

Macroeconomic Situation

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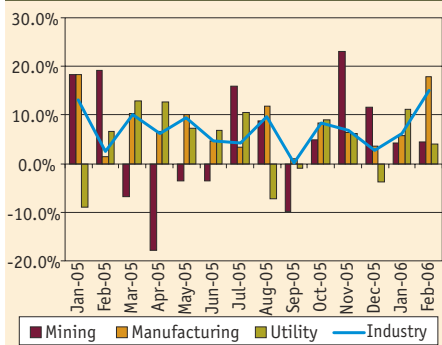
Summary

- Economic growth in 2006 is driven by the country's expanding industrial sector, which grew by a significant 15.1% year-over-year (yoy) in February, demonstrating significant upward acceleration.
- The government's prudent fiscal policy helped the country achieve a consolidated fiscal surplus of EUR 75.1 million at the end of February, which in annualized terms is equivalent to around 3% of projected annual GDP.
- March's annual consumer inflation remained at almost the same level as in the previous month (8.7% yoy.)
- The trade deficit remains the main driving force of the widening current account (CA) deficit, which reached EUR 661 million in February or 2.8% of the estimated full-year GDP. However, the existing gap is fully covered by surpluses in other components of the balance of payments.
- According to the new partnership strategy with the Bulgarian government, the World Bank will loan the country up to \$300 million per year between 2007 and 2009.

Economic Growth

In 2006, Bulgaria's real GDP growth is likely to remain at the previous year's level of 5.5% yoy. However, economic growth may reach 6% yoy in the medium term. The GDP growth acceleration may be a result of the comprehensive structural reforms currently being carried out in the country, which are also having an impact on rapidly expanding capital stocks.

Economic Growth by Sectors in 2005-2006, % yoy



Source: Bulgarian National Statistical Institute

Data released by the National Statistical Institute on the real sector's development shows that sales in the industrial sector grew by 15.1% yoy in February. This figure demonstrates significant upward acceleration from the previous month's growth of 6.2% yoy. However, data on industrial output growth (which accelerated slightly to 8.3% yoy up from 7.6% yoy in the previous month) suggests that due to some lag effect, industrial sector sales in March should be lower compared to February.

The current growth in Bulgaria's industrial sector was mainly due to rapid development in manufacturing. In

February, the country's manufacturing showed an impressive acceleration in growth, which surged by 17.9% yoy after 5.7% yoy growth in the previous month. Within manufacturing, the growth leaders were production of transportation equipment, office machinery and computers, and non-metallic mineral products. In February, they grew by 81% yoy, 68% yoy, and 22% yoy correspondently.

Expansion of Bulgarian industry was well backed by the developing mining sector, which grew in February by 4.4% yoy compared to 4.2% in the previous month, and increasing retail trade, which grew by 10.1% yoy in February, up from 0.4% yoy in January.

Fiscal Policy

During the first two months of the year, Bulgaria demonstrated prudent fiscal policy. Over the period, the country's consolidated fiscal surplus reached Lev 146.5 million (EUR 75.1 million) at the end of February, which in annualized terms is equivalent to around 0.3% of projected full-year GDP. The fiscal surplus is in line with the targeted budget surplus of 3% of GDP for 2006.

Consolidated Fiscal Program		
	Jan-Feb 2006, EUR million	Change, % yoy
Revenue	1,387.0	6.6%
Tax	1,163.5	8.4%
Non-tax	206.0	-5.9%
Grants	17.5	64.3%
Expenditures	1,311.9	6.5%
Public Wages, insurance	200.4	60.3%
Social and Health Insurance Contribution	64.2	42.6%
Social Expenditure	551.9	13.5%
Capital Expenditure	70.7	78.6%
Other	424.7	-20.8%
Balance	75.1	9.0%

Source: Bulgarian Ministry of Finance

In January-February, the fiscal budget demonstrated significant 6.6% yoy growth. Total budget revenues reached Lev 2.7 billion (EUR 1.4 billion). Over the period, the share of tax revenues in total budget revenues slightly increased to 83.9% up from 80.5% in 2005, which may signify the early success of the ongoing tax administration reform.

The implementation of the tax administration reforms creates certain short-term revenue risks. This is mainly due to some uncertainty in the successful implementation of the new practice of collecting excise taxes, while the state customs administration becomes the main government body responsible for this in July 2006. However, if successfully implemented, this measure should significantly reduce revenue losses from duty-free sales.

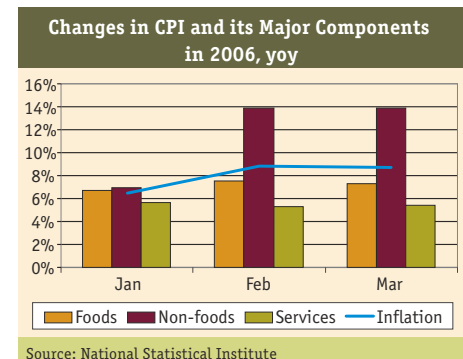
In January-February, budget expenditures grew at a slower pace than revenues. The cumulative rate of

their growth reached 6.5% yoy, while revenues grew by 6.6%. On a positive note, there was a significant acceleration in the growth rate of capital expenditures. Over the period, they grew by an impressive 78.6% yoy. However, their share in total budget expenditures still remains very low at about 5.5% at the end of February. There are some risks for successful budget execution this year. First, the planned employment cut in the central government might be difficult to implement, although it's already anticipated in the budget. Another risk is associated with some additional pressure on budget expenditures, which could appear as a result of some non-forecasted spending related to EU accession.

During the first two months of the year, Bulgaria continued to demonstrate thoughtful debt management. By the end of February, government and government guaranteed debt decreased by 0.4 percentage points and totaled EUR 6.5 billion, which translates into 27.9% of GDP. The stock of state external debt decreased to EUR 5.1 billion, which translates into around 23% of GDP. External government debt accounted for EUR 4.47 billion and government guaranteed debt amounted to EUR 0.54 billion. The breakdown of external debt by creditors suggests that international institutions still remain the most significant lenders to the country. The World Bank, International Monetary Fund, and European Union shares in the total debt stock account for 16.0%, 10.5%, and 5.6% respectively.

Monetary Sector

In March, consumer prices posted a 8.7% yoy increase, down slightly from 8.8% yoy in the previous month. Following the previous month's tendency, prices on major CPI components were growing at almost the same pace. Prices of foods, non-foods and services experienced a 7.3%, 13.9% and 5.4% yoy increase respectively.

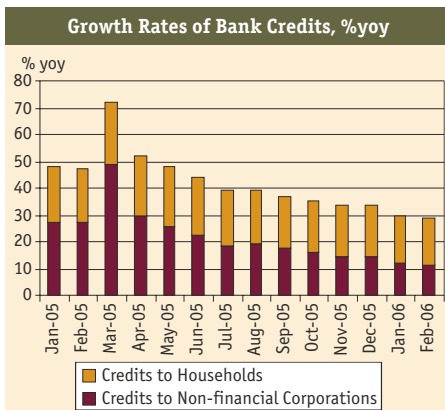


Source: National Statistical Institute

Growth of money supply (monetary aggregate M3) accelerated to 21.1% yoy in February, compared to 20.1% yoy in January. The acceleration occurred due to recovery of deposits growth after a small drop in the previous month. In month-over-month (mom) terms, an increase in money supply constituted 2% mom, compared to a 2.5% mom drop in January 2005.

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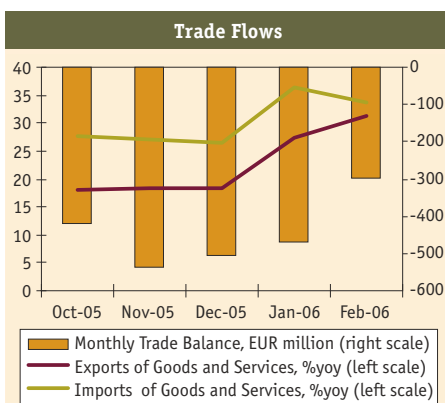
The base rate of the Bulgarian National Bank (BNB) was set at 2.28% per annum (p.a.) for March, up from 2.25% p.a. in February. The increase in the BNB base rate reflects development of the short-term money market in January-March. Over this period, Lev-denominated overnight rates surged to an all-time high 2.31% p.a. following the European Central Bank (ECB) decision to hike its rate. Bulgaria's money market responded to the ECB decision with an increase in the overnight rates on euro-denominated deposits, which spilled over to lev overnights.



Source: Bulgarian National Bank
 Note: The credit growth hike in March 2005 is due to a technical increase in credit volumes in anticipation of tougher regulation

In February, commercial banks' claims on the non-government sector increased to 40.4% of GDP up from 39.7% in the previous month. This acceleration of credit growth appeared despite the central bank's efforts to alleviate external imbalances by restraining credit activity.

International Trade and Capital

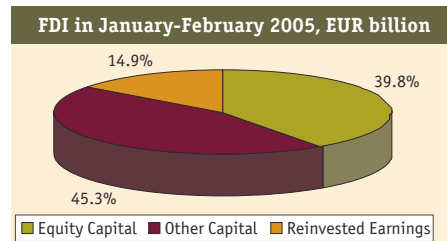


Source: Bulgarian National Bank, own calculations

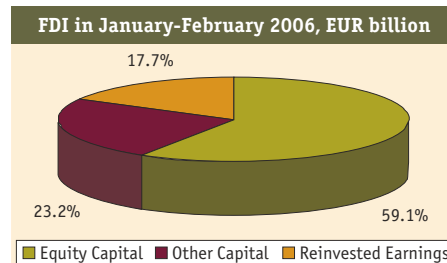
In January-February, Bulgaria's foreign trade gap continued to widen. During the period, the cumulative trade deficit in goods and services grew by 61.3% yoy and reached EUR 766 million. In February alone, growth of the trade deficit decelerated to

46.9% yoy down from 72.1% in the previous month thanks to export acceleration and import deceleration. However, the widening in the trade gap continued as growth of imports still outpaced that of exports. In February, Bulgarian exports surged by 31.4% yoy up from 27.5% yoy in the previous month, while imports grew by 33.7% yoy down from 36.5% in January. Although these movements decreased the trade gap, it still remains significant.

The trade deficit remains the major driving force of the widening current account (CA) deficit. In February, the CA gap reached EUR 661 million, which can be translated into 2.8% of estimated full-year GDP. On a positive note, large surpluses in the financial and capital accounts item of the balance of payments remained high enough to cover the CA deficit. This allowed the BNB to keep its foreign exchange reserves at a substantially high level of EUR 6.9 billion, which translates into almost 6 months of imports.



Source: Bulgarian National Bank, own calculations



Source: Bulgarian National Bank, own calculations

Net inflow of FDI and debt-related investment (trade credits, external loans, etc.) remained the major driving forces of the capital inflow, accounting for more than 60% of the financial account surplus. According to preliminary data released by the BNB, in January-February 2006 FDI in Bulgaria amounted to EUR 271.2 million (1.1% of GDP) against EUR 180.2 million (0.8% of GDP) attracted in the same period of 2005. Despite acceleration of FDI inflow compared to the respective period of the previous year, the FDI-to-GDP ratio is rather low. This may be explained by the reluctance of the country's government to push the privatization process, which resulted in the absence of privatization deals with foreign companies starting at the beginning of this year. The breakdown of FDI by type of investment shows that equity capital has become the largest type of investment in Bulgaria, reaching 59.1% of the total amount of FDI in Janu-

ary-February 2006 compared with 39.8% in the same period of the previous year. Another positive sign is an increasing share of reinvested earnings, which reached 17.7% during the first two months of this year against 14.9% in the corresponding period of last year.

Together with the leveraged consumption boom and FDI-related high demand for investment goods, real appreciation provides a strong impetus for imports, thus causing large trade and CA deficits. Therefore, the measures recently adopted by the Bulgarian government aiming to discourage aggregate demand by switching from a fully balanced budget target to a surplus of 3% of GDP (in case the CA deficit to GDP ratio remains above the 12% threshold) is very reasonable.

International Programs

In April, the IMF completed the second performance review under the pre-cautionary standby arrangement with Bulgaria, deciding to approve a waiver-request for the next IMF mission in three areas: (i) selection of winning bids for the sale of three large thermo-power plants, (ii) adoption of the National Revenue Agency procedural code in parliament, and (iii) incorporation of all Lev-denominated judicial accounts into the budgetary payments system. In addition, the IMF also approved a request for merging the third performance review into the fourth, which is supposed to take place in August before the expiration of the two-year standby arrangement.

The European Bank for Reconstruction and Development (EBRD) announced that it would invest around EUR 20 million in small and medium-sized private companies in the retail, distribution, healthcare, logistics and media sectors that have well established market positions or a defendable niche and have strong management. The investment will be done through the private equity group operating in Bulgaria and Romania.

The World Bank (WB) announced that it would lend up to USD 300 million per year to Bulgaria between 2007 and 2009, according to the new partnership strategy with the Bulgarian government. By adopting the new strategy, the WB will continue to assist Bulgaria in the EU accession process. The reserved funds will be invested in projects related to (i) development of the country's financial infrastructure; (ii) reduction of regional development disparities, and (iii) some other projects dealing with effective utilization of EU funds.

Other Developments and Reforms Affecting the Investment Climate

A financial stability report prepared by the World Bank ranks Bulgaria as number four among other

Central and East European countries in terms of nonperforming loans. Data provided in the report suggest that the share of nonperforming loans in total loans is around 8%, while in 2004 this indicator stood at 6.9%. In terms of bank return on equity, Bulgaria is ranked third in Central and Eastern Europe with 23.6%.

In April, the parliamentary commission on budget and finance passed the new draft law on the VAT in the first reading. The new law harmonizes the tax

collection procedures with EU requirements and practices. Although such adoption of the law is the requested step, the Ministry of Finance estimates that the change in the existing VAT collection system could reduce the budget revenue coming from VAT by EUR 230 million.

The Bulgarian state customs administration reported that there was a growth in its revenue by 34.9% yoy to EUR 0.8 billion in the first quarter of

2006. This figure is comprised of import charges from excise taxes, VAT, tariffs, fees and sanctions.

The Cabinet of Ministers approved a plan to decrease the number of Ministry of Finance employees. According to the plan, 10.4% of the staff at the ministry will be cut. The same plans were also approved for the Ministry of Labor and Social Affairs and some other state agencies. With this move, the government is trying to reduce budget expenditures and improve efficiency of public administration.

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