

Macroeconomic Situation

Summary

- In 2007, the Bulgarian economy grew at a very strong rate, surging by 6.2% year-over-year (yoy) in Q1, 6.6% yoy in Q2, and 4.5% yoy in Q3, which should bring the annual rate of growth to around 6%.
- Throughout 2007, Bulgaria's positive economic developments were supported by the government's prudent fiscal policy, which helped maintain a solid fiscal budget surplus at € 2.3 billion or 8.2% of full year GDP. However, when payments to EU funds are made, the total size of the surplus is likely to be around 4% of GDP.
- High growth of the consumer price index (CPI) at around 9.5% is three times higher than the initial government forecast, driven by the poor harvest and a significant increase in energy prices. High inflationary pressure came from the growth in consumption supported by significant growth in credit, which grew by around 60% yoy in January-October.
- The current account (CA) deficit continued on an upward trend, reaching 11% of projected full-year GDP in January-October. On a positive note, the same period FDI inflows were able to cover 120% of the CA gap.
- In October, household gross real income surged by 13% yoy with a corresponding increase in household consumption by 5.5% yoy.
- The rapidly widening current account (CA) deficit, which is likely to be around 19.5% of the projected full-year GDP at the end of 2007, still remains the most significant risk factor. However, Bulgaria managed to ensure significant foreign direct investments, which reached almost 92% of the existing CA gap at the end of November. Along with some insignificant borrowings on international market, the existing gap was easily covered.

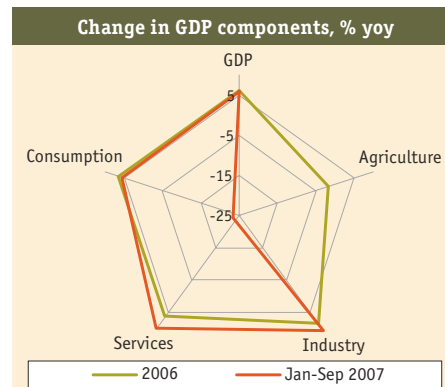
Outlook for 2008

2008 will be the second year of Bulgaria's membership in the European Union. GDP is expected to exceed the average rate in the EU and reach more than 6%. This expansion will be supported by the strong growth of private consumption, stimulated by decreasing personal income tax and growing income. Upward trends in construction, services and industry should ensure further growth in Bulgaria's real sector. Consumer inflation is expected to be within the range of 9-10%. Due to the existing current account gap, the government will continue its restrictive fiscal policy, aimed to reach a surplus of around 3%.

Economic Growth

The strong growth of the real sector demonstrated throughout the first three quarters of 2007, along with the relatively good performance in October, suggests that full year GDP growth will be around 6% yoy. The projected GDP growth is slightly lower than the initially forecasted number of 6.4% yoy incorporated into the country's fiscal budget. During the first three quarters of 2007, the Bulgarian economy posted sig-

nificant growth. However in Q3 its rate decelerated to 4.5% yoy down from 6.6% yoy demonstrated in Q2. It brings the cumulative economic growth in January-September to 5.7% yoy.



Source: National Statistical Institute

Good performance of the Bulgarian real sector in 2007 was backed by rapidly developing industrial and service sectors. In January-September, these two sectors posted 10.5% yoy and 9.7% yoy rates of growth respectively. The performance of the Bulgarian real sector could have been even better if the agricultural sector had not fallen so dramatically. During the period it dropped by 26.4% yoy due to extremely bad weather conditions. Such a deep decline in agriculture temporarily turned the country into a net importer of agricultural products.

The composition of GDP by demand component suggests that investment is the fastest growing element, increasing in January-September by 25.9% yoy. In the same period, the increase in consumption reached 5.7% yoy.

In October, Bulgarian industrial sector sales increased by 10.9% yoy, which demonstrates some acceleration as compared with 8.2% yoy growth in September. The acceleration was backed by the rebound major manufacturing including food processing, chemical production and the textile industry. On a positive note, the most significant increase in excess of 10% yoy was observed in those sub-sectors where the value added component is relatively high, including motor vehicles and office equipment.

An additional factor supporting growth of the real sector in 2007 was developing trade, although its performance was weaker than in the previous year. After several months of a downward trend, the Bulgarian retail sector started to recover in October, posting a 2.3% yoy rate of growth. The same tendency was observed in wholesale trade, which grew in October by a marginal 1% yoy, while retail trade continued to show very positive developments.

Fiscal Policy

Throughout 2007, the Bulgarian Ministry of Finance was able to conduct prudent fiscal policy,

maintaining a solid fiscal budget surplus. It can be estimated that due to the fiscal surplus of €2.02 billion or 7.2% of projected full year GDP at the end of November (if the contribution to EU funds is excluded), the 2007 final surplus will reach €2.3 billion or 8.2% of full year GDP. However, if the contribution to EU funds is calculated, the budget surplus in 2007 will be downsized to around 4% of GDP. The considerable increase in the budget surplus (by 45.9% yoy in January-November) was driven by a rebound in the growth rate of revenues, which substantially exceeded the growth rate of expenditures.

Consolidated Fiscal Program in January-November 2007

	€ billion	% of total	Change, % yoy
Revenue	10.95	100	11.5
Tax	8.8	80	10.8
Non-tax	2.15	20	14.7
Expenditures	8.7	100	5.9
Balance	2.3		45.9

Source: Bulgarian Ministry of Finance

In January-November, revenues were growing at an accelerated rate after a slight deceleration in January-October. During the period, revenues grew by 20.4% yoy, which exceeds the initial government projections of 18.9% yoy for the whole year. Tax revenues, which are the biggest contributor to total budget revenues (80% of the total revenues), continued to grow at an accelerated rate of 10.8% yoy and constituted Lev 17.5 billion (€ 8.8 billion) at the end of November. On a positive note, there was acceleration in the growth rate of non-tax revenues. In January-November, they grew by 14.7% yoy and reached Lev 4.2 billion (€ 2.12 billion).

Budget expenditures were also increasing during the period, although at a lower rate than revenues. In January-November they grew by 5.9% yoy and amounted to Lev 17.2 billion (€8.7 billion). EU membership requires a significant contribution into EU funds, which increases government expenditures and decreases the fiscal surplus to around 4% as of the end of 2007.

2008 Budget framework

	2007 est.	2008
Real GDP growth (% yoy)	6.4	6.4
CPI year-average, %	7.2	6.9
CPI year-end, %	9.3	4.5
General budget (% of GDP)	2	3
CA balance (% of GDP)	-21	-21.9
FDI net inflow (% of GDP)	16.6	15

Source: Bulgarian Ministry of Finance

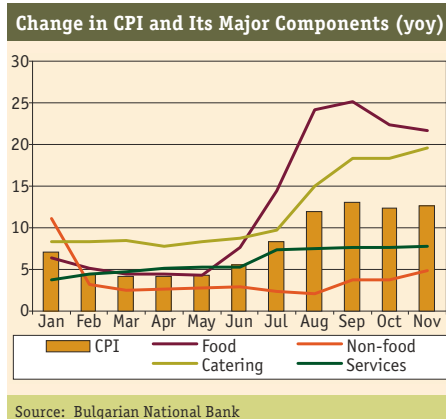
In October, the government continued to demonstrate thoughtful debt management, which is evident from the decrease in total public and publicly guaranteed debt. By the end of November, total debt constituted €5.75 billion, which can be translated into a decrease of 8.4% yoy. In terms of GDP, total government debt accounted for 22% of full year estimates compared to 27% at the same period

of last year. The decrease in the total amount of debt was accompanied by the government strategy of restructuring foreign currency debt into domestic currency. During the period, Lev-denominated debt increased to 21.5% of total government liabilities, up from 17.5% a year earlier.

The 2008 budget passed the final reading with a surplus target of 3% of GDP. The budget calculations are based on economic growth of 6.4%, annual average inflation of 6.9% and a CA deficit of 21.9% of GDP. The new Budget Law incorporates changes in several tax laws passed by the parliament, which includes new flat 10% personal income tax. Budget revenues are estimated at 44.1% of projected GDP.

Monetary Sector

In November, CPI marginally accelerated to 12.6% yoy up from 12.4% yoy demonstrated a month earlier. The highest price increase was registered in foods, which surged by twice as much as the total increase of the CPI. Such significant growth in food prices is caused by unfavorable weather conditions and flood damages experienced by the Bulgarian farmers last summer. On the opposite side, non-food products demonstrated a much lower increase in prices, which on average increased by 4.8% yoy in November. The existing trend in consumer prices in 2007 suggests that the year end with CPI inflation around 9.5% yoy, which is three times that initially projected by the Bulgarian monetary authorities.

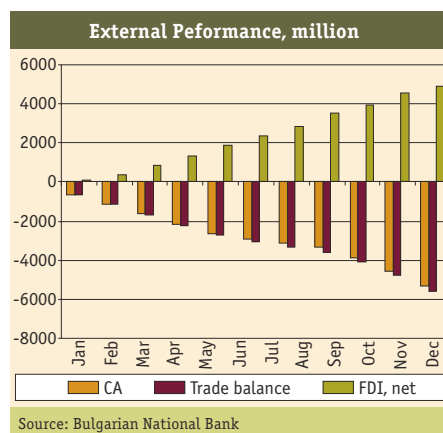


Following the tendency with consumer prices, producer prices on domestic markets have also been rising at an accelerated rate. During November, PPI rose at a rate of 13.2% yoy, which is 1.9 pps higher than in the previous month. Acceleration in the growth rate of producer prices was registered in manufacturing, while prices in metallurgy and extraction dropped by 2.2% yoy and 1.2% yoy respectively. This drop in prices had a positive impact on the overall PPI and eased general pressure on the overall index.

In 2007, Bulgaria demonstrated significant growth in credit, which surged by around 60% yoy in January-October. Such a high rate of growth can not be considered sustainable for the country's banking system. Although Bulgarian National Bank (BNB) undertook efforts to curb the growth in credit, their stock to the non-government sector continued to demonstrate significant growth during the period and surged by 58.6% yoy. However, if the BNB continues to provide tight monetary policy in 2008, it is very likely that the rate of growth in credit could be significantly downsized.

International Trade and Capital

In 2007, a widening CA deficit remained the most significant risk factor for the Bulgarian economy, and is likely to be around 19.5% of projected full-year GDP. The main source for such an increase in the CA deficit was, as before, a significant deterioration in the trade balance. On a positive note, until October net FDI inflow was able to cover the existing CA gap. However, FDI was 8% lower in November for full coverage of the existing CA gap. At the same time, FDI inflow in December will likely to be accelerated due to several big sales made in the previous months for which payments were still not transferred into the country.

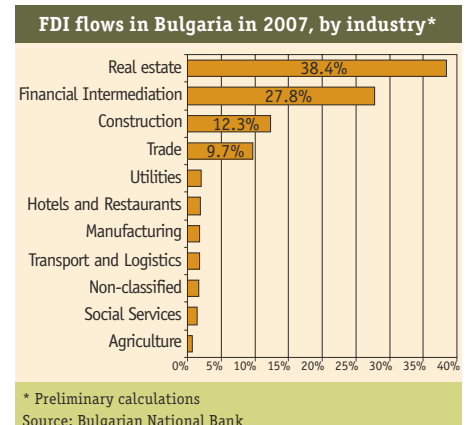


In January-November, the CA deficit surged by almost 70% and reached €5.3 billion, which translates into 21.9% of GDP. The main reason for such an increase in the CA deficit was a significant deterioration in the trade balance.

The Bulgarian trade deficit in goods and services continued to post further deterioration and reached almost 23% of projected full year GDP at the end of November, which demonstrates an almost 4 pps increase as compared with the previous month. The main reason for the worsening trend in the trade deficit is rapid growth in imports as compared with exports. In January-November, exports posted an 11.9% yoy rate of growth, while imports increased at a faster pace of

12.9% yoy. The main driving forces for growth in imports are increasing prices for energy resources and growing domestic consumption, which in November alone surged by real 4.3% yoy.

In January-November, net FDI inflows surged by 29.4% yoy and reached €4.8 billion. Some deceleration in the rate of growth of FDI is partially due to the sub-mortgage crisis on international markets,



which limited opportunities for Bulgarian businesses in attracting foreign capital.

As a reaction to deceleration in FDI growth, there was an increase in international borrowings, which reached €26.2 billion at the end of November. The monthly increase in gross foreign debt was 2.4% mom. On the negative side, the share of short term borrowing increased during the month by almost 3 pps. The distribution of FDI in the Bulgarian economy shows that the biggest part is devoted to real estate, which absorbs more than 1/3 of all investments.

Other Developments and Reforms Affecting the Investment Climate

Due to significant imbalances on international financial markets and a drop in the major international financial indices, the Bulgaria stock index SOFIX posted a deep decline, falling by around 20% in January. The downward trend was driven by the short-strategy of foreign individual investors. Since fundamentals of the stock market are strong, an upward correction is likely to occur in the coming months.

The IMF confirmed its recommendations for Bulgaria for 2008, which includes continuation of restrictive fiscal and income policies. These measures are aimed at limiting domestic demand. The IMF also called for further deepening of structural reforms to support competitive gains and further convergence of the country to EU living standards.

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