

Macroeconomic Situation

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Summary

- In January-November 2005, Bulgaria's real sector continued expanding, supported by increasing industrial and service sectors, where sales grew by 11.4% year-over-year (yoy) and 12.9% yoy respectively.
- The cumulative fiscal surplus during the first 11 months of 2005 reached EUR 912.5 million, which translates into 4.7% of estimated period GDP.
- An adjustment in energy tariffs and the effects of the summer floods have raised consumer prices to 6.9% yoy in November. Inflation is expected to be on a downward trend after the effect of these supply-push factors diminishes.
- November development of merchandise trade flows continued to show signs of improvement in the external sector, with exports accelerating to 18.2% yoy and imports slowing to 27.1% yoy in cumulative terms.
- The current account (CA) deficit reached EUR 2.7 billion (13.9% of estimated period GDP) in January-November. The net inflow of FDI remains one of the largest items covering this deficit, although its role in alleviating CA imbalances is gradually diminishing.
- Bulgarian state gas importer Bulgargaz rejected the proposal from Russia's Gazprom to introduce changes to the existing contract and insisted on unchanged prices for imported gas.

Economic Growth

Preliminary data released by the National Statistical Institute suggest that economic growth in Bulgaria is likely to reach 5.6% yoy in 2005. This growth was supported by strong development in the country's industrial and service sectors, which saw sales growth in January-November of 11.4% yoy and 12.9% yoy respectively.



The increase in industrial sector sales in November 2005 reached 8.2% yoy compared with 12.5% yoy in the previous month. The growth was mainly due to booming sales in the mining

subsector, which expanded over the period by an impressive 31.6% yoy. However, manufacturing demonstrated some deceleration in its rate of growth, which went down to 7.6% yoy compared with 13.1% yoy in the previous month. This brought the cumulative rate of growth over the first 11 months of 2005 to a still substantial 12.7% yoy.

The growth in manufacturing was stimulated by growing domestic consumption. In November, the growth-leaders within Bulgarian manufacturing were motor vehicle production, electronic machinery and chemicals production. Over the period, sales of these products grew by 48.4% yoy, 25.4% yoy and 18.8% yoy respectively. The deepest decline in sales was shown in office machinery, textiles and furniture, which decreased by 18.7% yoy, 14.6% yoy, and 8.1% yoy respectively.

Fiscal Policy

In January-November, Bulgaria demonstrated prudent fiscal policy. Over the period, the country's cumulative fiscal surplus reached Lev 1,779 million (EUR 912.5 million), which translates into 4.7% of estimated period GDP.

Consolidated Fiscal Program		
	Jan-Nov 2005, EUR million	Change, % yoy
Revenue	8,309.4	13.3%
Tax	6,642.9	12.8%
Non-tax	1,410.8	14.7%
Grants	255.7	18.4%
Expenditures	7,397.0	12.5%
Public Wages, insurance	794.0	9.7%
Social and Health Insurance Contribution	285.3	1.0%
Social Expenditure	2,832.3	10.5%
Capital Expenditure	852.5	48.0%
Other	2632.9	8.3%
Balance	912.5	20.4%

Source: Bulgarian Ministry of Finance

In November, the fiscal surplus increased by Lev 135.9 million (EUR 69.7 million). The fiscal performance demonstrated by Bulgaria during the 11 months supports the idea that the annual fiscal budget will run a surplus of around 1.5% of GDP.

Revenues reached Lev 16.2 billion (EUR 8.3 billion) in January-November, which is 13.3% higher than in the respective period of last year. Over the period, the share of tax revenues in total budget revenues remained at a substantial level of 79.9%, comparable with 80% in the same period last year.

In November, budget expenditures grew by 12.5% yoy compared with 13.3% yoy in the pre-

vious month. Some deceleration in the growth of expenditures is explained by the increase in social spending that took place in October.

During the first 11 months of 2005 Bulgaria demonstrated effective management over its debts.

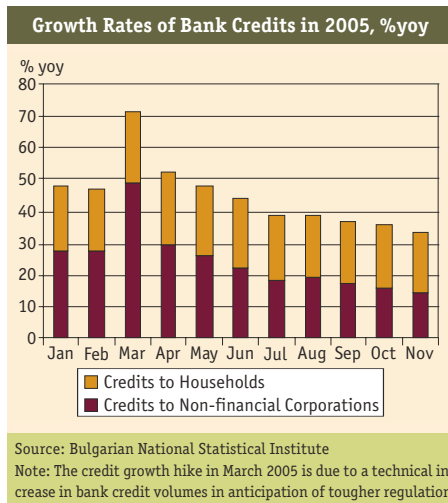
In November, the country's cumulative debt stock account increased by a meager EUR 127.6 million from the previous month's level and reached EUR 5.6 billion. The World Bank, International Monetary Fund, and European Union remain the largest lenders to the country; their shares in the total debt stock account for 18.5%, 13.1%, and 5.7% respectively.

Monetary Sector

Driven by temporary supply shocks, inflation accelerated to 6.9% yoy in November, up from 6.5% yoy a month before. The summer floods continued to have an effect on food prices, which increased by 8.6% yoy during the month. The increase in food prices made the largest contribution to the acceleration of the consumer price index (CPI), accounting for about half of the annualized inflation rate. Growth of service tariffs by 6.1% yoy was another major cause of CPI increase in November. It appeared as a result of the recently introduced energy tariffs hike. Non-food product prices posted a small reduction in their rate of growth compared to the previous month. In annualized terms, they increased modestly by 5.8% yoy. Although consumer prices growth somewhat exceed government forecasts, which envisaged 5.1% inflation by the end of 2005, the factors driving consumer prices are of a temporary supply-side nature and do not endanger price stability in the country.



The producer price index (PPI) grew by 7.5% yoy in November, compared to 6.2% yoy in October, mostly on account of a low base effect. At the end of the base year, producer prices dropped significantly driven by developments in the mining and manufacturing sectors. Throughout 2005, prices in mining grew significantly, posting a 17.2% yoy increase in November driven mostly by metal ore prices. Growth of prices in manufacturing and supply of electricity, water and gas was more modest and constituted 7.2% yoy and 5.6% yoy respectively.



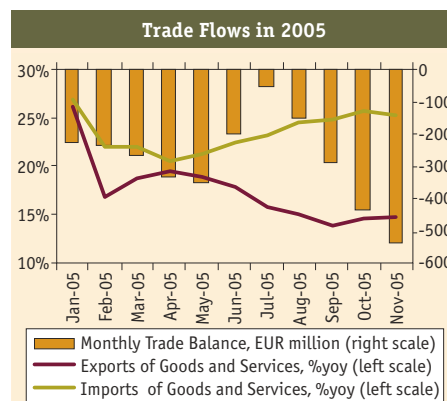
Money supply continued to gradually expand in November. Monetary aggregate M3 increased by 27.3% yoy, up slightly from 27.0% yoy a month before. Under the currency board arrangement adopted by Bulgarian authorities in 1997, all net inflow of foreign currency is purchased by the central bank and is, therefore, translated into monetary expansion. Thus, moderate growth of money supply over the last few months fully reflects development in the balance of payments with its financial account surplus slightly exceeding the current account deficit.

The interbank interest rate stayed at 2.06% per annum for the fifth month in a row. Accordingly, the base rate of the BNB was kept at a constant 2.04% per annum as well.

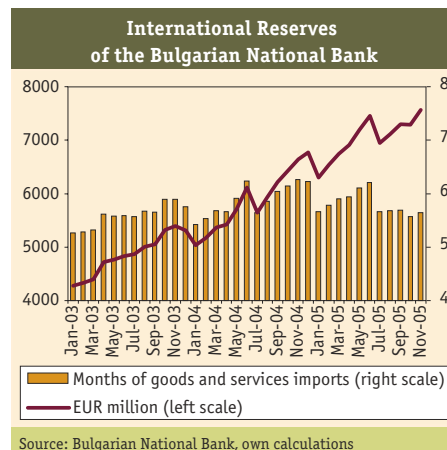
Bank lending to the private sector continued to slow. By the end of November, the stock of bank credits to the non-government sector grew by 32.4% yoy, compared to 34.7% yoy in October. Although the pace of growth is still above the 25% rate targeted by monetary authorities, the central bank has been successful in restraining high credit growth, which is considered one of the major reasons for the merchandise trade imbalances.

International Trade and Capital

In November, dynamics of merchandise trade flows continued to show signs of improvement. Cumulative growth of merchandise exports accelerated to 18.2% yoy, compared to 17.9% yoy in October. At the same time, imports of goods kept decelerating posting a 27.1% yoy increase in cumulative terms, down from 27.6% yoy a month before. Since growth of imports still substantially surpasses that of exports, the merchandise trade deficit continued to widen, but at a slower pace. Over January-November, the goods trade balance (FOB/FOB) constituted EUR 3.6 billion, which is 55% higher than in the respective period of the previous year. The pace of deterioration has thus slowed compared to the previous month, when the increase in cumulative merchandise trade deficit constituted 59% yoy.



In January-November, the balance of services remained positive in cumulative terms despite monthly deficits registered in October and November. Although a surplus in the services trade balance partially compensates for the large goods deficit, it remains too small in size to substantially affect current account development.



Driven by merchandise trade balance dynamics, the cumulative current account (CA) deficit reached EUR 2.7 billion in January-November. In relation to the estimated period GDP, the CA deficit remains quite large at 13.9%. On a positive note, large surpluses in the financial account and the net errors and omissions item of the balance of payments exceed the CA balance, keeping foreign reserves at a relatively high level. In November, international reserves of the central bank increased by EUR 0.3 billion. The stock of international reserves amounted to EUR 7.6 billion by the end of November, covering 5.6 months of goods and services imports.

The composition of the financial account underwent some changes in November. Although net inflow of FDI remains an important contributor to the financial account surplus, its role in alleviating CA imbalances has gradually diminished. Since the beginning of the year, net inflow of FDI amounted to EUR 1.5 billion, which is 42% higher than in the respective period of 2004. However, the pace of foreign investment inflow in 2005 was slower than the growth of the current account deficit. As a result, net FDI inflow was 55% of the CA deficit in January -November 2005 compared to 81% during the same period of the previous year. At the same time, debt-related items of the financial account start playing an increasingly important role in compensating for the CA deficit. In November alone, the increase in other investments, a debt-related item of the financial account, amounted to EUR 0.5 billion, driving the cumulative figure to EUR 2.1 billion.

The state investment agency forecasts (gross) FDI inflows in 2006 to be around EUR 2.3 billion, which is comparable to the 2004 figure and the amount expected to be received for 2005. Taking into account the slow privatization process and the large amounts of FDI attracted by Bulgaria over recent years, it is natural to expect no drastic increase in FDI inflow in 2006.

International Programs

In January, Bulgaria paid EUR 339.1 million ahead of the initially scheduled repayment of its debt to the International Monetary Fund (IMF) and the World Bank (WB). In addition to reducing the amount of the country's external debt, this repayment should make the Bulgarian economy less vulnerable to any negative external shocks.

The IMF mission to Bulgaria started to revise the country's two-year agreement with the Fund. The main subject of discussions is mea-

sures to seize a rapidly growing size of the current account deficit. Fiscal policy, education and public healthcare reforms are also on the agenda for the January meeting. The government-proposed increase in minimum wages, which will automatically lead to an increase in other social payments, is considered unacceptable at this stage by IMF officials due to the rapid deterioration of the CA deficit.

The Bulgarian Ministry of Finance and the European Commission signed an agreement under which seven environmental protection and transport promotion projects will be implemented within the next couple of years. The total financing will amount to EUR 164 million, of which EUR 133 million will be provided in the form of a grant from the EU pre-accession fund, EUR 19 million from the European Bank for Reconstruction and Development (EBRD) and EUR 12 million from the European Investment Bank (EIB) in the form of loans. The ob-

tained funds will be invested into the modernization of water supply systems in 5 cities and reconstruction of 3 railway roads.

The EBRD announced in January that it would continue investing in its projects in Bulgaria over the next two years. The bank will concentrate its activity on projects related to the energy sector, increasing the quality of the local governing, and private sector development. With these plans, the EBRD confirms its intention to remain the largest single investor in Bulgaria, having committed more than EUR 1.1 billion in about 60 different projects.

Other Developments and Reforms Affecting the Investment Climate

The Russian gas supplying company Gazprom asked the Bulgarian state gas importer Bulgargaz to introduce amendments to the ex-

isting long-term contract for import and transit of Russian gas. The proposed amendment is supposed to grant Gazprom the right to change the price of gas when the market price changes. These changes are inconsistent with the gas agreement signed in 1998, which is in effect until 2010. Bulgargaz rejected Gazprom's proposal and stated that it would cooperate with the Russian company in the future on an equal basis.

The Bulgarian Ministry of Transportation proposed a full-scale privatization of the national flagship carrier Bulgarian Air. The privatization strategy for the national airline is expected to be discussed by the Parliament in the first half of the year. This is consistent with the draft privatization strategy prepared by the former government. The strategy would allow participation of international financial investors in the proposed privatization deal.

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