

# Macroeconomic Situation

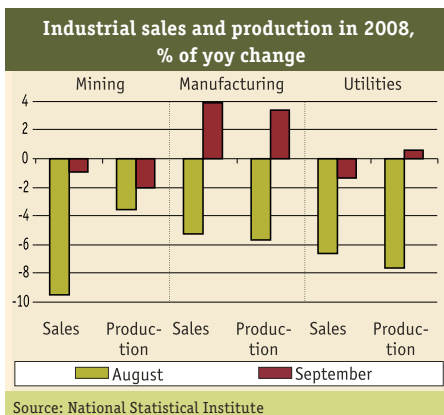
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### Summary

- In September, industrial sales increased by 3.3% year-over-year (yoy) and industrial production grew by 2.5% yoy. In manufacturing, sales and production rose by 3.9% yoy and 3.4% yoy, while both declined in mining.
- In January-October, republican budget revenues grew by 20% yoy and expenditures increased by 16.7% yoy. The surplus stood at Lev 4.2 billion, which is 6.8% of projected full-year GDP.
- The consumer price index (CPI) increased by 1.1% month-over-month (mom) in September and by 0.5% mom in October. Food contributed most to consumer inflation.
- The producer price index (PPI) declined by 0.4% mom in September and 0.9% mom in October. In September, producer deflation occurred mainly due to price drops in metallurgy and food. In October, a considerable decline in metal ore mining and manufacturing of basic metals was behind the PPI decrease.
- In September, the current account (CA) deficit shrank by 1.2% yoy. However, in January-September, the CA deficit increased by 38% yoy to €5,381 million (15.8% of projected full year GDP). The financial account stood at €8,302 million, or 24.4% of GDP. The change in reserves was €2,720 million (8% of GDP).
- At the end of November, mandatory reserve requirements were lowered to 10% from 12% in order to stimulate the economy.

### Economic Growth

In September, growth in industry resumed after a significant drop in August. Industrial sales increased by 3.3% yoy and industrial production rose by 2.5% yoy. Both sales and production improved significantly in all three types of industry - mining, manufacturing, and electricity, water and gas supply.



In mining, the decrease in sales and production was 0.9% yoy and 2% yoy respectively. Mining of metal ores increased slightly. Mining of coal and lignite declined (for the third consecutive month) on the back of dropping energy prices. However, mining

of non-metallic materials (most of which are used in construction) posted considerable growth - sales increased by 9.1% yoy and production grew by as much as 22%. This is explained by acceleration in construction to 17.7% yoy in September from 6.9% yoy in August. However, it does not seem likely that growth in mining of non-metallic products will be sustained because of the expected worsening dynamics in the construction sector.

In manufacturing, sales rose by 3.9% yoy and production increased by 3.4% yoy. Improvements were observed in most industries. In particular, sales and production in the food industry accelerated to 13.4% and 8.7% yoy in September from 1.4% yoy and 0.5% yoy in August. This became possible due to a good harvest in 2008. Also, the growth of sales and production accelerated in the chemical industry, manufacture of construction materials, and publishing and printing. At the same time, the situation in machine building was mixed - although dynamics improved in most of its areas in September compared to August, it remained negative in many of them or became only slightly positive. Indeed, short term prospects for machine building are pessimistic, as investment demand is likely to decelerate significantly. Furthermore, in metallurgy, whose performance was rather poor in September (though improved considerably compared to August), the situation is not likely to improve either because of shrinking global demand for metals due to the worsening state of the global economy.

In September, sales dropped by 1.4% yoy in electricity, water and gas supply and production grew only by 0.6% yoy. The sluggish dynamics in this sector is explained by several price increases and low demand because of the modest performance of manufacturing.

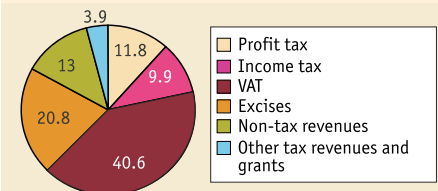
### Fiscal Policy

In January-October, execution of the republican budget was 86.9% of revenues and 67.9% of expenditures. The budget surplus exceeded 3.2 times its planned year-end amount.

During January-October, revenues and grants increased by 20% yoy, which is 1 pp lower than in January-September (though still much higher than the planned 13.1% yoy growth). Growth of tax revenues was stable at 20.3% yoy. While dynamics of profit and income tax revenues worsened (because of deceleration of economic activity on the back of negative developments in the global economy), growth of excise receipts accelerated. VAT revenue, comprising almost half of total tax revenues, increased steadily by 20.4% yoy. At the same time, non-tax revenues decelerated considerably, to 29.8% yoy in January-October from 36.8% yoy in January-September. This occurred mainly because of deceleration in entrepreneurial and property income to 43% yoy from 53.4% yoy, on the back of worsening conditions for business activities. How-

ever, deceleration in non-tax revenues does not put budget execution at risk, as their amount has already exceeded the full-year plan by a third.

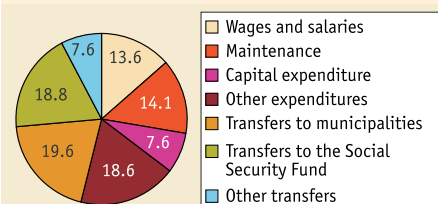
**Structure of republican budget revenues in January-October 2008, %**



Source: Ministry of Finance

Expenditures and transfers increased by 16.7% yoy, which is 0.2 pp lower than in January-September but 3.6 pp higher than the planned rate of growth. Expenditures accelerated to 8.9% yoy from 8.3% yoy due to somewhat intensified spending on maintenance, capital, social expenditures and scholarships, and social and health insurance contributions. Transfers decelerated to 27.3% yoy from 28.6% yoy because of a lower rate of increase in transfers to the Social Security Fund and to municipalities. At the same time, growth in transfers was much faster than the projected 7.3% yoy; in particular, transfers to municipalities, growing at 32.1% yoy, exceeded the projected full year amount by 14.4%.

**Structure of republican budget revenues in January-October 2008, %**



Source: Ministry of Finance

### Monetary Sector

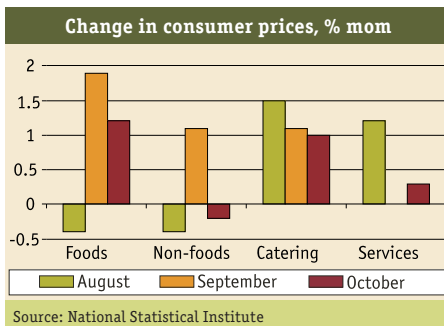
In September and October, 12-month consumer and producer inflation continued to decelerate. In these two months, the CPI increased by 11% and 10.9% yoy and the PPI rose by 11.3% and 8.9% yoy. Compared to the beginning of the year, consumer prices increased by 7.4% and 8% year-to-date (ytd), and producer prices grew by 9.4% and 8.5% ytd.

Consumer prices rose by 1.1% mom in September and by 0.5% mom in October. The major reason for the rise in the CPI during these two months was food inflation, which resumed after three summer months of falling food prices. Prices for food and non-alcoholic beverages increased by 2% mom in September and by 1.2% mom in October. The most

influential factor behind these dynamics was the increase in prices for meat due to a low supply of livestock on the domestic market and the inability to import meat cheaply (due to increased demand for meat from rapidly developing low-income countries). One more factor of growth in food prices was seasonal inflation in fruits and vegetables. At the same time, some food became cheaper due to a record crop harvest this year. Wheat and other crop products decreased in price by 7% mom in September and 4.7% mom in October.

Among non-food products and services, the highest price growth was observed in education - 10.9% mom in September and 4.9% mom in October. These dynamics are seasonal by nature and are explained by the beginning of the academic year. Also, clothing and footwear became significantly more expensive - by 3.4% mom in September and by 2.4% mom in October. Such price changes in this group of products are also typical for the season.

In September, the most significant decrease in non-food prices was for tourist services - by 17.7% mom - due to the end of the tourist season. In October, prices for oil products dropped most rapidly; in particular, high-octane A98 and A95 gasoline became cheaper by 7.8% and 8.9%. This happened due to the global decrease in oil prices on the back



of the deteriorating state of the global economy.

In the first two autumn months, the declining trend in producer prices that began in August continued. PPI dropped by 0.4% mom in September and by 0.9% mom in October. In the mining industry, there was a 0.5% mom rise in producer prices in September (with all types of mining experiencing some price increase), but it changed into a drop of 2.3% mom in October. In metal ore mining, prices fell by 5.1% mom in October, which was the biggest price decline during this month both in the mining sector and in industry overall. In manufacturing, prices decreased by 0.6% mom in September and by 1.2% mom in October. In September, the price drop occurred due to four industries: manufacture of basic metals (-1.2% mom), manufacture of electrical machinery and apparatus (-1% mom), manufacture of

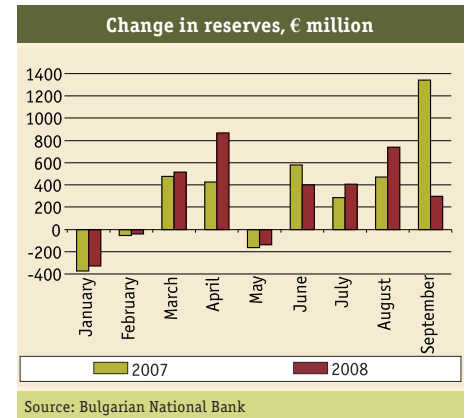
food products (-0.5% mom), and manufacture of pulp, paper and paper products (-0.4%). In October, prices fell in two industries: manufacture of basic metals (-1.4% mom) and manufacture of rubber and plastic products (-0.5% mom). At the same time, in electricity, water and gas supply, no deflation was observed during the first two months of autumn. In September, producer prices did not change in this sector, and in October, they increased by 1.2% mom mainly because of a 24% increase in natural gas prices that occurred on October 1st.

### International Trade and Capital

In September, the CA deficit shrank compared to the same month of the previous year. However, the decrease was not as big as in the previous month; in September, the CA deficit became smaller by 1.2% yoy compared to 14.2% yoy in August. The major reason why there was no significant shrinking in the CA deficit is a considerable deterioration in the trade balance. The trade deficit increased by 15.1% yoy compared to 7.5% yoy in August. Growth in goods exports of 17% yoy was only slightly faster than the 16.4% yoy growth in goods imports (in contrast, goods exports rose by 14.2% yoy in August and outpaced goods imports, which increased by 11.9% yoy, by 2.3 pp). At the same time, total improvement in net services, income and current transfers was considerable - they increased more than two and a half times yoy. However, in absolute terms, this improvement was only marginally sufficient to compensate for the deterioration in the trade balance and to prevent the CA gap from further widening.

In January-September, the CA deficit stood at €5,381 million, or 15.8% of projected full year GDP. The trade deficit amounted to €6,449 million (19% of GDP). In relative terms, the increase in the CA and trade deficit during the first nine months of the year was somewhat slower than during January-August. The CA deficit increased by 38% yoy and the trade deficit rose by 29.5% yoy, compared to 42% yoy and 31.4% yoy during the first eight months of the year. The financial account stood at €8,302 million (24.4% of GDP). It increased by 4.9% yoy, compared to 11% yoy in January-August. However, data on the financial account usually comes with significant lag, which means that after revisions its dynamics may turn out to be better. In particular, there may be some improvement in the data on FDI, which, according to the first estimate, stood at €3,660 (10.8% of GDP), declining by 22.4% yoy. However, it is highly likely that even after revisions FDI dynamics will turn out to be negative, as according to comparable data, FDI fell by 3.9% yoy (according to the initial estimate, FDI in January-September 2007 stood at €3,807 million). FDI performance is expected to worsen further due to increased risks of investing on the back of global financial turmoil.

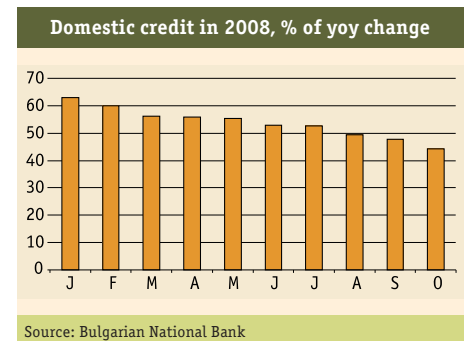
In January-September, the increase in reserves was not as large as in the same period of the previous year. Reserves grew by €2,720 million, which is a decline by €78 million (or 8.9%) yoy. However, one of the reasons for this decline is the base effect. In January-September, the base of comparison was high due to an unusually large increase in reserves in September 2007 - €1,340 million.



### Other Developments and Reforms Affecting the Investment Climate

On November 27th, the Bulgarian National Bank (BNB) lowered mandatory reserve requirements on all resources attracted by banks to 10% from 12%. This decision came into force on December 1st, 2008. Furthermore, on January 1st, 2009, the reserve requirements on funds from abroad will go down to 5% from the present 10%. In addition, after that day, the banks will not be required to form reserves on resources from central and local budgets.

These measures are aimed at stimulation of credit expansion, which is expected to have a favorable impact on economic activity in the country. During the last several months, credit growth has been gradually decelerating, mainly because of a lower inflow of funds from abroad on the back of global financial problems.



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