Bulgaria
Macroeconomic Situation

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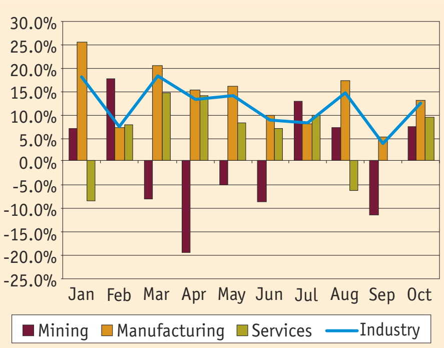
Summary

- In October, Bulgaria's industrial sector showed significant acceleration in its rate of growth; sales grew by 12.5% year-over-year (yoy) up from 3.6% yoy in September.
- Prudent fiscal policy in January-October supported a further increase in the government's surplus to EUR 842.8 million, which represents 4.7% of estimated period GDP.
- The effects of the summer floods continued to have an impact on the inflation rate, which reached 6.5% yoy in October, up from 5.4% yoy in September. Inflation is expected to be on a downward trend through the end of the year due to the continuing decrease in fuel prices as well as a high base effect.
- Backed by a rebound of exports in all commodity groups, cumulative merchandise exports posted an increase of 17.9% yoy in October for the first time since May.
- FDI inflow remains high enough to compensate for the widening current account (CA) deficit, which increased further in January-October to EUR 2.2 billion or 12.8% of estimated period GDP.
- The World Bank (WB) presented a draft of the new country strategy, which aims to support areas that are directly related to Bulgaria's integration into the European Union (EU).

Economic Growth

In October, Bulgaria's economy continued its expansion and formed a serious basis for 5.6% yoy annual economic growth. The growth was supported by the increasing industrial sector, where sales grew by an impressive 12.5% yoy in October, compared to a meager 3.6% yoy in September.

Economic Growth by Sectors in 2005, % yoy



Source: Bulgarian National Statistical Institute

The growth in the industrial sector was mainly due to a significant acceleration in growth in the extracting industry and manufacturing. After a significant drop by 11.1% yoy in September, the Bulgarian extracting industry performed extremely well and showed a 7.6% yoy growth in sales. This growth was driven by increasing domestic demand for extracting products from the country's manufacturing sector.

Sales in manufacturing accelerated from 4.7% yoy in September up to 13.1% yoy in October. The growth in manufacturing appeared in response to growing domestic consumption and exports. By product breakdown, the growth-leaders within Bulgarian manufacturing were motor vehicle production, transportation equipment manufacturing, and chemicals production, which grew by 56.0% yoy, 25.7% yoy and 22.3% yoy respectively. On the opposite side, the steepest decline was shown in office machinery, radio, television and telecommunication equipment, and furniture, which decreased by 21.7%, 4.3%, and 4.27% yoy respectively.

The growth in the country's real sector was also supported by the growing service sector. In particular, the retail and wholesale sectors grew by 13.1% yoy and 13.9% respectively in October.

Fiscal Policy

Since the beginning of the year, Bulgaria has demonstrated prudent fiscal policy. In January-October, the country's cumulative surplus reached Lev 1,643.4 million (EUR 842.8 million), which represents 4.7% of estimated period GDP. In October alone, the fiscal surplus increased by Lev 108.2 million (EUR 55.5 million), which translates into 11.4% yoy growth. The positive fiscal performance demonstrated by Bulgaria over the last 10 should allow 2005 to end with a surplus of around 1.5% of GDP.

Consolidated Fiscal Program

	Jan-Oct 2005, EUR million	Change, % yoy
Revenue	**7,526.1**	**13.1%**
Tax	6,015.6	13.1%
Non-tax	1,292.2	13.2%
Grants	218.4	11.4%
Expenditures	**6,683.4**	**13.3%**
Public Wages, insurance	714.4	9.8%
Social and Health Insurance Contribution	256.6	1.3%
Social Expenditure	2,580.4	10.8%
Capital Expenditure	737.9	56.5%
Other	2394.1	9.0%
Balance	**842.8**	**11.4%**

Source: Bulgarian Ministry of Finance

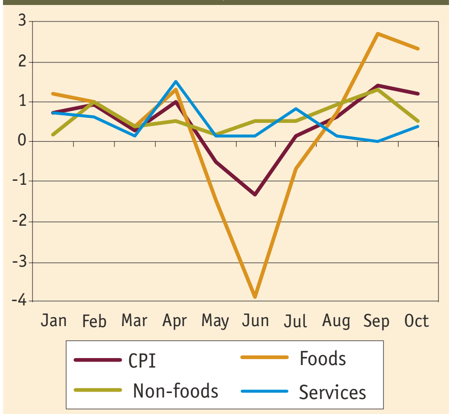
Revenues reached Lev 14.68 billion (EUR 7.5 billion) in January-October, which is 13.1 percentage points higher than in the respective period last year. The on-going changes in the structure of budget revenues suggest that the importance of tax revenues has been constantly increasing, while the importance of grants has been diminishing. Over the period, the share of tax revenues increased to 79.9% compared with around 75% in the same period of last year.

After excellent performance in the previous month, when budget expenditures grew at a slower pace compared to budget revenues, the situation changed in October. Due to significant social payments that usually at the end of the year, the growth in budget expenditures accelerated at a faster pace. They grew by 13.3% yoy over the period against 13.1% yoy growth in revenues. Nevertheless, there is still enough room to be confident that the budget will be in surplus at the end of the year.

In January-October, Bulgaria showed thoughtful debt management. Although the country's total external debt decreased by a meager EUR 8.0 million in October, the cumulative debt stock account remained almost unchanged from the previous month's level of EUR 5.470 billion. International financial institutions (IFIs) remain the country's largest lenders. Their shares in Bulgaria's debt are distributed as follows: (i) the World Bank — 16.7%, (ii) the International Monetary Fund — 13.9%, and (iii) the European Union — 5.8%.

Monetary Sector

Growth of CPI and Its Major Components in 2005, % mom



Source: Bulgarian National Statistical Institute

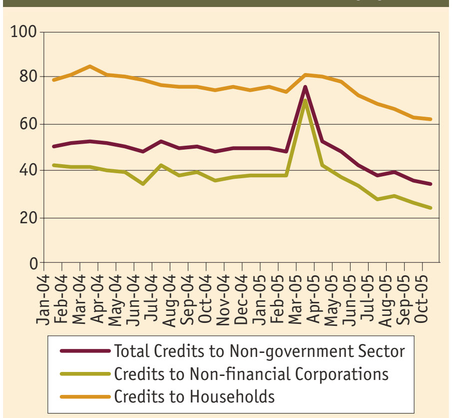
The summer floods continue to affect consumer price dynamics. A series of natural disasters that affected around 80% of the country's territory resulted in a lower supply of domestically produced agricultural products and increasing prices. Due to this temporary adverse shock, food prices exhibited a notable increase. In October, they grew by 2.3% month-over-month (mom) driving up the consumer price index (CPI) to 1.2% mom. On the positive side, growth of non-food prices decelerated significantly to 0.5% mom, partly due to lower fuel prices. Service tariffs were also on a moderate track, posting a 0.4% mom increase.

In annualized terms, CPI inflation surged to 6.5% yoy compared to 5.4% yoy in September. However, a substantial part of this hike is attributable to the low base effect of last year when CPI posted only a minor increase due to a decline in food prices. Taking into account this base effect as well as the continuing decrease in fuel prices, the inflation rate is expected to be on a downward trend during the last few months of the year.

The producer price index (PPI) decelerated to 6.2% yoy, down from 6.9% yoy in September. This drop was mainly due to declining wholesale fuel prices.

In October, growth rates of monetary aggregates were in line with usual trends. Money supply, measured by monetary aggregate M3, grew by 27.0% yoy, up slightly from 26.6% yoy in September. At the same time, growth of the monetary base decelerated to 27.5%, down from 30.4% yoy a month before. The interbank interest rate stayed at 2.06% per annum for the forth month in a row. Accordingly, the base rate of the BNB was kept at a constant level as well.

Growth Rates of Bank Credits, %yoy



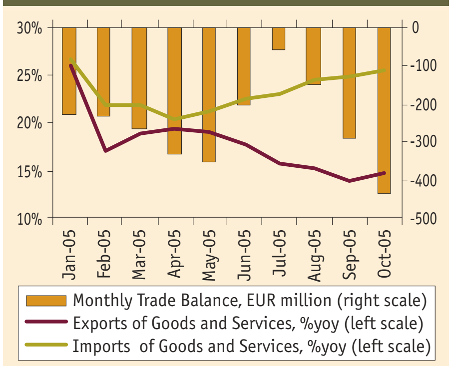
Source: Bulgarian National Statistical Institute
Note: Credit growth hike in March 2005 is due to technical increase in credit volumes in anticipation of tougher regulation

Bank lending to the private sector demonstrated some deceleration in its rate of growth. By the end of October, the stock of bank credits to the non-government sector grew by 34.7% yoy, compared to 36.1% yoy in September. Although the downward trend points to the effectiveness of credit restraints introduced at the beginning of the year, the deceleration is still not as strong as monetary authorities would desire. Booming crediting is one of the main reasons for the quickly worsening trade balance. Further toughening of credit regulations that will come into effect in January 2006 is likely to have a stronger restrictive effect on the dynamics of bank credit. In addition, the BNB has decided to launch a regular monitoring survey in order to gain more control over overall growth of credit, including those given by non-banking firms.

International Trade and Capital

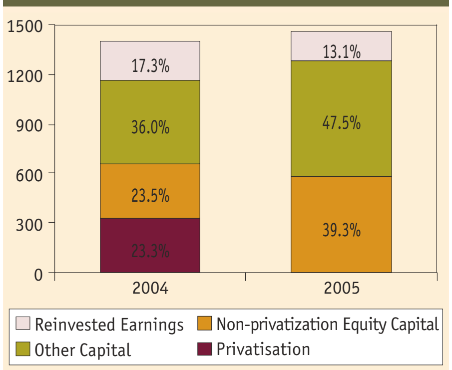
The October dynamics of trade flows shows improvements in the external sector. In particular, monthly growth of merchandise exports surged to 23.9% yoy, up from a meager 5.8% yoy in September. An increase was registered in all commodity groups. Exports of investment goods have continued to be driven by supply of vehicles, and exports of consumer goods have rebounded due to clothing and footwear products. Notably, the on-going slowdown of iron and steel exports was more than compensated for by the upsurge in exports of other metals. This brought exports of raw materials to a positive growth figure. As a result of these monthly developments, cumulative exports posted an increase of 17.9% yoy for the first time since May.

Trade Flows in 2005



Source: Bulgarian National Bank, own calculations

FDI by Type of Investment in January-October, EUR million



Source: Bulgarian National Bank, own calculations

At the same time, merchandise imports continued to accelerate driven by investment goods and energy materials, posting a cumulative growth of 27.6% yoy, up from 26.7% yoy in September. The merchandise trade deficit reached EUR 4.1 billion. This translates into 23.6% of estimated period GDP, steering current account development.

In January-October, the cumulative current account (CA) deficit was EUR 2.2 billion (12.8% of estimated period GDP), posing a major challenge to economic policy. On a positive note, FDI inflow was high enough to bring the financial account to a level that almost fully balanced the CA deficit. Overall, Bulgaria attracted EUR 1.4 billion of FDI over January-October (8.1% of estimated period GDP). The structure of FDI by type of investment has changed significantly this year due to the passive privatization policy pursued by the new government. Although such a policy is likely to hinder the total inflow of FDI, it may amplify the marginal positive effect of FDI on the economy by affecting the structure of incoming foreign capital in favor of green-field investment.

International Programs

In December, the World Bank (WB) presented a draft of the new strategy for Bulgaria. The medium-term programme will be focused on investments in areas that are directly related to Bulgaria's integration into the EU. The WB will also support government initiatives related to increasing labor productivity and developing human capital. The new strategy is designed to help local authorities in achieving higher efficiency in the EU-pre-accession process.

In December, the IMF office announced that it supports labour market reform in the country. In particular, it expects that even in the very initial stage when the share of the social burden paid by employers will be decreased from 70% to 65%, very positive results will be obtained. The IMF opposed the efforts of the Ministry of Social Policy to block the medium-term reform plan set in the insurance code, which should shift the burden of mandatory social insurance to equal terms for employees and employers. These actions should stimulate entrepreneurship activities in the country and support further development of the SME sector.

In November, the EBRD confirmed its previously announced plans to acquire minority stakes in two local retail power groups owned by Austria's EVN and Germany's E.O.N. The EBRD plans to buy around 65% of their shares. Their investment plan for Bulgaria also envisages financing of the country's infrastructure. In particular, it will invest in projects related to improving the railway infrastructure, the thermo-power complex in Maritsa, and several other industrial projects. In addition to that, the

EBRD is willing to allocate around EUR 40million for modernization of Varna and Bourgas international airports.

Other Developments and Reforms Affecting the Investment Climate

The Bulgarian coalition council announced its plan to initiate new constitutional amendments in the area of judicial structures in December. These actions were recommended by EU. These reforms should further reduce the immunity of magistrates and other high-ranking government officials against court proceedings. Other proposed changes are supposed to improve the process of law implementation in fighting corruption and crime.

The Bulgarian labor unions announced a national strike that was initiated by the country's teachers. The strike committee demands an immediate hike in wages for social workers by 4% starting at the beginning of next year. However, the government wants to introduce a different approach and start social sector wage increases no earlier than 2007.

In December, Deloitte presented a detailed analysis of the investment environment in the country. The study concludes that despite the high share of FDI inflows to GDP, the country is facing a risk of rapid decreases in investment volumes due to a high dependence on several large-scale projects. It recommended that the government pay special attention to attracting small and medium-sized foreign investments. The country's competitive advantages against other countries in the region are defined as telecommunications and IT technologies, machinery, and electric and electronic appliances. The Bulgarian government is also advised to undertake urgent measures to increase the quality of the infrastructure and education services.