Key developments and challenges

The financial sector has coped well with the crisis, although many small and medium-sized enterprises (SMEs) have experienced difficulties in accessing finance and the provisioning for non-performing loans has risen considerably. A continued close coordination among foreign banks and their local subsidiaries, regulators, and international institutions is important to ensure that financial intermediation increases once the crisis subsides.

Infrastructure quality has improved, but key challenges remain, including: further liberalisation of the electricity market; new water sector reforms; improved waste management; and further road sector development.

The full force of the global economic crisis has meant falling exports, reduced capital inflows and a sharp decline in domestic demand. An important challenge for the government is to balance the need for a sound fiscal policy to provide comfort to the markets, with the need for sufficient economic stimulus to prevent a prolonged recession.

Country data

<table>
<thead>
<tr>
<th>Population (in millions)</th>
<th>7.6</th>
</tr>
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<tbody>
<tr>
<td>Area (‘000 sq km)</td>
<td>111.0</td>
</tr>
<tr>
<td>GDP (in billion US$, 2008)</td>
<td>49.9</td>
</tr>
<tr>
<td>Average transition score (scale: 1 to 4.33)</td>
<td>3.56</td>
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</table>

Progress in structural reform

Business environment and competition

The conditions for doing business in Bulgaria have improved in recent years. According to the World Bank’s Doing Business 2010 survey, Bulgaria is ranked 44 out of 183 countries. However, in the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) Bulgarian companies identified an inadequately educated workforce, difficulties in accessing finance and competition from the informal sector as the main obstacles to their development.

The European Commission (EC) in its annual report on progress under the Co-operation and Verification Mechanism of July 2009 noted that there was a new momentum in Bulgaria in terms of improving the judiciary and combating corruption and organised crime. However, the Commission also noted that the steps taken so far to address these issues have had only a limited impact, and that many shortcomings still needed to be addressed. The situation will be reassessed by the EC in the summer of 2010.

Infrastructure

The development of the first Energy Efficiency Action Plan for 2008-10, and the introduction of new legislation for renewable energy in November 2008 are expected to add to the substantial investments in energy efficiency and renewable energy sources that have occurred over recent years. Some initial problems with the Renewable Energy Act, such as an unbalanced allocation of the green premiums that form the subsidies for renewable energy, were addressed by the regulator in June this year. Also, better coordination of the country’s environmental strategy and national energy policies is expected to promote further investments in energy efficiency and renewable energy sources in the country. Effective liberalisation of the electricity market has not yet taken place despite a legal framework that provides for a full market opening. This lack of market development in the electricity sector has prevented a flexible price mechanism from providing an adequate anti-crisis response at a time when the economic slow-down has pushed unregulated market prices below the regulated electricity tariffs.

As a result of the immediate shortage in gas supply that followed the dispute between Russia and Ukraine at the beginning of 2009, a number of new policies and projects have been initiated to promote energy security in the country. Bulgaria signed the Nabucco gas pipeline project in July 2009 with three other EU countries and Turkey. Steps have also been taken to increase gas interconnectivity with Greece and Romania and to enhance gas storage facilities.

A new Water Act was approved in June this year and, if implemented successfully, will allow for more local control and new contractual arrangements for the operating water utilities. In the roads sector, further clarification of responsibilities for investments, maintenance and use of structural funds is needed, and delays in bringing the country’s waste management in line with best standards is also expected to be addressed following increased pressure from the EC.

Financial sector

Existing regulations ensure that the banks are well capitalised and have a high level of provisioning and thus the financial sector was well placed to weather the international financial and economic crisis. The authorities have also introduced measures to support the sector in response to the crisis. In line with other EU countries the state guarantee on bank deposits was increased from Lv 40,000 (£20,000) to Lv 100,000 (£50,000) and the Bulgarian Development Bank will grant Lv 500 million to the commercial banks in the country in 2009 to fund small and medium-sized enterprises. At the beginning of 2009 the central bank requested banks to maintain their Tier I capital adequacy ratio at a minimum of 10 per cent. Also, most major banks have committed themselves to capitalise their profit and to ensure that their funds remain in the country.

The majority of banks are now focusing on sustainable and prudent lending rather than competing for market share, as seen in previous years. There has also been renewed competition for local deposits as funding from abroad has been limited or expensive. As a consequence, credit growth during the first half of 2009 was very low, and interest rates on deposits have remained high so far this year.
Macroeconomic performance

After several years of strong economic growth, Bulgaria has experienced a sharp slow-down that began in the fourth quarter of 2008 and has continued throughout the first half of 2009. The weakness in economic activity has come through two channels. First, a reduction in external demand, with exports down as much as 30 per cent over the first six months of 2009 year on year. Second, domestic demand has contracted as private capital inflows have dried up significantly and consumer and investor sentiment have worsened. Industrial output, construction, tourism and other services are all down sharply.

The internal and external imbalances associated with the years of strong growth have mostly been reduced. The rate of inflation fell to below 1.5 per cent in August 2009 (from 12 per cent in 2008) because of the reduced domestic demand, as well as lower world prices for some food and commodity imports. The declines in consumer and investment spending have also led to a further slow-down in imports during the first half of 2009. Thus, despite the fall in exports, the trade deficit has dropped and the current account deficit narrowed to 18.1 per cent of GDP in annualised terms at the end of the first half of 2009, down from 24.6 per cent of GDP at the end of 2008. Fiscal policy has remained prudent (with the exception of pre-election months in the second quarter of 2009). In 2008 the general government surplus was 3 per cent of GDP and the new government is planning for a balanced budget for 2009 and 2010 mainly by improving tax compliance and cutting expenditures sharply.

Outlook and risks

As an open economy increasingly integrated into the European Union’s internal market, with a banking sector primarily owned by international banking groups with head offices in other EU countries, Bulgaria’s economic recovery is very much dependent on developments in the European Union as well as other neighbouring countries. The Bulgarian economy is forecasted to shrink by 6 per cent in 2009, with only a modest recovery starting in 2010.

There is a risk that the asset quality of banks could deteriorate significantly if the economic slow-down is deeper or longer than expected. There are also some vulnerabilities linked to Bulgaria’s large external financing needs arising from current account deficits and the fact that one-third of the external debt is short term. At the same time, medium-term prospects for growth remain favourable and Bulgaria has a well capitalised and well regulated banking sector while the central bank holds a large amount of foreign reserves. The overall fiscal position is also sound with fiscal reserves in excess of the low level of gross public debt, and Bulgaria’s history of fiscal surpluses reflects an understanding across the political spectrum of the importance of fiscal prudence in the context of the currency board arrangement.
### Structural and institutional change indicators

<table>
<thead>
<tr>
<th>Enterprise</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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<tr>
<td>Privatisation revenues (cumulative, in per cent of GDP)</td>
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<td>18.0</td>
<td>21.4</td>
<td>22.8</td>
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<tr>
<td>Private sector share in GDP (in per cent)</td>
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<td>75.0</td>
<td>75.0</td>
<td>75.0</td>
<td>75.0</td>
<td>75.0</td>
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<td>Private sector share in employment (in per cent)</td>
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<td>69.0</td>
<td>71.0</td>
<td>71.0</td>
<td>73.0</td>
<td>74.0</td>
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<td>Budgetary subsidies and current transfers (in per cent of GDP)</td>
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<td>Share of industry in total employment (in per cent)</td>
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<td>23.5</td>
<td>23.2</td>
<td>22.5</td>
<td>22.1</td>
<td>21.1</td>
<td>na</td>
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<td>Change in labour productivity in industry (in per cent)</td>
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<td>10.0</td>
<td>11.1</td>
<td>11.2</td>
<td>10.5</td>
<td>9.5</td>
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<td>Investment/GDP (in per cent)</td>
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<td>23.5</td>
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<td>na</td>
<td>na</td>
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<td>EBRD index of small-scale privatisation</td>
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<td>4.0</td>
<td>4.0</td>
<td>4.0</td>
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<td>EBRD index of large-scale privatisation</td>
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<td>4.0</td>
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<td>4.0</td>
<td>4.0</td>
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<td>Share of administered prices in CPI (in per cent)</td>
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<td>22.1</td>
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<td>Number of goods with administered prices in EBRD-15 basket</td>
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<td>Share of trade with non-transition countries (in per cent)</td>
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<td>78.0</td>
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<td>Share of trade in GDP (in per cent)</td>
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<td>106.8</td>
<td>117.6</td>
<td>119.2</td>
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<td>Tariff revenues (in per cent of imports)</td>
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<tr>
<td>Number of banks (foreign-owned)</td>
<td>35 (25)</td>
<td>35 (24)</td>
<td>34 (23)</td>
<td>32 (23)</td>
<td>32 (21)</td>
<td>30 (22)</td>
<td>na</td>
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<td>Asset share of state-owned banks (in per cent)</td>
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<td>2.3</td>
<td>1.7</td>
<td>1.8</td>
<td>2.1</td>
<td>2.0</td>
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<td>Asset share of foreign-owned banks (in per cent)</td>
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<td>81.6</td>
<td>74.5</td>
<td>80.1</td>
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<td>Non-performing loans (in per cent of total loans)</td>
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<td>3.8</td>
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<tr>
<td>Domestic credit to private sector (in per cent of GDP)</td>
<td>26.7</td>
<td>35.2</td>
<td>42.9</td>
<td>47.1</td>
<td>66.8</td>
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<td>Domestic credit to households (in per cent of GDP)</td>
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<td>14.4</td>
<td>16.6</td>
<td>23.0</td>
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<tr>
<td>– Of which mortgage lending (in per cent of GDP)</td>
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<td>2.7</td>
<td>4.8</td>
<td>7.2</td>
<td>10.4</td>
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<td>Stock market capitalisation (in per cent of GDP)</td>
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<td>19.7</td>
<td>31.1</td>
<td>51.3</td>
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<td>Stock trading volume (in per cent of market capitalisation)</td>
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<td>22.8</td>
<td>35.2</td>
<td>19.6</td>
<td>34.2</td>
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<td>Eurobond issuance (in per cent of GDP)</td>
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<td>3.7</td>
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<tr>
<td>EBRD index of reform of non-bank financial institutions</td>
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<td>2.3</td>
<td>2.3</td>
<td>2.7</td>
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<tr>
<td>Infrastructure</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed-line (mobile) penetration rate (per 100 inhabitants)</td>
<td>35.9 (44.7)</td>
<td>35.0 (60.7)</td>
<td>32.2 (80.7)</td>
<td>31.2 (107.3)</td>
<td>30.1 (129.5)</td>
<td>29.7 (140.1)</td>
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</tr>
<tr>
<td>Internet users (per 100 inhabitants)</td>
<td>12.0</td>
<td>16.0</td>
<td>20.0</td>
<td>23.9</td>
<td>31.0</td>
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<td>Railway labour productivity (1989=100)</td>
<td>75.2</td>
<td>78.4</td>
<td>73.7</td>
<td>76.3</td>
<td>74.5</td>
<td>70.0</td>
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<td>Residential electricity tariffs (USc kWh)</td>
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<td>8.4</td>
<td>8.8</td>
<td>9.1</td>
<td>10.9</td>
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<tr>
<td>Average collection rate, electricity (in per cent)</td>
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<td>92</td>
<td>93</td>
<td>93</td>
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<tr>
<td>GDP per unit of energy use (PPP in US dollars per kgoe)</td>
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<td>3.5</td>
<td>3.6</td>
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<td>na</td>
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<td>EBRD index of infrastructure reform</td>
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<td>– Electric power</td>
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<td>3.7</td>
<td>3.7</td>
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<td>– Railways</td>
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<td>3.3</td>
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<td>3.3</td>
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<tr>
<td>– Roads</td>
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<td>2.3</td>
<td>2.7</td>
<td>2.7</td>
<td>2.7</td>
<td>2.7</td>
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<tr>
<td>– Telecommunications</td>
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<td>3.3</td>
<td>3.7</td>
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<td>– Water and wastewater</td>
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### Macroeconomic Indicators

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<tr>
<th>Output and expenditure</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
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<tr>
<td>GDP</td>
<td>5.0</td>
<td>6.6</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
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<td>-6.0</td>
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<tr>
<td>- Private consumption</td>
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<td>5.3</td>
<td>5.5</td>
<td>8.5</td>
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<td>- Public consumption</td>
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<td>6.8</td>
<td>4.1</td>
<td>-2.5</td>
<td>3.4</td>
<td>-3.4</td>
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<td>- Gross fixed capital formation</td>
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<td>13.5</td>
<td>23.3</td>
<td>14.7</td>
<td>21.7</td>
<td>20.4</td>
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<tr>
<td>- Exports of goods and services</td>
<td>10.7</td>
<td>12.7</td>
<td>8.5</td>
<td>8.7</td>
<td>5.2</td>
<td>2.9</td>
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<tr>
<td>- Imports of goods and services</td>
<td>16.4</td>
<td>14.5</td>
<td>13.1</td>
<td>14.0</td>
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<td>4.9</td>
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<td>Industrial gross output</td>
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<td>13.5</td>
<td>13.0</td>
<td>14.3</td>
<td>11.9</td>
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<td>Agricultural gross output</td>
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<td>-4.4</td>
<td>0.9</td>
<td>-18.3</td>
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<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
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<tbody>
<tr>
<td>Labour force (end-year)</td>
<td>-0.4</td>
<td>2.0</td>
<td>0.2</td>
<td>4.1</td>
<td>0.7</td>
<td>0.4</td>
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<tr>
<td>Employment (end-year)</td>
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<td>3.1</td>
<td>2.4</td>
<td>5.9</td>
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<th>Unemployment (end-year)</th>
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<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
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<tbody>
<tr>
<td>Labour force (end-year)</td>
<td>12.7</td>
<td>11.8</td>
<td>9.9</td>
<td>8.4</td>
<td>6.2</td>
<td>5.1</td>
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<table>
<thead>
<tr>
<th>Prices and wages</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
</tr>
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<tr>
<td>Consumer prices (annual average)</td>
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<td>6.1</td>
<td>5.0</td>
<td>7.3</td>
<td>8.4</td>
<td>12.3</td>
<td>2.6</td>
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<tr>
<td>Producer prices (annual average)</td>
<td>5.6</td>
<td>4.0</td>
<td>6.5</td>
<td>6.5</td>
<td>12.5</td>
<td>7.6</td>
<td>0.2</td>
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<td>Gross average monthly earnings in economy (annual average)</td>
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<td>7.0</td>
<td>10.7</td>
<td>11.3</td>
<td>19.5</td>
<td>21.7</td>
<td>na</td>
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<table>
<thead>
<tr>
<th>Government sector</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>-0.9</td>
<td>2.2</td>
<td>1.9</td>
<td>3.3</td>
<td>3.5</td>
<td>3.0</td>
<td>-0.1</td>
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<tr>
<td>General government expenditure</td>
<td>38.1</td>
<td>36.7</td>
<td>37.5</td>
<td>35.3</td>
<td>37.2</td>
<td>36.5</td>
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<tr>
<td>General government debt</td>
<td>45.9</td>
<td>40.1</td>
<td>31.3</td>
<td>24.6</td>
<td>19.8</td>
<td>19.6</td>
<td>na</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Monetary sector</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broad money (M2, end-year)</td>
<td>18.8</td>
<td>23.3</td>
<td>24.3</td>
<td>26.9</td>
<td>31.3</td>
<td>8.7</td>
<td>na</td>
</tr>
<tr>
<td>Domestic credit (end-year)</td>
<td>33.9</td>
<td>34.2</td>
<td>33.0</td>
<td>15.3</td>
<td>58.8</td>
<td>33.0</td>
<td>na</td>
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<table>
<thead>
<tr>
<th>Interest and exchange rates</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base interest rate</td>
<td>2.8</td>
<td>2.4</td>
<td>2.1</td>
<td>3.3</td>
<td>4.6</td>
<td>5.8</td>
<td>na</td>
</tr>
<tr>
<td>Lending rate (less than 1 year)</td>
<td>9.2</td>
<td>8.4</td>
<td>8.6</td>
<td>9.0</td>
<td>8.9</td>
<td>11.2</td>
<td>na</td>
</tr>
<tr>
<td>(Leva per US dollar)</td>
<td>1.5</td>
<td>1.4</td>
<td>1.7</td>
<td>1.5</td>
<td>1.3</td>
<td>1.4</td>
<td>na</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>External sector</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td>-1,022.2</td>
<td>-1,671.1</td>
<td>-3,304.6</td>
<td>-5,658.7</td>
<td>-10,039.4</td>
<td>-12,577.4</td>
<td>-5,648.7</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-2,575.9</td>
<td>-3,687.9</td>
<td>-5,490.8</td>
<td>-7,038.1</td>
<td>-9,991.4</td>
<td>-12,864.8</td>
<td>-7,232.8</td>
</tr>
<tr>
<td>- Merchandise exports</td>
<td>7,081.4</td>
<td>9,931.2</td>
<td>11,776.4</td>
<td>15,101.4</td>
<td>18,575.3</td>
<td>22,585.5</td>
<td>16,809.9</td>
</tr>
<tr>
<td>- Merchandise imports</td>
<td>9,657.3</td>
<td>13,619.1</td>
<td>17,267.2</td>
<td>22,129.5</td>
<td>28,566.7</td>
<td>35,450.3</td>
<td>23,042.7</td>
</tr>
<tr>
<td>Foreign direct investment, net</td>
<td>2,070.3</td>
<td>2,879.2</td>
<td>4,004.8</td>
<td>7,582.8</td>
<td>11,432.5</td>
<td>8,472.2</td>
<td>5,775.1</td>
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<tr>
<td>Gross reserves, excluding gold (end-year)</td>
<td>6,291.0</td>
<td>8,776.3</td>
<td>8,519.7</td>
<td>10,941.3</td>
<td>16,487.9</td>
<td>17,871.9</td>
<td>na</td>
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<tr>
<td>External debt stock</td>
<td>13,439.1</td>
<td>17,276.3</td>
<td>19,383.6</td>
<td>27,223.9</td>
<td>42,563.4</td>
<td>51,634.7</td>
<td>na</td>
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</table>

<table>
<thead>
<tr>
<th>Memorandum Items</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Estimate</th>
<th>Projection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (end-year, million)</td>
<td>7.8</td>
<td>7.8</td>
<td>7.7</td>
<td>7.7</td>
<td>7.8</td>
<td>7.6</td>
<td>na</td>
</tr>
<tr>
<td>GDP (in millions of leva)</td>
<td>34,627.5</td>
<td>38,822.6</td>
<td>42,797.4</td>
<td>49,361.0</td>
<td>56,519.8</td>
<td>66,728.1</td>
<td>64,378.1</td>
</tr>
<tr>
<td>GDP per capita (in US dollars)</td>
<td>2,561.8</td>
<td>3,175.8</td>
<td>3,522.7</td>
<td>4,111.2</td>
<td>5,204.1</td>
<td>6,561.1</td>
<td>na</td>
</tr>
<tr>
<td>Share of industry in GDP (in per cent)</td>
<td>24.9</td>
<td>24.4</td>
<td>26.1</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Share of agriculture in GDP (in per cent)</td>
<td>10.0</td>
<td>9.2</td>
<td>8.0</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Current account/GDP (in per cent)</td>
<td>-5.1</td>
<td>-6.8</td>
<td>-12.2</td>
<td>-17.9</td>
<td>-25.4</td>
<td>-25.2</td>
<td>-12.6</td>
</tr>
<tr>
<td>External debt - reserves (in US$ million)</td>
<td>7,148.1</td>
<td>8,500.1</td>
<td>10,864.0</td>
<td>16,282.6</td>
<td>26,075.5</td>
<td>33,762.8</td>
<td>na</td>
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<tr>
<td>External debt/GDP (in per cent)</td>
<td>67.2</td>
<td>70.1</td>
<td>71.3</td>
<td>86.0</td>
<td>107.6</td>
<td>103.5</td>
<td>na</td>
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<tr>
<td>External debt/exports of goods and services (in per cent)</td>
<td>133.8</td>
<td>123.8</td>
<td>119.8</td>
<td>133.5</td>
<td>169.7</td>
<td>168.8</td>
<td>na</td>
</tr>
</tbody>
</table>

1 In 2003 and 2004 general government expenditure includes capital transfers for about 0.4 per cent of GDP, which were classified below the line in the Budget Law.
2 Until 2005, effective interest rate at end-month, based on the average annual yield attained at three-month government securities primary auctions. Since 1 February 2005, the simple average of the daily values of LERDINIA (Lev Overnight Index Average), for the business days of the preceding month.