

Macroeconomic Situation

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Summary

- Following some slowdown in June, Bulgaria's real sector returned to show very good performance in July, mainly due to significant acceleration in the extracting industry and manufacturing.
- Due to prudent fiscal policy, the country's fiscal budget surplus reached EUR 581.2 million over January-July.
- In July, the consumer price index (CPI) accelerated to 3.7% year-over-year (yoy), up from 3.6% yoy in the previous month, while the producer price index (PPI) decelerated to 6.5% yoy, down from 7.1% yoy in June.
- The rapidly increasing size of the current account (CA) deficit remains a significant risk factor; widening by 98.2% yoy in January-July, it reached EUR 1.48 billion. Concerns regarding rapid widening of the CA deficit are raised even further due to the 14.7% yoy decline in FDI over the period.
- The Bulgarian Parliament appointed the heads of all major committees handling preliminary legislative works and supervising government policies in the respective areas.

Economic Growth

Very good performance by the real sector forced the Bulgarian National Bank (BNB) to review its forecast for 2005 GDP growth. It is expected to reach around 5.6% yoy. This is 1 percentage point higher than initially forecasted by the government. In July, the Bulgarian real sector performed relatively well, rebounding from the sharp deceleration in the previous month.



In July, industrial sector sales grew by 9.7% yoy compared to 8.7% yoy in June. The main driving forces of this growth were the surging mining sector and manufacturing. Despite some deceleration, manufacturing continued to register solid growth, expanding by 9.5% yoy in July. Following a decline for four months in a row, the mining sector recovered in July, advancing by an impressive 12.3% yoy. The July increase in the Bulgarian mining sector is due

to a 47.6% yoy growth in metal ores mining, which appeared as a result of some stabilization on the world market for metals.

By product breakdown, the growth-leaders in July were primarily sectors with relatively high value added. In particular, electrical machinery demonstrated growth by 32.8% yoy, manufacturing of chemicals and chemical products grew by 18% yoy. On the other side, some sectors have continued to decline. In July, the deepest decline was observed in manufacturing of office machinery and computers. It has continued to show a negative trend, which started in March and reached a 37.1% yoy decline in July. In more general terms, the ongoing changes in the country's manufacturing support the idea of structural changes in the economy.

Fiscal Policy

In July, Bulgaria demonstrated good fiscal performance. The monthly-consolidated budget surplus amounted to 6.1 million (EUR 3.1 million), bringing the cumulative January-July surplus to Lev 1,133.3 million (EUR 581.2 million). Although the July rate of growth in the fiscal surplus was significantly lower than in June, it is 16% higher than in the respective period last year. The prudent fiscal policy over the first 7 months suggests that the 2005 fiscal year may end with a budget surplus at 1.5%-2.0% of GDP.

Consolidated Fiscal Program		
	Jan-July 2005, EUR million	Change, % yoy
Revenue	5283.4	14.5%
Tax	4171.9	13.9%
Non-tax	974.6	16.1%
Grants	137.0	22.4%
Expenditures	4702.3	14.3%
Public Wages, insurance	492.5	11.2%
Social and Health Insurance Contribution	177.0	2.7%
Social Expenditure	1790.3	10.4%
Capital Expenditure	492.2	63.9%
Other	1750.3	11.1%
Balance	581.2	16.0%

Source: Bulgarian Ministry of Finance

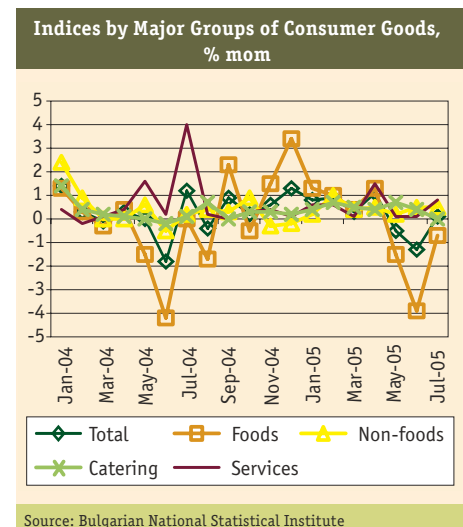
In January-July, cumulative budget revenues reached Lev 10.3 billion (EUR 5.3 billion), which demonstrates growth by 14.5% yoy. Tax revenues, which account for 79.0% of the total budget revenue, grew by 13.9% yoy over January-July. Over the period, non-tax revenue, which constitutes 18.4% of total budget revenues, surged by an impressive 16.1% yoy. In January-July, the amount of grants received by the government surged by 22.4% yoy, which is substantially lower than the 97.5% yoy increase in January-June.

On a positive note, budget expenditures grew at a slower pace of 14.3% yoy in January-July compared with a 14.5% yoy growth in revenues. The increasing trend in capital expenditures has been ongoing throughout the year. Over the period, capital expenditures reached EUR 492.2 million, increasing by 63.9% yoy. This outstanding growth in capital formation expenditures builds a solid base for the country's future economic expansion.

Despite the growing budget surplus, the country's external debt continued to increase. In July, Bulgaria's total external debt grew by EUR 490.5 million and reached EUR 6.58 billion. This increase is mainly due to the issuing of Global Bonds and Eurobonds, which account for about 38.3% of total external debt. The increasing quality of the country's investment climate makes external borrowing cheaper compared with the borrowing from institutional lenders. Although the largest lenders remain international financial institutions (IFIs) such as the World Bank (16.7%), the International Monetary Fund (14.7%) and the European Union (5.7%), their shares are declining.

Monetary Sector

In July, consumer inflation accelerated to 3.7% yoy, up from 3.6% yoy in June. July's acceleration is mainly due to some increase in prices for services, which account for 28% of the total consumer basket. July became the second month in row when prices for services continued to grow. Over the month they grew by 7.4% yoy compared with 6.8% yoy in June, while prices for food decelerated from 1.1% yoy in June to 0.4% yoy in July.



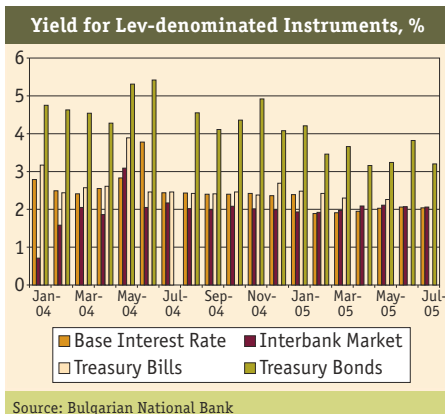
In July, the producer price index (PPI) decelerated to 6.5% yoy compared with 7.1% yoy in June. The decrease in the PPI rate of growth is mainly attributed to some slowdown in growth

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for energy prices and a lower rate of growth in mining and manufacturing prices (10.8% yoy and 7.1% yoy respectively). This decrease in the PPI rate is consistent with our initial forecast. It might also lead to further deceleration of the CPI over the next couple of months, since there is a significant time lag between PPI and CPI dynamics.

Over the period, the Bulgarian National Bank (BNB) continued to increase money supply (M3). In July, the M3 component reached Lev 23.2 billion. However, the M3 rate of growth has experienced some acceleration from 25.4% yoy in June to 26.4% yoy in July. On the positive side, the stock of domestic credit increased by a higher rate. In July, it surged by 30.7% yoy. This growth stimulates domestic consumption and consequently positively affects economic growth. However, such significant growth in domestic credit and consumption also stimulates the growth of imports and exacerbates the external imbalance of the country.

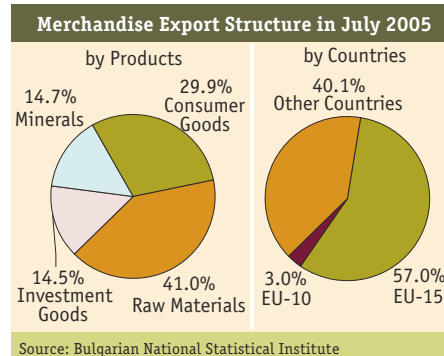
In July, the BNB decreased the level of the base interest rate by 0.2 percentage points to 2.04% compared with 2.06% in the previous month. This step was absolutely consistent with the BNB's policy of stimulating business activity in the country. The decrease in the base interest rate drove the proportional decrease in yields of all lev-denominated instruments, which makes internal credits relatively cheap.



July was the second month in a row when the BNB's official foreign reserves continued to demonstrate a decreasing trend. Over the period they shrunk to EUR 6.36 billion, down from EUR 6.86 billion in June and EUR 6.9 billion in May. Although this trend is negative, it should not affect the country's macroeconomic stability, since the current size of the foreign reserves is able to cover almost seven months of imports.

International Trade and Capital

In July, the merchandise foreign trade deficit (FOB-CIF) grew by EUR 413.3 million, which brought the cumulative trade deficit in January-July to EUR 2.62 billion. The widening of the trade deficit accelerated in January-July to 36.3% yoy compared with a 28.9% yoy increase in January-June. This acceleration is mainly due to an increase in energy sources, which are an important component of Bulgarian imports.



In July, merchandise exports reached EUR 858.7 million, demonstrating 9.2% yoy growth. This brings January-July cumulative exports to EUR 5.2 billion, which translates into 19% yoy growth compared with 21.1% yoy in January-June. Following the previous three month trend, the highest rate of growth in the country's exports was observed in the group of high value added products. The value of exports in investments goods, which account for 14.5% of the country's total exports, grew by 34.0% yoy in July, minerals by 29.4% yoy, raw materials by 6.5%, and consumer goods by -3.6%. EU countries remain the biggest consumers of Bulgarian exports. In July, 60.0% of total exports went to the EU-25, compared with 59.2% in June and 55.7% in May. The solid growth in the export of investment goods supports the idea of structural changes in the economy and its growing importance on the world markets for high value added products.

In January-July, merchandise imports grew at a faster pace than exports. Over the period, imports advanced by 24.3% yoy to EUR 7.9 billion. In July alone, imports grew by 27.6% yoy, which is still less than in the previous month when the rate of growth reached 30.3% yoy. Due to the existing summer tendency for fuel prices to grow, it is very likely that the country's imports will continue to expand, deepening the already existing trade deficit.

In January-July, the current account (CA) deficit continued to accelerate. Over the period, its

size widened by 98.2% yoy compared to 47.2% yoy in January-June, and reached EUR 1.48 bil-



lion. It is likely that the CA deficit will maintain its increasing trend in the coming months due to the expanding trade deficit.

The consequences of a rapidly widening CA deficit are exacerbated by the decline in foreign direct investment (FDI) inflows. In January-July, the total amount of FDI inflows reached EUR 832.0 million, which represents a drop of 14.7% yoy. However, the Bulgarian State Investment Agency projects that the gross inflow of FDI will increase through the end of the year to EUR 2.2 billion due to already committed green-field investments.

International Programs

In September, the short-term IMF mission came to Bulgaria. The main purpose of this visit was stated to be a meeting with the newly appointed government. The Fund officials also confirmed that the longer regular mission would take place in late September and early October. The purpose of that mission is to perform a review under the two-year precautionary agreement expiring in September of the next year. The review will be focused on the legislative amendments required for starting full-scale operations at the National Revenue Agency. The mission will also discuss government measures for further improvements in fiscal policy.

In August, the newly elected Prime Minister Stanishev met with World Bank (WB) authorities to discuss prospects for further cooperation. The shared view is that strategic cooperation between Bulgaria and the WB is possible in long-term programmes and projects that should be well coordinated. Among the main problems that should be addressed by this co-operation is the low-income level, which is substantially lower than in the EU member countries.

In September, European Bank for Reconstruction and Development (EBRD) officials made an announcement that those households that

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received a loan under the energy efficiency programme would be given an up to 20% discount of the value of the investment made in the energy efficiency project. The energy efficiency project costs EUR 50 million and will be in effect by the end of 2006.

Other Developments and Reforms Affecting the Investment Climate

The Bulgarian Parliament appointed the heads of all major commissions handling preliminary legislative works and supervising the government policies in the respective areas. Officials of

the left-wing BSP will chair the panels for budget policies, defense, judicial reforms, agriculture, EU integration, corruption fighting, and several other policy sectors. The former senior ruling partner NMS-II, now the second partner in the ruling coalition, takes over the panels of foreign policy, public order and home affairs, transport, and 3 other minor panels. The ethnic MRF will control the panels for economic policies, energy, local self-government, education, and social affairs. Each of the four opposition blocs will also chair one parliamentary commission.

In September, the Bulgarian National Statistical Institute announced that the rate of unem-

ployment calculated by ILO-methodology declined by 2% yoy in Q2 and reached 10%. The decrease in the level of unemployment is a strong argument in favor of the country's current economic policy.

In September, the Ministry of Finance and Ministry of Social Affairs reached an agreement regarding the minimum wage hike. As of next year, the minimum monthly wage will be increased to Lev 160 (EUR 82). This represents a 6.7% increase from its current level, which is substantially lower than the 25% increase introduced at the beginning of this year.

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