SigmaBleyzer

Bulgaria
Macroeconomic Situation

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Summary

- Following a sharp slowdown in February, the real sector continued advancing in March, supported by 17.6% year-over-year (yoy) growth in the industrial sector;

- In the first quarter (Q1), the fiscal situation was favorable — the fiscal budget surplus of EUR 246 million suggests that 2005 might end with a surplus;

- The consumer price index (CPI) accelerated to 4.3% yoy in March, while the producer price index (PPI) surged to 7.5% yoy;

- The size of the current account (CA) deficit remains a significant risk factor, widening by 31% yoy in January-February, bringing the annualized gap to 8.5% of full year GDP;

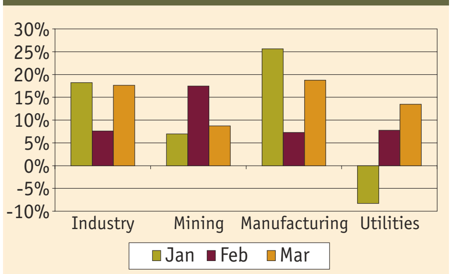
- Net inflows of foreign direct investments (FDI) were able to cover only 17% of the CA gap, leading to a deficit in the overall balance of payments in the amount of EUR 337 million;

- The Accession Treaty, signed in April, reconfirmed the schedule for Bulgaria to become a full member of the EU in January 2007.

Economic Growth

In March, the real sector experienced significant expansion following a slowdown in February. The growth was encouraged by the rapid accelaration of industrial sales, which increased 17.6% yoy, compared with only 7.6% yoy in February.

Economic Growth in 2005 by Sector



Source: Bulgarian National Statistical Institute

Within the industrial sector, manufacturing demonstrated the highest rate of growth. In March, sales in this sector expanded by 18.8% yoy. Although this rate of growth is lower than in January when sales advanced 25.3% yoy, it is still well above February's rate of 7.3% yoy. Production of radios, televisions and communication equipment demonstrated the highest rate of growth within Bulgarian manufacturing. In March, sales in this sector grew by a record high 82.1% yoy, compared with 52.5% yoy in February and 14.9% yoy in January. Driven by strong domestic and foreign demand for metalurgical products, manufacturing of metals continued to demonstrate significant growth of 20.9% yoy.

In March, the mining sector grew by a moderate 8.7% yoy, compared to 17.5% yoy in February and 7% yoy in January. Some deceleration in the sector was mainly on account of a serious decline in the rate of growth in metal ore extraction, which increased by only 7.7% yoy after 45.4% yoy growth in the previous month. However, strong growth in manufacturing of metals should increase demand for metal ores within the coming months.

In March, sales in the utility sector grew by an impressive 13.5% yoy, compared to 7.8% yoy in February. However, the rate of growth in this sector could have been even higher if sales in collection, purification and distribution of water showed positive growth instead of a 2% yoy decline.

Fiscal Policy

In Q1 2005, Bulgaria demonstrated prudent fiscal policy. The cumulative surplus of the consolidated budget reached Lev 479 million (EUR 246 million), which represents a more than double increase over the same period last year. A significant fiscal surplus registered in Q1 suggests that the government forecast of a consolidated budget deficit at 0.4% of GDP was based on a very pessimistic scenario. It is very likely that 2005 will end with a surplus.

Consolidated Fiscal Program, Q1, 2005

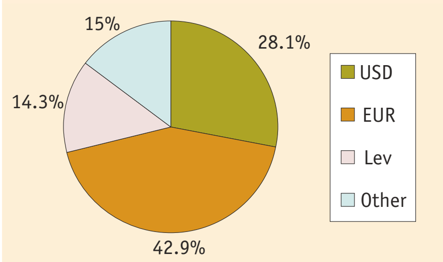
	Million EUR	%, yoy
Revenue	**2,136.0**	**14.6**
Tax	1,745.0	16.1
Non-tax	367.0	15.9
Grants	266.7	-45.8
Expenditures	**1,890.0**	**8.2**
Public wages, insurance	196.4	9.4
Social and health insurance contribution	70.3	2.2
Social expenditure	746.0	7.7
Capital expenditure	152.3	44.2
Other	725.1	5.6
Balance	**246.0**	**110.0**

Source: : Bulgarian Ministry of Finance

Over Q1, budget revenues and grants reached Lev 4.17 billion (EUR 2.14 billion), which represents a growth of 14.6% yoy. Tax revenues, which account for some 82% of total budget revenues, grew at a higher rate than non-tax revenues. The rate of growth in tax revenues reached 16% yoy against 15.8% yoy growth in non-tax revenues. Another positive sign is the 45.8% yoy decrease in grants obtained by the government, which suggests the increasing importance of domestic resources.

In Q1, government expenditures grew by 8.2% yoy and reached Lev 3.7 billion (EUR 1.89 billion). Social expenditures, which are the largest part of budget expenditures, expanded by 7.6% yoy. In January-March, they reached Lev 1.46 billion (EUR 0.75 billion), comprising 39.4% of total budget expenditures. On a positive note, capital expenditures grew by a significant 44.2% yoy to Lev 297 million (EUR 152.3 million), representing 8.1% of total expenditures. This increase in capital formation spending should secure the country's future economic growth.

Government and Government Guaranteed Debt, end of March

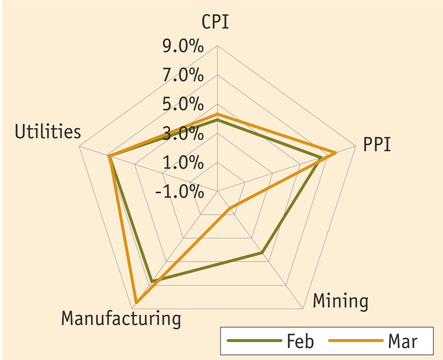


Source: Bulgarian Ministry of Finance

In January-March, the government's debt management can be considered very efficient. Government and government guaranteed debt decreased to EUR 7.3 billion from EUR 8 billion at the beginning of the year, which includes EUR 1.4 billion in domestic debt and EUR 5.9 billion in external debt. In January-March, the debt to GDP ratio declined to 34.6% from 40.9% in December 2004. In Q1, the highest share of forex debt payments were in US dollars (EUR 0.83 billion) followed by payments in euro (EUR 0.17 billion), and in levs (EUR 0.09). This composition of debt payments is beneficial to the country, considering the current exchange rate between the US dollar and the euro.

Monetary Sector

Inflation, yoy, Febuary-March 2005



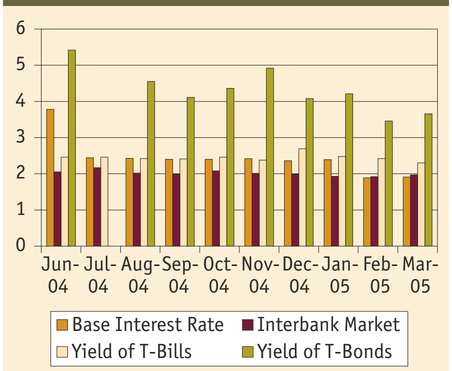
Source: Bulgarian National Statistical Institute

In Q1, the consumer price index (CPI) accelerated to 3.8% yoy, which is 0.1 percentage points above the government forecast for this year. The main acceleration of CPI took place in March, when prices increased by 4.3% yoy, up from 3.9% yoy in February and 3.4% yoy in January. This acceleration is due to an increase in prices for both foods and services, which together account for almost 66% of the consumer basket. In March, they grew by 5.5% yoy and 4.9% yoy respectively. Despite some stabilization in world prices for oil, the prices of transport services increased in March by 5% yoy, which is significant acceleration compared to 3.3% yoy growth in February and 1.9% yoy in January. Since transportation cost is an important input into the other consumer basket products, this increase may have a spillover effect on consumer prices in the coming months.

In March, the producer price index (PPI) surged by 7.5% yoy, up from 6.5% yoy in February. As in the previous month, the main inflationary factor for producers was growing world prices for metals. In March, metallurgical products experienced the highest inflation. Prices for basic metals increased by 18.1% yoy, contributing to 8.5% yoy of the average weighted manufacturing prices. Prices in the mining sector experienced the lowest increase at only 0.5% yoy. It is very likely that in the following months, PPI inflation will not vary significantly from its current level and PPI will be below 8% yoy.

In March, the Bulgarian National Bank (BNB) continued to increase money supply (M3), which grew by 32.4% yoy. This increase is consistent with the BNB's strategy to avoid credit restraints. A symmetric monthly hike was also recorded in overnight deposits and domestic credits in foreign currency, which grew by some 33% yoy each.

Yield for Lev-denominated Instruments, %



Source: Bulgarian National Bank

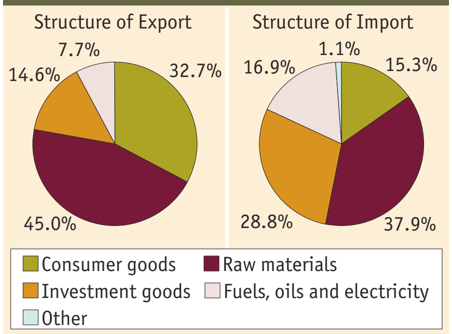
In March, the stock of domestic credit reached Lev 17.69 billion (EUR 9.07 billion), increasing by 60% yoy compared to 32.7% yoy growth in February. Acceleration in domestic credit growth was recorded in all components, including non-financial entities and households.

In April, the official foreign reserves of the National Bank continued to increase and reached EUR 6.64 billion. The foreign reserves showed less than half the increase in April compared to March (EUR 158 million and EUR 330 million respectively). The current level of foreign reserves is a positive signal for possible improvements in the country's external position.

International Trade and Capital

In January-February, the merchandise foreign trade deficit reached EUR 554 million, representing a 37% yoy increase. This is mainly due to the significant widening of the foreign trade gap in February, which grew by some 45% yoy. These figures bring the annualized merchandise deficit to almost 13% of projected GDP. The deterioration of the country's merchandise foreign trade is due to increasing oil imports.

Structure of Export and Import, February 2005



Source: Bulgarian National Statistical Institute

In January-February, merchandise exports reached EUR 1.3 billion. However, the rate of export growth slowed down to 11% yoy in February compared to 27.6% yoy growth in January. Total exports accounted for some EUR 646 million in February. The highest share of Bulgarian exports was raw materials (45% of the total.) In February, the growth rate demonstrated by this group reached 21.1% yoy. The second largest product group is clothing and footwear, which accounted for 20.2% of the total country's exports. However, unlike raw materials, this group experienced a 4.7% yoy decline.

In January-February, merchandise imports reached EUR 1.84 billion, which represents a 19.3% yoy increase. In February, the growth of imports slowed to 17.9% yoy from 28% yoy in January. Raw materials, which account for 37.9% of the country's total imports, grew by 6.8% yoy. Investment goods are the second largest group within Bulgarian imports; in February, this group had the highest rate of growth among imported goods, advancing by about 34% yoy. On the negative side, high oil prices generated import growth in fuel, oil and electricity by 22.5% yoy. Nevertheless, the ongoing structural changes in Bulgarian imports (the increasing share of investment goods) should positively affect the country's future development.

In January-February, the current account (CA) deficit widened by 31% yoy and reached EUR 0.465 billion. If annualized, the deficit translates into 8.5% of the country's GDP. The size of the CA deficit and acceleration in the rate of its growth remains a significant risk factor for the Bulgarian economy.

Another negative sign raising concerns is the fact that January-February's net inflows of FDI covered only 17% of the CA gap. In the first two months of 2005, net inflows of FDI dropped by more than 3 times compared to the same period last year, reaching only EUR 79 million. The existing CA deficit and low level of FDI led to the overall balance of payments deficit, which reached EUR 337 million. A further slowdown in exports along with unfavorable world oil prices may cause further worsening of the balance of payments.

International Programs

In April, the Bulgarian Parliament approved the draft agreement with the World Bank (WB) for the third programmatic adjustment loan (PAL 3) in the amount of $150 million. In order to match the currency structure of the country's foreign reserves, the actual financing will be arranged in euros. The loan will be repaid in 17 years with a grace period of 5 years. PAL 3 is designed to support structural reforms in the real sector and to modernize energy, railway, telecoms and water distribution infrastructure. In April, the WB announced that it was working on a new memorandum for Bulgaria. The new memorandum would assess the economic developments in the country and propose new parameters for co-operation for the next three years.

In May, the Bulgarian government and EU signed four memorandums on disbursement of PHARE grants for a total of EUR 33 million. The government will be co-financing the projects with additional resources in the amount of EUR 7 million. All grants are designed for programs supporting cross-border co-operation. In line with the goals of the programmes, the government is planning to increase the number of border crossings with neighbor countries, including Greece, Macedonia and Serbia.

The European Bank for Reconstruction and Development (EBRD) passed a concept (pending final review) for setting up a EUR 50 million credit line. The line is mediated by Bulgarian commercial banks in support of residential energy efficiency projects. The financing is to start in May. The programme will be complemented by a EUR 10 million grant secured by the Kozloduy International Decommissioning and Support Fund (KIDSF). The programme is designed to provide the know-how and financial assistance required for the emergence of a residential energy market, as energy efficiency is often hindered by market imperfections and high start-up costs.

Other Developments and Reforms Affecting the Investment Climate

In April, Bulgaria signed the Accession Treaty with the EU, completing the most important phase of the process for joining the EU. The act reconfirms the schedule for Bulgaria to become a fully-fledged member of the EU at the beginning of 2007. However, the full membership date could be delayed by one year in case of significant deviations from policy commitments. The list of reform objectives refers to the judicial sector, corruption and crime fighting. Since a delay would require a unanimous vote by the twenty-five existing EU members, an actual delay in Bulgaria's accession to the EU beyond 2007 is extremely unlikely.

The Bulgarian National Social Security Institute (NSSI) approved the planned increase in pensions by an average of 7%. This increase will be effective from June 1. The deductions for those persons who do not meet work experience criteria will be raised at a steeper rate (13%), since their pensions are significantly lower compared to the others. A similar adjustment is made for payments to different groups of disabled persons. The income adjustment scheme is consistent with the general framework set under the IMF programme.

A survey conducted by the leading Bulgarian sociology company, Mediana Agency, revealed that the middle class in Bulgaria comprises nearly 20% of the population. Its share has increased three-fold over the past five years. The results show there are six groups of Bulgarians: rich, well off, in good financial condition, in straitened circumstances, poor, and living in total poverty.

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