

Macroeconomic Situation

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Summary

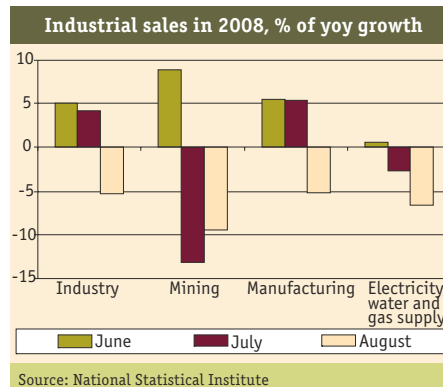
- In August, growth of industrial production and sales was negative. Industrial production declined by 6% year over year (yoy) and sales decreased by 5.4% yoy.
- According to GDP estimates, economic growth was 5.6% yoy in the third quarter of 2008. In particular, gross value added (GVA) in agriculture increased by 37.8% yoy.
- In January-September, republican budget revenues increased by 21% yoy and expenditures grew by 16.9% yoy. The budget surplus stood at 6.6% of projected full-year GDP.
- At the end of September, public debt stood at 17.1% of GDP, including 12.2% for external debt and 4.9% for domestic debt.
- In August, the consumer price index (CPI) increased by 0.1% mom and the producer price index (PPI) declined by 0.1% mom. In January-August, consumer inflation was 6.3% year-to-date (ytd) and producer inflation reached 10% ytd.
- In January-August, the current account (CA) deficit stood at 14% of projected full year GDP. In August, the CA deficit shrank by 14.3% yoy. The trade deficit continued to post growth, but its pace (7.5% yoy) was much lower than during the preceding months of the year.
- In November, Fitch downgraded Bulgaria's sovereign rating to BBB- from BBB. The agency explained that declining financial flows to the country may result in contraction of domestic demand and recession. On a positive note, Fitch does not consider the probability of a deep economic and financial crisis in Bulgaria to be high.

Economic Growth

In August 2008, growth in industry was negative. Industrial sales declined by 5.4% yoy and industrial production shrank by 6% yoy. In mining, reduction in sales was 9.5% yoy and the decrease in production was 3.6% yoy. Mining of coal and lignite and of non-metallic raw materials fell significantly, the reason for which must be decreasing energy prices and deceleration of the building industry. In contrast, mining of iron ores grew, but it is highly likely that its dynamics is also going to worsen because of reduction in global demand for metals.

In manufacturing, sales declined by 5.3% yoy and production fell by 5.7% yoy. Negative growth was observed in almost all sectors. Still, there were some exceptions, among them manufacture of rubber and plastic products, printing and publishing, manufacture of other transport equipment, and manufacture of radio, television and telecommunication equipment. In these industries, growth was positive, though decelerating in most.

In electricity, water and gas supply, sales were down by 6.6% yoy and production shrank by 7.6% yoy. This was caused by a significant increase in electricity prices, which occurred at the beginning of July, and by a decline in manufacturing in August.



According to the experimental express GDP estimates done by the National Statistical Institute, GDP grew by 5.6% yoy in the third quarter of 2008. By production, the leading sector was agriculture, where GVA increased by 37.8% yoy (due to much better weather conditions in 2008 than in 2007). Growth in industry and services was 4.3% and 3.5% yoy, respectively. By final use, gross fixed capital formation increased most — by 10.9% yoy. Final consumption expanded by 3% yoy, and exports and imports rose by 3.9% and 2.9% yoy, respectively.

During the first nine months of 2008, GDP grew by 6.5% yoy. GVA in agriculture, industry and services rose by 21%, 6.2% and 5.7% yoy respectively. Final consumption became larger by 4.1% yoy, gross fixed capital formation grew by 18.3% and the increase in exports and imports was 5.8% and 7.4% yoy, respectively.

Fiscal Policy

In January-September, the execution of the republican budget was 78.7% by revenues and 60.4% by expenditures. The budget balance was 3 times larger than planned by year end.

Revenues and grants increased by 21% yoy. Tax revenues, which constitute 86.4% of revenues and grants, grew according to plan — by 20.2% yoy. Non-tax revenues, whose share in revenues and grants was 13.6%, increased much faster than planned — by 36.8%. The dynamics of tax revenues was predominantly influenced by VAT earnings (accounting for almost half of all tax revenues), which increased by 20.2% yoy, the same proportion as tax revenues overall. Revenues from excises and profit tax rose even more — by 21% and 26.2% yoy, respectively (with excises significantly outpacing plan). However, income tax revenue grew less rapidly, by 12.6% yoy, lagging behind the plan of 18.9% yoy growth. At the same time, non-tax revenues increased very fast in all categories.

Expenditures and transfers grew by 16.9% yoy. The relatively high growth in expenditures and transfers was mainly due to transfers, which increased by 28.6% yoy. In particular, transfers to municipalities rose by 34.3% yoy (and exceeded the planned full year amount by 2.4%), and those to the Social Secu-

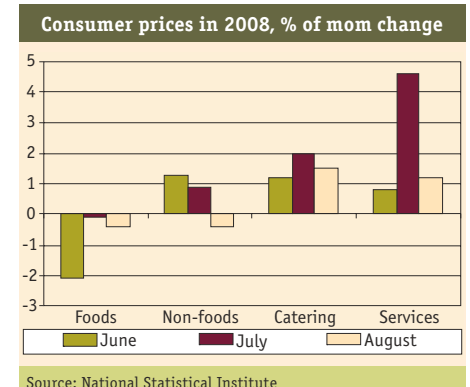
rity Fund increased by 36.1% yoy. At the same time, expenditures grew only by 8.3%; the main expenditure categories — maintenance, wages and salaries, and capital expenditures — grew by 5.5%, 14% and 4.3% yoy, respectively.

At the end of September, public debt stood at €5,396 million, or 17.1% of projected full-year GDP. Out of this amount, €3,835 million was external debt and €1,551 million was domestic debt (12.2% and 4.9% of GDP, respectively). Compared to the beginning of the year, public debt shrank by 5.5% ytd; external debt decreased by 5.6% ytd and domestic debt decreased by 5.2%.

Monetary Sector

In August, consumer prices increased by 0.1% mom. Deflation was observed in some product categories. Prices of food and non-alcoholic beverages were lower by 0.4% mom due to the good harvest. In transport, prices declined by 1.7% mom, which is explained by a drop in oil prices. Clothing and footwear became cheaper by 1.3% mom.

At the same time, significant price increases were observed in catering and in utilities. Restaurant and hotel services became more expensive by 1.4% mom, due to seasonally high demand for such services and tightness on the labor market. Utilities grew in price by 2% mom because of the August 1st increases in prices for water throughout the country (prices were raised in 39 Bulgarian cities and towns) by more than 15% mom on average. The reason behind this increase was a 14% rise in electricity prices, which occurred on July 1st and led to a considerable increase in costs for water distributors, in whose cost structure electricity has a very high share (for some Bulgarian distributors, electricity costs are as much as half of total costs).



Producer prices declined by 0.1% mom in August. In mining, prices dropped by 1.2% mom, due to a decrease in prices in metal ore mining by 4.1% mom. In manufacturing, deflation by 0.5% mom occurred, solely thanks to a 1.3% price decrease in the food industry (caused by the good harvest this year); in the rest of manufacturing industries, prices continued to grow. In electricity, water and gas supply, prices

increased by 2% mom, because of a 14.4% mom price increase in collection, purification and distribution of water.

In January-August, the consumer price index increased by 6.3% ytd and the producer price index rose by 10% ytd. During September 2007-August 2008, the CPI grew by 11.2% yoy and the PPI increased by 11.8% yoy.

International Trade and Capital

For the first time during the year, the CA deficit shrank in August compared to the same month of the previous year. The CA deficit stood at €228 million, compared to €265 million in August 2007, which is a 14.3% reduction yoy. Such an improvement in the CA balance became possible due to better dynamics of net services, income and transfers. In sum, they amounted to €406 million, which is a €82 million (or 25.3%) improvement yoy. At the same time, the trade balance continued to deteriorate, but at a much lower pace than in previous months. In August, the trade deficit stood at €634 million, which is a 7.5% increase yoy; in contrast, during January-July the trade deficit rose by as much as 35.1% yoy. This deceleration is explained by significantly slower growth of goods imports, which stood at 11.9% yoy in August compared to

27.5% yoy in January-July. Though goods exports also decelerated, this occurred not as rapidly — export growth slowed down to 14.3% yoy in August from 23.6% in the first seven months of the year.



Source: Bulgarian National Bank

In January-August, the CA deficit stood at €4,770 million (14% of projected full-year GDP), a 42% increase yoy. The capital account was €227 million (0.7% of GDP) and the financial account totaled €6,821 million (20% of GDP), which is 11% growth yoy. As a result, reserves increased by €2,420 million, or 47% yoy.

Other Developments and Reforms Affecting the Investment Climate

On November 10th, Fitch downgraded the sovereign rating of Bulgaria (to BBB- from BBB), along with several other countries of the region — Hungary, Kazakhstan and Romania. According to Fitch, "Emerging Europe is the most vulnerable Emerging Market region to the deterioration in the global financial and economic environment", primarily due to large current account deficits, high levels of short-term external debt, and also because of significant currency mismatches on balance sheets and high trade openness.

Regarding Bulgaria, Fitch believes there may be recession as a consequence of the expected decline in external financial flows, which will mean a necessity to sharply reduce domestic demand in order to reduce the presently huge current account deficit. On a positive note, according to Fitch, the risk of a deep economic and financial crisis is limited, due to large fiscal reserves and a commitment to the currency board arrangement.

Bulgaria's Sovereign Ratings

Agency	Rating	Date of the last revision or confirmation
Standard&Poor's	BBB+/Stable	29 November 2006
Moody's	Baa3/Stable	25 September 2008
Fitch	BBB-/Stable	10 November 2008

Source: Chonds.Info

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