

Macroeconomic Situation

Oleg Ustenko, Edilberto Segura

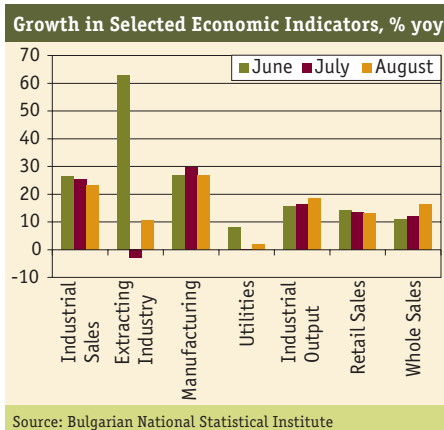
Summary

The Bulgarian economy continues to grow. In August, the main sources of growth were the industrial sector (23.1% year-over-year (yoy) increase in sales), the service sector (driven by a 17.3% yoy increase in the number of foreign tourist visits), and wholesale and retail trade (16.3% yoy and 13.2% yoy respectively.) The government has maintained prudent fiscal policies, generating a cumulative fiscal surplus in January-August equal to 2.8% of projected full-year GDP, which helped push fiscal reserves to EUR 2.46 billion. The amount of public debt dropped by EUR 11 million in August and reached 42.3% of GDP.

In October the 2005 budget was introduced; it targets a fiscal deficit of 0.5% of GDP and is based on a 5.3% economic growth rate. In September, the increase in food prices and non-alcoholic beverages generated consumer inflation of 6.2% yoy. Due to the rise in oil and metal prices, the producer price index (PPI) reached 4.9% yoy in August.

For the first time since the beginning of the year, Bulgaria showed a current account surplus (EUR 234.8 million) in July. This is due to a decrease in the trade deficit, and an increase in current transfers. FDI stock in January-July reached EUR 1.3 billion and most likely will amount to some EUR 2.5 billion by the end of this year. The EBRD's EUR 20 million senior-loan and a reserve fund of EUR 10 million will be issued to facilitate further competition in Bulgaria's leisure hotel industry. The World Bank published its report on the country's law on education. In its latest report, S&P outlined high growth potential for Bulgaria. Moody's issued a press release for possible upgrades of several debt issuers in Bulgaria.

Economic Growth



In August, the Bulgarian economy continued to show substantial development, which should assure full year GDP growth of around 5.5%. Arguments in favor of this estimate are provided by the double-digit growth in the industrial sector, tourism, the telecom and construction sectors as well as the increased grain crop.

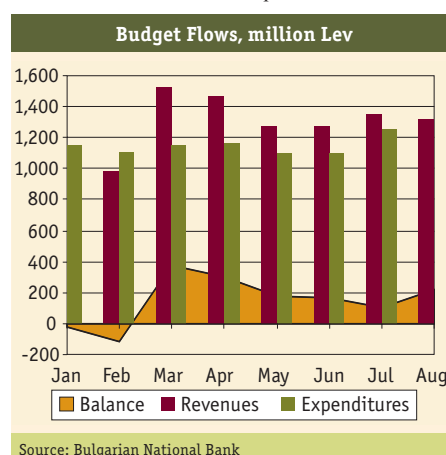
Industrial sales grew by some 23.1% yoy in August, marking only a slight deceleration compared to July when the growth rate was 25.3% yoy. However, industrial output grew at a steeper rate and showed a 18.5% yoy increase in August. This outpaced the rate of 16.5% yoy reported in July and bodes quite well for GDP performance in Q3.

The manufacturing sector continued to outperform the extracting businesses and state utilities. However, the growth rate declined slightly in August to 26.8% yoy, down from 28.9% yoy in July. In August, the leading sectors within manufacturing were production of basic metals (99.1% yoy), medical, precision and optical instruments, watches and clocks (63.9% yoy), and fabricated metal products, except machinery and equipment (59.8% yoy). Radio, television and communications equipment manufacturing remains the only sector where production has been constantly shrinking since the beginning of the year. In August, industrial sales in this sector dropped by some 51.6% yoy compared to a 20.5% decrease in July.

In August, the mining sector showed a 10.6% yoy increase, following a 2.8% yoy decline in July. This is mainly due to a 17.5% yoy increase in metal ore mining. The solid growth of metal products production will continue to drive the increase in the country's mining sector over the next few months.

Agricultural sector performance was positively affected by the good harvest this summer. The increase in the grain crop reached some 30% yoy, which will substantially contribute to the country's GDP growth.

In January-September, growth in the service sector was driven by a 17.3% yoy increase in the number of foreign tourist visits, compared to initial expectations of 12-15% yoy. However, the growth rate in September saw a slowdown from the previous months.



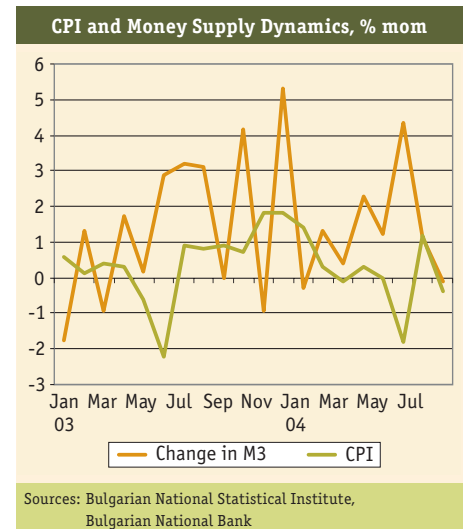
Wholesale and retail trade performed very well, showing substantial growth. Wholesale trade continued to accelerate, reaching a record high of 16.3% yoy in August, prompted by booming manufacturing sales. Retail trade maintained a fast expansion rate of 13.2%

yoy in August and 13% yoy in January-August, with a minor slowdown compared to July.

Fiscal Policy

In August, Bulgaria continued to show very good fiscal performance. The country's budget surplus increased by some Lev 215 million (EUR 110 million) during the month. It brings the accumulated general budget surplus over January-August to Lev 1,191 million (EUR 609.5 million.) The fiscal surplus accounts for some 2.8% of projected full-year GDP.

Monthly budget revenues in August amounted to Lev 1.32 billion (EUR 672 million.) This represents a decline in monthly revenue by 2.6% month-over-month (mom) compared to July. At the end of August, cumulative fiscal revenues reached Lev 10.31 billion (EUR 5.28 billion). At the same time, monthly budget expenditures declined from Lev 1.251 billion (EUR 640.2 million) to Lev 1.1 billion (EUR 563 million), bringing cumulative expenditures in January-August to Lev 9.12 billion (EUR 4.67 billion.) This prudent fiscal discipline in January-August pushed the fiscal reserve to Lev 4.801 billion (EUR 2.46 billion.) Over the same period, government deposits at the Bulgarian National Bank increased to Lev 4.347 billion (EUR 2.22 billion.)



In January-August, the amount of public debt was constantly decreasing. It dropped by EUR 11million in August, to 42.3% of projected full year GDP. However, the stock of domestic debt increased by EUR 22 million bringing the cumulative annual number to 6.7% of projected full year GDP. Due to the debt buy-back of discount Brady bonds in July, debt exposure to the US dollar was significantly reduced. At the end of August, debt was almost equally exposed to fixed and floating interest rates. The share of US dollar-denominated liabilities accounts for some 37.2% of total public debt, compared to 48.5% in local currency and euros, and 14.3% in other currencies.

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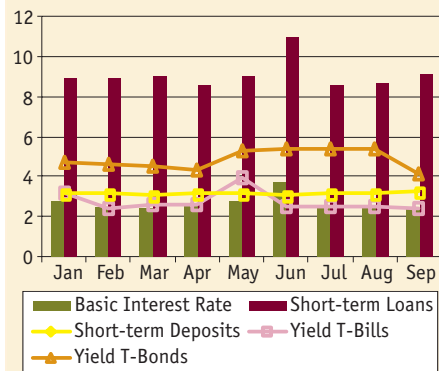
In October, the Ministry of Finance sent next year's draft budget for discussion to other ministries and major budget recipients. The government is targeting a general budget deficit of 0.5% of GDP next year based on expectations for 5.3% real GDP growth. Both expenditures and revenues are expected to rise at a faster rate than nominal GDP. Expenditures should rise by 11.0% yoy and revenues by 11.9% yoy. The IMF, however, is concerned that the deficit may be larger than anticipated if the government were to proceed with proposed increases in minimum wages and other public expenditures.

Monetary Sector

In September, the CPI grew by 6.2% yoy, which represents a slowdown compared to last month's level of 6.3% yoy. The main reason for the increase in CPI was the rise in food prices and non-alcoholic beverages. In September, they grew by 2.3 and 2.4 percentage points respectively on a month-over-month basis. These changes reflect seasonality in agricultural product prices.

In August, the producer price index (PPI) dropped to 4.9% yoy from 8.2% yoy in July. However, PPI increased by 0.2 percentage points on a month-over-month basis. The highest price increase was in electricity, water and gas (by 0.8 percentage points compared to the previous month) and in mining (by 0.7 percentage points).

Interest Rates by Instruments Nominated in Lev, %



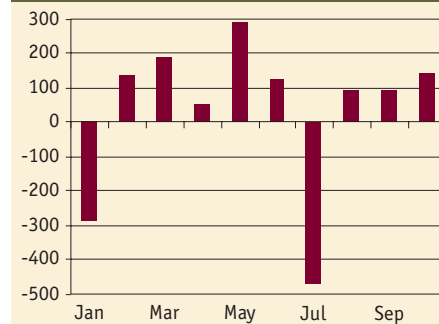
Source: Bulgarian National Bank

In October, the Bulgarian National Bank (BNB) increased the base interest rate to 2.44% from 2.39% in September. At the same time, the interest rate spread for local currency denominated deposits and loans widened from 5.47% in August to 5.82% in September. This is due to 0.51% increase in the rate for short-term loans and a 0.16% increase in the rate for short-term deposits. In September, the yield of both Lev-denominated T-Bills and T-Bonds decreased to 2.41% and 4.11% respectively, from 2.46% and 5.42% in August.

Throughout the year, the Bulgarian National Bank has continued to increase its official foreign reserves.

The acceleration of the rate of growth of foreign reserves in October to 54% compared to the previous month significantly contributed to the total amount of reserves. In October, their total stock reached EUR 6.32 billion. Due to the projected fiscal account surplus and prudent monetary policy it is forecasted that foreign reserves would continue to grow till the end of this year.

Change in Official Foreign Reserves, EUR million

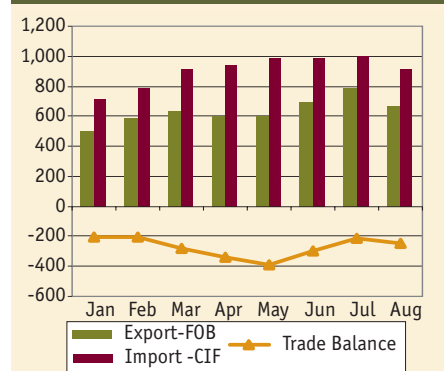


Source: Bulgarian National Bank

International Trade and Capital

In July, the balance of payments performed extremely well. It was the first month since the beginning of this year that Bulgaria showed a current account (CA) surplus, which reached EUR 234.8 million. This positive change represents a 14.5% yoy increase. It brings the cumulative CA deficit in January-July to EUR 711.7 million compared to EUR 946.5 million in January-June, a decrease of 24.8% over the same period last year. The improvement in July moves the annualized CA deficit to around 7% of GDP compared to 8.6% last year.

Foreign Trade Dynamics, yoy %



Source: Bulgarian National Bank

In July, foreign trade increased significantly by price effects stemming from the markets of base metals (in the case of exports) and oil supplies (in the case of imports.) In July, exports grew at a faster rate than imports. 13% growth in exports offset by 8% growth in imports decreased the country's monthly trade deficit to EUR 208

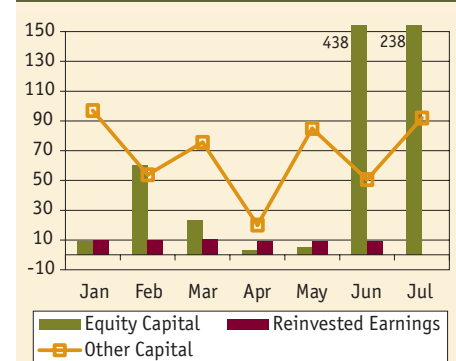
million, which brings the January-July trade deficit to EUR 1.51 billion. This deficit accounts for 7.5% of full-year GDP.

In July, the major imported goods were raw materials, which account for 39.9% of the total amount of imports. The second largest group was investment goods, including machines and equipment, which constituted 25.2% of imports. On the export side, the largest group was also raw materials (41% of total exports) and consumer goods (33.9% of total exports.) The large and growing share of investment goods in Bulgaria's merchandise trade should positively affect the country's development in the long run.

The share of trade with the EU-25 member countries increased-with the export share growing from 58.1% in June to 58.9% in July, while the share of imports remained unchanged at 57%. The main export destinations were Italy (13.8% of total exports), Germany and Greece (each with 10%.) In July, the main countries importing to Bulgaria were Germany, Russia and Italy, which accounted for 15%, 14% and 11% respectively of total imports.

The CA surplus in July was due to a decrease in the trade deficit and an increase in current transfers. In July, current transfers reached EUR 120.2 million compared to EUR 75.8 million in the previous month, which represents a more than two-fold increase compared to the same period last year. The surplus of trade in services decreased to EUR 281.4 million in July from EUR 328.9 in June, and it was offset by a EUR 95 million decrease in the trade deficit in July.

Forms of FDI Inflow to Bulgaria, million EUR



Source: Bulgarian National Bank

In July, the net inflow of FDI decreased to EUR 330 million from EUR 497.3 million in June, bringing the FDI stock in January-July to EUR 1.3 billion. 72% of these investments came in the form of equity capital. The sector breakdown of FDI inflow shows that 32% of the total amount of FDI in January-July went to the transport, storage and communication sectors; the second largest was the wholesale and retail trade sector (27% of all FDI); real estate attracted 22% of the country's FDI.

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

FDI inflows should exceed the previous expectations of the Bulgarian Investment Agency, which was set at an amount of EUR 2 billion, likely reaching at least EUR 2.5 billion this year. This figure accounts for some 13% of 2004 GDP.

International Programs

In October, the European Bank for Reconstruction and Development (EBRD) approved a concept review for financing the completion of construction on the five-star Hermitage Grand Hotel in the Black Sea resort, Golden Sands. This project will facilitate further competition in the Bulgarian leisure hotel market, which suffers from a lack of supply of quality hotel accommodations. The financing was requested by the Bulgarian company Sunny Travel, which is fully owned by the Sigma Capital Hospitality, Leisure and Tourism Holding Company. The Bank will secure a EUR 20 million senior-loan and a reserve fund of EUR 10 million. The final board approval will be in December.

The International Monetary Fund (IMF) announced a possible withdrawal from the precautionary agreement reached with Bulgaria if the plan for raising the minimum wage by 25% is implemented next year. However, the Ministry of Finance plans to proceed with the wage plan despite the IMF's opposition. The

Fund would also object to the government's efforts to widen additional budget expenditures in 2005 from the initially imposed cap of 1% of GDP to around 1.8%.

The International Finance Corporation (IFC) is reportedly planning to open a regional fund (with headquarters in Sofia) aimed at supporting long-term projects in transport and energy infrastructure as well as healthcare and other social reforms. The IFC is currently involved in local energy projects co-financed by the EBRD and local authorities and would most likely expand cooperation with the EU financing authorities acting in the region.

Other Developments

The World Bank (WB) published its report on the country's law on education, based on a recent survey done in Bulgaria. It recommends that local authorities decrease the number of universities teaching law from the existing 10 to 5. The WB report finds that low fund utilization is the major problem in law education. The general conclusion is that the total number of 41 universities in the country is too high for a population of 7.9 million. The universities are not able to attract qualified staff while professors are teaching in different universities and cities, resulting in a lower quality of education. The study emphasizes that the

budget transfers to the education system account for some 4.5% of GDP, which is in line with the EU average of 5%.

The October S&P report outlined Bulgaria's high growth potential, prudent fiscal policies and the country's progress in European integration. S&P concludes that Bulgaria is well prepared for completing EU accession in 2007 and joining the European monetary union most likely in 2010. These conclusions have played a key role in the latest one-notch upgrade of the country's rating. Bulgaria's long-term foreign currency rating is currently at BBB- with a stable outlook. S&P states that further rating improvements will hinge on sustaining a cautious policy mix, compatible with Bulgaria's monetary regime and smooth convergence toward EU accession. External imbalances are expectedly seen as the country's major weakness until joining the European monetary union.

Moody's has issued a press release for possible upgrades of several debt issuers in emerging markets, including Bulgaria. Apart from the country's sovereign rating, the agency hints at a possible upgrade for the country's largest lender, DSK Bank. Moody's has placed the country under review for a possible upgrade. Currently, Moody's ranks Bulgaria's sovereign rating at Ba2 with a stable outlook level, which is two notches below Fitch and S&P.