

Macroeconomic Situation

Oleg Ustenko, Edilberto Segura, Olena Kramarska

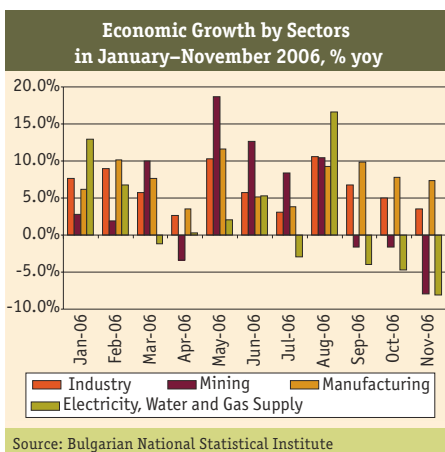
Summary

- In 2006, Bulgaria demonstrated good real sector performance with an annual rate of growth of around 6% year-over-year (yoy), which was driven by the expanding industrial sector, services and trade.
- In January-November, the fiscal surplus rose to EUR 1.3 billion, which translates into 5.5% of projected full-year GDP.
- In December, the consumer price index (CPI) demonstrated further acceleration, increasing by 6.5% yoy as compared to 6.1% in November, which brings the average annual inflation to 7.3% yoy.
- The current account (CA) deficit remains a significant risk factor, reaching 12.9% of the projected full-year GDP in January-November. On a positive note, FDI inflows were able to cover 106.2% of the existing CA gap in the same period.
- On January 1, 2007, Bulgaria officially joined the European Union (EU), which opens a new opportunity for the country's further development.

Economic Growth

In 2006, the Bulgarian economy grew at an accelerated rate, posting a growth of 5.6% yoy in Q1, 6.6% yoy in Q2, and 6.7% yoy in Q3, which should bring the annual rate of growth to around 6% yoy. Industrial production, which surged in January-November by 6.2% yoy, remains the most important source of the country's growth.

In January-November 2006, sales of the country's industrial sector posted a solid growth of 6.7% yoy. A higher pace of growth in sales compared to production is partly due to the stores formed in the previous year and sold in the first half of 2006.



During November itself, industrial production increased only marginally by 3.5% yoy. Moreover, November was the third month in a row when the industrial sector experienced significant deceleration in its rate of growth after a solid increase of 5% yoy in the previous month and 6.8% yoy two months before. The main reason for such a slowdown in the in-

dustrial rate of growth is the unsatisfactory performance of the mining sector, which production shrunk by 8% yoy in November following decreases in the previous two months.



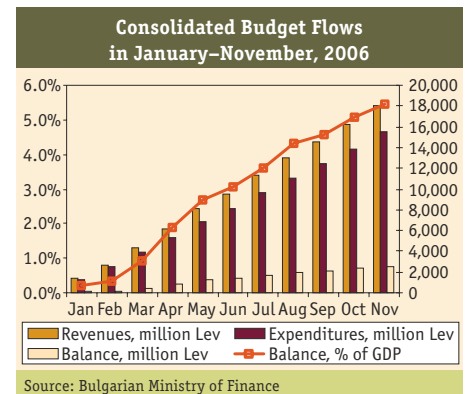
The main driving force for Bulgarian industry remains manufacturing. Despite some slowdown experienced over the last three months, manufacturing continues to post solid rates of growth. In November, manufacturing production surged by 7.4% yoy. The product breakdown of manufacturing shows that the most significant growth was observed in production of fabricated metal products, which jumped by 36% yoy in November. Solid growth was also demonstrated by companies producing motor vehicles, trailers and semi-trailers. After a significant decline in the previous two months, this sub-sector demonstrated recovery, surging by 26.8% yoy. However, it's still very early to argue that such an increase will develop into a new trend. On the other extreme, manufacturing of radios, televisions, and communication equipment saw its production drop by 52.3% yoy in November; manufacturing of tobacco had a drop of 30.8% yoy, while publishing and printing declined by 22.3% yoy.

In November, utility production became an additional factor that negatively affected the overall performance of Bulgaria's industrial sector. Moreover, it was the third month in a row when this sector experienced a significant decrease. During the month, its production dropped by 8.1% yoy. The main reason for this decline is relatively good weather conditions as compared with the same period of the previous year and the broad introduction of energy saving technologies, which decreased the demand for energy resources.

Fiscal Policy

In January-November, the government conducted prudent fiscal policy. The growth of revenues outpaced growth of expenditures, and the budget surplus reached Lev 2.5 billion (EUR 1.3 billion). The existing fiscal budget surplus can be translated into 5.5% of projected full-year GDP. However, based on the latest forecast by the Bulgarian Ministry of Finance claiming that the full-year fiscal surplus should be not more

than 3.5% of GDP in 2006, a boost in December's expenditures can be anticipated.



In January-November, revenues continued to grow at an accelerated rate. During the period, revenue collections grew by 11.2% yoy as compared to 10.5% yoy in January-October and reached Lev 18.0 billion (EUR 9.2 billion), which is about 40% of projected full-year GDP. Acceleration in growth rates was registered in all revenue components. Thus tax collections, which contribute over 80% to total revenues, grew by about 13% yoy and amounted to Lev 14.6 billion (EUR 7.5 billion). Non-tax revenues grew by 1.1% yoy as compared to 0.6% yoy in January-October and reached Lev 2.8 billion (EUR 1.4 billion), while grants increased by 23% yoy, amounting to Lev 0.6 billion (EUR 0.3 billion).

Budget expenditures were also increasing at an accelerated rate in January-November, although much slower than revenues. Thus, consolidated budget expenditures rose by 7.5% yoy during the period, amounting to Lev 15.5 billion (EUR 7.9 billion) or 34% of projected full-year GDP. Social expenditures, which are the biggest component of budget expenditures, continued to grow at a stable rate of 38% yoy since January-October, reaching Lev 6.2 billion (EUR 3.2 billion) by the end of November. On a positive note, there was further acceleration in the growth rate of capital expenditures, which rose by 6.6% yoy in January-November as compared to 3.8% yoy in January-October, and amounted to Lev 1.8 billion (EUR 0.9 billion).

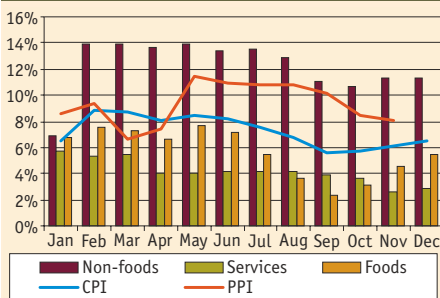
In November, the government continued to demonstrate thoughtful debt management. Total government and government-guaranteed debt was further decreased. In November, their total amount dropped by EUR 57.1 million and reached EUR 6.27 billion by the end of November. In terms of GDP, total debt constituted 26.9%, which is 0.3 percentage points lower than in the previous month. The decrease in the total debt stock was due to a decline in external debt, which shrank by EUR 54.5 million during the month, and constituted EUR 4.2 billion. At the same time, the stock of domestic debt experienced an increase by EUR 1.4 million, bringing the total debt stock to 24.6% of period GDP. The breakdown of external debt by type of creditor

shows that the World Bank (WB), International Monetary Fund (IMF) and European Union remain the main lenders to the country. Their shares in total debt stock are 12.8%, 4.4% and 4.1% respectively.

Monetary Sector

In December, prices of consumer goods and services demonstrated further acceleration in their rate of growth. Thus, driven by an increase in the prices of food and non-food products, CPI rose by 6.5% yoy in the last month of the year up from 6.1% yoy in November. Year-end inflation, therefore, turned out to be on the same level as in 2005, while average inflation was 7.3% for the year, which is 4.5 pps higher than in 2005. A product breakdown of CPI components shows that the highest price increase was registered in non-food prices, which rose by 11.3% yoy for the second month in a row. Food prices rose by 5.4% yoy, accelerating by 0.8 pps since November and contributing 2 pps to the overall consumer price index. Acceleration in CPI growth rates was also attributed to service prices, which grew by 2.8% yoy after a 2.6% yoy increase in November.

Changes in CPI, its Major Components, and PPI in 2006, yoy



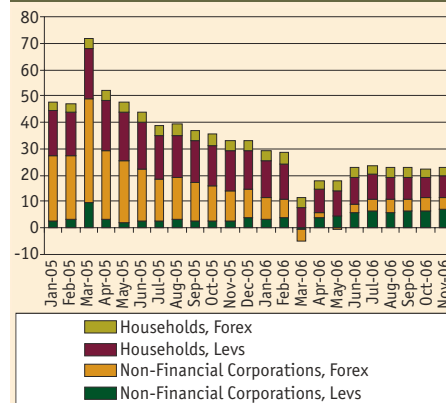
Source: Bulgarian National Statistical Institute

Contrary to the CPI, growth of the Producer Price Index (PPI) slowed down in November, posting a deceleration trend for the seventh month in a row. In November, growth of prices of locally traded industrial goods slowed down to 8.1% yoy, as compared to 8.5% yoy in October. Deceleration in the growth of prices was also registered in the mining sector as well as in the utility sector, where producer prices grew by 41.1% yoy and 9.1% yoy respectively versus 46.8% yoy and 12.4% yoy in the previous month. At the same time, manufacturing producer prices rebounded in November, growing by 4.5% yoy up from 3.4% yoy in October.

In November, broad money supply (M3) rose by 26.5% yoy, accelerating slightly from the previous month and reaching Lev 30.4 billion. The monetary base grew at a slightly slower rate than money supply (23% yoy), and amounted to Lev 9.8 billion by the end of the month. As a result, the monetary multiplier constituted 3.1, which is only marginally lower than in the previous month.

In December, the Bulgarian National Bank (BNB) continued to raise the nominal base interest rate, which was set at 3.26% up from 3.19% in November.

Growth Rates of Banks Credits, yoy % in 2005-2006



Source: Bulgarian National Bank

In November, bank credits to households and non-financial corporations grew by 23.6% yoy, demonstrating stable growth since August and reaching Lev 21.6 billion. At the same time, growth of credits issued in Levs accelerated from the previous month to 28.4% yoy, while growth of credits issued in foreign currency remained at the previous month's level of 18.3% yoy. Non-financial corporations remained the largest debtors of the banks, with the share of credits issued to them being 58.8%, while the share of credits issued to households was 40.2%. The share of credits taken by households in foreign currency remained rather low — 7.4%, while the share of non-financial corporations' credits in foreign currency exceeded those taken in national currency — 37% versus 22%.

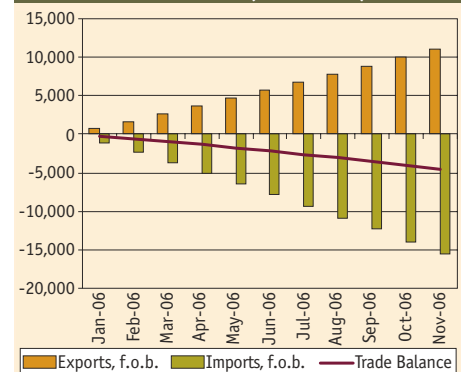
International Trade and Capital

In January-November, the Bulgarian trade deficit in goods and services continued to post further deterioration. Only in November it surged by EUR 0.5 billion, which brings the cumulative number for January-November to EUR 4.5 billion. This amount is equivalent to 18.8% of the country's period GDP compared to the 16.5% deficit posted one month earlier. The trade deficit continues to widen due to a decrease in world prices for metals as compared with the previous year, along with a parallel increase in energy prices.

Starting in May 2006, Bulgarian exports have been showing a positive trend, posting a faster rate of growth than with imports. In November, exports grew by 27.9% yoy, while imports posted 3.3 pps lower growth. Although this trend is positive, the higher growth experienced in exports is still not enough to eliminate the existing gap in trade. A geographical breakdown of Bulgarian exports shows

that the country is deeply integrated with the EU member states, which consumed 55.1% of the exported goods from Bulgaria in November. Moreover, the recent accession of Bulgaria to the EU should further deep this integration.

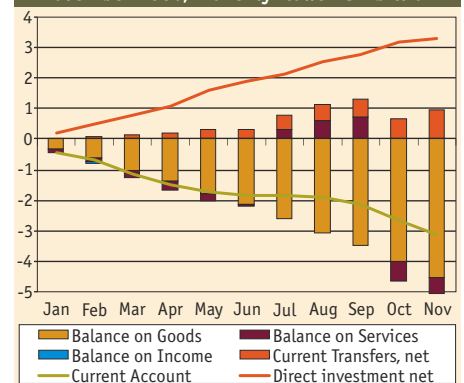
Bulgarian Foreign Trade Indicators, in EUR million (cumulative)



Source: Bulgarian National Bank, The Bleyzer Foundation

Imports continued to post some deceleration in their rate of growth. In November, it grew by 24.6% yoy after a 25.6% yoy increase in the previous month and 26.4% yoy two months before. This positive trend might continue in the following months due to slower growth of imported energy resources as compared to the previous year. In nominal terms, Bulgarian imports increased in November by EUR 1.6 billion in FOB prices. At the same time, exports grew by EUR 1.0 billion, which is still not enough to cover the gap in the trade balance.

Current Account Components in January-November 2006, monthly flows EUR billion



Source: Bulgarian National Bank, The Bleyzer Foundation

In January-November, the CA deficit continued to increase. At the end of the period, its cumulative amount reached EUR 3.11 billion compared with EUR 2.66 billion at the end of the previous month. The existing CA gap can be translated into 12.9% of projected full-year GDP, which is 1.9 pps higher as compared with the previous month's level. In November alone, the increase in the CA gap was

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Where Opportunities Emerge.

Sofia Office, Bulgaria

10, Dimitar Manov Str., 5th floor,
Sofia, 1408
Tel: (359-2) 953 15 85 Fax: (359-2) 953 19 89
E-mail: office@bg.sigmableyzer.com

slightly lower compared with October data and constituted EUR 0.46 billion. A significant deterioration in the trade balance remains the main reason for the widening CA deficit.

Although the CA deficit remains a significant risk factor for the Bulgarian economy, it's successfully covered by the significant amount of FDI inflows. In January-November, the cumulative amount of FDI reached EUR 3.31 billion, which is more than enough to cover the existing CA gap. The existing FDI-to-CA deficit ratio at the end of November was 106.2%. Moreover, Bulgaria's accession to the EU will serve as an important driver for further increases in FDI, which decreases the importance of concerns related to the CA deficit.

International Programs

After a period of long debates, the agreement for construction of a bridge across the Danube, connecting Bulgaria and Romania, was signed. The two countries could not reach an agreement on the location of the bridge for over 10 years. The tender for the bridge construction was won by the Spanish company FCC Construction, and the project is planned to be finished by 2010. Danube Bridge II, which is a part of the European transport corridor IV, is going to receive significant EU funding, with the European Commission providing EUR 70 million.

In December, the World Bank announced its intentions to support Bulgaria in its efforts to integrate within the European community. Within this framework, the WB is going to start a two-year program of economic analysis for encouraging production efficiency, which will include several analytical reports and studies in this area. In addition, under the Strategy for Partnership approved in June 2006, the WB will provide technical and financial support for reforms in education, health care, and improvement of roads, trade and municipal infrastructure. Moreover, the WB is going to provide a grant in the amount of \$1 million for education projects aimed at enhancing labor productivity in Bulgaria.

Other Developments and Reforms Affecting the Investment Climate

On January 1st, Bulgaria officially joined the EU. The EU accession opens a new opportunity for Bulgaria after a 17-year period of transition from a planned economy to a free market, and full integration into the single market of the richer EU countries. As a result of Bulgaria and Romania's accession to the EU, the newly enlarged Union of 27 members now has around 500 million citizens and is the world's largest market and trade partner. During the celebration, Bulgaria's leaders emphasized that the country's membership in the EU is not aimed at con-

suming benefits but at strengthening the economic and political power of the Union and exporting political stability to other Balkan countries.

The Bulgarian Privatization Agency estimates that 2006 revenues from the sale of state companies constituted EUR 489 million. The calculations comprise 24 majority stakes, 10 units separated from state enterprises, and minority stakes placed on the Bulgarian stock exchange. The major receipt of EUR 206 million is due to the sale of the thermo-power plant in Varna to the Czech Electricity Company (CEZ). The Privatization Agency signed several deals for heating utility companies in large cities, excluding the capital Sofia. However, the privatization process is not finalized yet and all related revenues will be received in 2007. In early 2007, the agency will be finalizing the privatization of the national air carrier Bulgaria Air. The expected amount of this deal is estimated as EUR 6.65 million for the full stake, which is at least three times lower than initially anticipated.

The State Labor Agency announced that Bulgaria's unemployment rate increased slightly in November to 8.7% due to the seasonal labor market effect. It is anticipated that this level of unemployment will continue through the end of March at the latest. It is also expected that labor supply will slightly decline in 2007 due to the fact that some job seekers could move to other EU countries since 9 members of the EU fully opened their job markets — the 7 countries that joined EU in 2004, plus Finland and Sweden.

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123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
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Sofia Office, Bulgaria

10, Dimitar Manov Str., 5th floor,
Sofia, 1408
Tel: (359-2) 953 15 85 Fax: (359-2) 953 19 89
E-mail: office@bg.sigmableyzer.com