SigmaBleyzer

Bulgaria
Macroeconomic Situation

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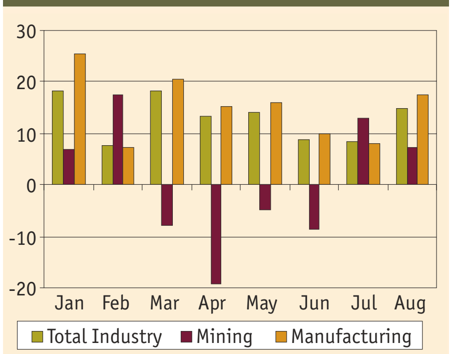
Summary

- In August, Bulgaria's real sector continued to show very good performance, mainly due to significant acceleration in the country's manufacturing.
- The country's prudent fiscal policy helped it accumulate a fiscal budget surplus in the amount of EUR 676.0 million over January-August.
- In August, consumer price inflation accelerated further to 4.9% year-over-year (yoy), up from 3.7% yoy in July, driven by adverse supply shocks. The producer price index (PPI) accelerated slightly to 6.6% yoy, up from 6.5% yoy in July.
- Growth of the monetary base slowed to 33.5% yoy in August, down from 35.3% yoy in July, reflecting deterioration in the balance of payments.
- The current account (CA) deficit doubled in August, bringing the cumulative figure to EUR 1.6 billion. The financial account surplus was still sufficient to cover this gap, but FDI inflow, which reached EUR 0.9 billion in January-August, continues to slow down.
- The Human Development Index moved Bulgaria from the group of less developed countries to the developed group, which is due to recognition of the country's significant achievements made over the last few years.

Economic Growth

In August, the real sector performed extremely well. Rapid expansion of industrial sales grew by 14.9% yoy compared with 8.3% yoy in the previous month, supporting the country's economic growth. The outstanding performance of the industrial sector supports the idea that Bulgaria will be able to show economic growth of around 5.6% yoy in 2005.

Economic Growth by Sectors in 2005, % yoy



Source: Bulgarian National Statistical Institute

The main driving force of the industrial growth was sugar manufacturing. In August, its sales grew by 17.6% yoy compared with 9.7% yoy in July. Although the mining sector performed poorly compared to the previous month (when it demonstrated an impressive 12.3% yoy growth), it was able to reach 7.3% yoy growth.

By product breakdown, the growth-leaders within Bulgarian manufacturing were vehicles, chemicals and chemical products, and electrical machinery. In August, they grew by 32.0% yoy, 26.6% yoy, and 25.8% yoy respectively. Among other solidly growing sectors were textiles and pulp and paper with 22.7% yoy, and 17.8% yoy growth respectively. On the opposite side, some decline was registered in the manufacturing of office machinery and computers (decrease by 3.3% yoy), and furniture production (decrease by 1.9% yoy) over the month. The recent developments in manufacturing sectors suggest that the good performance of the real sector revived after some negative trends in the previous month.

Fiscal Policy

In August, Bulgaria demonstrated prudent fiscal policy. The monthly consolidated budget surplus reached Lev 184.9 million (EUR 94.8 million), which brought the country's January-August cumulative surplus to Lev 1,318.2 million (EUR 676.0 million). Although the August rate of growth in the fiscal surplus was lower than in June, it is still 10.6 pps higher than in the respective period of last year. Good fiscal performance over the last 8 months suggests that the government has a very strong chance to finish this fiscal year with a significant surplus of no less than 1.5% of GDP, despite the deficit initially forecasted by the government of around 1% of GDP.

Consolidated Fiscal Program

	Jan-Aug 2005, EUR million	Change, % yoy
Revenue	**6,030.1**	**14.0%**
Tax	4,780.8	14.0%
Non-tax	1,082.3	13.8%
Grants	167.0	17.5%
Expenditures	**5,354.1**	**14.5%**
Public Wages, insurance	562.8	10.7%
Social and Health Insurance Contribution	202.1	2.1%
Social Expenditure	2,056.8	10.8%
Capital Expenditure	570.0	67.2%
Other	1962.3	10.6%
Balance	**676.0**	**10.6%**

Source: Bulgarian Ministry of Finance

In January-August, cumulative budget revenues reached Lev 11.76 billion (EUR 6.0 billion), which represents growth by of 14.0% yoy. Over the period, tax revenues accounted for 79.3% of the total budget revenues, and demonstrated growth of 14.0% yoy. The same growth tendency was observed in non-tax revenue, and grants obtained by the government. In January-August they surged by 13.8% yoy and 17.5% yoy respectively. Some acceleration in the rate of growth in grants reflects the current transfers made to the country to support its preparation for EU accession.

In January-August, budget expenditures grew at a faster pace compared to growth in revenues. Over the period they grew by 14.5% yoy against 14.0% yoy growth in revenues. Despite some imbalance in the rate of growth, a very positive note is the on-going growth of capital expenditures, which have been increasing throughout the year. Over the period they reached EUR 570.0 million, surging by 67.2% yoy. If this trend continues, public investments may play an important role in ensuring sustainability of the country's economic growth.

In January-August, Bulgaria demonstrated prudent debt management. Over August, the country's total external debt fell by EUR 93.7 million, which brought the cumulative debt stock to EUR 5.48 billion. This drop in debt is due to the principal repayments to the IMF in the amount of EUR 20.4 million, to the World Bank in the amount of EUR 11.6 million, and to other creditors, which received from EUR 56.6 million the government. Although the largest lenders remain international financial institutions (IFIs) such as the World Bank (16.7%), the International Monetary Fund (14.7%) and the European Union (5.7%), their shares are declining over the time.

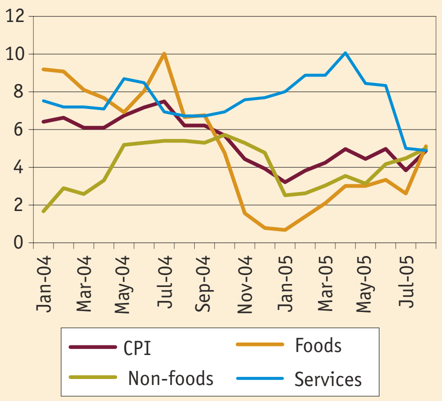
There is a very high certainty that the government will continue its very prudent fiscal policy in the next year. The Ministry of Finance has already revealed the macroeconomic parameters for 2006. Next year's budget will incorporate a forecasted GDP growth of 5.3%, and annual average inflation with a rate not exceeding 4.4%.

Monetary Sector

In August, consumer price inflation (CPI) accelerated further to 4.9% yoy, up from 3.7% yoy in July and 3.6% yoy in June. This acceleration was mainly driven by adverse supply shocks. Flood damages contributed the upward pressures on food products prices, which grew by 5.1% yoy during the month. Prices for non-food products increased by 5.0% yoy. This is partially due to hikes in fuel prices. On the opposite side, prices for services demonstrated significant deceleration from the average 8.8% yoy in the first half of 2005 down to 4.9% yoy in August. This slowdown reflects the absence of the service tariffs adjustment usually made in July. The adverse supply shocks should continue pushing the inflation rate up through the end of 2005, but the annual figure is not likely to exceed the 6% rate.

In August, producer price index (PPI) growth accelerated slightly. The index increased by 6.6% yoy compared to 6.5% yoy in the previous month.

Changes in CPI and Its Major Components, % yoy



Source: Bulgarian National Statistical Institute

Money supply, measured by monetary aggregate M3, increased by 29.0% yoy in August, up from 26.4% yoy growth registered in July. Most of this acceleration is attributable to the low base effect, namely to technical reduction in M3 in August 2004, as the balance of payments (a fundamental factor fueling monetary expansion) keeps deteriorating. This is confirmed by development of narrower monetary aggregates, specifically the monetary base. In August, the monetary base grew by 33.5% yoy compared to 35.3% yoy in July and almost 40% yoy growth throughout the second quarter of 2005.

The Bulgarian National Bank's (BNB) efforts to restrain the credit boom seem to have yielded some positive results. The stock of commercial bank credits to non-financial entities grew by 40.1% yoy to Lev 16.3 billion (EUR 8.3 billion) by the end of August. This is only slightly higher than 39.8% yoy growth in July, but significantly lower than 44.8% yoy in June. Of the total growth figure, credit to households increased by 66.2% yoy and credit to non-financial entities by 28.2% yoy. Yet, both types of credit contributed equally to overall growth, due to a smaller share of household borrowings from commercial banks.

The interbank money market was very stable in August. The interest rate on interbank loans was at the same 2.06% p.a. as in July. Accordingly, the BNB's base rate has not been changed as well.

International Trade and Capital

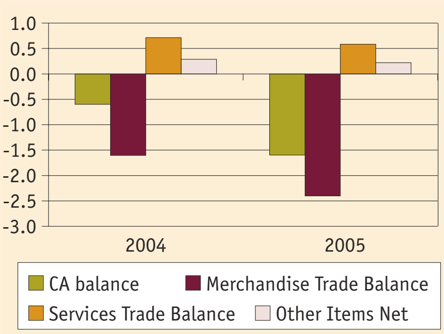
In January-August, the Bulgarian merchandise trade balance deficit kept rising. This is due to further divergence of the country's export and import growth rates. Over the period, exports increased by 18.8% yoy, which is slightly below the 19.0% yoy growth in January-July. At the same time, imports grew at a faster pace and accelerated to 26.1% yoy compared to 24.3% yoy in January-July. As a result, the cumulative trade deficit in January-August widened by 43% yoy and reached EUR 3.1 billion.

A geographical breakdown of Bulgaria's international trade suggests that the EU remains the dominant consumer of the country's exports and the main destination for the import flows. In January-August, exports to the EU-25 grew by 17% yoy, which explains more than half of total export growth. Exports to the neighboring countries of Central and Eastern Europe (CEE) surged by 21.5% yoy. However, its contribution to the overall growth rate of exports was relatively smaller due to the trivial weight of CEE countries in Bulgaria's exports structure. In January-August, one-third of the overall increase in imports was caused by growing imports from the EU countries. The relatively low contribution of the EU component to Bulgarian import growth (compared to exports) is due to some on-going geographical restructuring in the country's imports. In particular, this is partly explained by an increase in prices for energy resources imported from the CIS region.

By end-use structure, the increase in exports of raw materials explains about half of all export growth over January-August. One-fourth is attributable to the increase in exports of investment goods. Over the period, the highest rate of growth was registered in vehicle exports, which almost tripled. This positive tendency reflects a gradual reorientation of Bulgarian exports towards commodities with a higher degree of value added. The positive tendency on the imports side is also a steady increase in the share of investment goods, which is largely dominated by machinery and equipment items, and vehicles. Growth of this group explains about one-third of the total import increase. Yet raw materials remain the largest group of imported products, accounting for more than 30% of imports.

The balance of payment (BoP) data from the BNB reveals further deterioration of the current account (CA) balance. In August alone, the CA gap was EUR 115 million, twice last month's figure. This caused an increase in the cumulative CA deficit to EUR 1.6 billion. Although this figure is much higher than the EUR 0.6 billion cumulative CA deficit registered in the same period of 2004, most of the difference is explained by a low base effect. The CA deficit continues to be covered by the financial account surplus generated mostly by FDI inflow. Over January-August, net FDI inflow amounted to EUR 1.2 billion. Yet part of this figure is due to a mergers and acquisitions increase, which reflects transfer of shares of Bulgarian MobiTel Company. As a result of all these changes in BoP, BNB foreign exchange reserves increased by EUR 168 million to EUR 7.1 billion in August, which partially offsets the July reduction.

Current Account and Its Major Components in January-August, EUR billion



Source: Bulgarian National Statistical Institute

International Programs

October's IMF regular mission is intended to evaluate the country's performance specified in the two-year Precautionary Programme, which expires in September 2006. The review should be fully completed in December. The mission has to reach an agreement with the Bulgarian government on issues related to the country's fiscal policy for the next year. In particular, the IMF is (i) pushing for a general budget surplus of around 3% of GDP next year; (ii) supporting the package of tax amendments proposed by the Ministry of Finance aiming to reduce the pension insurance burden by almost 6% through the increase in property tax and excise for tobacco by some 20%. The IMF has indicated that the planned tax relief should be in line with the budget balance target.

The Bulgarian Parliament ratified the government arrangement with the World Bank (WB) for disbursement of the third Programmatic Adjustment Loan (PAL 3). The loan in the amount of EUR 116 million will be repaid in 17 years, which also includes a grace period of 5 years. This financing is to be used for poverty reduction, infrastructure development and improving the overall business climate in the country.

In October, the EU provided a EUR 1 million grant to Bulgaria under the PHARE financial agreement. The grant will be used to initiate a project designed to improve civil and criminal procedures in the country. In particular, this project will provide support to the national and local legal aid commissions, judicial enforcement and training programs for magistrates and judicial officers on civil and criminal code.

Other Developments and Reforms Affecting the Investment Climate

The United Nations' (UN) Human Development Index (HDI), which is calculated as a weighted average of economic and social indicators and covers 177 countries, has placed Bulgaria in 55th place in the overall ranking. In doing so, the UN moved Bulgaria into the group of developed countries from the less developed group, in which Bulgaria was placed by previous reports. This was due to the recognition of the country's achievements in economic growth, improvements in life expectancy and child mortality rates, and significant progress in many other living standard indicators. The new published HDI rating placed the country well behind all other new EU member states.

A recently completed comparative analysis by Ernst&Young of investment climates in Europe found that Bulgaria occupies 15th place in its investments attractiveness among other European countries. The study suggests that some 2.2% of the total amount of FDI invested in Europe was made in Bulgaria over 2004. Thus, Bulgaria outranks Italy, Turkey, Greece, Austria and Portugal.

Published in September, the Global Competitiveness Report prepared by the World Economic Forum (WEF), improved its ranking for Bulgaria. The country climbed one place, from 59th in 2004 to 58th in 2005. Two other EU-candidates, Turkey and Romania, were ranked further down (66th and 67th respectively.)