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Bulgaria
Macroeconomic Situation

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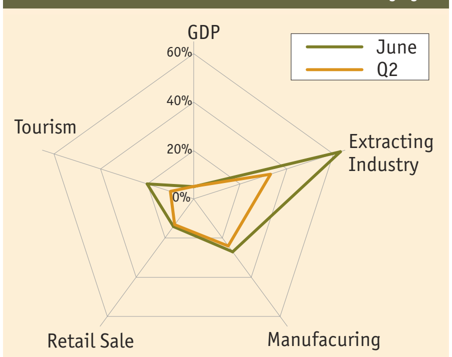
Summary

In the first half of the year, the Bulgarian economy demonstrated sustainable growth. GDP growth in the second quarter of the year stayed above 5% year-over-year (yoy), supported by increases in industrial output (18.8% yoy in May) and a 20% yoy growth in the tourist sector. The government maintained prudent fiscal policies. The general budget surplus grew to 2.3% of GDP in the first half of the year, bringing the country's fiscal reserve to a record high level of EUR 2.6 billion at the end of June. The 10% yoy increase in average food prices in July accelerated CPI inflation to a 3-year record high of 7.6% yoy. Due to rapid imports growth, the merchandise trade deficit continued to deteriorate. The trade gap widened by 18.5% yoy in May and 35% yoy in January-May. However, the current account (CA) deficit was reduced in May, which moves the annualized CA deficit to around 8% of GDP. Still, the overall balance of payments in January-May showed a surplus due to capital inflows that was 4 times larger than in the same period last year. The Bulgarian Parliament ratified a signed agreement with the World Bank for the Second Programmatic Adjustment Loan. In August, the Japanese Bank for International Cooperation signed a long-term loan financing a project for modernization of Maritsa East 2 thermo-power plant. International credit rating agency Fitch upgraded Bulgaria's position to investment grade and Moody's is expected to do the same within the next few months.

Economic Growth

In the second quarter of 2004, economic growth in Bulgaria is likely to stay at 5.4% yoy or about the same level as in the first quarter (5.3% yoy). The recent GDP growth was caused by a rebound in Bulgaria's industrial and tourist sectors.

Growth in GDP and Selected Sectors, % yoy



Source: Bulgarian National Statistical Institute

Industrial sector sales showed strong performance in June, rising by 26.4% yoy. The main driver of industrial growth in June was the extracting industry, showing the best growth rate of 62.9% yoy. This was due to a more than double increase in the metal extraction group. The manufacturing firms have exceeded the average rate for the whole industry. Therefore, the estimate for output growth of the industrial sector in the second quarter of 2004 is that it will accelerate to 18.8% yoy compared to 16.2% yoy in the first quarter.

June was the third month of accelerating retail sales growth, which hit a new record high of 14.1% yoy and 12.8% yoy in the first half of the year. The service sector showed good performance due to the increase of tourism to Bulgaria during the summer. The number of foreign tourists visiting Bulgaria picked up by 20% yoy in July.

Growth acceleration in the second quarter would most likely result in GDP growth of around 5.4% yoy in the first half of 2004.

Fiscal Policy

Facilitated by robust economic growth, fiscal performance was at an acceptable level during the first half of the year. In January-June, the general fiscal budget posted a surplus of Lev 878 million (EUR 449 million). The monthly surplus in June was Lev 168 million. However, while the government is targeting a full-year deficit of 0.7%, the figures for the first half of the year account for some 2.3% of projected full year GDP, or 0.5 percentage points higher than in 2003.

In the first half of 2004, consolidated budget revenues reached Lev 7.65 billion (EUR 3.91 billion) or 5.1% higher than the same period of the previous year. Growth in revenues was secured by a 7.5% yoy increase in tax receipts. In particular, the revenue hike in the summer period reflects increased collection of VAT and excise taxes due to growing tourism. The tourist effect is confirmed by several municipalities on the Black Sea coast, which saw a 45% annual increase in tax revenues for their territories.

Despite the significant growth in budget revenues, growth in expenditures was lower in the first half of 2004. It reached Lev 6.8 billion (EUR 3.5 billion) or 2.4% yoy. However, expenditures in June were almost the same as in the previous month — Lev 1.103 billion compared to Lev 1.097 in May.

The large general budget surplus has pushed the fiscal reserve to a record high. In June, the fiscal reserve jumped by EUR 264 million. Such a significant increase in fiscal reserves was also aided by privatization receipts for Bulgarian Telecom. At the end of June, these reserves had reached EUR 2.6 billion.

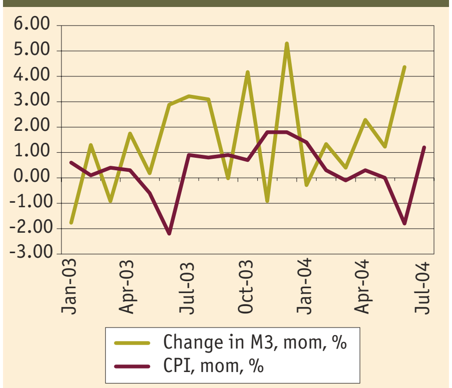
The amount of public debt (internal and external) amounted to EUR 8.8 billion at the end of June, or 45.3% of projected full year GDP. In June, the debt stock rose by 0.1% or EUR 5.7 million. Since January, public debt dropped by EUR 113.5 million (1.3% yoy).

Public debt should drop further in July due to debt buyback and regular principal payments adjusted with the newly approved World Bank loan, and due to a decrease in the yield of 15-year Euro-denominated local government bonds from 6.06% in January to 5.94% in July.

Monetary Sector

CPI inflation continued to accelerate, reaching a 3-year record high of 7.6% yoy in July, compared to 7.3% yoy in June and 6.8% yoy in May. During July, CPI rose by 1.2% on a month-over-month basis, after it was close to zero in May and fell in June.

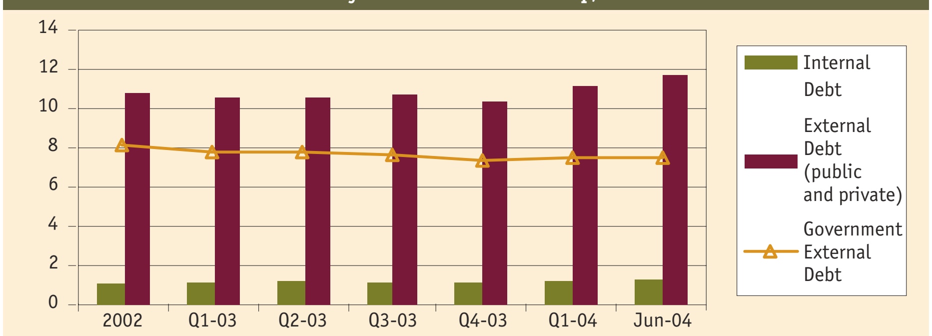
CPI and Money Supply Dynamics, 2003-2004



Sources: Bulgarian National Statistical Institute, Bulgarian National Bank

The main source of the significant increase in CPI was the rise in food prices. In July, average food prices grew by 10% yoy. A combination of seasonal import protection tariffs and local supply shocks for some of the agricultural products has turned the food market into the most unstable price factor this summer. However, the

Public Debt Dynamics in 2002-2004 eop, EUR billion



Source: Bulgarian National Bank

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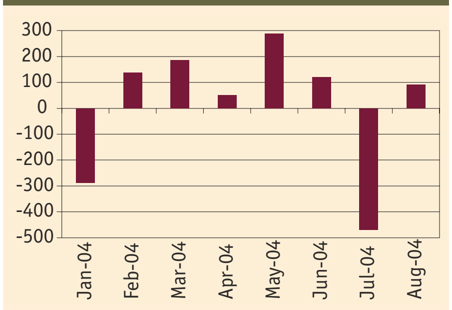
sliding prices of grain and related products are likely to bring down CPI inflation in the coming months. External oil shocks and changes in state regulated energy prices have also influenced CPI dynamics in July, but to a much lesser extent than food sales.

In June, the producer price index (PPI) slowed to 6.9% yoy, compared to 8.6% yoy in May and 6.3% in April. This drop in the PPI might cause a downshift in the CPI in the next few months.

At the end of June, the assets of the banking system increased by 22% yoy in real terms and picked up to 53% of GDP. The stock of credit to non-financial entities rose by 39% yoy, demonstrating a slight slowdown in line with the central bank's efforts to curb rapid credit expansion.

In an attempt to stimulate economic growth, the Bulgarian National Bank (BNB) lowered its base interest rate from 2.44% per annum in July to 2.40% in August.

Change in Official Foreign Reserves, EUR million*



*As of August 20th
Source: Bulgarian National Bank

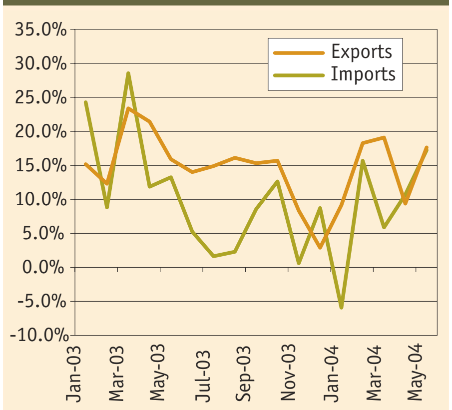
In the third week of August, Bulgaria's official foreign reserves increased to EUR 5.8 billion after declining by EUR 470 million in July due to the early retirement of $679.3 million discount Brady bonds. The government deposit with the central bank increased at a steeper pace by EUR 290 million in the first 3 weeks of August, which reflects seasonal surpluses in the general budget.

International Trade and Capital

In May, the Bulgarian economy demonstrated some progress in its balance of payments. The CA deficit was reduced from EUR 216.2 million in April to EUR 200.1 million in May, which represents a reduction of 5.7% yoy. The cumulative CA deficit of January-May amounted to EUR 918.4 million or 3.7% lower than in the same period last year. The improvement in May moves the annualized CA deficit to around 8% of GDP compared to 8.6% in 2003.

The major contributor to the narrowing CA gap in January-May was an increase in travel revenues (30% yoy) and net current transfers (49% yoy). The CA gap is expected to continue narrowing due to the seasonally higher weight of the tourist sector. However, high oil prices partly offset this positive gain and may lead to a new deterioration in the CA balance in the fall and winter.

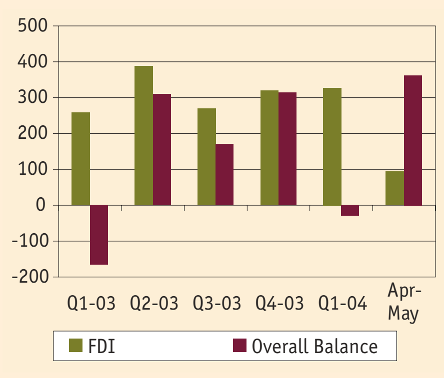
Change in Export-Import yoy, %



Source: Bulgarian National Bank

In May, the balance of merchandise foreign trade netted a deficit of EUR 308 million compared to EUR 267.6 million in April. Exports and imports grew at almost the same rates, 17.4% yoy and 17.8% yoy respectively. The trade gap widened by 18.5% yoy in May and 35% yoy in January-May. The balance of trade in services was positive and accounted for EUR 67.7 million in May, compared to a EUR 45.5 million deficit in April, bringing the cumulative deficit in January-May to EUR 12.2 million.

Net FDI Flows and Overall Balance, EUR million



Source: Bulgarian National Bank

The regional breakdown of foreign trade shows a steady increase in the share of trade with EU member countries. In January-May, imports from EU countries increased by 14.3% yoy while exports rose by 9.7% yoy. In January-May, the highest expansion rate for Bulgarian exports is recorded in Greece, Romania, and Serbia and Montenegro. The product structure of exports is improving. The share of goods with high value added is increasing. However, exports to EU member countries are coming mostly in the form of raw materials and items with a low level of value added.

Despite the existence of the CA deficit, the overall balance of payments showed a surplus of EUR 299.7 million in May, compared to EUR 62.3 million in April. It brings the cumulative balance of payments in January-May to EUR 333.6 million, which is 4 times more than in the same period last year. The net inflow of FDI has dropped by 24.6% yoy to EUR 421 million in January-May. In May, net portfolio investments increased to EUR 29.9 million and errors and omissions reached EUR 225.1 million.

The State Investment Agency reported that tender commitments from the privatization of seven power distributors will bring additional FDI inflows of EUR 700 million in October, which will push the non-debt external financing far above the CA gap this year.

International Programs

The agreement with the World Bank for the Second Programmatic Adjustment Loan (PAL-2) in the amount of EUR 123.7 million has been ratified by Parliament. This loan will be repaid in 17 years with a grace period of 5 years. The loan is divided into two tranches. The second tranche, in the amount of EUR 20 million, is conditioned on satisfactory progress in the privatisation of the Bulgarian Tobacco holding. The first tranche, in the amount of EUR 103.7 million, will be transferred to the country immediately.

In August, the Japanese Bank for International Cooperation signed a long-term loan for the financing of a project to modernize the Maritsa East 2 thermopower plant. The amount of the loan is EUR 226 million. The loan is fully guaranteed by the Bulgarian government.

Other Developments

Moody's recently announced that plans for EU accession have had a significant positive effect on the credit ratings of second tier accession countries. Because of this, Moody's will be able to rate the sovereign issuers of these countries at a level that could be up to several notches higher than that indicated by their stand-alone credit fundamentals. The prospect of EU enlargement would help eliminate currency risk by the time Bulgaria officially joins. In the near future, the agency is expected to raise the Bulgarian sovereign rating by a 2-notch upgrade for the long-term foreign currency rating, from Ba2 stable outlook to the lowest band of the investment grade scale (Baa3).

The international credit rating agency Fitch upgraded Bulgaria's long-term foreign currency position from a positive outlook (BB+) to a stable outlook (BBB-). The short-term foreign currency and the long-term local currency ratings were also raised by one notch to BBB and F3, respectively. The country's long-term foreign currency debt is now ranked at the lowest investment grade level.

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