SigmaBleyzer

Bulgaria
Macroeconomic Situation

November 2007

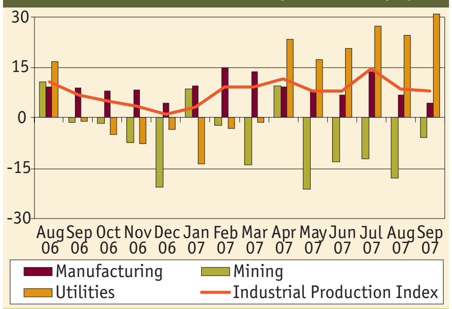
Summary

- In September, positive developments in Bulgaria's real sector were supported by the expanding industrial sector, whose production grew by 7.9% year-over-year (yoy).
- January-September's consolidated budget surplus reached 6.4% of full-year GDP, which is well above the government's initial target of 2%.
- The consumer price index (CPI) posted a 12.4% yoy increase, which represents some marginal deceleration from the previous month's level.
- The current account (CA) deficit still remains a significant risk factor, reaching 13.8% of projected full-year GDP in January-September, representing some growth from the previous month's level of 12%. On a positive note, in the same period FDI inflows were able to cover 103.6% of the CA gap.
- The Bulgarian Parliament passed amendments to the Law on Personal Income Tax, which introduces a flat rate of 10%, replacing the current progressive scale of 0% to 24%.

Economic Growth

In September, Bulgaria's real sector continued to demonstrate positive developments. Following the previous months' trend, this strong performance was supported by the rapidly developing industrial sector.

Index of Industrial Sales by Sector, % yoy



Source: National Statistical Institute

In January-September, industrial production was on an upward trend, surging by an impressive 7.9% yoy. Positive performance of Bulgarian industry is mainly due to the fast acceleration in growth in the utility sector, which increased during this period by 30.6% yoy. The performance could have been even better if manufacturing had been able to continue posting higher rates of growth as in the first months of the year. However, in January-September it showed an increase of 4.4% yoy, which diminished the cumulative growth of the entire industrial sector.

Within Bulgarian manufacturing, growth was supported by the strong performance of textile production, food processing and chemical products. The opposite trend was shown by radio, television and communication equipment, where production continued to shrink.

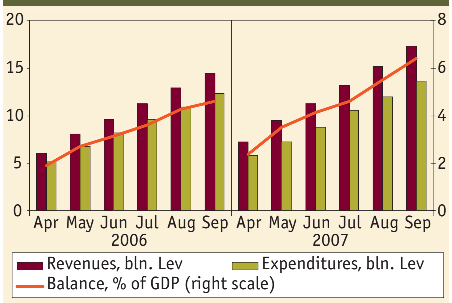
In September, the real sector experienced significant downward pressure from mining. During the month, mining sales dropped by 7% yoy. This is mainly due to increasing volatility in world prices for non-ferrous metals and already accumulated high stocks.

Positive developments in the country's real sector were not supported enough from the side of the retail trade, whose growth slowed for the tenth consecutive month. In September, growth of retail trade decelerated to 2.1% yoy down from 3.6% yoy a month earlier.

Fiscal Policy

In January-September, the government conducted prudent fiscal policy. The consolidated fiscal budget surplus was increasing and reached 6.4 % of full-year GDP. The actual budget performance is well above the initial government forecast of 2%.

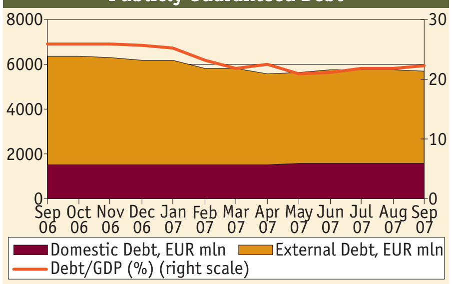
Consolidated Budget Flows



Source: Bulgarian Ministry of Finance

In January-September, fiscal revenues continued to grow. During the period, consolidated budget revenues increased by 19.5 % yoy, while posting even higher growth of 20.9 % yoy in the republican budget. The most significant increase was observed in revenues received from corporate income taxes, which surged by an impressive 40.4% yoy. This increase can be partially explained by (i) introduction of measures aimed to improve tax administration and (ii) downsizing in the rate of corporate income tax to the current 10%, which was introduced in January 2007.

Dynamics of Domestic and External Public and Publicly Guaranteed Debt



Source: Bulgarian Ministry of Finance

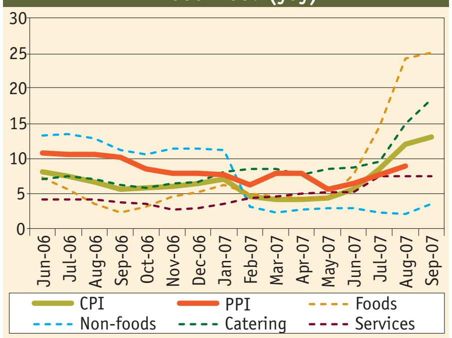
Expenditures grew in January-September at a lower rate than revenues and posted a 9.5% yoy rate of growth. Social payments, which account for the largest share of budget spending (more than 40%), grew by 6.8 % yoy. On a very positive note, the most accelerative rate of growth was demonstrated by capital expenditures, which surged during the period by an impressive 33.5% yoy. Since capital expenditures were mainly directed to infrastructural projects, this should create a significant base for further economic growth.

In January-September, the Bulgarian government continued to implement a thoughtful debt management policy. During the period, government debt declined by 8.1 % and reached EUR 5.7 billion. This brings the debt-to-GDP ratio to around 22%, which is one of the lowest levels in the region. The existing debts are well structured. The lion's share of total debt is long term borrowings (92%). Medium-term borrowings account for 6.8 % and short term borrowings are around 1%. The insignificant share of short term capital should ensure the country's financial stability and reduce risks related to the current turbulence on international financial markets.

Monetary Sector

In October, the consumer price index (CPI) posted a 12.4% yoy increase, which represents some marginal deceleration from the previous month's level. The main contribution to CPI growth was made by food, whose share in the consumer basket is around 50%. Surging by 22.4% yoy in January-February, food put significant pressure on consumer inflation. Another serious factor driving up CPI was the increase in prices for services, which surged by 7.7% yoy. Due to the existing trend, it is very likely that the year will end with inflation above 10%.

Changes in CPI, PPI and CPI Major Components in 2006–2007 (yoy)



Source: Bulgarian National Statistical Institute

In October, the producer price index (PPI) experienced some deceleration. By the end of the month, inflation of producer prices stood at 8.9% yoy, demonstrating a 0.2 pps slowdown since the previous month's level. Acceleration in price growth within PPI components was noticed in utilities. On the opposite side, the highest deceleration was observed in the mining industry.

Active domestic crediting and currency inflow, which created significant demand on local currency, were among the key factors increasing monetary aggregates. In January-October, broad money (M3) was on an upward trend posting a 28.5% yoy

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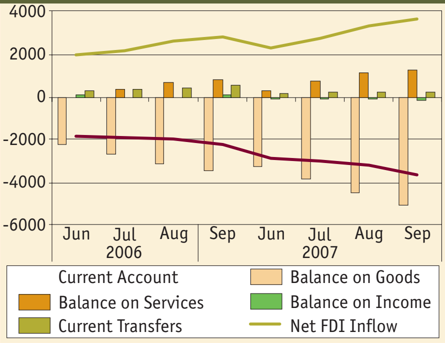
increase. The same trend was observed with narrow money (M1), which reached EUR 9.9 billion (Lev 19.3 billion).

In January-October, the Bulgarian National Bank (BNB) continued its policy to limit credit growth. However, despite recently introduced regulations on increases in commercial banks' reserve requirements from 8% to 12% as of September 1st, credit growth posted an increase of around 59% yoy. Within this number, the fastest growing component was loans to the non-financial sector, which surged during the period by 63.5% yoy to EUR 10.5 billion. Although the rate of growth in loans to households was lower compared with the non-financial sector, it is still very high and reached EUR 6.5 billion at the end of the period. This number can be translated into a 52.6 % yoy rate of growth. Due to such strong growth in domestic borrowings, the BNB should continue its restrictive policy to limit credit growth in order to ensure financial stability.

International Trade and Capital

In January-September, the Bulgarian trade deficit in goods and services was on an upward trend and reached EUR 5.1 billion, which is translated into 19% of the country's period GDP compared with around an 18% trade deficit posted one month earlier. As in the previous month, the upward trend in the trade deficit is due to a base effect — in particular, to the low level of energy prices in the previous year and to some current weakening in the prices for metals, which is the most sensitive group of Bulgarian exports in goods and services.

Current Account Components and Net FDI Inflow, EUR million



Source: Bulgarian National Bank

Bulgarian exports continued on an upward trend, surging by 9% yoy in January-September. As in the previous months, the lion's share of the country's exports was obtained by raw materials, which represented around 40% of the total volume of exports in goods. Within raw materials, the most exported goods were metals, whose weight within this group was more than 40%. The second heavily exported group of goods was consumer goods, which accounts for a quarter of Bulgaria's total exports. In contrast to raw materials, which are mostly exported to the EU, consumer goods are mainly directed to the CIS and Balkan countries.

In January-September, imports grew at a faster pace as compared with exports and posted a 17.9% yoy rate of growth. A breakdown of the country's imports by product shows that the largest share belongs to raw materials. In September, they occupied one third of total imports of goods. Increasing household consumption was a significant driver of growth in the volume of imported consumer goods, which grew during the period by almost 20% yoy.

In January-September, the CA continued to widen and reached 13.8% of projected full-year GDP compared with 12% demonstrated in the previous month. Despite the existing gap in the CA, it is fully covered by strong FDI inflow. In January-September, FDI was able to cover 103.6% of the existing CA gap.

Other Development and Reforms Affecting the Investing Climate

The Global Competitiveness Report 2007/2008, prepared by the World Economic Forum, moved Bulgaria down by five positions from 74th to 79th out of 122 countries and 83rd in the business competitiveness ranking out of 131 economies. This downgrade was due to some slowdown in institutional reforms.

The Bulgarian Parliament passed amendments to the Personal Income Tax Law in a final reading. According to the new law a flat tax rate of 10% will be introduced, which will replace the current progressive scale of 0% to 24%. The new tax model will be effective from the beginning of 2008. This measure should increase competitiveness of the Bulgarian economy and make it more interesting for international investors.

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