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Summary

- Following good performance in April, the real sector continued to expand in May, supported by 14.3% year-over-year (yoy) growth compared to 13.1% yoy in the previous month.
- Fiscal policy in January-May was prudent; the fiscal budget surplus of EUR 510.2 million should secure positive fiscal performance with a whole year budget surplus at more than 1% of GDP.
- The consumer price index (CPI) declined in May to 4.6% yoy from 5.1% yoy in the previous month, while the producer price index (PPI) slowed down from 7.7% yoy in April to 5.9% yoy in May.
- The rapidly increasing size of the current account (CA) deficit remains a significant risk factor; widening by 20.1% yoy in January-April, it reached EUR 1.25 billion.
- The negative trend of an increasing CA deficit is strengthened by the declining amount of net FDI inflows, which dropped in January-April by 20% yoy.
- The left-wing opposition party BSP won a plurality in the June Bulgarian parliamentary elections and received 34% of the seats in Parliament. Negotiations to form a majority coalition in Parliament are continuing.

Economic Growth



In January-May, Bulgaria's real sector performed extremely well. It is very likely that GDP growth in the first six months of the year will exceed 5% yoy. This growth is supported by expanding industry and the service sector, which grew by 8.2% yoy and 7.4% yoy respectively in the first quarter of 2005, and have continued their expansion in the second quarter.

In May, industrial sector sales grew by 14.3% yoy. This increase is due to significant growth in manufacturing, which expanded by 15.9% yoy over the month. Within the industrial sector, the biggest decline was observed in the extracting industry. In May, it dropped by 4.4%

yoy. This figure incorporates a 6.9% yoy decline in coal extraction and a 5% yoy decline in mining of metal ores. This reflects the ongoing process of industrial sector reorientation towards higher value added products.

By manufacturing breakdown, the growth leaders were sectors producing high value added products. During the month, sales of electrical machinery, motor vehicles, and communication equipment grew by 59.2%, 58.6%, and 31% yoy respectively. The biggest decrease was observed in the tobacco industry and textile production, where sales dropped by 16.4% yoy and 3.3% yoy respectively.

In May, sales in the utility sector grew by 8.3% yoy. This increase is mainly attributed to increasing gas consumption by households and services during the tourist season. The expansion of this sector will continue during the summer, which will have a very positive effect on the country's overall economic situation.

Fiscal Policy

Consolidated Fiscal Program		
	Jan-May 2005, EUR million	Change, % yoy
Revenue	3,769.2	15.3
Tax	2,952.0	13.8
Non-tax	749.0	20.4
Grants	68.2	28.5
Expenditures	3,259.0	12.2
Public Wages, insurance	347.7	9.9
Social and Health Insurance Contribution	124.6	2.5
Social Expenditure	1,254.4	9.0
Capital Expenditure	295.9	66.8
Other	1,236.4	3.7
Balance	510.2	40.1

Source: Bulgarian Ministry of Finance

In May, Bulgaria demonstrated prudent fiscal policy. The cumulative January-May consolidated budget surplus reached Lev 994.8 million (EUR 510.2 million), demonstrating 40.1% yoy growth, which significantly exceeds the initial government forecast. During the month, the surplus increased by Lev 321.8 million compared to Lev 193.8 million growth in April. The existing surplus will bring the whole year budget surplus to around 1% of GDP.

In January-May, budget revenues grew by 15.3% yoy and reached Lev 7.35 billion (EUR 3.8 billion). Non-tax revenue, which accounts for 19.9% of total budget revenues, demonstrated the highest rate of growth. During the period it grew by 20.4% yoy while tax revenue, which accounts for 78.3%, grew by 13.8% yoy. In January-May, the amount of grants received

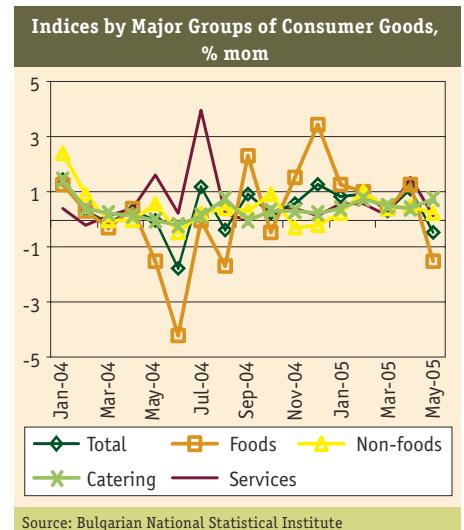
by the Bulgarian government increased by 28.5% yoy after a 38.65% yoy decrease in January-April.

In January-May, budget expenditures grew at a slower pace of 12.2% yoy compared with a 15.3% yoy growth in revenues. Over the period, capital expenditures demonstrated the highest rate of growth, at 66.8% yoy. Cumulative capital formation expenditures reached EUR 295.9 million, and will positively influence Bulgaria's long-term economic development.

In May, the country's external debt decreased to EUR 6.1 billion. The structure of debt by type of creditor shows that the highest weight is concentrated in Global Bonds and Eurobonds, which account for some 34.9% of total external debt. The largest lenders are the World Bank (15.5%), the International Monetary Fund (13.9%), and the European Union (5.3%).

Monetary Sector

The consumer price index (CPI) decelerated from 5.1% yoy in April to 4.6% yoy in May. This deceleration is mainly due to some decrease in food prices, which account for 38% of the consumer basket. In May, foods became 0.5 percentage points cheaper compared with the previous month. Since the prices for food should be relatively stable in the coming months due to the new harvest, it could be expected that CPI inflation will not exceed 5% yoy.

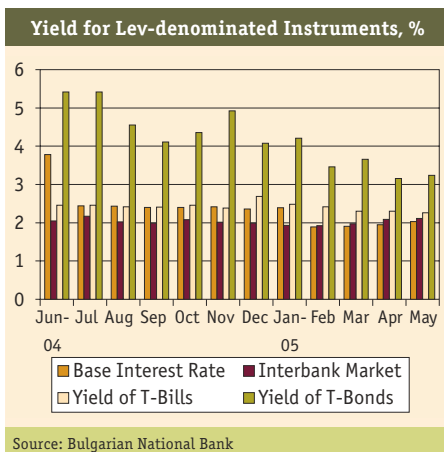


In May, the producer price index (PPI) increased by 5.9% yoy, slowing down from 7.7% yoy in April. The steepest increase in producer prices was observed in metal foundry and energy distribution, which surged by 15.5% yoy and 6.7% yoy respectively. Since PPI dynamics follow the CPI trend with a one-two month lag, it is very likely that PPI inflation will continue to decelerate over the next few months.

Macroeconomic Situation

In May, the Bulgarian National Bank (BNB) continued to increase money supply (M3). At the end of the month, M3 surged by 23.3% yoy compared to 21.8% yoy in the previous month, reaching Lev 18.3 billion. The stock of domestic credit increased by 38.9% yoy, which should have a positive effect on the country's economic growth.

The increase in the level of the base interest rate made by the BNB in May from 1.95% in the previous month to the current 2.03% drove the increase of all Lev-denominated instruments. Nevertheless, the current interest rate is well below last year's level, which reflects the increasing competition on the financial market. It is also consistent with the general BNB policy on stimulating the country's economic development.



In May, the BNB's official foreign reserves increased by EUR 260 million and reached EUR 6.9 billion. The current size of the foreign reserves is able to cover more than 7 months of Bulgarian imports and should secure the country's stability.

International Trade and Capital

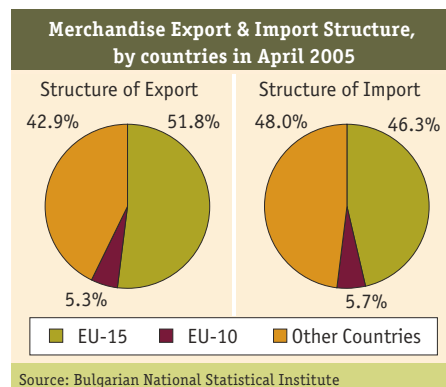
In April, the merchandise foreign trade deficit grew by EUR 368 million versus EUR 884 million in January-March. This increase brought the cumulative trade deficit in January-April to EUR 1,252 million, which represents 20.1% yoy growth compared to a 27.1% yoy increase in January-March. This deceleration in the rate of trade deficit growth is due to relatively good performance in April, when it grew by 7.3% yoy compared to 18.3% yoy growth in the previous month. The slowdown in the trade deficit's rate of growth is due to some increases in prices for metals.

In April, merchandise exports grew at a fast pace of 24.7%, reaching EUR 749 million. This brings cumulative January-April exports to

EUR 2.8 billion. The increase in cumulative exports in January-April reached 21.8% yoy compared to 20.8% yoy in January-March. On a very positive note, the highest rate of growth in April was observed in a group of high value added products. The growth of export in investment goods, which account for some 18% of the country's total merchandise export, was 62.8% yoy. EU countries are the biggest consumers of Bulgarian exports. In April, 57.1% of the total exports went to the EU-25.



In January-April, merchandise imports grew at a faster pace than exports and reached EUR 4.1 billion, which represents a 21.5% yoy increase. In April, the growth of imports declined to 21.5% yoy from 22.5% yoy in March. The geographical breakdown of the country's imports shows that the EU remains the main exporter to Bulgaria. In April, 52.0% of the country's imports came from the EU-25, of which 89% originated in the EU-15. In April, the rate of growth in imports generated in the EU-25 was 2.2% month-over-month (mom), while the total rate of import growth slowed down to almost 1% mom. Non-European imports have decreased by 4% mom. It is likely that the same trend will continue in the coming months.



In January-April, the current account (CA) deficit widened by 35.67% yoy and reached EUR 982.8 million. The most significant increase in the deficit appeared in March, when it grew by 68.3% yoy, which translates into EUR 234.1

million. In April, the growth rate of the CA deficit was 23.7%, reaching EUR 278.4 million.

The increasing CA deficit is negatively affected by the declining amount of net FDI inflows. In January-April they dropped by 20% yoy to EUR 334.5 million. After a significant increase in the rate of growth in March, the net inflow in April decreased by almost 42.8% mom and reached EUR 84.1 million. However, FDI in April increased by almost 111.1% yoy and further growth could be expected within the next several months. This improvement should decrease the deficit of the overall balance of payments.

International Programs

In June, the World Bank (WB) presented a new programme designed to facilitate regional trade and increase the efficiency of the transport sector in Southeast Europe. The programme intends to boost national and cross-border cooperation among customs agencies, and enhance the efficiency and competitiveness of transport through reforms in the customs administration. The WB also announced that it would grant \$10 million to Bulgaria's Project for Energy Efficiency. This financing will be provided for operation of the Energy Efficiency Fund, which was established in 2004.

In May, the executive board of the International Monetary Fund (IMF) approved the first review of the Bulgarian government programme for economic and financial reforms. This approval allows the IMF to continue its 25-month stand-by arrangement in the total amount of \$146 million. This stand-by arrangement is intended to help Bulgaria in its transition to full EU membership.

In June, the Bulgarian government announced that it supported the project for improvement and extension of the water supply through funding to the local water and sewage utilities. The Bourgas water and sewage utility is the first pilot company, and will sign a loan agreement with the European Bank for Reconstruction and Development (EBRD). The total amount of the project is EUR 31.7 million, of which EUR 11 million will be secured by the EBRD. Another EUR 19.7 million will come through the EU pre-accession programme.

The United States Agency for International Development (USAID) will extend a \$0.5 million grant under a project to strengthen the Bulgarian judicial system. The Initiative for Strengthening the Judicial System in Bulgaria Programme entails the building of information centres at the courts, providing access to information, and speeding up the administration of

justice. The program starts from the Supreme Judicial Council and expands to the local courts. The funds will be distributed among non-profit NGOs. Each applicant may receive between \$3,000 and \$25,000 to be absorbed within a period of between four and nine months.

Other Developments and Reforms Affecting the Investment Climate

In June, the left-wing opposition party BSP won a plurality in the Bulgarian parliamentary elections. The BSP received 31% of the votes cast,

which provides it with 82 out of a total 240 seats or 34% of the voting power. The outcome of the general elections is largely consistent with the forecasts based on opinion polls, which were published prior the elections. Negotiations to form a majority in Parliament are ongoing. It requires the agreement of three parties to form a majority. The main remaining issue is which party will have the Prime Minister's position.

In June, Bulgaria prepared the National Development Plan. This is a key strategic document, which Bulgaria will use to negotiate financing

from the EU structural funds. After Bulgaria joins the EU it has to receive EUR 3.8 billion from the EU-structural funds, EUR 1.3 billion of which will be financed by Bulgaria itself.

The Bulgarian General Prosecutor's Office announced in June that it would propose tax amnesty for dirty capital in the very near future, which should increase stability in the country. The exact form of amnesty is yet to be determined by the Bulgarian Parliament and public discussion.