

Oleg Ustenko, Olena Bilan, Edilberto Segura

Summary

- Preliminary statistical data suggests that GDP growth in 2005 will be around 5.4% year-over-year (yoy), supported by solid growth in industry and trade, where sales grew by 11.0% yoy and 12.0% yoy respectively.
- 2005 ended with a budget surplus that reached EUR 505.5 million, which is equivalent to 2.4% of estimated annual GDP.
- Consumer prices increased by 6.3% yoy (end of period) in 2005, mainly driven by adverse supply shocks and adjustments in utility tariffs. The outlook for 2006 inflation is also modest, with consumer prices forecasted to grow by around 6%.
- Thanks to the continuing slowdown of imports growth, the cumulative trade deficit widened at a slower pace, but still reached a high EUR 3.57 billion (16.8% of estimated GDP) in 2005.
- The current account deficit stood at a record high EUR 3.16 billion in 2005 (14.9% of estimated GDP), but was securely covered by surpluses in the other components of the balance of payments.
- In 2005, the private consumption index surged by 3.6% yoy, while households' real income increased by 4.5% yoy.

Economic Growth

Statistical data released by the National Statistical Institute on the real sector's development suggests that country's economic growth for 2005 will likely be around 5.4% yoy, which is only 0.2 percentage points lower than in 2004, when GDP growth reached 5.6% yoy. Such stable development is a good argument in favor of the economic policy instituted by the current government.



The current growth was supported by strong development in the country's industrial and trade sectors. During the year, their sales grew by 11.0% yoy and 12.0% yoy respectively.

In December 2005, sales in the industrial sector grew by 5.0% yoy, which is only half of the previous month's growth, when this sector's expansion reached 10.4% yoy. The current growth was mainly due to the rapidly booming mining sector, whose sales grew by

18.1% yoy. The performance of the country's manufacturing in December was not as impressive as in the previous month when it grew by 10.1% yoy. During the month it increased by a meager 5.6% yoy. However, good performance demonstrated in the previous month allowed the annual rate of growth in manufacturing to reach 12.2% yoy.

December's growth in retail trade slowed to 12.5% yoy down from 15.1% yoy in the previous month, which brings the annual hike in retail trade to 12.8%. The annualized growth in the wholesale sector reached 11.6% yoy, despite its significant slowdown in December when it grew by only 2.8% yoy.

Fiscal Policy

Bulgaria demonstrated prudent fiscal policy in 2005. During the year, the country's cumulative fiscal surplus reached Lev 985.7 million (EUR 505.5 million), which is equivalent to 2.4% of annual GDP. Some decrease in the annual fiscal surplus compared with the previous 11 months is due to December's decline in surplus by Lev 793.6 million (EUR 407 million).

Consolidated Fiscal Program		
	Jan-Dec 2005, EUR million	Change, % yoy
Revenue	9,221.9	13.4%
Tax	7,427.4	13.4%
Non-tax	1,530.0	13.5%
Grants	264.4	13.5%
Expenditures	8,716.4	11.8%
Public Wages, insurance	907.8	5.7%
Social and Health Insurance Contribution	325.3	-0.9%
Social Expenditure	3,167.5	9.9%
Capital Expenditure	1,218.7	50.8%
Other	3,097.1	6.2%
Balance	505.5	49.4%

Source: Bulgarian Ministry of Finance

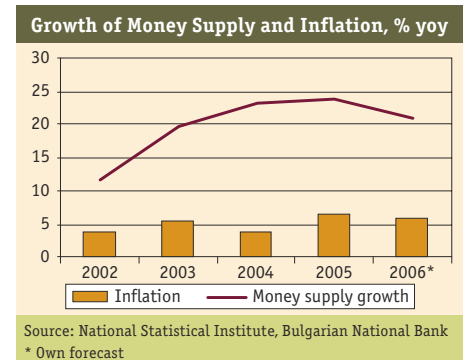
On the revenue side, the fiscal budget demonstrated significant 13.4% yoy growth in 2005. Total budget revenues reached Lev 18.0 billion (EUR 9.2 billion). Over the period, the share of tax revenues in total budget revenues remained at a substantial level of 80.5%, which is exactly the same weight that was registered in 2004.

Expenditures grew at a slower pace than revenues in 2005; their rate of growth reached 11.8% yoy, while revenues grew by 13.4%. Some deceleration in expenditure growth was mainly due to the fiscal budget performance in December. The registered changes in the structure of expenditures were very positive. The main evidence of this is a significant acceleration in the growth rate of capital expenditures, which grew by an impressive 50.8% yoy. The increase in their share to 14.0% up from 10.4% in 2004 should create a solid basis for the country's further economic development.

During 2005, Bulgaria demonstrated thoughtful debt management. The stock of state debt decreased to EUR 5.4 billion, which translates into 23.1% of GDP. This positive development brings Bulgaria into the group of countries within the Central and South Europe region with the lowest debt-to-GDP ratio. The breakdown of debt by creditor suggests that international institutions still remain the most significant lenders to the country. The World Bank, International Monetary Fund, and European Union shares in the total debt stock account for 18.9%, 12.8%, and 5.3% respectively.

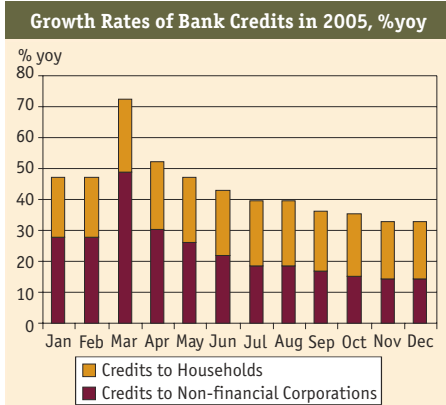
Monetary Sector

In December, growth of consumer prices decelerated to 6.3% yoy down from 6.9% yoy in November. Prices on major CPI components (foods, non-foods and services) were growing almost at the same pace, with a 6.8%, 6.4% and 6.2% yoy increase respectively. In 2005, inflation was primarily caused by supply-side factors, such as the poor agricultural harvest and high oil prices. Some adjustments in utility tariffs that took place in April and November also added to acceleration of inflation. The outlook for 2006 inflation is similar to 2005 figures with year-end consumer prices posting around a 6% yoy growth rate. It is likely that adjustments to utility tariffs will continue throughout the year as heating companies are already pushing for price adjustments due to the increase in prices for natural gas. In addition, thanks to continuous requests by power generating companies, the cheap electricity threshold for households is likely to be removed this year. An increase in the excise rate on alcohol and tobacco will be another factor driving inflation up. On a positive note, the agricultural harvest in 2006 is likely to be better than in the previous year, which should contribute to lower food prices.



In December, growth of the producer price index (PPI) continued to accelerate mostly on account of a low base effect. During the month, PPI increased by 9.6% yoy, compared with 7.5% yoy growth in November. The low base for comparison originated from a significant drop in producer prices at the end of 2004, which was driven by developments of prices in the mining and manufacturing sectors. Prices in mining grew rapidly throughout 2005, posting a 25.7% yoy increase by year end. Growth

of prices in manufacturing and supply of electricity, water and gas was more modest and constituted 8.9% yoy and 6.9% yoy respectively.



Source: Bulgarian National Bank
 Note: The credit growth hike in March 2005 is due to a technical increase in credit volumes in anticipation of tougher regulation

Growth of money supply (monetary aggregate M3) slowed to 23.8% yoy in December, compared to 27.3% yoy in November. This was because the usual December hike in money supply development related to the end of the fiscal year was smaller than in 2004. In month-over-month (mom) terms, an increase in money supply constituted only 5.2%, compared to 8.1% mom in December 2004. In 2006, growth of money supply is expected to stay at the same level as in 2004 and 2005, backed by tougher fiscal conditions on the one hand, and improvements in the balance of payments situation on the other.

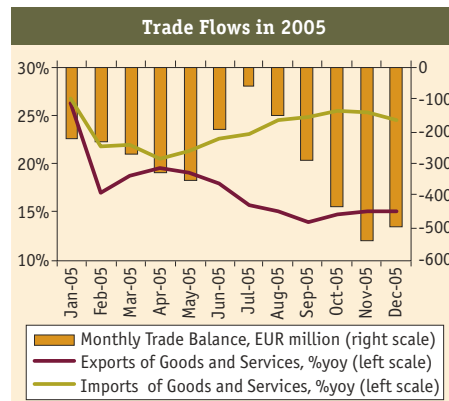
The interbank interest rate increased only slightly in December to 2.07% per annum (p.a.), after staying at a constant 2.06% p.a. five months in a row. Accordingly, the base rate of the Bulgarian National Bank (BNB) was increased to 2.05% p.a. from 2.04% p.a.

Bank lending to the private sector continued to decelerate, albeit at a slower rate. By the end of 2005, commercial banks claim on the non-government sector grew by 32.3% yoy, posting only a tiny decline from the 32.4% yoy increase a month before. Although credit growth declined from almost 50% yoy at the end of 2004 to the current 32% thanks to the efforts of monetary authorities, the IMF continues to insist on tougher regulation for 2006 than those proposed by the central bank. As a compromise, the BNB has tightened the requirements for mortgage lending through amendments to the ordinance on capital adequacy, but retained most of the other requirements as recommendations for central banks.

International Trade and Capital

Positive trends in the foreign trade flows became stronger in December. For the first time since the middle of the year, the monthly goods and services trade deficit went down, to EUR 493 million. This

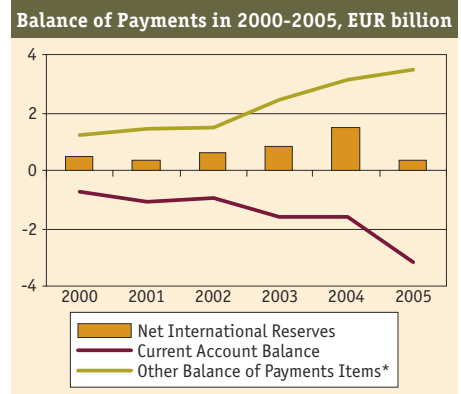
is almost 9% lower than the November figure. This figure is fairly encouraging as it may indicate that the disturbing widening trade gap trend will be reversed. The reduction in the monthly trade gap was mainly due to a slowdown of imports growth to 24.4% yoy from 25.2% yoy in November. At the same time, growth of exports was stable reaching 14.9% yoy, the same as the month before. Yet, since the monthly trade balance was still negative, the trade deficit continued to increase in cumulative terms. In 2005, the goods and services trade balance constituted EUR 3.57 billion, which is 80% higher than in 2004. On a positive note, the pace of deterioration has slowed compared to the previous month, when the increase in the cumulative trade deficit constituted 92% yoy.



Source: Bulgarian National Bank, own calculations

The trade deficit remains as the major driving force of the widening current account (CA) deficit. In 2005, the CA gap reached EUR 3.16 billion, which translates into 14.9% of estimated full-year GDP. This is almost a two-fold increase compared to 2004. On a positive note, large surpluses in the financial account (FA) and the net errors and omissions item of the balance of payments remained high enough to cover the CA deficit. This allowed the BNB to increase its foreign exchange reserves, although by a smaller amount than in 2004. In 2005, BNB international reserves grew by EUR 0.3 billion compared with a EUR 1.4 billion increase in 2004.

Net inflow of FDI and debt-related investment (trade credits, loans, etc.) remained the major driving forces of capital inflow, accounting for 65% and 66% of FA surplus (net of reserves) respectively. According to preliminary data, Bulgaria managed to attract EUR 1.8 billion of FDI in 2005. This is EUR 0.4 billion or 18% lower than in 2004. The slowdown of FDI inflow was partially caused by the reluctance of the new government to push the privatization process, which resulted in the absence of privatization deals with foreign companies in 2005. However, the preliminary FDI figure is likely to be revised upwards when all data related to acquisitions of domestic assets by foreigners becomes available.



Source: Bulgarian National Bank, own calculations
 * Other Balance of Payments Items = Capital Account + Financial Account (net of international reserves) + Net Errors and Omissions

Bulgarian authorities fully recognize the economic risks caused by the large CA deficit. In an economic report ordered by the President in January 2006, real appreciation of the national currency stemming from the peg to the euro is mentioned as an economic risk factor that shall be taken into account by the government. With a 6.3% inflation rate in Bulgaria in 2005 and 2.1% in the EU-25, real appreciation of the Bulgarian Lev with respect to the euro stands at 4.2%. Together with the leveraged consumption boom and FDI-related high demand for investment goods, real appreciation provides a strong impetus for imports, thus causing large trade and CA deficits. In response to these developments, Bulgarian authorities have recently adopted a set of measures aimed at discouraging aggregate demand. In particular, pushed by the continuous pressure from the IMF, the Bulgarian government announced in January that it will switch from a fully balanced budget target to a surplus of 3% of GDP in case the CA deficit to GDP ratio remains above the 12% threshold. Along with the recent BNB measures aimed at containing the decelerating but still rapid credit growth, this gives solid grounds to believe that the balance of payments imbalances will be alleviated in 2006.

International Programs

The International Monetary Fund (IMF) mission and the Bulgarian authorities reached an agreement on the fiscal parameters for 2006. It was agreed that the government would switch from a fully balanced budget target, which was initially proposed by the government, to a surplus of 3% of GDP if the annual CA deficit exceeds 12% of GDP. Also agreed upon were a set of recommended measures for easing the rapid credit expansion to households.

In February, Bulgaria completed an early debt repayment to the IMF in the amount of EUR 151.4 million. With the debt repayment of EUR 147.4 million made in the previous month, the total repayment

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

reached EUR 298.8 million. As a result, the country's total outstanding liabilities to the IMF dropped to EUR 394 million. The latest repayment is applied to six tranches disbursed under the two-year-standby-arrangement, which was signed in 2002. This development should positively affect the country's debt-to-GDP ratio.

In January, the World Bank (WB) office in Bulgaria presented a new economic report for the country. The report outlines the main achievements and problems in the country's economic policy. It also provides public policy recommendations for further economic improvements in the areas of business regulations, the labor market, education, and infrastructure.

The newly announced EBRD investment strategy for Bulgaria focuses on projects related to development of the country's SME sector, infrastructure, and infrastructure projects with a concentration in

energy efficiency. The EBRD emphasized that the country achieved significant economic progress supported by the solid expansion of the private sector, which accounts for 75% of the total economy.

Other Developments and Reforms Affecting the Investment Climate

Monitored by the State Statistical Institute, the private consumption index surged by 3.6% yoy in 2005, while the real income of households increased by 4.5% yoy. The difference between the two numbers was savings, which reflects a positive development for securing the country's future economic development.

The UK became the twelfth country to ratify the EU accession treaty with Bulgaria, which comes into force on March 1st. Bulgaria has also previously

signed treaties with Cyprus, the Czech Republic, Estonia, Greece, Hungary, Italy, Latvia, Malta, Slovakia, Slovenia, and Spain. Other EU members should sign the agreement with Bulgaria by the end of 2006.

In February, parliament passed in the first reading constitutional amendments aimed to improve the work of the country's judicial system. The amendments also reduce the immunity of magistrates and lawmakers. In a final reading, a law of the Interior Ministry was also passed. The new law meets the EU requirements for this institution. It introduces competitive procedures for all major appointments at the ministry and clearly specifies its role in the country's judicial system.

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

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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