

Macroeconomic Situation

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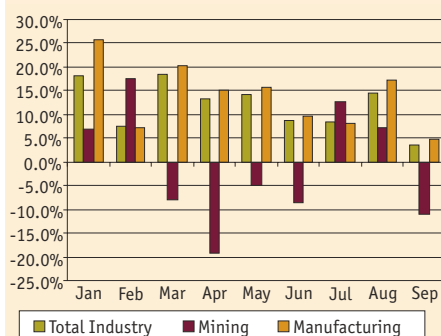
Summary

- In September, Bulgaria's industrial sector experienced some slowdown in its rate of growth; sales decelerated from 14.9% year-over-year (yoy) in August to 3.6% yoy.
- The government's prudent fiscal policy brought the country's January-September cumulative surplus to EUR 787.3 million, which corresponds to 5.1% of estimated period GDP.
- Driven by temporary adverse supply shocks, the consumer price index (CPI) reached 5.4% yoy in September, up from 4.9% yoy in August. However, year-end inflation is likely to be in line with the government forecast of 5.1% yoy.
- Following an agreement with the International Monetary Fund (IMF), the Bulgarian National Bank (BNB) has toughened credit regulations to curtail surging imports.
- The size of the cumulative current account (CA) deficit has continued to be the main area of concern. Over January-September, its size increased almost three times above the corresponding period last year and reached 11.7% of estimated period GDP.
- Parliament passed amendments to the excise tax legislation introducing increased taxes for alcohol and cigarettes.

Economic Growth

Good performance of the industrial sector in the first eight months of the year built a solid base for the country's overall economic growth in 2005 of around 5.6% yoy. However, in September the real sector did not expand as rapidly as in previous months due to the decrease in the industrial sector's rate of growth. Monthly sales of this sector grew by a meager 3.6% yoy compared to the impressive 14.9% yoy growth in the previous month. The main reason for the deceleration in industrial growth was the declining mining sector. In September, its sales dropped by 11.1% yoy compared with 7.3% yoy growth in August.

Economic Growth by Sectors in 2005, % yoy



Source: Bulgarian National Statistical Institute

Over the period, the manufacturing sector showed some positive developments, increasing by around 4.7% yoy. However, this growth demonstrates a significant deceleration compared with the previous month's solid growth rate of 17.6% yoy.

In September, the growth-leaders within Bulgarian manufacturing were manufacturing of motor vehicles, leather products and electrical machinery, which grew by 108.4% yoy, 29.8% yoy and 20.5% yoy respectively. On the opposite side, the deepest decline was registered in office machinery manufacturing and printing (which decreased by 36.2% and 21.6% yoy respectively). Both the positive and negative tendencies demonstrated by the different sectors of the country's manufacturing over the last year suggest that they will become overall trends, which reflects structural changes in the country's production.

Fiscal Policy

In January-September, Bulgaria demonstrated prudent fiscal policy. The monthly consolidated budget surplus reached Lev 217.0 million (EUR 111.3 million), which brought the country's January-September cumulative surplus to Lev 1,535.3 million (EUR 787.3 million). The existing cumulative surplus translates into 5.1% of estimated period GDP. Although the most recent rate of growth in the country's fiscal surplus was slightly lower than in August, it is still 18.1 percentage points (pps) higher than in the respective period of the last year. The prudent fiscal performance demonstrated by the government over the last 9 months suggests that 2005 will be finished with a surplus of around 1.5% of GDP.

Consolidated Fiscal Program

	Jan-Sep 2005, EUR million	Change, % yoy
Revenue	6,790.1	13.9%
Tax	5,399.2	13.9%
Non-tax	1,186.8	13.4%
Grants	204.2	18.6%
Expenditures	6,002.9	13.4%
Public Wages, insurance	640.7	10.1%
Social and Health Insurance Contribution	230.0	1.6%
Social Expenditure	2,313.8	10.6%
Capital Expenditure	649.7	118.0%
Other	2168.7	3.6%
Balance	787.3	18.1%

Source: Bulgarian Ministry of Finance

The cumulative amount of revenues reached Lev 13.24 billion (EUR 6.8 billion) in January-September, which translates into a 13.9% yoy rate of growth. The budget revenue structure suggests that taxes remained the main

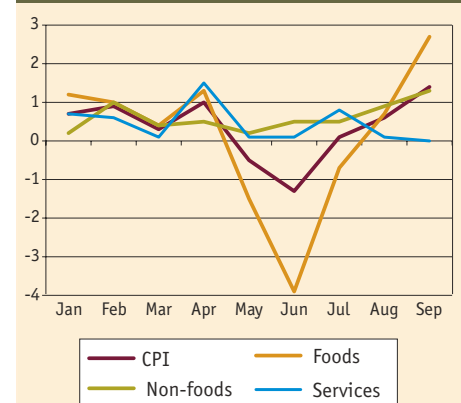
source of budget revenues over the period. Moreover, their share has been constantly increasing, to the current 79.5%. The growth tendency was also observed in non-tax revenue items and grants obtained by the government. In January-September, they surged by 13.4% yoy and 18.6% yoy respectively.

On a very positive note, during the first eight months of the year, budget expenditures grew at a slower pace compared to the growth in revenues. They grew by 13.4% yoy over the period compared to a 13.9% yoy growth in revenues. This is mainly due to a significant increase in budget revenues over September. However, there is not enough evidence that this tendency will continue in the following months.

In January-September, Bulgaria demonstrated prudent debt management. Over September, the country's total external debt decreased slightly by EUR 5.0 million, which brought the cumulative debt stock to EUR 5.478 billion. This drop in debt is due to principal repayments to the IMF in the amount of EUR 26.2 million. Although the largest lenders remain international financial institutions (IFIs) such as the World Bank (39.1%), the International Monetary Fund (14.2%) and the European Union (5.8%), their shares have been constantly declining since January 2005.

Monetary Sector

Growth of CPI and Its Major Components in 2005, % mom



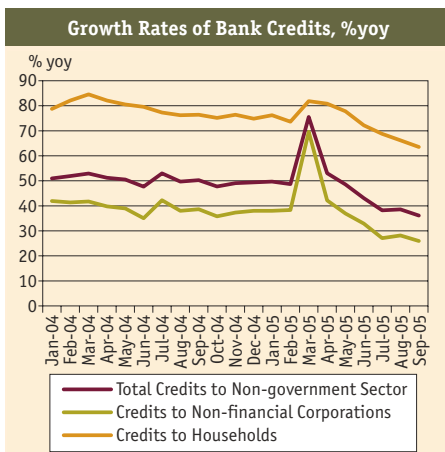
Source: Bulgarian National Statistical Institute

Due to temporary supply shocks, the growth in consumer products prices continued to accelerate in September reaching 5.4% yoy, up from 4.9% yoy in August. The monthly consumer price index (CPI) posted a 1.4% month-over-month increase thanks to a seasonal increase in food prices reinforced by the negative effects of flood damage experienced during the summer. The flood damage effect is also reflected in the gradual acceleration of seasonally neutral annualized growth rates of food prices, which constituted a

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5.5% yoy increase compared to 5.1% yoy in August. Non-food price growth also sped up, partly due to rising fuel prices. In September, non-food prices grew by 6.1% yoy, up from 5.0% yoy in the previous month. The effect of adverse oil price shocks is manifested in the growth of the transport category of CPI, which surged by as much as 16.3% yoy in September. Taking into account the current decline in world oil prices, it is expected that growth of consumer prices will slow down soon and that the year-end inflation rate will be in line with the government forecast of 5.1% yoy.

The producer price index (PPI) grew by 6.9% yoy in September, up from 6.6% yoy in August, backed by continuing growth of prices in manufacturing and energy resources.



Source: Bulgarian National Statistical Institute
 Note: Credit growth hike in March 2005 is due to technical increase in credit volumes in anticipation of tougher regulation

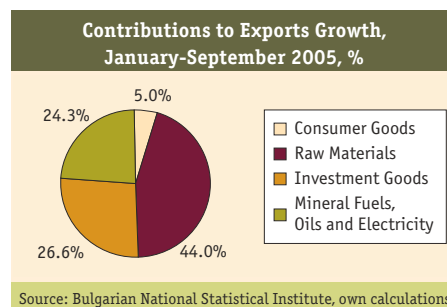
In September, growth rates of monetary aggregates were on a downward trend, reflecting deterioration in the balance of payments. Money supply, measured by monetary aggregate M3, grew by 26.6% yoy, compared to 29.0% yoy in August; the monetary base growth was at 30.4% yoy rate, down from 33.5% yoy a month before. The interbank interest rate stayed at 2.06% p.a. for the third month in a row. Accordingly, the base rate of the BNB was kept at a constant level as well.

By the end of September, the stock of bank credit to the non-government sector grew by 36.1% yoy, down from 38.6% yoy in August. The apparent downward trend indicates that a series of credit restraints introduced by the BNB at the beginning of the year has proved to be quite successful. However, the IMF and local monetary authorities agreed that further toughening of credit regulations is needed, as the ongoing slowdown of growth rates is not enough to significantly affect the quickly worsening trade balance.

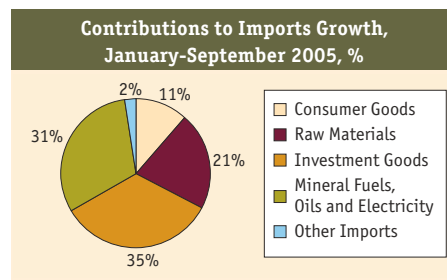
Following this agreement, the executive council of the BNB approved a set of measures in November aimed at reducing the growth rate of credit to 20% yoy. The amendments come into force at the beginning of 2006. Banks violating the introduced requirements will have to keep a pre-specified amount of additional obligatory reserves within the central bank. If enforced properly, constraints on credit growth seem to be effective in smoothing external imbalances.

International Trade and Capital

In January-September, the Bulgarian merchandise trade balance experienced further deterioration. Over the period, the trade deficit (fob/cif) reached EUR 3.6 billion (23.4% of estimated period GDP), demonstrating an almost 50% yoy increase. The widening of the trade gap is attributable to both a slowdown of exports and an acceleration of imports.



Source: Bulgarian National Statistical Institute, own calculations



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In September, exports increased by a meager 5.8% yoy, which is the lowest growth rate since January 2004. As a result, cumulative export growth slowed to 17.2% yoy, down from 18.8% yoy in January-August. This reduction is to a large extent explained by deceleration of exports to the EU-25, the major consumer of Bulgarian goods. By end-use structure, the slowdown of nominal growth rates was observed in all export categories, except for consumer goods, which demonstrated some acceleration.

On the other hand, the inflow of all major commodity groups (except raw materials) was boosted in September. The major contributors to import growth were investment goods and

energy materials. They accounted for 35% and 31% of total import growth respectively, which constituted 26.7% yoy in January-September, up from 26.1% yoy in January-August. An increase in nominal volumes of energy materials imports is mostly due to higher world prices for oil, while the increase in imports of investment goods is due to a physical increase in their imported quantity. Most likely, the high domestic demand for machinery and equipment is related to foreign direct investments, as many newly created or existing enterprises acquired by foreign owners require establishment or an upgrade of production lines.

The widening merchandise trade gap remains the main reason for current account (CA) deterioration. In January-September, the cumulative CA deficit constituted EUR 1.8 billion (11.7% of estimated period GDP), which is three times above the corresponding 2004 figure. Even taking into account the low base effect of the previous year induced by the favorable tourist season, the present-day CA deficit looks fairly high. In addition, the short-term prospects look quite pessimistic as a seasonal increase in demand for energy will prompt imports of energy materials, while the positive services balance is likely to diminish due to the end of the tourist season. Although the CA deficit continues to be covered by a positive financial account balance, generated by a net inflow of FDI that amounted to EUR 1.3 billion (8.4% of estimated period GDP) over January-September, the issue of ensuring external stability should be addressed as soon as possible. Fiscal tightening accompanied by strictly enforced bank lending restraints may hold back domestic demand, thus, diminishing import growth.

International Programs

The regular IMF mission to Bulgaria completed its evaluation of the country's performance as specified in the two-year Precautionary Programme. The mission did not reach an agreement on the budget programme for next year. It was also announced that the IMF would delay its conclusions on line benchmarks and performance criteria of the Standby Programme. The IMF also pushed for more radical fiscal tightening in 2006, which is fully consistent with its previously announced strategy for Bulgaria.

In November, EBRD announced its plans on acquiring minority stakes in two local retail power groups owned by Austrian and German groups. The existing arrangements between the current owners and the state allow new entities to acquire up to 12% of the electricity distribution units. The existing investment plan of

EBRD for the country envisages financing to develop infrastructure. In particular, it targets modernization of railways, Varna and Bourgas international airports, and the thermo power complex in Maritsa.

In November, the International Finance Corporation (IFC) and the German Investment and Development Agency (DEG) sold their 19.13% and 19.17% stakes respectively in ProCredit bank to ProCredit. In exchange, IFC received shares from the holding company. All other investment positions of IFC in Bulgaria remain unchanged.

Other Developments and Reforms Affecting the Investment Climate

In October, Parliament passed in a final reading amendments to the excise tax legislation, introducing increased tax for alcohol and cigarettes. The increase goes up to 60% for some products. The parliament is also planning to pass additional changes aiming to fix the retail prices of cigarettes and retain a large price margin for local brands. The current excise tax law will be effective by the end of June 2006.

The EU Commission issued its regular monitoring reports for Bulgaria. The report states that

the main areas of its concern lie in the country's judiciary and law enforcement. In particular, Bulgaria is asked to continue its efforts in fighting corruption and organized crime, which should improve the rule of law and guarantee citizen's rights.

In November, it was announced that the offices of the Minister of Finance and Prosecutor General might launch a joint initiative on the introduction of certain amendments to the line tax legislation allowing criminal charges against overdue tax payments. The implied changes would most likely refer to large amounts only.

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