgaria*, published by the *European Commission in February*. The report stresses that in the coming months, further efforts are needed to achieve convincing results.

In late February, the Council of Ministers adopted the *Schedule for urgent measures and actions of the Government and the judiciary to meet benchmarks for progress in judicial reform, fighting corruption and organized crime*. The document contains 85 measures, 32 of which are time constant and cover the period from February to July 2012. At the end of March the functions and activities were presented of the *Centre for Prevention and Combating Corruption and Organized Crime under the Council of Ministers*. The first project on which specialists from the Center will work focuses on public procurement.

Privatization. The resource of available companies under the Agency for Privatization and Post Privatization Control is very limited. Outside the so called "Prohibited list" are only 20 companies with majority state shares and it will be difficult to find investors for most of them. Unless action is

undertaken to change this list, the effectiveness and the existence of the institution is under question.

The work plan of the Agency for 2012 sets several priorities: first – the selling of the shares of "Holding Bulgarian State Railways" EAD; work on the completion of privatization procedures will continue for the sale of minority stakes amounting to 33 per cent of the capital of energy distribution companies through "Privatization market" of the Bulgarian Stock Exchange; Strategy for privatization of "VMZ" EAD, Sopot; sale of the largest state construction company - "Technoexportstroy" EAD, Sofia; sale of the rest of state shareholding in "Terem - Georgi Benkovski" Ltd., Plovdiv and in the capital of "Terem - General Vladimir Zaimov" Ltd. Bozhurishte; of the real estate properties - private state property will be offered for sale "Redakcionen corpus," on "Tzarigradsko Shosse" Blvd., Sofia. The Ministry of Finance as principal of the companies "Bulgarian Stock Exchange - Sofia" AD and "Central Depository" AD has assigned to the Agency for Privatization and Post Privatization Control to prepare and implement a privatization procedure for the sale of a package of 50.0542 percent of the BSE and 43.7 percent the capital of the "Central Depository" to a strategic investor.

Concessions. Zero investor interest is expressed to the ambitious government program for public-private partnership and concessioning of facilities from the port, airport and railway infrastructures. The Ministry of Transport and Information Technologies closed the concession procedure for "Cargo area - a separate part of a civil airport for public use Plovdiv." The other two airports with open concession procedures are: "Civil airport for public use Ruse" and "Gorna Oryahovitsa Airport." The Ministry of Transport and Information Technologies announced public procurement for the preparation of legal, financial and environmental analysis of Sofia Airport and Airport Balchik. The concession procedure may begin in September and be completed within 2012.

There is no public information on the development of concession procedures for river and sea ports.

The Government approved the Bill on Amending the *Law for the Black Sea coast*. The objectives of the project are to introduce legal definitions and concepts for improving the control of concession contracts and leases of beaches, to simplify the procedure for concessions, regulation of the financing, and control of lease contracts. Some of the proposals in the Bill relate to the provision of free and pedestrian access to beaches.

Amendments to the *Mineral Resources Act*, which came into force in mid-2011 led to a twofold increase in revenues of municipalities from concession revenues.

PUBLIC FINANCES. The trend of decreasing **budget deficits** at the beginning of the year continues in 2012, and the excess of expenses over revenue at the end of February amounts to BGN 565 million, compared to BGN 750 million in the first two months of 2011. Over 40% of the deficit is due to the costs on EU funds. This is due to a lesser extent to the weaker absorption of EU funds and more to the higher spending.

Consolidated **revenues** for the first two months increase by 11.5% yoy. Unlike the beginning of 2011, for the first two months of 2012 the accumulated proceeds from the main groups of revenues - VAT and excise duties - have increased yoy by 30% and by 7%. Against the background of real economy development, however, this effect seems to be due to higher prices, of for example food,

energy, transport, and not to recovery in domestic demand. Measures undertaken to increase NRA VAT collection have also contributed to this.

In the four major groups of **expenditure** - salaries, ongoing maintenance, capital, social costs and scholarships - changes on an annual basis for the first two months of 2012 range between -2.6% and 29.6%. The trend from 2011 of reducing costs for salaries at the beginning of the year is offset by growth in total expenditure of 1.9% in February. The same applies for operating maintenance costs, but they increase 3 times less – by 0.6%. Capital expenditure registers tremendous growth on an annual basis - 29.6%, which is entirely due to costs incurred in February. Social costs for the first time demonstrate annual decline - 2.6%, but it is due to the high base of January 2011. Despite the statistical effect the spending in the first two months decreases compared to 2010.

The fiscal reserve amounts to BGN 3.8 billion as of February, which is both far from the level of comfort, and below the legally permissible minimum of BGN 4.5 billion. This is deterioration from its level by BGN 1.2 billion compared to December. The strong reduction of reserves can be explained by two seasonal effects. First, payments to farmers under European programs were made in January and amount to about BGN 650 million. Funds for farmers are paid by Fund "Agriculture," which is part of the fiscal reserve and later, usually within three months it is reimbursed by EU funds. Besides, the maturity date of the five-year government bonds worth BGN 295 million was also in January.

Over the past four years the governments in power have continuously reduced the size of the fiscal reserve. If spending from the reserve continues without recovering the funds, the practice to use funds from it for current needs, as data show, could lead to the loss of some targeted funds. This happened in 2011 with the decision to transfer the NHIF reserve to the account of the state budget, which after that could spend the money not for reforming the health system, as was the original concept, but on current expenses.

Gross government debt as of February amounts to 14.9% of projected GDP, which is 0.6 percentage points lower than its level in December 2011. The decrease is due to a greater degree to the contraction of foreign debt - by 0.5 percentage points - and less to domestic obligations - by 0.1 percentage point lower.

By the end of 2012 maturities of government bonds are due worth BGN 381 million and the projected budget deficit is of BGN 1.1 billion. Given the low levels of the fiscal reserve, the bulk of this financing will be covered by issuing debt. Given the competition between domestic and foreign financial markets, this could be problematic. The upcoming maturity should not be forgotten of global bonds in euros in mid-January 2013, worth BGN 1.6 billion. It is a good idea to provide these funds this year. Otherwise, managers run the risk of being pressed for funds, provision of which is conditional. It will depend both on the public finance policy implemented and on the international financial markets' conditions, and their behaviour and attitudes. In other words, the government runs the risk to leave itself at the mercy of the markets (something markets are not known of).

Since the beginning of the year certain changes in tax laws have come into effect, but the tax environment remain predictable. Higher rates of excise duties on diesel and kerosene, and a duty on methane were introduced. However, there are no changes made in direct taxes – corporate, income, insurance. Nonetheless the minimum wage and minimum thresholds were increased,

which effectively increases the tax base and affects negatively investments, and the creation of new jobs and employment.

The government continues to talk about reducing VAT by 2 percentage points, but as mentioned in the previous report, this step must be well considered, together with analysis of its impact. Such a decision seems dangerous against the increasing risks to the country's economic growth this year, and from this - the uncertainty of expected revenues this year.

SOCIAL AND HEALTH POLICY. The first months of implementation of the adopted last year changes to the *Social Security Code* show that they are a step in the right direction for limiting increase in costs for pensions and benefits. Furthermore, it is clear that they will not solve the acute problems of the pension system and confirm the need for stronger and longer-term reforms.

Against this background, quite suddenly the Deputy Prime Minister and Finance Minister Simeon Djankov made a statement before the media that one or two increases in pensions in 2013 may be possible, in case economic growth is higher than projected. The statement sounded pretty pre-electional, bearing in mind the real possibilities of the government.

The government adopted *Amendments to the Law on Guarantee Fund of the sustainability of the pension system*. The idea is its funds to be invested in Bulgarian securities. The current management of the Silver Fund (part of the fiscal reserves deposited in BNB at low yield) is contrary to the very idea of a Silver Fund, which provides long-term stability of pension system. In fact, despite the public debate, the main rival parties - the BNB and the Ministry of Finance - withheld their true interests and intentions and the debate was not very reasonable or beneficial. The only positive effect is that the question was put on the agenda of the need to manage the funds in the Silver Fund, and the search for solutions will continue so that the fund could truly fulfill its purpose in the interest of Bulgarian pensioners.

The latest months were a period of *significant personnel changes in the healthcare system*. GERB representatives are now managing all major health institutions which loaded them with great burden of public expectations and responsibilities for significant improvement. All necessary institutional prerequisites for implementing a reform policy in health care are present. The question is whether the ruling party is so willing and ready or would rather choose to keep status quo till after the upcoming elections. The first public appearance of the NHIF new manager and of the Health Minister do not signal energizing in reforms, but rather demonstrate a willingness to engage in some specific problems of the system, and partly improve it.

FINANCIAL SYSTEM. In the first quarter of 2012 reserves in foreign currency decrease slightly compared to last quarter of 2011. The decrease is determined by the reduction in fiscal reserves at the BNB, which reaches 3.25 billion as of February, the lowest amount of liabilities to the government since February 2006. At the end of March the fiscal reserves in BNB rise to BGN 4.03 billion, but in early April decrease again, reaching BGN 3.4 billion.

The monetary base (notes and coins in circulation and liabilities to banks) slightly decreases compared to December, but the average volume for the quarter exceeds by 2.3% the level from the last quarter of 2011 and by 6.0% the level from the same period in 2011. The increase in the monetary base is the result of the continuing increase in liabilities to banks, while notes and coins in circulation decrease slightly compared to December.

As of February 2012 the **banking system** remains stable. Amounts of assets and borrowings are relatively unchanged over previous months, but on an annual basis there is an increase. Bank liquidity remains high, at the end of 2011 the ratio of liquid assets to liabilities is 25.57%, and at the beginning of the year there are no significant changes in its value. The total capital ratio decreases slightly, reaching 17.53 % in December 2011, but remains at levels significantly exceeding those defined by regulations. Providing financial resources to fund activities of banks in the past year, however, is done mainly through operations on the domestic market. The growth trend in the deposits of non-financial corporations, households and NPISHs continues. Despite the increasing share of these deposits provides stability to the deposit base of the banking system as a whole, their relatively high price reflects negatively on the profitability of Bulgarian banks. The return on assets and equity decreases slightly on an annual basis due to the contraction in profits generated by the banks in the system during the last year.

Major risk to the stability of the banking system comes from the still the fragile recovery of the Bulgarian economy from the crisis and the accompanying weak domestic demand, the rising unemployment, and the uncertainty of future household income and the low investment activity, which explain the relatively low demand for loans and the deterioration of loan portfolios. At the end of 2011 the proportion of exposures over 90 days in gross loans (excluding credit institutions) continues to grow, albeit at a weaker pace. Given the uncertain economic environment no improvement could be expected of the banking system in the short term.

The leasing market continues to shrink and in the last quarter of 2011, the annual rate of decline in receivables is slowing down again - 12.1% against 13.2% in the third quarter. Compared to the previous quarter the reduction in total loans granted by leasing companies is 4.5%. Loans for new business continue their upward trend, with annual growth of 31.3% (over 23.3% in the previous quarter) and the increase from the third quarter of 2011 is 17.7%.

In 2011 the state of the leasing market continues to be influenced by the effects of the economic crisis. Weak economic activity and declining domestic consumption are the main factors that have a negative effect on the status and the prospects of companies in the industry. The continuing decline in market volume is a direct consequence of the uncertainty in consumer expectations in terms of Bulgarian economy recovering from the crisis. However, there are, although weak, signals for improved conditions on the leasing market, given the continuing upward trend in claims under new business and the continued slowdown in the annual rate of decline in claims. However, it could not be expected to substantially improve the conditions on the leasing services market in the short term.

The contraction on the insurance market continues in the last quarter of 2011 – according to preliminary data of the Financial Supervision Commission (FSC) there is a decrease of 4.5% in the gross premium income compared to the fourth quarter of 2010², and throughout 2011 the reduction from the previous year amounts to 1.0%. The negative trend in earnings is through either segments of the insurance sector –general insurance records an annual decline of 1.1% over the previous year, and life insurance - 0.5%. Benefits paid in 2011 also decrease - both in general insurance (7.1%) and in life insurance (1.2%).

² At the end of 2011 "General Insurance GRAWE Bulgaria" JSC, merged into the sole owner of its capital - "Gratser Vekselzeitige Versicherung Aktiengesellschaft" and for data comparability reasons of the data for 2010 have been excluded from those of the given company.

The main factor affecting the recovery of the sector is the still unfavorable economic environment in the country and the consumer uncertainty about the economy. For this reason no significant improvement could be expected in the condition of the insurance market in the short term, but the results of the general insurance sector for 2011 and the great market potential - low insurance density and insurance penetration – the companies in this industry will likely be among the first to recover from the crisis.

Capital Market. In the first quarter of 2012 there have been significant changes in the structure of BSE. In order to optimize the segmentation of the capital market changes have been made in the Rules of the Exchange. As of 01.03 a secondary market opened for shares of low-liquidity companies to be traded. Any stock issues that do not meet certain minimum liquidity criteria and quality of corporate governance have been moved to it, and thus on the main market only actively traded companies should remain. The division aims to increase the quality of statistical information for the Bulgarian market and to avoid distortion created by firms with non-market behavior. The expected result of the changes is to improve the image of the Bulgarian capital market and the effective concentration of investor interest in real market public companies.

In the first quarter of year three of the indices (SOFIX, BG40 and BGTR30) continue to lose their value and only the BGREIT index shows upward trend. However, the number of closed transactions decreases by 30.2 % over the fourth quarter of 2011, lots traded decrease by 8.9%, while turnover declines by 66.9% (after an increase of 162.35% in the last quarter of 2011), and is at levels close to those of the third quarter of the previous year.

The blue chip index *SOFIX* loses 4.1% of its value in the first three months of the year. The broad measure *BG40* decreases (by 8.44%). They both vary within relatively narrow limits. In late March *BGTR30* is by 2.8% below its level from the beginning of the year, the difference between its lowest and its highest values during the quarter is 15.4 points. Only the sector index of companies investing in real estate *BGREIT* increases 21.8% since the beginning year.

ENERGY. On 28 March the Government officially stopped the project for building a second nuclear power plant. The Minister of Economy and Energy was responsible for organizing the negotiations for settlement of the relations between "NEK" EAD and "Atomstroyexport" ZAO, and for submitting a proposal for building a new nuclear power plant at the site of Kozloduy NPP. The National Assembly supported the Government. The decision entrusts the Government to study the conditions for the construction of a combined vapour and gas plant at the Belene site.

In April the Council of Ministers gave agreement in principle under Art. 45, para. 1 ASUNE for undertaking actions necessary for building a new nuclear power at the site of NPP "Kozloduy." The Cabinet also adopted a plan for urgent and specific actions in preparation for the examination of an operational team of the IAEA to assess the operational safety of units 5 and 6 of Kozloduy NPP. The inspection will be held from 26 November to 13 December 2012. In April *the first stage was launched in NPP "Kozloduy" of the preparation for extension of the operation of units 5 and 6 of the plant for up to 20 years.*

At the end of March the commitment of Government was confirmed to accelerate procedures under the project so that a final investment decision on the pipeline "*South Stream*" be made in November. In early April the Council of Ministers announced *pipeline "Nabucco"* in its Bulgarian section for *national site*. In late March, results were announced from negotiations in Moscow between the Bulgarian delegation led by Minister Delyan Dobrev and the Management of

"Gazprom." It has been agreed that for the remaining nine months of the contract with "Gazprom", i.e. by the end of 2012 Bulgaria will pay by 11.1% lower price for delivered natural gas. In March in Ankara a *Joint Declaration to accelerate the construction of interconnector Turkey-Bulgaria* was signed. Within two months the Joint Energy Working Group should report on the progress of the project for construction of the Interconnection Bulgaria-Turkey.

In late March the Parliament passed *the Law amending the Law on Renewable Energy*, which entered into force on 10 April. Some of the more important changes are related to replacing the licensing regime for companies in the area of installation, maintenance, repair and reconstruction of facilities in energy projects for renewable energy with a registration regime; with the introduction of simpler procedures for small renewable energy sources; the price for purchasing electricity from renewable sources; with information on the Internet about producers of electricity from renewable sources.

TRANSPORT. Preliminary NSI data show that *in the fourth quarter of 2011, goods transported by road and water transport*, based on seasonally adjusted data decrease by 10.8% compared to the third quarter of last year. A decrease of 4.5% is observed in the *work done* resulting from the actual distance over which goods are transported. Passengers transported by land, water and urban electric transport decrease by 0.7%, and the work done - by 1.7 % over the previous quarter.

After latest inspections in April on the progress and the quality of construction works at *highway "Trakia"* it was confirmed that on July 1 Lot 2 and Lot 3 of the Stara Zagora to Yambol will be put into operation with a total length of 67.5 km, as well as the first 15 km. of Lot 4 of the Yambol to Karnobat (total length 49.08 km). In early April the construction started of Lot 4 of *"Struma" Highway*. On 22 February the European Commission approved the application form for building *Highway "Maritza."* The total costs for the construction of Lot 1 and Lot 2 of "Orizovo-Harmanli" is over Euro 203.8 million. The *underground* section of "Mladost" 1 to "Tzarigradsko shosse" at Inter Expo Center was completed ahead of the deadline and put into operation on 25 April. The newly built track has a length of 2.2 kilometers and has two stations - Mladost 3 and Tzarigradsko Shosse, and at the second one a large underground parking buffer is built with 1300 parking places.

According to the MRDPW at the end of March about 72% were completed of the construction works on *Danube Bridge 2*, and related infrastructure is ready up to 89%. This second Danube bridge is expected to be completed by late November this year. In January three contracts were signed with selected contractors for the reconstruction and electrification of *railway line Dimitrovgrad - Svilengrad*.

In late January the Government approved a Bill on Amending the Road Traffic Act. The changes and improvements aim at unifying the concepts and their implementation, as defined by the term "speed road." For motorways and high speed roads the construction of commercial facilities within the road and in the service area is not allowed. In March the Government approved the Bill on Amending the Road Transport Act. The aim is to strengthen control of documenting and reporting the activities of motor carriers to protect the fiscal position and to prevent tax evasion.

TOURISM. According to NSI data in the fourth quarter of 2011 compared to same quarter of 2010 the total number of *persons traveled* age 15 and over, for private purposes decreases by 9.2% (those traveled in the country decrease by 6% and those abroad - 32%). Overall, the total number of *nights spent* in all places of shelter and accommodation in the fourth quarter of 2011 *remains at*

the level as the same period of 2010. Meanwhile, the nights spent by Bulgarian residents increase - by 8.5%, while overnight stays of foreigners decrease by 13.8%). *Accommodated persons increase* by 6.1%. The proportion of accommodated Bulgarian residents is 71.9% of all accommodated. Accommodated foreigners increase by 2.5 thousand (1.1%). Total *number of beds* taken in accommodation places is 16.1%, or by 1.8 percentage points more than registered over the same period of 2010. Compared to the fourth quarter of 2010 the total number of places for accommodation decreases (1.2%), as well as the number of beds (10.3%). *Revenues* from nights spent are 3.3% higher over the same period last year. This is due to an increase in revenues from Bulgarian residents (6.8%), while revenues from foreigners decrease (by 0.4%).

According to latest NSI data in February 2012 trips of *Bulgarian residents abroad* are by 10.5% less compared to January, and visits of *foreign nationals* to Bulgaria are by 17.1% less than in January.

According to some hoteliers the favorable weather for skiing until April may compensate lagging revenues from the winter season. According to other estimates around 7% growth in tourism for the entire winter season can be expected. These are the most optimistic forecasts based on recent months when the snow is abundant and is believed to be attracting more tourists.

AGRICULTURE. The good performance in agriculture in 2011, when its share in GVA grew by 5.6 per cent, and in GDP - up to 4.8 per cent, and the fact that this year the sector will get BGN 1.2 billion in EU subsidies and national complementary payments, bring the hope that agriculture can replace exports as a factor of economic growth. Unfavorable weather conditions during autumn sowing, and the long and cold winter, however, decrease the hope for a strong harvest in grain production this year. However, it will probably reach its normal levels of about 3.6-4 million tons of wheat and 800 thousand tons of barley. Only cole seed (rape) cannot reach its annual production of 500 thousand tons, given that almost half of the areas have been frozen and have been plowed after that. At the same time expectations are for a relatively good global wheat harvest, which has already pushed international grain prices down by around 12-14 per cent compared to last year. Given that Bulgarian agriculture is increasingly becoming monoculture (over 90 percent of arable areas are occupied by cereal and industrial crops, while fruit and vegetables decrease continuously) no strategy has been created for its development as an effective combination of different sub-sectors, no proactive policy was carried out, perhaps its role in the economy will remain unstable. Moreover, there are two opposite trends observed globally - increased demand for agricultural produce, given the increase in population and change in the culture of consumption, and demand reduction due to the crisis and the rising unemployment. Bulgarian agriculture will also be developing under the influence of these two trends and it is therefore difficult to say whether we will see a year of high prices of agricultural production and consequently a greater share of the sector in the economy, or will have to satisfy with moderate incomes and lesser contribution.

REGIONAL POLICY AND EUROPEAN FUNDS. Implementation of operational programs shows that out of the total budget of Euro 8 billion (under Structural and Cohesion Funds, not including the Agricultural fund) Euro 5.375 billion or 67% of the allocations have been contracted as of January 31, 2012. The paid amount is Euro 1.5 billion or 19.2%. If the agricultural fund is included, the budget exceeds Euro 11 billion, of which disbursed are Euro 2.6 billion or 22.8% of all funds.

The Government puts efforts to increase the absorption of EU funds. Ambitions for 2012 are to achieve 90% of contracted under all operational funds and programs and 38-40% payment of subsidies. 10 priorities are outlined in the absorption of EU funds:

- Starting the mechanism for providing financial and technical assistance from the European Investment Bank and the World Bank.
- Starting the mobile group under JASPERS.
- Opening greater part of the planned 27 information centers in the cities.
- Starting projects funded by the Financial Mechanism of the European Economic Area (EEA) and the Norwegian cooperation program.
- Complete the process of negotiations for the next programming period.
- Clarify the national priorities in terms of operational programs for the next programming period.
- Complete text of the Law on management of EU funds.
- Develop the texts of the operational programs. This is a process that should start now to ensure quality.
- Finalize the development of the National Development Plan - Bulgaria 2020.
- Speed up contracting under EU funds.

In early 2012 the Parliament adopted at first reading *the Law on Public Private Partnership (PPP)*. The law has been seriously criticized that it mostly repeats provisions of the Law on Concessions and the Public Procurement Act.