

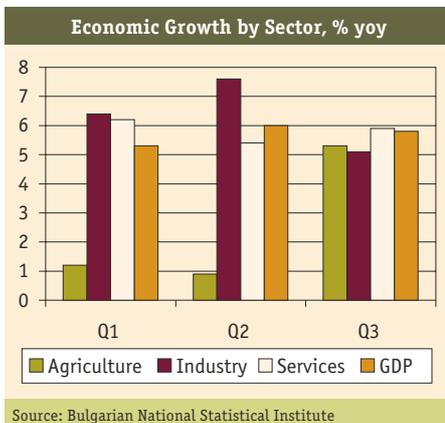
Oleg Ustenko, Edilberto Segura

Summary

In the third quarter (Q3) of 2004, real gross domestic product (GDP) soared by 5.8% year-over-year (yoy), making the government's expectation of 6% yoy GDP growth for 2004 very realistic. Meanwhile, in January-November, the budget surplus reached EUR 756 million, accounting for 3.9% of projected full-year GDP. In another positive sign, the consumer price index (CPI) slid to 4.5% yoy and the producer price index (PPI) decelerated to 7.3% yoy for November. The size of the current account (CA) deficit remains a major concern, widening by 23.9% yoy for January-October period and reaching EUR 2 billion. This brought the annualized CA gap to 6.8% of GDP. Although the CA deficit remains high, FDI inflows have generally matched it, reaching EUR 1.2 billion with expectations of reaching EUR 2 billion by the end of 2004. In December, the IMF mission and the Bulgarian government failed to reach a consensus on policy criteria and benchmarks for 2005. Talks will continue in March 2005.

Economic Growth

In the third quarter of 2004 (Q3), the rate of GDP growth accelerated to 5.8% yoy, bringing the cumulative rate of growth in January-September to 5.7% yoy. This solid economic growth was supported by expansion of export-oriented industrial sectors and the good performance of agriculture, tourism, and telecommunications.



In Q3, the share of GDP produced by the industrial sector grew by 5.1% yoy, which represents a slowdown compared to the 6.3% yoy growth achieved in January-September. However, industrial sales began to accelerate in October and reached a 23% yoy increase, which will positively affect the annual rate of growth.

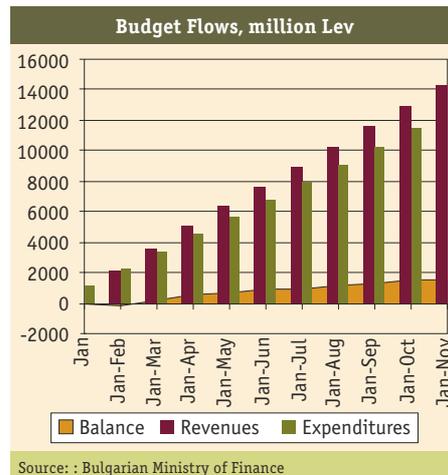
In October, the most significant rate of growth within the industrial sector was demonstrated by the manufacturing subsector (27% yoy). Within manufacturing, the faster growing sectors are still manufacturing of basic metals (129% yoy), office machinery and computer production (119%) and manufacturing of related transport equipment (62% yoy).

In Q3, the Bulgarian service sector experienced significant growth. The growth of the value added produced by the service sector reached 5.9% yoy. This was mainly due to the country's booming tourism sector. The agricultural sector accelerated to 5.3% yoy in Q3 from a weak 1% growth in the first half of the year. This positive agricultural performance was due to a good grain harvest.

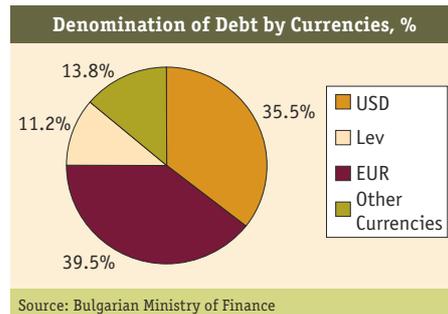
Structural improvements in the country's economy and strong demand hikes in neighboring countries will lead to further increases in Bulgaria's GDP, which will likely stay around 6%. It will also positively affect next year's economic growth.

Fiscal Policy

In January-November, Bulgaria implemented prudent fiscal policy. The budget surplus reached Lev 1.5 billion (EUR 756 million), which represents 3.9% of projected full-year GDP compared to a surplus of 2.6% achieved in the previous year. However, the full-year surplus is expected to drop to 0.3% of GDP (against the previously estimated 1.4% of GDP) due to year-end spending increases.



In January-November, consolidated budget revenues and grants reached Lev 14.3 billion (EUR 7.2 billion), which represents growth of 8.5% yoy compared to 7.8% yoy in January-October. Significant increases in tax collection in November were due to the record-high import duties on oil recently imposed by the government.



During the same period, government expenditures rose at a lower rate (2.6% yoy) and reached Lev 12.8 billion (EUR 6.45 billion). However, the government transferred Lev 260 million (EUR 133 million or 0.7% of GDP) in December to a newly established public company for investments in small infrastructure projects, which should decrease the overall surplus of the consolidated budget. This additional spending will bring the December surplus to around 3.6% of GDP. One third of that amount could be considered as politically motivated expenditures driven by the forthcoming general elections.

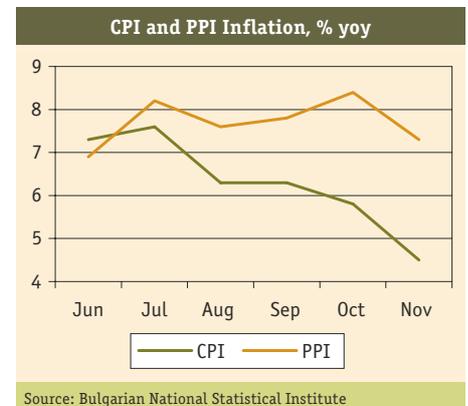
In October, government and government-guaranteed debt totaled EUR 8.14 billion in nominal value. This includes EUR 1.3 billion of domestic debt and EUR 6.82 billion of foreign debt. The monthly decrease in nominal terms was EUR 64.9 million, which is due to exchange rate fluctuations.

The cumulative debt to GDP ratio was 41.9% in October, which represents a decrease of 0.3 percentage points from the previous month. The debt to GDP ratio of domestic and foreign debt was 6.8% and 35.1%, respectively. In the total structure of debt, foreign debt accounts for some 83.7% and domestic debt for 16.3%, which represents no change compared to the previous month.

The share of debt denominated in US dollars decreased to 39.5% in October from 36.2% in September. On the other hand, the share of debt denominated in euros increased to 39.5% from 39.1%. This development may have positive consequences in the future if the euro begins to depreciate against the US dollar.

In December, Parliament approved a second and final reading of the 2005 budget. The new budget includes a deficit of some 0.47% of GDP. Compared to the initial version from the Ministry of Finance, overall fiscal revenues and expenditures are increased by 0.2% of GDP.

Monetary Sector



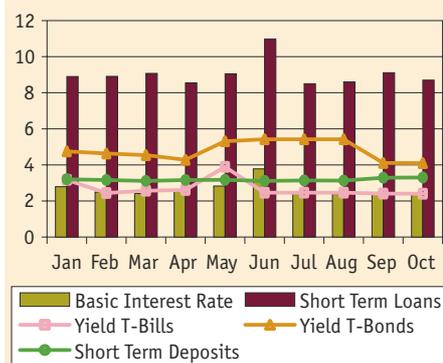
In November, growth in the consumer price index (CPI) slid to 4.5% yoy from 5.8% yoy in October. The slight decrease in the CPI was driven by a decline in non-food products by 0.3% month-over-month (mom) and of transportation costs by 0.9% mom, which together ac-

count for 36% of the consumer basket. The decrease in food prices was expected given the positive supply shock from the good grain crop in 2004. The January-November, average inflation increased by 6.3% yoy. This increase can be partly explained by the record high budget surplus generated in the same period.

The producer price index (PPI) decelerated to 7.3% yoy in November from 8.4% yoy in October. The difference between producer and consumer indicators is largely driven by higher weights of metal and oil inputs in the basket of producer prices, which significantly increased over the last three months.

In November, the growth in money supply (M3) accelerated to 14.7% yoy, up from 12.2% yoy in October. The monetization of the economy has reached some 50% of GDP compared to 49% in the same period in 2003. This should lead to a decrease in the velocity of circulation and increased investments in the economy.

Interest Rates by Instruments Nominated in Lev, %



Source: Bulgarian National Bank

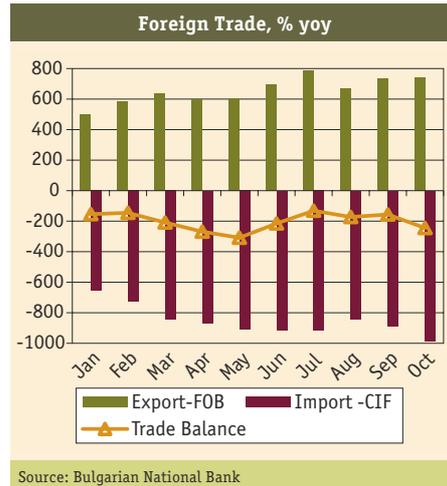
In December, the National Bank announced that the base interest rate will be calculated as an average value of the interbank overnight lending rates (LEONIA) for the previous month starting in February 2005. Currently, the rate is set in accordance with the yield on 3-month government bills. These changes will reduce the base interest rate, which was set at 2.36% in December against 2.05% for LEONIA.

In November, the National Bank continued to increase its official foreign reserves. They grew from EUR 6.43 billion in October to EUR 6.64 billion in November. Due to the existing fiscal account surplus and prudent monetary policy, foreign reserves will continue to grow in December. However, due to additional year-end government spending, it is very likely that the rate of growth of foreign reserves in December will slow down slightly and a further significant increase of reserves will reappear only in 2005.

International Trade and Capital

In January-October the foreign trade deficit widened by 23.9% yoy and reached EUR 2 billion, which accounts

for roughly 10.3% of projected full year GDP. The monthly deficit increased at a slower rate of 9.1% yoy. This is due to a higher rate of import growth. In October, imports grew by 22.7% yoy, while exports rose by 19% yoy. In January-October imports grew at a rate of 18.4% yoy compared to a 16.8% yoy increase in exports. Therefore, the monthly performance in October was relatively good given the seasonal increase in the oil imports and record-high oil prices.



Source: Bulgarian National Bank

Following three months of solid improvements in the current account (CA) balance in October, Bulgarian economy returned to a CA deficit. The monthly deficit reached EUR 209.4 million following a EUR 35.1 million surplus in September and a EUR 147.8 million surplus in August. The CA deficit in October brings the annualized CA gap to 6.8% of GDP. The January-October CA gap reached EUR 765 million, which represents a decrease of 19.5% yoy. The deterioration in the CA balance was caused by high oil prices, seasonal increases in the domestic consumption of oil, and a seasonal decrease in the tourist sector. In addition, there was some decrease in metal prices in October, which negatively affected the country's exporters.

Although the CA deficit remains high, the FDI inflows are able to match such a deficit. In January-October, net FDI inflow reached EUR 1.2 billion. Due to the privatization of several large companies in November and December, the cumulative annual FDI net inflow is very likely to reach EUR 2 billion.

International Programs

The European Commission has approved the government's proposal for starting construction on the southwestern part of the Sofia ring road. The total size of investment is estimated at EUR 148.5 million. The EU will secure EUR 111.4 million as a grant under the ISPA Preaccession Programme. The project was initiated in 2001, but the government has not yet settled legal issues related to compensation for properties on the planned road's territory. The new motorway is supposed to speed up traffic on the international route.

In December, the IMF mission ended its assignment in Bulgaria without agreements with the government on policy issues related to the planned 25% minimum wage hike and the fiscal expenditure plans for 2005. The IMF mission announced that negotiations on the 2-year precautionary agreement would continue in March 2005. The IMF mission and the Bulgarian government failed to reach a consensus on the policy criteria and benchmarks for 2005.

EBRD will set up a EUR 60million fund for the rehabilitation of residential buildings designed to increase their life and improve their insulation. The financing is comprised of a EUR 50 million loan and a EUR 10 million grant. The grant will be intermediated by local commercial banks. A large part of the deal is linked to the international fund for decommissioning of old nuclear power units. The final contract is planned to be signed in March 2005.

Other Developments and Reforms Affecting the Investment Climate

Moody's has issued a positive report for Bulgaria outlining the country's strong economic growth, reduced public debt, and large investment inflows. In order to keep investor confidence in the country's fiscal policy, Moody's warned that the fiscal reserve should be used only for the purpose of debt coverage. In November, Moody's upgraded Bulgaria's long-term ratings to Ba1 positive outlook. This rating is one notch below the investment grade marks given to Bulgaria by Fitch and S&P.

The Non-Bank Financial Supervision Agency announced that it expects the total amount of non-bank financial assets to have reached 14.6% of GDP at the end of 2004. This amount includes total stock market capitalization of Lev 4 billion (EUR 2.1 billion), Lev 768 million of assets in pension funds, Lev 41million of asset management funds, and insurance premiums of Lev 832 million.

The National Statistical Institute announced its forecast for investment growth in 2005. It expects investments to grow by 2.4% in 2005. This estimate is based on a survey that covers firms generating 96% of the country's industrial output. The interviews were held at the end of November.

In December, the Bulgarian Privatization Agency released a press note that confirms the plan for a public offering of 35% of BTC (telecom operator), the state's entire stake. The offering should take place in the middle of February 2005. The shares will be traded only in exchange for state compensation notes. These notes were issued to cover nationalized properties. Therefore, privatization of BTC will not bring additional cash revenues to the country's budget. This plan needs to be confirmed by the Ministry of Finance, which initially advocated the sale of 15% of the company's assets for cash.

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