

Macroeconomic Situation

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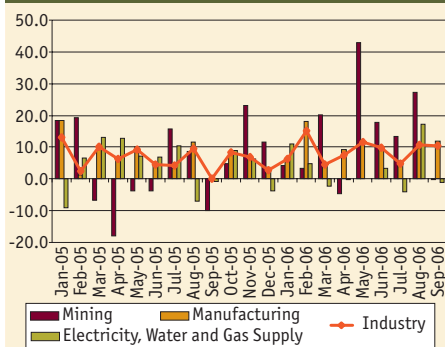
Summary

- In September, positive developments in Bulgaria's real sector were supported by the expanding industrial sector, whose sales grew by 10.4% year-over-year (yoy), and retail trade, which surged by 16.5% yoy.
- January-September's consolidated budget surplus reached 4.6% of full-year GDP, which represents some deceleration from 51% yoy growth demonstrated in August to the current 37% yoy level.
- The consumer price index (CPI) posted only a marginal acceleration to 5.7% yoy in October, up from 5.6% yoy demonstrated in the previous month.
- The current account (CA) deficit still remains a significant risk factor, reaching 8.7% of projected full-year GDP in January-September, representing some growth from the previous month's level of 7.9%. On a positive note, the same period FDI inflows were able to cover 135% of the CA gap.
- President Georgi Parvanov won the second round of the presidential election on October 29th by receiving 75.9% of the vote cast. President Parvanov's second 5-year term officially starts on January 22nd, 2007.

Economic Growth

In September, Bulgaria's real sector continued to demonstrate very positive developments. As in the previous month, such strong performance was supported by the rapidly developing industrial sector and retail trade.

Economic Growth by Sectors in 2005–2006, % yoy



Source: Bulgarian National Statistical Institute

September was the second month in a row when industrial sector sales grew above 10% yoy. During the month, they surged by a significant 10.4% yoy. This growth was mainly supported by manufacturing, which increased by 12% yoy. The monthly performance might have been even better if other industrial sub-sectors did not experience some decline. In particular, after notable growth in the previous month by more than 27% yoy, sales in the country's mining sector shrunk by 0.2% yoy. After 17.2% yoy growth in August, sales in the utility sector shrunk by 1.1% yoy.

Although September's data on industrial output production showed the same tendency as with industrial

sales, the overall monthly level of production was slightly lower than sales. In September, the monthly index for industrial output posted a 6.4% yoy increase, which is 4 percentage points (pps) lower compared with the growth in sales. Since there is a certain time-lag between output and sales, some deceleration in September's output should negatively affect growth in industrial sales during October. However, this tendency might be neglected if industrial output returns to the acceleration trend in November.

Solid growth in sales of Bulgaria's manufacturing was supported by production of transportation means, basic metals, electrical machinery and furniture, whose sales grew by 95.2% yoy, 32.8% yoy, 29.4% yoy, and 24.5% yoy respectively. The monthly performance of manufacturing could have been even higher if there hadn't been downward pressure from radio and TV producers, chemical goods such as plastic and rubber, publishing and printing, which continued to demonstrate a downward trend, declining by 23.0% yoy, 7.0% yoy, and 3.2% yoy respectively.

In September, the Bulgarian mining sector experienced a downturn, which appeared after four months in a row of very strong expansion. Although world metal prices were still at a very decent level, Bulgarian metal ore's extracting grew at a much lower pace of 6.1% yoy as compared with the previous month's data. On the opposite side, coal mining dropped by 5.8% yoy during September, which is mainly due to the modernization currently being implemented at several coal-fired thermal plants and related to the decline in demand for coal.

Good performance of the country's real sector was supported by surging retail trade, whose sales in September accelerated by 16.5% yoy. On the other hand, September's wholesale trade performance was significantly weaker and posted only a 1.7% yoy rate of growth.

Fiscal Policy

In January-September, the government conducted prudent fiscal policy. The fiscal surplus was increasing and constituted EUR 1.078 billion (Lev 2.1 billion) or 4.6 % of full-year GDP. However, the growth rate of the fiscal surplus decelerated somewhat to 37% yoy representing a slight slowdown from 51% yoy posted in January-August. This deceleration is mainly due to a slowdown in the rate of growth in revenue collection and some acceleration in the growth rate of expenditures.

In January-September, fiscal revenues continued to grow. However, a slight slowdown was observed in their rate of growth. During the period, revenues grew at a rate of 10% yoy as compared to 10.4% yoy in January-August, and reached Lev 14.5 billion (EUR 7.4 billion). Deceleration was observed in the growth rates of taxes and grants, which grew by 11% yoy and 20% yoy respectively as compared

to 12.2% yoy and 30.8% yoy in January-August. On a positive note, the decline of non-tax revenues, the second largest component of budget revenues, became not as steep as in the previous month. As of the end of September, it shrunk by 0.2% yoy compared with a 0.7% yoy decline in January-August.

Consolidated Fiscal Program in January–September 2006

	EUR million	% of total	Change, % yoy
Revenue	7,415.1	100	10
Tax	5,990.0	81	11
Non-tax	1,180.5	16	-0.2
Grants	244.6	3	20
Expenditures	6,337.2	100	6
Public Wages, insurance	980.5	16	53.5
Social and Health Insurance Contribution	314.2	5	37
Social Expenditure	2,612.5	41	13.2
Capital Expenditure	646.8	10	-0.1
Other	1,783.3	28	-17.5
Balance	1,017.6		37

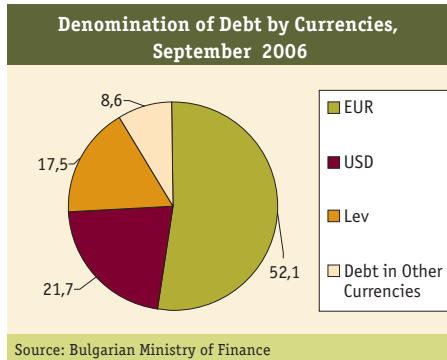
Source: Bulgarian Ministry of Finance

Contrary to revenues, expenditures grew at an accelerated rate in January-September after some slowdown in January-August. During the period, they increased by 6% yoy, reaching Lev 12.4 billion (EUR 6.3 billion) or 27% of projected full-year GDP. The acceleration was mainly due to the rise in the growth rate of social expenditures, the largest component within budget expenditures. According to the Ministry of Finance, they grew by 13.2% yoy up from 12.8% yoy in January-August and constituted Lev 5.1 billion (EUR 2.6 billion).

The objectives of the fiscal policy for the next year, as presented by the Minister of Finance, are maintaining macroeconomic and fiscal stability, creating conditions for economic growth, improving competitiveness of the Bulgarian economy and raising the quality of life in Bulgaria. The Minister also noted that the 2007 Budget provides for an increase in pensions by 8.5% starting 1st of July 2007, as well as for an increase in public sector wages by 10%. The minimum non-taxable threshold is going to be raised from Lev 180 to Lev 200 and the minimum monthly salary — from Lev 160 to Lev 170. In addition, the corporate income tax is going to be reduced from 15% to 10%, which will make it one of the lowest within the EU member states.

In September, the amount of public and publicly guaranteed debt slightly increased, which was due to some increase in the amount of domestic debt. The increase in domestic debt by about EUR 8.7 million was only partially compensated for by a decline in external debt of about EUR 8.5 million, causing an increase of 0.2 million in total debt. Thus, by the end of the month, the total public debt amounted to EUR 6.4 billion, including EUR 1.5 billion of domestic debt and EUR 4.8 billion of external debt. As a percentage of GDP,

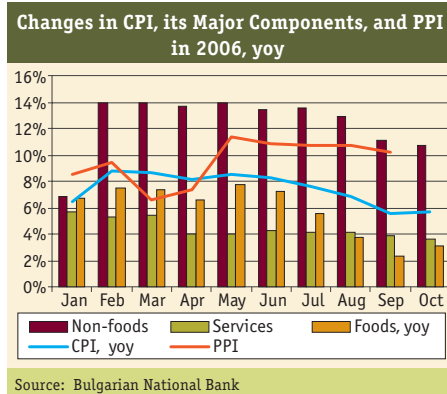
total debt remained unchanged since the previous month at a level of 27.3%. In 2007, the government is going to continue to conduct prudent fiscal policy aimed at further debt reduction, as it was noted by the Minister of Finance during the presentation of the 2007 Budget in the Parliament.



The breakdown of debt by currency suggests that its foreign currency structure experienced some changes. Thus, during the month, shares of USD and Lev-denominated debt rose to 21.7% and 17.5% respectively, and the share of EUR denominated debt fell to 52.1%. The breakdown of external debt by type of creditor shows that the World Bank, International Monetary Fund and European Union, with shares of 16.7%, 6%, and 5.3% respectively, remain the largest lenders to the country.

Monetary Sector

In October, the consumer price index (CPI) posted a 5.7% yoy increase, which represents only a marginal increase of 0.1 pps from its previous month's level. The increase was due to acceleration in the growth rate of food prices, which grew by 3.1% yoy as compared to 2.3% yoy in September and contributed 1.15 pps to overall price inflation. At the same time, service rates and non-food prices continued to decelerate. In October, they constituted 3.6% yoy and 10.7% yoy growth respectively.

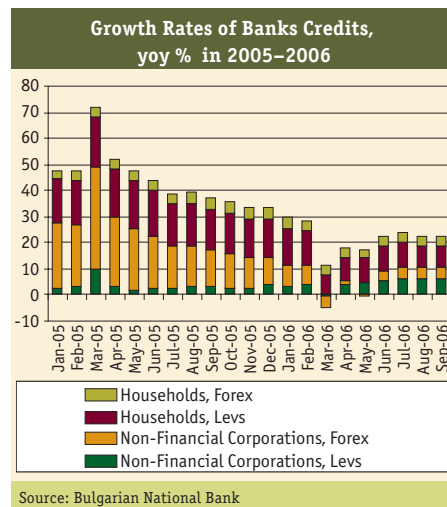


In September, the producer price index (PPI) of domestically produced goods was further decelerat-

ing. By the end of the month, inflation of producer prices stood at 10.1% yoy, demonstrating a 1.3 pps slowdown since it started its deceleration in April 2006. On the opposite side, acceleration in PPI inflation was noticed in the mining and utilities industries, where prices grew by 54.7% yoy and 11.3% yoy respectively. In the mining industry, the biggest price increase was demonstrated by mining of metal ores. In September, its prices grew by 121.8% yoy as compared to 115.3% yoy in August. In utilities, the biggest price increase was observed in the supply of electricity, gas, steam and hot water, which increased on average by 13.2% yoy.

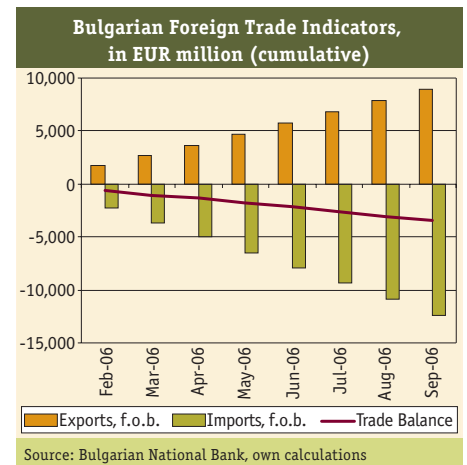
In September, money supply (M3) grew at a rate of 24.7% yoy, which is 2.2 pps higher than in the previous month, and reached Lev 29.6 billion. At the same time, the monetary base grew at an accelerated rate of 21.8% yoy in September, as compared to 18% yoy in August, and constituted Lev 9.5 billion. As a result, the monetary multiplier was 3.1, which is only slightly lower than in the previous month.

The Bulgarian National Bank continued to raise the interest rate, which in October was set at 2.98 per annum (p.a.).

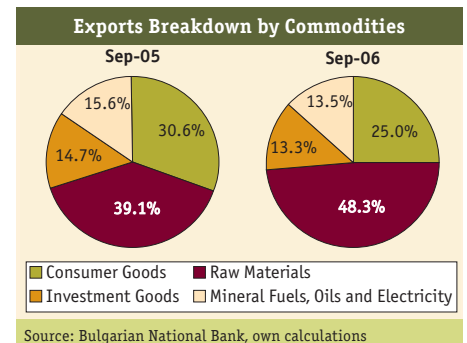


In September, the volume of banking system credit to the non-government sector remained almost unchanged from the previous month's level. By the end of September, it reached Lev 20.7 million, as compared to Lev 20.3 million in August. However, as compared with the previous year's level, the growth in banking system credit to the non-government sector represents a 23% yoy increase. Slight acceleration was noticed in the growth rate of credit to households, while slight deceleration was registered in the growth of non-financial corporations' credit. In September, credit to households and non-financial corporations grew at a rate of 32.6% yoy and 17.3% yoy respectively, compared to 32.2% yoy and 17.5% yoy respectively in the previous month.

International Trade and Capital



In January-September, the Bulgarian trade deficit in goods and services was on an upward trend and reached EUR 3.5 billion, which is translated into 14.3% of the country's period GDP compared with the 12.9% trade deficit posted one month earlier. As in the previous month, the upward trend in the trade deficit is due to a base effect-in particular, to the low level of energy prices in the previous year and to some current weakening in the prices for metals, which is the most sensitive group of Bulgarian exports in goods and services.

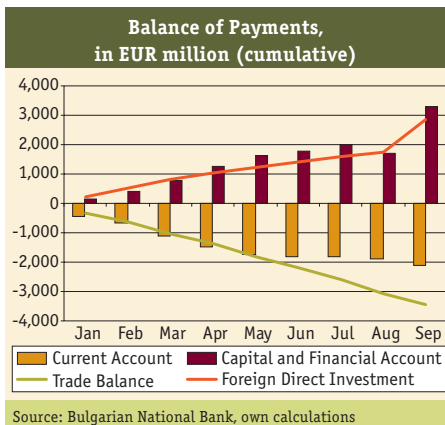


September became the fifth month in a row when Bulgarian exports posted a faster rate of growth as compared with imports. During the month it surged by a strong 30.9% yoy, while the rate of growth in imports was 4.5 pps points lower. However, the demonstrated rate of growth in exports was still insufficient to cover the negative trend in the country's trade gap. In nominal terms, January-September's exports reached EUR 8.9 billion. The lion's share of the country's exports was obtained by raw materials, which represented 48.3% of the total volume of exports in goods in September. Within raw materials, the most exported goods were metals, whose weight within this group was 43.5%. The second heavily exported group of goods was consumer goods, which accounts for a quarter of Bulgaria's total exports. In contrast to raw materials, which are

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mostly exported to the EU, consumer goods are mainly directed to the CIS and Balkan countries.

Imports continued to post some deceleration in their rate of growth in January-September, increasing by 26.4% yoy, which is slightly low compared with 27.1% yoy growth demonstrated in the previous month. In nominal terms in FOB prices, as of the end of September, Bulgarian imports reached EUR 12.4 billion, which is almost 40% more than the same period total volume of exports. A breakdown of the country's imports by product shows that the largest share belongs to raw materials. In September, their share was 38.1%. Moreover, 20.3% of the total volume of this group of imports belonged to ores. Increasing domestic consumption was a significant driver for growth in the volume of imported consumer goods. In January-September, they grew by 20.2% yoy and reached 14% of the total volume of Bulgarian imports.



In January-September, the CA continued to widen and at the end of period reached EUR 2.1 billion, which can be translated into 8.7% of projected full-year GDP compared with 7.9% demonstrated in the previous month.

Despite the existing gap in the CA, it is fully covered by strong FDI inflow. In January-September,

FDI was able to cover 135% of the existing CA gap. During the period, it surged by a strong 11.8% yoy. Since Bulgaria's forthcoming accession to the EU should secure an additional increase in FDI inflow in the short and medium run, the risk of having a CA deficit is relatively low.

International Programs

Bulgaria's Ministry of Labor and Social Policy announced in November that under the EU PHARE programme for implementation of the de-institutionalization project, Bulgaria will receive a grant of EUR 6.67 million. The project aims to improve living standards for children, the elderly and people suffering from psychological disorders. EUR 4.67 million will be used for medical treatment and education of children as well as the elderly, and another EUR 2 million will be used to establish hospital facilities for people with psychological disorders.

In November, the EBRD announced that it would issue a loan for EUR 15 million to the United Bulgarian Bank (UBB) and Commercial Bank Allianz Bulgaria. UBB, the third largest Bulgarian Bank, will receive EUR 10 million, which will be used for enhancing energy efficiency of Bulgarian industrial enterprises. Another EUR 5 million will be directed to Allianz Bank and used to support the development of small and medium size enterprises. The EUR 5 million loan will be issued under the EU/EBRD SME Finance Facility and will be complemented by a grant in the amount of EUR 1 million from the European Commission for technical assistance and financial incentives.

Other Developments and Reforms Affecting the Investment Climate

President Georgi Parvanov, who received 64% of the vote cast in the first round of the presidential election on October 22nd, won a second round on October 29th. In the second round, President Parvanov

was supported by 75.9% of the votes against 24.1% cast for opposition leader Volen Siderov. The results show that the EU integration perspective, which was the subject of discussion between the two candidates, has no alternative and is highly supported by the majority of Bulgarian voters. President Parvanov became the first Bulgarian democratically elected President to win a second 5-year term, which officially starts on January 22nd, 2007.

Data on the country's unemployment (calculated based on ILO methodology) showed that in Q3 its period-average dropped to 8.8% down from 9% posted in Q2. The decline may reflect a seasonal increase in the number of jobs. Therefore, there is not enough evidence to argue that the level of unemployment is on a downward trend.

In October, S&P upgraded its long-term foreign currency status for Bulgaria to BBB+ up from its initial level of BBB. This upgrade is in line with the previously defined positive outlook for Bulgarian currency, and is mainly due to Bulgaria's forthcoming entry into the EU. Now S&P ranks Bulgaria one notch above Fitch and two notches above Moody's, which are also likely to change their grades for the country in a very short time.

The Bulgarian state energy regulator announced that household prices for electricity enforced as of October 2006 would remain unchanged until July 2007. The European Parliament foreign policy panel expressed its concerns regarding the low level of flexibility in Bulgarian tariff policy for electricity and should discuss this issue shortly.