Bulgaria
Macroeconomic Situation

June 2005

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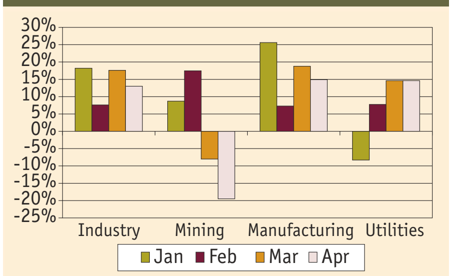
Summary

- Following a sharp acceleration in March, the real sector experienced a small slowdown in April due to decelaration in industrial sector growth, which stood at 13.1% year-over-year (yoy) compared to 18.4% yoy in the previous month;
- The fiscal situation in April was favorable — the fiscal budget surplus of EUR 345 million suggests that 2005 will end with a surplus of around 1% of GDP;
- The consumer price index (CPI) accelerated to 5.1% yoy, while the producer price index (PPI) surged to 7.7% yoy;
- The size of the current account (CA) deficit remains a significant risk factor, widening by 41.6% yoy to EUR 707 million in January-March;
- Net inflows of foreign direct investments (FDI) are able to cover only 25% of the CA gap;
- 96% of the Parliament voted to support the act for ratification of the EU Accession Treaty.

Economic Growth

In April, the real sector performed well, although it experienced some slowdown in its rate of growth. The main reason for this was deceleration in the industrial sector, which grew by 13.1% yoy compared to 18.4% yoy in the previous month.

Economic Growth in 2005 by Sector



Source: Bulgarian National Statistical Institute

Within the industrial sector, the biggest decline was observed in the extracting industry. April was the second month in a row when sales of this sector went down. In March, it dropped by 8.1% yoy and by 19.5% yoy in April. This is due to some reorientation in the country's export from the raw materials towards higher value added products. An additional argument supporting the idea of the structural changes is that manufacturing remains the most rapidly growing sector withing Bulgarian industry.

In April, manufacturing expanded by 14.9% yoy while the rate of growth reached 20.4% yoy in the previous month. Within manufacturing, the highest rate of growth was demonstrated by electrical machinery (up 39.8% yoy), metallurgy (up 26.8% yoy), and wood products manufacturing (up 22.5% yoy). The driving forces of growth in these sectors are increasing internal and external demand. On the opposite side, a steep slowdown was observed in office supply manufacturing (down 20.3% yoy), clothes (down 16.5% yoy), and medical equipment (down 10% yoy).

This is mainly due to increasing competition on the domestic market from imports and their relatively low competitiveness on international markets.

In April, sales in the utility sector grew by 14.6% yoy, the same as in March. The new tourist season will drive expansion of this sector even further, which will have a positive effect on the country's overall economic growth.

Fiscal Policy

In April, Bulgaria demonstrated prudent fiscal policy. The surplus of the consolidated budget increased by Lev 193.8 million (EUR 99.4 million). This increase brings the January-April cumulative surplus to Lev 673 million (EUR 345 million), which represents growth by 27.2% yoy. In the coming summer months, fiscal revenues related to tourist sector will continue to widen the budget surplus. It is very likely that the 2005 budget surplus will be around 1% of GDP.

Consolidated Fiscal Program

	Jan-Apr 2004, EUR million	Jan-Apr 2005, EUR million	%, yoy
Revenue	**2,614.1**	**2,953.7**	**12.99**
Tax	2,059.1	2,351.4	14.20
Non-tax	504.5	571.3	13.22
Grants	50.5	31.0	-38.62
Expenditures	**2,342.9**	**2,608.4**	**11.33**
Public Wages, insurance	243.2	267.7	10.06
Social and Health Insurance Contribution	93.1	96.1	3.22
Social Expenditure	926.8	1,000.9	7.99
Capital Expenditure	145.8	222.2	52.37
Other	934.0	1,021.6	9.38
Balance	**271.2**	**345.2**	**27.29**

Source: Bulgarian Ministry of Finance

In January-April, budget revenues grew by 13% yoy and reached Lev 5.76 billion (EUR 2.95 billion). Tax revenue, which accounts for some 79.6% of total budget revenues, demonstrated the highest rate of growth. During the period it grew by 14.2% yoy, while non-tax revenue grew by 13.3% yoy. In January-April, the amount of grants received by the Bulgarian government decreased by 38.65% yoy, which is a positive tendency, suggesting that the budget is becoming less dependent on foreign aid.

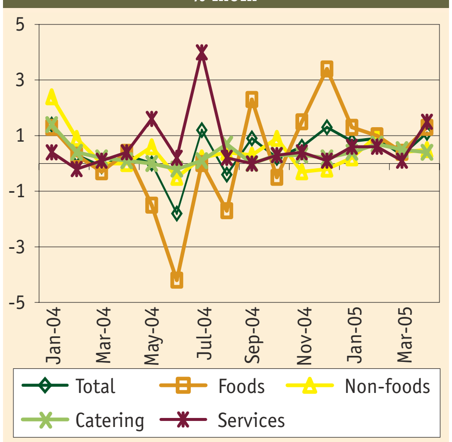
In January-April, budget expenditures grew at a slower pace of 11.3% yoy compared with a 13% yoy growth in revenues. On the positive side, capital expenditures grew by 52.37% yoy, while social and health insurance grew by only 3.22% yoy. Substantial growth in capital formation expenditures should positively affect the country's long-term economic growth.

In March, the country's external debt increased by 12.2% yoy and reached EUR 12.9 billion. The cumulative debt stock accounts for around 60.7% of projected full year GDP. The increase in external debt is a negative signal suggesting that the government should be more restrictive in its borrowings.

Monetary Sector

In April, the consumer price index (CPI) accelerated to 5.1% yoy from 4.3% yoy in March. This acceleration is mainly due to a significant increase in prices for services, whose share in the consumer basket is 28%. During the month they grew by some 10% yoy or 1.5% month-on-month (mom). The rate of price growth in food products reached 1.3% mom mainly due to an increase in prices for vegetables. However, in the coming months, the prices for food should not experience any significant growth due to the new harvest. Therefore, CPI inflation will be mainly dependent on prices in the service sector and non-food prices.

Indices by Major Groups of Consumer Goods, % mom



Source: Bulgarian National Statistical Institute

In April, the producer price index (PPI) surged by 7.7% yoy, which demonstrates a small increase from 7.5% yoy in March, and 6.5% yoy in February. The PPI remains well above the CPI mainly due to growth in oil and metal prices, whose share in the producer basket is significantly higher than in the consumer basket. It is very likely that in the coming months, PPI inflation will experience some decrease due to the stabilization in prices for metals and oil.

In April, the Bulgarian National Bank (BNB) continued to increase money supply (M3). At the end of the month, M3 reached Lev 22 billion (EUR 11.28 billion), which demonstrates a growth of 28% yoy. This increase is consistent with the BNB's strategy to avoid credit restraints. During the month, domestic credit grew at a rate of 43% yoy compared to 60.1% yoy in March. This positive trend should continue in the coming months.

In April, the size of the BNB's foreign assets continued to increase and reached Lev 11.3 billion (EUR 5.8

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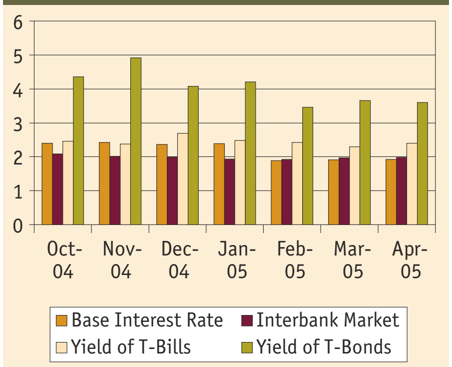
billion), which demonstrates 12.88% yoy growth. At the same time, the stock of the BNB's official foreign reserves reached EUR 6.64 billion. This increase should secure the country's macroeconomic stability and make it less dependent on the external shocks.

Yield for Lev-denominated Instruments, %



Source: Bulgarian National Bank

International Trade and Capital

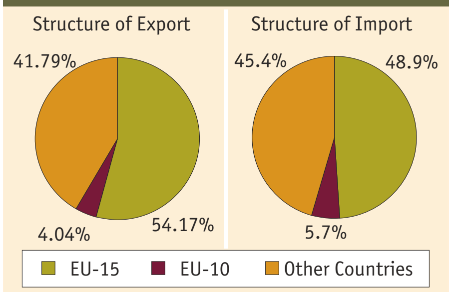
In January-March, the merchandise foreign trade deficit reached EUR 652 million, representing 28.2% yoy growth comparing with a 37% yoy increase in January-February. This deceleration in the rate of trade deficit growth is due to relatively good performance in March, when it grew by 15% yoy compared to 45% yoy growth in the previous month. The existing deficit in merchandise foreign trade brings the annualized merchandise deficit to some 11.8% of projected full year GDP. The deterioration of the country's merchandise foreign trade is due to increasing imports of oil and automobiles.

In January-March, merchandise exports reached EUR 2.1 billion, which represents 20.8% yoy growth compared to 18.7% yoy in January-February. In March, the highest growth was seen in raw materials, which account for some 44% of the country's total merchandise exports. The rate of growth in this group was equal to the total export rate of growth in March, which reached 24.5% yoy. Within this group, export of raw materials for the food industry was the leader, demonstrating a 176.8% yoy increase. The second largest group in Bulgarian exports is consumer goods, which accounts for 28.7% of the country exports. However, it grew by only 2% yoy during the month.

A geographical breakdown of Bulgarian export shows that the country has continued to re-orient its trade towards the EU. In March, 59% of the country's export was sent to the EU, while the average for 2004 was one percentage point less. Within the EU group, the main destination of the country's export is the EU-15, which absorbs almost 90% of the total export to the EU-zone. Such EU-oriented export should significantly ease Bulgaria's accession to EU.

In January-March, merchandise imports grew at a faster pace than exports and reached EUR 2.7 billion, which represents a 22.5% yoy increase. In March, the growth of imports accelerated to 22.5% yoy from 17.9% yoy in February. The EU remains the main exporter to Bulgaria. In March, 50.5% of the country's imports came from the EU-25, of which almost 90% was originated in the EU-15. In March, the rate of growth in imports generated in the EU-25 was almost half the total rate of import growth. However, so far there are no substantial reasons to conclude that the importance of the EU's imports is decreasing since its share has remained pretty stable over the last twelve months (in March 2004, 54.6% of Bulgarian imports came from the EU-zone).

Composition of Bulgarian Import and Export in March 2005



Source: Bulgarian National Statistical Institute

In January-March, the current account (CA) deficit widened by 41.6% yoy and reached EUR 707 million. The most significant increase in the deficit appeared in March, when it grew by 68.3% yoy, which translates into EUR 236 million. The existing CA deficit and the low level of FDI led to the overall balance of payments deficit; this could negatively affect the country's future development.

Another concern is the fact that January-March's net inflows of FDI have dropped by 23% yoy and reached EUR 274 million. However, after a significant decrease in the rate of growth in January and February, the net inflow in March accelerated by almost 50% yoy and reached EUR 175 million. This improvement should decrease the deficit of the overall balance of payments and give additional benefits to the monetary authorities.

International Programs

At the end of March, the Bulgarian government's external debt to the World Bank (WB), the biggest international lender to the country, reached EUR 929 million. In January-March, this debt decreased by EUR 2 million. Debt to the International Monetary Fund (IMF) is estimated at EUR 855 million, which represents a decrease by EUR 14 million in January-March.

In May, Bulgaria signed an agreement with the WB for a loan in the amount of $150 million. In the agreement for this loan, the WB introduced a new approach to its operations in the country. Investment proposals, which should be in line with the purposes of the loan, should come from the local authorities and the WB will make the final selection. The loan will support projects related to poverty reduction, infrastructure development, energy, healthcare, education, and other programs meant to improve the living standards and business environment in the country.

In May, the IMF executive board completed the first performance review under the two-year precautionary agreement with Bulgaria. The IMF approval contains waivers on non-observance of several performance criteria: (i) ceilings on general government expenditure and central government arrears and (ii) transfer of all autonomous budgetary entities to the single treasury account. The IMF executive board review allows a tranche disbursement of EUR 40 million under the EUR 110 million standby arrangement. The IMF points out that despite problems in meeting some of the agreed criteria and benchmarks, Bulgaria's macroeconomic performance has exceeded the expectations set under the standby arrangement.

The European Bank for Reconstruction and Development (EBRD) announced in May that two new loans in the total amount of EUR 157.5 million would be provided for modernization of Maritsa East 1 thermo-power complex. The total estimated cost of the project is EUR 1.05 billion. The project is designed to increase efficiency in the energy-generating sector.

Other Developments and Reforms Affecting the Investment Climate

In May, the Bulgarian Parliament passed in two readings the act for ratification of the EU Accession Treaty. 96% of all members of the Parliament backed the EU integration process. Such strong support shows that the forthcoming general elections cannot reverse Bulgaria's foreign policy agenda. However, the European Commission announced that it would send warning notes to Bulgaria concerning the slow implementation of certain reform targets, mainly reforming the country's judiciary system.

In June, the Bulgarian Cabinet of Ministers passed budget projections for 2006-2008. The forecast is in line with the previously announced GDP growth of 5.3%-5.5% per year and annual inflation rates of 3.7%-4%. The Cabinet expects the new budget to be fully balanced in 2006, and to run a surplus of 0.7% of GDP in 2007 and 2008. The Cabinet also announced some changes in the country's debt management. Several changes that will be introduced are intended to decrease the country's debt-to-GDP ratio to less than 35% of GDP.