

Macroeconomic Situation

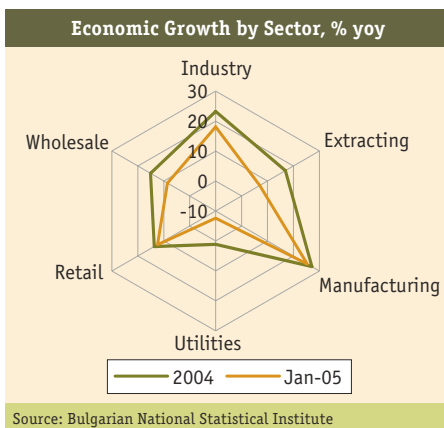
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Summary

- Supported by the rapid expansion of the industrial sector, which grew by 18.1% year-over-year (yoy) in January, the real sector has performed extremely well.
- The fiscal budget situation in January was also favorable, with a fiscal budget surplus reaching EUR 45 million, which suggests that this year's budget performance will significantly exceed the earlier projected deficit of 0.4% of GDP.
- The consumer price index (CPI) accelerated in February to 3.9% yoy, while the producer price index (PPI) decelerated to 4.8% yoy.
- The size of the current account (CA) deficit remains a major concern, reaching EUR 1.45 billion in 2004. This brought the CA gap to 7.5% of full year GDP. Although the CA deficit remained high, foreign direct investment (FDI) inflows were able to cover it comfortably. In 2004, the cumulative net inflow of FDI reached EUR 1.96 billion or 10.1% of annual GDP.
- The study done by the Organization for Economic Co-operation and Development (OECD) shows that Bulgarian small and medium-sized enterprises (SMEs) now have easier access to financial and informational resources.

Economic Growth

In January, the real sector performed extremely well. This growth was encouraged by the strong expansion of industrial sales, which grew by 18.1% yoy.



Within the industrial sector, manufacturing demonstrated the highest rate of growth. In January, sales of this sector grew by 25.3% yoy. However, this rate of growth is lower than in the previous month when manufacturing grew by some 31.2% yoy, and almost the same as the annual average rate demonstrated in 2004 when manufacturing advanced 27.1% yoy. Tobacco production showed the highest rate of expansion (68.5%) due to the expectation of a possible increase in excise duty on tobacco prod-

ucts. Due to the growing exports of metals and high metal prices, metallurgy continued expanding. In January, this sector grew by 57.6% yoy. The prospects for this sector are favorable due to the increasing demand for metals on international markets. On the negative side, output of the high value added industries have continued to decline. In January, the sharpest drop was observed in the manufacture of motor vehicles, trailers and semi-trailers, where sales declined by 31.3% yoy.

Electricity, gas and water supply decreased by 7.6% yoy in January compared with an 11.6% yoy increase in December. This decline was expected and is due to the seasonal drop in utility consumption.

In January, retail trade expansion decelerated to 12.4% yoy from 15.7% yoy in the previous month. In wholesale trade, the rate of growth decreased to 8.6% yoy compared to a record 20.6% yoy in December.

Fiscal Policy

In January, Bulgaria demonstrated prudent fiscal policies. The monthly surplus of the consolidated fiscal budget reached Lev 88 million (EUR 45 million). This figure suggests that 2005- budget performance will be significantly better than the earlier projected annual deficit of 0.4% to GDP.

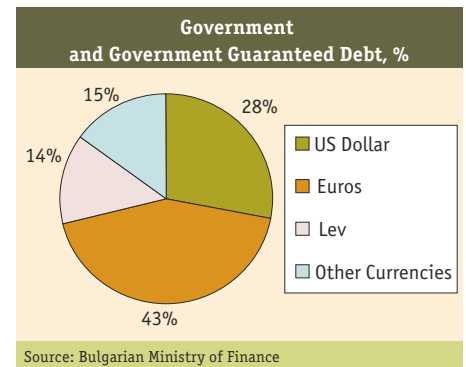
Budget, in million EUR		
	2005 projection	Jan-05
Revenue	8,308.7	680.0
Tax	6,785.1	573.3
Non-tax	1,256.9	105.6
Grants	266.7	1.0
Expenditures	8,409.2	635.0
Public Wages, Insurance	1,230.3	57.9
Social and Health Insurance Contribution	3,126.7	21.3
Social Expenditure	627.7	240.0
Other	3,425.0	315.8
Balance	-100.5	45.0

Source: Bulgarian Ministry of Finance

In January, budget revenues and grants reached Lev 1.33 billion (EUR 0.68 billion), which represents a growth of 17% yoy against 8.7% yoy in 2004. Tax revenues account for some 85% of the total budget revenues. A significant increase of duties on imported oil, initiated by the government in November 2004, continues to have a very positive effect on tax collections.

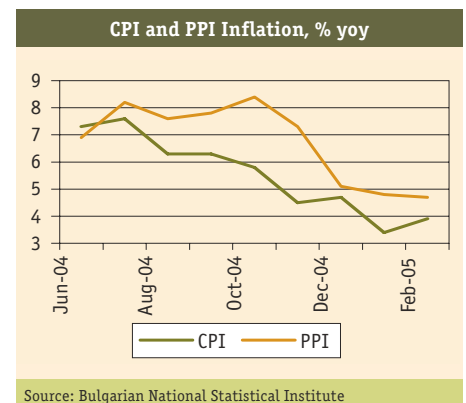
In January, government expenditures grew by 7.5% yoy and reached Lev 1.24 billion (EUR 0.64 billion). Social expenditures, which comprise 38% in the total amount of budget expenditures, grew by 8.5% yoy. These figures are an additional argument in favor of the government ending this year with a significant surplus.

In January, government and government guaranteed debt decreased to EUR 7.4 billion. The debt decrease in the amount of EUR 0.6 billion compared to the previous month is due to the repayment of IAB Brady Bonds one month ahead of schedule. Foreign and domestic debts account for 81.2% and 18.8% of the total amount of government and government guaranteed debt, respectively. The debt to GDP ratio declined to 34.8% in January from 40.9% in December. The weight of US dollar denominated debt decreased to 28% from 31% in December, with a corresponding increase in the weight of other currency denominated debts. The decrease in the weight of US dollar denominated debts since early 2005 is due to the large share of the US dollar forex composition in debt payments.



Monetary Sector

In February, the consumer price index (CPI) accelerated to 3.9% yoy compared to 3.4% yoy in January. The acceleration of CPI is due to a substantial increase in food prices, which increased by 1.5% yoy in February against a 0.8% yoy increase in the previous month. This trend in food prices started in September 2004 and will likely continue until the new harvest. Another factor accelerating CPI was the increase in prices for services from 7.9% yoy in January to 8.8% yoy in February. An additional factor in inflation acceleration in February was an increase in oil prices. However, due to possible downward corrections in oil prices and stable tariffs in the energy sector, it is very likely that there will be slow-down in inflation over the coming months.

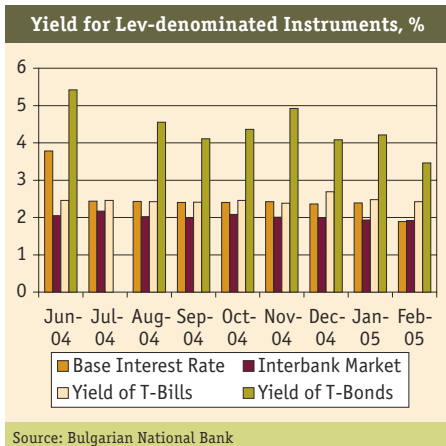


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The producer price index (PPI) decelerated to 4.8% yoy in January from 5.1% yoy in the previous month. The main inflationary factor for producers was a 21.5% yoy increase in metal prices, which appeared as a result of international metal market dynamics. Another factor that helped drive up PPI in January was the 6.8% yoy increase in oil prices. Since additional external price shocks are very unlikely, PPI inflation should not exceed its current level in the next few months.

In February, the Bulgarian National Bank (BNB) continued to increase money supply (M3), which grew by 24.1% yoy. This increase is consistent with the BNB's strategy to increase the level of monetization of the economy, which should stimulate investments.

In February, the stock of domestic credit reached Lev 14.73 billion (EUR 7.53 billion), which represents a growth of 32.7% yoy compared to 38.1% yoy growth in January. Some slowdown in domestic credit growth was recorded in all components. Growth in credit to non-financial entities slowed to 36.5% yoy in February from 37.3% yoy in January. Growth in loans to households decelerated to 75.1% yoy in February from 79.2% yoy in the previous month.



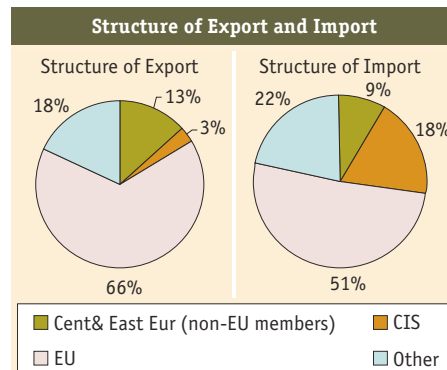
Source: Bulgarian National Bank

In March, the official foreign reserves of the National Bank continued to increase after some decrease at the end of 2004. They reached EUR 6.48 billion in March, up from EUR 6.43 billion in February. The existing foreign reserves are able to cover almost 8 months of the country's imports, which eliminates possible risks related to external shocks.

International Trade and Capital

In January, the merchandise foreign trade deficit reached EUR 199 million, representing a 29% yoy increase. The extrapolation of this growth rate brings the 2005 annualized trade deficit to EUR 2.7 billion, or 13.5% of projected full year GDP. The merchandise foreign trade deterioration is due to an increase in the amount of imported oil.

In January, merchandise exports increased by 27.6% yoy and reached EUR 640 million. The increase in exports reflects the favorable demand for Bulgarian metals on international markets. The importance of the metal sector for Bulgarian exports is reflected in the group of processed goods. In January, exports of this group grew by 34.1% yoy. Exports to EU countries continue to accelerate. In January, they grew by some 25.1% yoy. The product breakdown of Bulgarian exports to EU countries shows that they consist mainly of metal products.



Source: Bulgarian National Statistical Institute

In January, merchandise imports increased by 28.2% yoy, which demonstrates a higher rate of growth than in exports. Imports in January reached EUR 839 million (FOB prices). The existing hike in imports is due to the increase in oil prices. Since oil prices have already stabilized, it should be expected that next month's imports will grow at a slower pace than the current rate of growth.

In 2004, the current account (CA) deficit reached EUR 1.45 billion, which is equivalent to 7.5% of full year GDP. These figures demonstrate a decrease in the size of CA by 11% yoy. The CA gap was improved due to increased tourism inflows and transfers. However, the size of the CA deficit is still a significant risk factor for the Bulgarian economy in 2005.

On a positive note, net inflows of FDI have been able to match the existing CA deficits. In 2004, FDI inflows reached EUR 1.96 billion or 10.1% of annual GDP, advancing 5.8% yoy. Due to the favorable investment climate in the country, some FDI inflows can be also expected in 2005.

International Programs

In March, the International Monetary Fund (IMF) mission announced its support of the Bulgarian government's plan to pay bonuses to unemployed persons who had found jobs without state intermediation. The IMF also supports the government initiative to finance lump-sum payments to children and to provide options for early retirement of unemployed who are close to pension age. It is very likely

that the two-year precautionary agreement with the IMF will have a positive grade and the stand-by agreement will expire 3 months before the country's membership in the EU.

In March, the World Bank (WB) Board of Directors approved Bulgaria's Energy Efficiency Project, which aims to support a large increase in energy efficiency investments in Bulgaria through development of self-sustaining and market-based financing mechanisms. The main components of the project include: (i) improvements in energy transmission, (ii) loans to subprojects that would increase energy efficiency in specific companies, and (iii) capacity building and information barrier removal. The project will be financed through the Global Environment Facility Fund, which granted \$10 million for the project's implementation.

EUR 60 million financing from the European Investment Bank (EIB) to support infrastructure development has started to transfer to Bulgarian commercial banks. These funds will be distributed between local participants of the program on a tender basis.

The International Finance Corporation (IFC) will provide a \$25 million loan for the UK gas and oil extraction company Melrose Resources for its facilities in Bulgaria. The project aims to increase gas extraction from the local concessions. The targeted level of extraction should cover 10% of the natural gas demand in the country.

Other Developments and Reforms Affecting the Investment Climate

During its April session, the Foreign Affairs Committee of the European Parliament decided to recommend the go-ahead for the signature of accession treaties with Bulgaria. The target date for treaty signature is April 25. This decision makes Bulgaria one of the most attractive investment destinations in Southeast Europe.

In February, the international rating agency S&P improved the outlook for Bulgaria from stable to positive. This was done as recognition of the country's success in the rapid reduction of public debt, made possible by the recent buyback of Brady bonds in the amount of \$1 billion. All ratings are affirmed at BBB- and BBB for long-term foreign and local currency instruments, respectively. The expected upgrade over the next year will depend on successful continuation of public debt reduction management.

In March, Parliament ratified the Additional Protocol to the EU-Bulgaria Association Agreement. This protocol extends the time during which the steel sector remains eligible for restructuring support. The declared time is eight years from January 1, 1998, or the date of accession to the EU, whichever occurs sooner. These actions should attract

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more investments into the country's steel industry and positively affect its competitiveness.

The Bulgarian Agency for Economic Analysis and Forecasting (AEAF) to the ministry of finance launched drafting of the national development plan for 2007-2013. The AEAF warns that one of the risks for the country is related to the low capacity of EU funds utilization. The country's membership in the EU is creating many opportunities for increas-

ing investment and improving weak infrastructure. However, the process could be seriously impeded by inefficient administrative procedures. The national development plan is the major tool for improving fund utilization processes through the effective selection of priority investment areas.

The study done by the Organization for Economic Co-operation and Development (OECD) shows that small and medium-sized enterprises (SMEs) now

have easier access to financial and informational resources. The study shows that the biggest improvement in 2004 was related to the banking sector, which reduced interest rates for loans issued to SMEs. However, in 2005 businesses expect further improvements in access to informational resources.

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