Bulgaria
Macroeconomic Situation

February 2005

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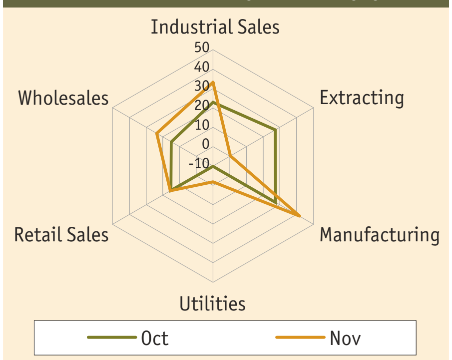
Summary

Preliminary estimates indicate that the real economy expanded at an annual rate of 5.7% in 2004, slightly above the government forecast of 5.5% for the year. This growth was supported by rapid expansions of industry (industrial sales increased by 33.2% year-over-year (yoy) by November), the agricultural sector (which grew by 8.3% yoy in 2004), and the service sector (whose gross value added increased by 6.1% yoy in November). During the year, the fiscal budget situation was also favorable, with a fiscal budget surplus reaching EUR 338 million in 2004, or about 1.7% of projected full-year GDP. In another positive sign, the consumer price index (CPI) slid to 4.0% yoy in 2004 and the producer price index (PPI) decelerated to 5.1% yoy. On the other hand, the size of the current account (CA) deficit remains a major concern, reaching EUR 1.1 billion in January-November. This brought the annualized CA gap to 7.3% of GDP. Although the CA deficit remained high, foreign direct investment (FDI) inflows were 33% higher than the deficit and were able to cover it comfortably. In January-November, the cumulative net inflow of FDI reached EUR 1.5 billion. Additional increases in FDI are expected due to future privatization receipts. In January 2005, the Bulgarian parliament started consideration of draft constitutional amendments that would allow foreigners to buy land in the country.

Economic Growth

Economic Growth by Sector, % yoy



Source: Bulgarian National Statistical Institute

According to the latest estimates, GDP grew by 5.7% in 2004. This high growth rate was supported by rapid expansion of industrial sales, which increased by 33.2% yoy in November, following an expansion of 22.8% yoy in October. Within the industrial sector, the highest rate of growth was achieved in manufacturing, which grew by 41.6% yoy in November. Within this sector, manufacture of basic metals showed the highest expansion (112% yoy in November) due to growing exports of metals and high metal prices. Manufacture of tobacco products was the second fastest growing sector within manufacturing (54% yoy in November). On the other hand, there was a continuing declining trend in sales of some of the high value added product sectors, such as radio, television and communication equipment. Production of these products declined by 18% yoy in November. Motor vehicle production also shrunk by 15% yoy during this period.

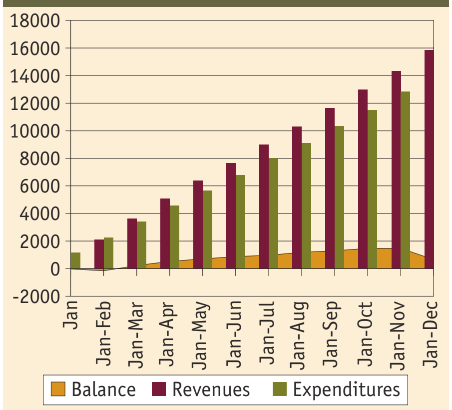
A growing agricultural sector made a significant contribution to the country's economic growth in 2004. Last year, the gross value added of the agricultural sector rose by 8.3% yoy, which demonstrates a significant improvement compared to the previously announced 3.5% yoy growth in January-September.

The service sector has also continued to experience significant growth. During November, the gross value added of this sector increased by 6.1% yoy. The solid growth of the service sector supports the country's overall economic performance.

Fiscal Policy

During 2004, Bulgaria implemented prudent fiscal policies. The annual surplus of the consolidated fiscal budget reached Lev 659 million (EUR 338.1 million), which represented 1.7% of estimated GDP (while the initial government forecast was 0.7% of GDP).

Budget Flows, million Lev



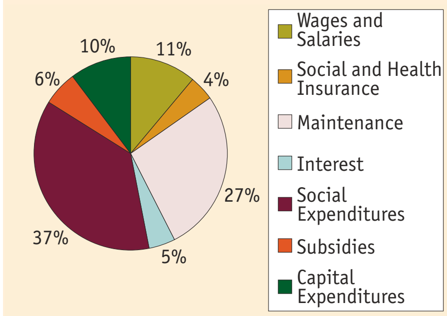
Source: : Bulgarian Ministry of Finance

In 2004, consolidated budget revenues and grants reached Lev 15.9 billion (EUR 8.15 billion), which represented a growth of 8.7% yoy compared to 8.5% yoy in January-November. A significant increase of duties on imported oil, initiated by the government in November, led to record high tax revenues collected in December (Lev 1.54 billion).

Over the last year, government expenditures rose at a lower rate (2.8% yoy) and reached Lev 15.20 billion (EUR 7.79 billion). However, a significant increase in government expenditures appeared in the last months of 2004, when the government transferred Lev 260 million (EUR 133 million) to assist several social development projects. This decreased the expected budget surplus to the current level of 1.7% of GDP.

In November, government and government guaranteed debt decreased slightly to EUR 8.02 billion from EUR 8.14 billion in the previous month. The EUR 128 million decrease in total debt was due to the current repayments and exchange rate fluctuations in the review period. The decrease in the absolute amount of debt and the increase in GDP led to a drop in the debt-to-GDP ratio, which fell from 41.9% in October to 41.3% in November. Consequently, the-debt-to-GDP ratio of foreign debt went down to 34.4% from 35.1% in the previous month. However, the corresponding ratio of domestic debt remained unchanged (6.9%). This was mainly due to the low weight of domestic debt in the total structure of government and government guaranteed debt, which amounted to 16.8% of all debt in November.

Structure of Budget Expenditures in 2004, %

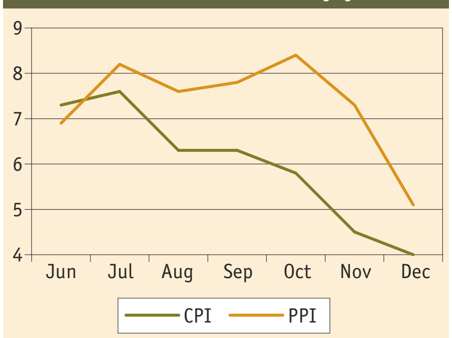


Source: Bulgarian Ministry of Finance

The weight of US dollar denominated debt decreased to 34.58% in November, from 39.5% in October. At the same time, the share of debt denominated in euros increased to 40.17% from 39.5% in the previous month.

Monetary Sector

CPI and PPI Inflation, % yoy

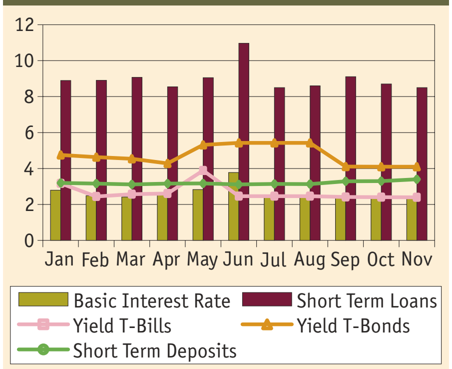


Source: Bulgarian National Statistical Institute

In December, consumer price index (CPI) growth slid to 4.0% yoy from 4.5% yoy in November. The decrease in CPI inflation was due to a fall in food prices, which dropped by almost 1.0% month-over-month (mom) in December, and by a decrease in non-food prices of 0.6% mom. This trend in food prices started in September 2004 and will likely continue during the first months of 2005. The main argument in favor of this forecast is a good harvest in 2004.

The producer price index (PPI) decelerated to 5.1% yoy in December, from 7.3% yoy in November and 8.4% yoy in October. The PPI index remains well above the CPI index due to the higher weight of metal and oil inputs in the basket of producer prices. In addition, changes in the regulated prices of heating and electricity supplies also contributed to PPI growth. However, favorable dynamics in the international markets and some deceleration in growth of oil prices contributed to a slowdown in the rate of PPI growth during the last months of the year.

Interest Rates by Instruments Nominated in Lev, %



Source: Bulgarian National Bank

A new inflation slowdown can be expected in 2005. This slowdown will be driven by likely downward corrections in oil prices and stable tariffs in energy sectors.

The real effective exchange rate of the Lev has been appreciating significantly since 1997 when the currency board was introduced. In December, the appreciation of the effective exchange rate, deflated by CPI, slowed to 7% yoy from 9.2% yoy in July. This trend is likely to continue in 2005.

In December, the National Bank continued to increase money supply (M3). The main purpose of this was to increase the level of monetization of the economy and, consequently, to increase bank credits and investments. Growth in M3 accelerated to 15.1% yoy in December, compared to 14.7% in November, and 12.2% yoy in October.

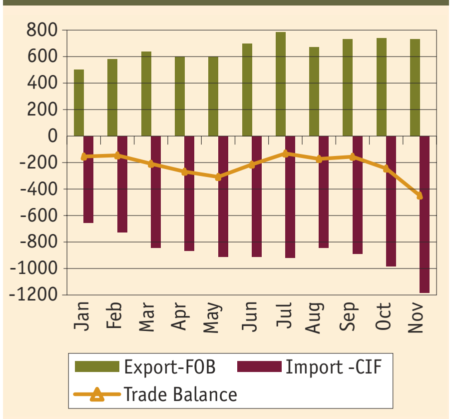
The official foreign reserves of the National Bank continued to increase, growing from EUR 6.64 billion in November to EUR 6.77 billion in December. This increase was made possible by the fiscal account surplus and prudent monetary policy. However, due to the 25% increase in minimum wages, which became effective in January 2005, it is very likely that the rate of growth of foreign reserves will slow in the first months of 2005.

International Trade and Capital

In January-November, the merchandise foreign trade deficit reached EUR 3.2 billion, representing a growth of 24.7% yoy. This trade deficit accounted for some 16% of the country's GDP. Moreover, during November, the monthly merchandise foreign trade deficit widened at a faster pace than in earlier months and reached EUR 448 million, a growth of 29.3% yoy.

On the export side, the product breakdown of Bulgaria's international trade shows that miscellaneous manufactured articles had the highest weight in the country's exports (26% of the total) in January-November. This was followed by machinery and transport equipment (12%), and mineral fuel, lubricants and related materials (11%). On the import side, machinery and transport equipment had the highest share (29% of total imports). The second largest imported group of products was raw materials (21%).

Foreign Trade, million EUR



Source: Bulgarian National Bank

The geographical breakdown shows that in January-November, 58% of the country's export went to EU-25 countries, and 14% to other Central and Eastern European countries that are not members of the EU. EU-25 countries are also the biggest importers of Bulgarian products (54% of total imports). The second largest importer is the CIS (19% of total imports).

In January-November, exports grew at a lower rate than imports (18.3% yoy compared to 19.0% yoy for imports). However, growth of exports in November was steeper than growth of imports (35% yoy against 33% yoy), which positively affected the overall trade deficit.

In November, the current account (CA) deficit reached EUR 361 million, representing 33% yoy growth. During the entire period from January to November, the CA deficit amounted to some EUR 1.1 billion (a 7.8% yoy increase). By November, the CA deficit had already reached 5.8% of projected full-year GDP.

On a positive note, net inflows of FDI have been able to match the existing CA deficits. In fact, the flow of FDI is about one-third higher than the CA deficit. In January-November, the cumulative net inflow of FDI increased by 25% yoy and reached EUR 1.5 billion. Additional improvements in full-year FDI statistics can be expected due to significant payments for privatization received in December.

International Programs

The Bulgarian Cabinet of Misters approved an action plan on distribution of the EU financed Phare Programme in support of institutional building and infrastructure in the country. The total amount of financing approved by the European Commission was EUR 144.3 million. The financing will be provided during 2005.

The World Bank agreed with the view of the Bulgarian Ministry of Finance that the high stock of fiscal reserves is not compatible with new public debt creation and agreed to reallocate its future programmes to the private sector. The World Bank and the Ministry agreed to use the earmarked $150 million under the PAL-3 for projects that would not raise the public debt. The World Bank announced that it is generally satisfied with the implementation of the structural reforms agreed with the government.

Previously announced financing from the European Investment Bank (EIB) in the amount of EUR 60 million to support infrastructure development will be provided through the local banks. Raiffeisenbank Bulgaria has been identified as the first Bulgarian bank on the list of banks participating in the allocation of the funds to be disbursed by EIB.

Other Developments and Reforms Affecting the Investment Climate

The Bulgarian parliament started the first reading of the draft constitutional amendments allowing foreigners to buy land in the country. In order to become effective, the draft should pass three readings. The changes to the constitution are expected to take place before the signing of the EU accession treaty.

In January, President Parvanov announced that he is ready to schedule the regular general elections for June 25, 2005 in line with recommendations made by all major parties. However, President Parvanov is proposing further debates on the date before issuing the line decree. Regarding the EU accession referendum, the President wants it to take place in the fall of 2005 or in the spring of 2006.

The Bulgarian Ministry of Energy announced that privatization revenues received from this sector reached EUR 1 billion in 2004, of which EUR 0.7 billion has been generated by the sale of the national retail power grid. Due to privatization in the energy sector, the number of state owned energy companies has declined from 87 to 24 over the last four years. Currently, the privatization agency is contemplating sale procedures for 17 out of the 24 remaining state energy companies.

The World Bank presented the results of the recent study "Bulgarian Education System Effectiveness: Prospects for the Future." The study shows that the country's education system is rapidly deteriorating. The study also finds a significant gap in the quality of education in large and small cities. However, the study concluded that there were some improvements in access to education by socially vulnerable groups. The World Bank recommended reforming the existing system of education in preliminary, middle and high schools in order to meet the requirements of the developing labor market.

Bulgaria is becoming a very popular tourist destination. In 2004, the country attracted 4.6 million foreign tourists, a 14% increase compared with the previous year. The largest number of visitors were reported from Greece, Germany and the UK.