Bulgaria
Macroeconomic Situation

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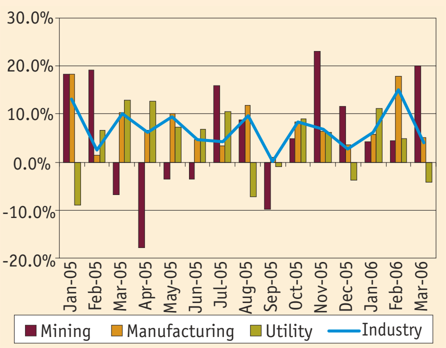
Summary

- In March, growth of Bulgaria's industrial sector decelerated to 4.1% year-over-year (yoy) after impressive growth of 15.1% yoy in the previous month.
- An increase in public wages and other social expenditures caused some decrease in the size of the consolidated fiscal surplus compared with initial forecasts, which in annualized terms went down to 0.9% of projected annual GDP in March from the 3%level in the previous month.
- Annual consumer inflation showed a positive tendency of slight deceleration from 8.7% yoy in March to 8.1% yoy in April.
- The trade deficit is still the main driving force of the widening current account (CA) deficit, which reached EUR 1.05 billion in March or 4.4% of estimated full-year GDP. However, the existing gap is fully covered by surpluses in other components of the balance of payments and, in particular, by significant growth in foreign direct investments (FDI), which almost doubled in January-March compared with the same period of the previous year.
- The newly released EU-report on Bulgaria says that although the country has achieved good results in judicial reform and fighting corruption, both issues should still be on the government's agenda.

Economic Growth

In March, the real sector experienced some slowdown in its rate of growth following significant expansion in February, which is in line with our previous month's forecast. Some slowdown in growth was due to decelaration of industrial sales, which increased by 4.1% yoy, compared with the outstanding 15.1% yoy in February.

Economic Growth by Sectors in 2005-2006, % yoy



Source: Bulgarian National Statistical Institute

Within the industrial sector, mining demonstrated the highest rate of growth. In March, sales in this subsector expanded by 20% yoy compared with 4.4% yoy in the previous month. The remarkable growth in mining was mainly driven by an increase in metal ores mining on a back of surging metals' prices.

The performance of the country's manufacturing sector was not as impressive in March as in the previous month, but was still solid. In March, aggregate growth in manufacturing was 5.1% yoy compared with an impressive 17.9% yoy one month earlier. Since the weight of manufacturing in the total structure of the country's industrial sector is the highest, deceleration in its rate of growth had a large effect on aggregate industrial growth. Within Bulgarian manufacturing the best performares were manufacturing of fabricated metal products (which surged during March by an impressive 41.1% yoy), followed by manufacturing of electrical machinery (which grew by 36.9% yoy), and manufacturing of wood products (surging by 16.4% yoy.)

March's economic growth was supported by good performance of the country's surging retail sector, which increased during the month at almost the same rate as in February and posted a 10.2% yoy increase. On the negative side, wholesale trade continued to demonstrate a downward trend, posting a 0.7% yoy decline after an even more dramatic decline in the previous month when this sector shrunk by 2.4% yoy.

Fiscal Policy

In January-March, the consolidated budget surplus shrunk by 10.5% yoy and constituted Lev 479.3 million (EUR 219 million), which is equivalent to 0.9% of projected full-year GDP. Although the relative size of the fiscal surplus experienced some decline during the period, the country's prudent fiscal policy is in line with initially anticipated parameters.

Consolidated Fiscal Program in January–March 2006

	EUR million	Change, % yoy
Revenue	**2,237.9**	**5.1%**
Tax	1,890.5	8.6%
Non-tax	354.6	–10.8%
Grants	20.4	–12.2%
Expenditures	**2,018.5**	**7.1%**
Public Wages, insurance	307.3	56.9%
Social and Health Insurance Contribution	98.4	40.7%
Social Expenditure	865.9	16.4%
Capital Expenditure	131.6	–13.2%
Other	615.1	–15.0%
Balance	**219.3**	**–10.5%**

Source: Bulgarian Ministry of Finance

On the revenue side, the fiscal budget saw some slowdown in its rate of growth in January-March. During the period, revenues increased by around 5% yoy compared to 6.6% yoy in the previous month and reached Lev 4.2 billion (EUR 2.2 billion). Some weakening in budget inflow performance is due to declining revenue from non-tax and grants items, which decreased by 10.8% yoy and 12.2% yoy respectively. An increase in tax revenues by 8.6% yoy alleviated some negative effect from decreasing revenues in other items and made it possible to keep the overall budget balance in surplus.

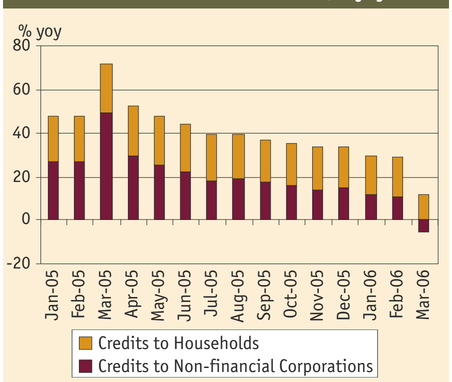
On the expenditure side, they grew by 7.1 % and reached Lev 3.9 billion (EUR 2 billion) in January-March. This is mainly due to an increase in social expenditures, which was anticipated in the 2006 budget. During the period, significant acceleration in the rate of growth was observed in public wages, and social and health insurance contributions, which grew by 56.9% yoy and 40.7% yoy respectively. To keep the budget in surplus, the government needed to sacrifice its capital expenditures. During the period, they dropped by 13.2 % yoy.

In January-March, the Bulgarian government implemented thoughtful debt management. By the end of March, the total amount of public and publicly guaranteed debt continued to show a positive tendency. During the period, they decreased by 0.4% as compared with the previous month and went down to EUR 6.5 billion, which constituted 27.8% of GDP. The stock of the state's external debt decreased to EUR 4.9 billion, constituting 21.3% of GDP, while the stock of domestic debt increased to EUR 1.5 billion, constituting 6.5% of GDP. The structure of external debt by type of creditor did not experience any significant changes. The World Bank, International Monetary Fund and European Union are still the country's largest investors; their shares in total debt stock are 16.5%, 7.2% and 5.2% respectively.

Monetary Sector

In April, consumer price inflation (CPI) inflation decelerated to 8.1% yoy down from 8.7% yoy in March, which is backed by some deceleration in growth of food and service prices. During the month, food prices increased by 6.6% yoy compared with 7.3% yoy in March. Non-food prices grew by 13.7% yoy down from 13.9% yoy in March. The main driving force of this increase, as in the previous month, was high oil prices. On a positive note, service tariffs posted a 4.0% yoy increase in April, which is the lowest level in the last 7 years.

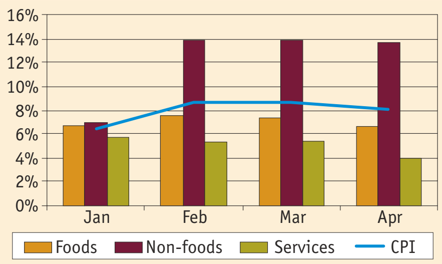
Growth Rates of Bank Credits, %yoy



Source: Bulgarian National Bank

Since the beginning of the year, the producer price inflation (PPI) has demonstrated a downward trend. In March it dropped to 6.5% yoy, down from 9.6% yoy in February and 8.7% yoy in January. The National Statistical Institute also started to calculate a wider producer price indicator, which in addition to the regular PPI includes prices for exported goods. Similar to PPI, the producer price indicator showed 10.5% yoy growth in January, 11.7% yoy in February, and 9.5% yoy in March.

Changes in CPI and its Major Components in 2006, yoy



Source: Bulgarian National Bank

In March, growth of money supply slowed to 10.1% yoy down from 21.1% yoy in February. This is reflected in a considerable slowdown in deposits growth from 24% yoy in February to 10% yoy in March.

In order to restrain credit growth, the Bulgarian National Bank (BNB) continued to raise the base rate, which for April was set at 2.48% per annum (p.a.). This is 0.20 percentage points higher than in March. Consequently, the interbank rate for Lev-denominated deposits increased to 2.62 % p.a by the end of April.

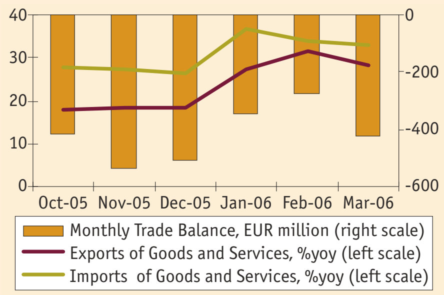
In March, claims of commercial banks on the non-government sector grew by 4.2% yoy and constituted 40.5% of GDP. However, this movement demonstrates only a marginal increase from the previous month level of 40.4% of GDP. This is another argument to support the idea that the BNB is actively working on limiting credit expansion.

International Trade and Capital

In January-March, Bulgaria's foreign trade gap continued to expand. During the period, the cumulative trade deficit in goods and services reached EUR 1.04 billion, which demonstrates a 47.4% yoy rate of growth. In March alone, growth of the trade deficit accelerated to 58.9% yoy up from 46.9% yoy in the previous month, which is mainly due to significant growth in imports. In March, growth in exports posted a rate of 22.8% yoy, while imports grew at a significantly faster pace of 31.9% yoy. The main reason for the latest increase in imports is a jump in energy prices.

The existing trade deficit is the main driver for the widening of the current account (CA) deficit. In January-March, the CA gap reached EUR 1.05 billion, which can be translated into 4.4% of estimated full-year GDP. In March alone, the CA deficit increased by EUR 387.5 million compared with a EUR 227.5 million increase in the previous month. On a positive note, the existing deficit in the CA is covered by a large surplus in the financial and capital accounts' item of the balance of payments, which amounted to EUR 569.5 million at the end of March or 2.4% of estimated full-year GDP. Although the total size of the existing surplus in the financial and capital accounts is still reasonably high, it shrunk in half in January-March compared with the corresponding period of the previous year.

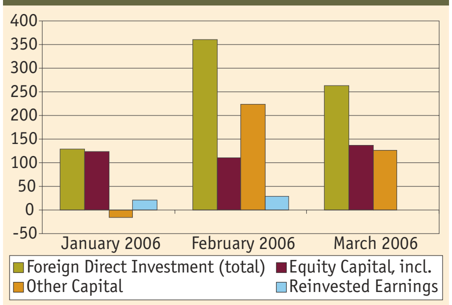
Trade Flows



Source: Bulgarian National Bank, own calculations

Some decrease in the country's financial and capital accounts pushed the National Bank to slightly decrease its foreign exchange reserves. However, they are still at a substantially high level and able to cover 4.7 months of Bulgarian imports.

FDI in January–March, million EUR



Source: : Bulgarian National Bank, own calculations

Bulgaria showed very good performance in attracting FDI. In January-March, net inflow of FDI almost doubled compared with the same period of the previous year and reached EUR 740 million. The existing amount of FDI inflow is able to cover around 70% of the CA deficit. Although private equity investments have been increasing during January-March, there was some negative sign from the side of portfolio investments, which decreased by EUR 52.6 million. It is likely that the existing outflow in portfolio investments was motivated by a widening CA gap.

International Programs

In May, the Bulgarian government and the IMF agreed that they would extend the acting precautionary agreement through the end of March 2007. Bulgaria will pursue joint policy targets with the IMF by the end of 2006. The last three months of the extension period will be technical and should not contain any criteria related to macroeconomic policy for 2007. It was also agreed that Bulgaria would not apply for a new agreement with the IMF after the end of the extension period.

The Bulgarian Ministry of Finance announced in May that its key partners in utilization of European funds are the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD). It was also confirmed that EIB and EBRD are two international institutions that are extremely important for Bulgaria as advisors in forming an effective strategy for the country's further economic development. Currently, Bulgaria is in the process of consultations with both EIB and EBRD on several projects that are related to infrastructure and municipal development. The EBRD announced that its plans over the next five years include around EUR 500 million investments in Bulgarian and Romanian economies.

At the end of 2006, Bulgaria will start to finance construction projects in the area of public transportation with a total amount of EUR 236 million. The project includes construction of a EUR 160 million bridge, which should connect two ports in Bulgaria and Romania, and construction of adjacent facilities in Bulgaria. The project is co-financed by the EU PHARE and ISPA pre-accession programs, the French Development Agency, the German Credit Institution for Reconstruction and Development, the European Investment Bank, and Bulgarian institutions.

Other Developments and Reforms Affecting the Investment Climate

The European Commission announced in May that Bulgaria has achieved good results in reforming the country's judicial system and fighting corruption over the past few months. However, the released report says that further measures in both fields still need to be implemented.

In its latest statement in May concerning Bulgaria, S&P underlines that the country's prudent fiscal and monetary policies were more important for the sovereign ratings than the precise timing of EU membership. In regard to the current economic situation, the agency outlines the high CA deficit as a major concern due to some risk associated with possible foreign capital outflows.

In May, the international credit rating agency Moody's upgraded its rating for Bulgaria. The decision was based on positive results achieved by the country while implementing a successful strategy of

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foreign currency debt service. The credit ceiling for Bulgaria was raised to A1 from Baa3 for long-term instruments. The outlook remained stable. The ratings for government bonds and the foreign currency ceilings for bank deposits stayed unchanged at Baa3.

The National Statistical Institute reported that in January-March, the country's unemployment level based on ILO methodology dropped by 1.6 percentage points to 9.7%. However, since many job seekers have a weak educational background and are not flexible enough to get new qualifications or to move to regions with better job opportunities, it is possible that in the medium-term the rate of unemployment could slightly increase.

According to the survey of the National Statistical Institute done in April, private businesses should intensify their investment activity during this year. It was reported that private companies working in the industrial sector plan to increase the total amount of their investments in 2006 by an average of 11.7% yoy . The breakdown by sector shows that 43% of the investments will be directed into energy and water distribution projects, 36% into intermediary production, and 10% into food processing.

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