

Macroeconomic Situation

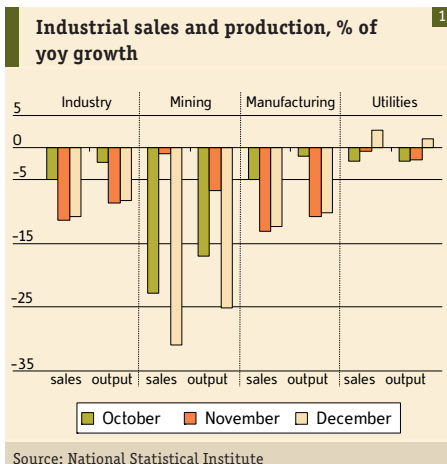
Edilberto Segura, Hanna Cherednychenko

Summary

- In December, industrial sales plunged by 10.8% yoy and industrial production dropped by 8.3% yoy.
- According to estimates, GDP growth was 3.6% yoy in the fourth quarter and 6% in 2008.
- In 2008, the consolidated budget surplus stood at 3% of estimated GDP.
- Consumer prices grew by 7.8% yoy and producer prices declined by 1% yoy in 2008.
- In 2008, the current account deficit stood at 24.5% of GDP, with the trade deficit reaching 26.1% of GDP.
- In February, Standard & Poor's worsened the risk assessment for the Bulgarian banking system.

Economic Growth

At the end of 2008, the situation in the industrial sector deteriorated. In November, industrial sales declined by 11.5% yoy and industrial production shrank by 8.8% yoy, which was much worse than in October (when a decline in industry was observed for the first time in 2008). In November, the deepening of the decline occurred mostly as a result of sharply worsening dynamics in manufacturing, while negative growth in mining became more moderate. In contrast, in December, improvements were observed in manufacturing, while dynamics of mining deteriorated rapidly. However, on the whole, performance of industry did not change much in December compared to November - sales decreased by 10.8% yoy and production dropped by 8.3% yoy.

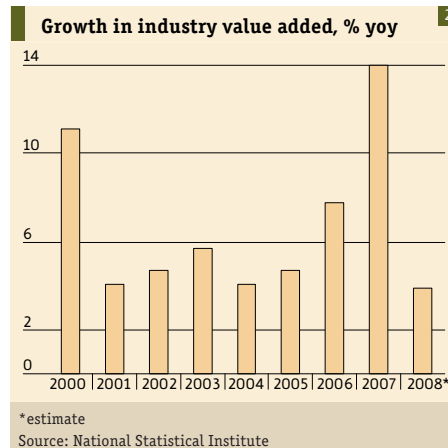


Both in November and December, metallurgy was among the worst performing sectors. Output in mining of metal ores, after declining by a third in November yoy (which was better though than by half yoy in October), dropped by almost two thirds yoy in December. Manu-

facture of basic metals also showed poor results, declining by 10.8% yoy in November and 16.6% yoy in December. On a positive note, manufacture of fabricated metal products increased by 7.2% yoy in December, although it fell by 16.2% yoy in November.

In machine building, the drop was significant in November, but the situation improved in December. Such was the case in manufacture of office machinery, electrical machinery, radio, television and communication equipment, and medical, precision and optical equipment. However, in most of these sectors, growth was still negative in December.

A stable situation was observed in the food industry, which demonstrated moderate positive growth throughout all of the fourth quarter of 2008. Its output increased by 4.8%, 3.5% and 4.6% yoy in October, November and December. This stability is explained by the fact that food products are a necessity and, as a consequence, demand for them remains relatively stable even when incomes slow down.



According to preliminary estimates, GDP increased by 3.6% yoy in the fourth quarter, decelerating from 6.8% yoy in the third quarter. Final consumption increased by 2.8% yoy, and its major component, individual consumption, rose by 3.9% (compared to 5.4% yoy and 5.9% yoy in the previous quarter). Furthermore, investment into fixed capital grew by 9.7% yoy, down from 22.7% yoy in the third quarter. Regarding external trade, both exports and imports shrank in real terms - by 6.8% yoy and 3.7% yoy. Though dynamics of both became negative, the trend of imports outpacing exports remained in place (in the third quarter, exports and imports grew by 3.8% yoy and 4.2% yoy). By economic sector, there also was significant deceleration in each. In services and agriculture, the pace of growth shrank in half - to 3.2% yoy and

20.6% yoy (from 6.4% yoy and 44.3% yoy), and in industry value added decreased by 0.1% yoy, compared to growth of 2.1% yoy in the third quarter. While deceleration in agriculture is connected mostly with seasonal factors, worsening dynamics of services and industry suggests that business activity indeed became sluggish, which happened as a result of decelerating internal and external demand, more expensive credit resources and decreasing business confidence.

In 2008, GDP grew by 6% yoy according to preliminary estimates. Final consumption and gross capital formation rose by 4.1% yoy and 13.1% yoy (in particular, individual consumption and investment into fixed capital increased by 4.9% yoy and 18.4% yoy). Exports expanded by 2.8% yoy, lagging behind imports, which grew by 4.8% yoy. By economic activity, value added in agriculture increased most - by 23.4% yoy, then services, where it grew by 5.7% yoy, and the slowest, though still significant, growth was observed in industry, where value added grew by 3.9% yoy.

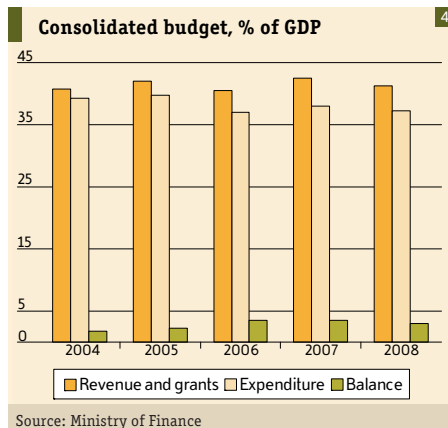


Fiscal Policy

In 2008, consolidated budget revenues increased by 13.5% yoy and totaled Lev 27.3 billion, while expenditures rose by 14.4% and amounted to Lev 24.6 billion. Bulgaria's contribution to the EU budget was Lev 0.7 billion. As a result, the consolidated budget surplus was Lev 2 billion (3% of estimated GDP), just 1.9% higher than in the previous year (when it stood at 3.5% of GDP). Regarding the structure of the consolidated budget, 96.5% of its revenues and 97% of expenditures were those of the national budget and the remaining 3.5% and 3% were EU funds. The national budget was in surplus of Lev 1.4 billion, and the balance of EU funds was Lev 0.6 billion (which equals the Lev 2 billion surplus of the consolidated budget).

Macroeconomic Situation

In the structure of the national budget the major components were the republican budget - 70.8% by revenue and 38.4% by expenditure, social security funds - 20.7% and 34.2% respectively, and municipal budgets - 6.8% and 20.8% respectively. Social security funds and municipal budgets, whose revenues were much lower than expenditures, were the major receivers of transfers. They got Lev 2.8 billion (a 31% yoy increase) and 3.1 billion (24.3% yoy growth) of transfers, mostly from the republican budget.



The republican budget surplus stood at Lev 1.6 billion, which is substantially higher than anticipated (by more than a quarter). Revenues were over-executed by 1.8%. This became possible thanks to the much better than predicted performance of non-tax revenues, mainly that of entrepreneurial and property income. At the same time, tax revenues were 3.7% lower than expected. Receipts from VAT, profit and income taxes turned out to be lower than forecasted by 8.9%, 3.7% and 9.3%. This was a consequence of a worse than predicted situation in the real sector in 2008, especially in the second half of the year. In fact, the cumulative dynamics of income tax revenue was unsatisfactory already in May, and underperformance of receipts from VAT and profit taxes was observed since August and October respectively. On a positive note, in 2008, excise revenues were over-executed by 6.7%, which partially compensated for the under-execution of the other major tax revenues.

Expenditures and transfers were under-executed by 0.4%. The level of execution of expenditures was 90.9%. Among the main expenditure items, only capital expenditures met plan, while spending for wages and salaries was 3% lower and for maintenance 8% lower than projected. Notably, almost half of 2008 capital expenditures and a quarter of

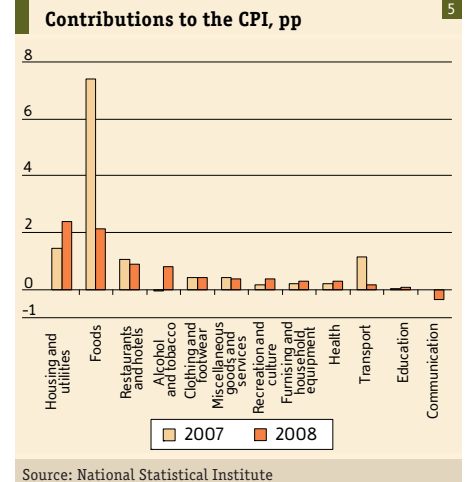
spending for maintenance were made in December. A large share of investment spending at the end of the year was due to the intent not to expose to risk the execution of current expenditures during the year. Transfers were executed by 113.7%. Their over-execution was mostly due to larger than projected (by 43.9%) transfers to municipalities, while transfers to Social Security Funds were lower than planned by 3.7%.

Monetary Policy

In 2008, the consumer price index (CPI) rose by 7.8% yoy, decelerating from 12.5% yoy in 2007. This improvement was mostly due to much lower food inflation in 2008 than in 2007. In 2008, food prices rose by only 6% yoy compared to 21.1% yoy in 2007 (and made a contribution of 2.1 pp to the CPI down from 7.4 pp in 2007). In addition, catering prices did not grow as rapidly in 2008 as in 2007, increasing by 10.2% yoy in contrast to 19.3% yoy a year before. The deceleration became possible due to moderating food prices. At the same time, price growth in this sector was still substantial due to rapidly increasing labor costs as a result of a tight labor market for most of 2008.

However, in some groups of consumer goods and services prices grew faster in 2008 than in 2007. In particular, costs of utility services increased by 15.5% yoy up from 8.2% yoy in 2007 (and their contribution to consumer inflation rose to 2.4 pp from 1.4 pp). Also, prices accelerated significantly in recreation and culture (to 13.9% yoy from 4.2% yoy) and in education (to 18% yoy from 10.3% yoy), which was caused mainly by rising labor costs.

In 2008, deflation was observed only in communication services. There, prices fell by 6% yoy, much more substantially than in 2007, when they dropped by 0.5% yoy. In fact, communication prices, affected by intensifying competition in the sector, were on a declining path since February, decreasing by 0.1-0.4% mom for most of the year. However, the most significant drop (5.2% yoy) occurred in November, which must have been a reaction to worsening consumer confidence.



In 2008, producer prices declined by 1% yoy. This was a result of deflation during the last five months of the year, especially the last two months, after significant price increases in the first half of the year (in July, producer prices peaked at 13.1% ytd). Following moderate price decreases in August, September and October (by 0.1%, 0.4% and 0.9% mom respectively) prices dropped by 3.2% mom in November and 5.8% mom in December.

In fact, while prices were still growing in most industries in November (and deflation occurred mainly due to significant price drops in two industries - mining of metal ores and manufacture of basic metals), deflation became universal for industry in December. In that month, producer prices increased only in one mining sector (other mining and quarrying), two manufacturing sectors (manufacture of apparel and production of building materials) and also in electricity, water and gas supply, where prices are regulated.

However, in 2008 on the whole, prices became higher in most industries, and deflation occurred only due to a decrease in metal ore prices by 18.7% yoy, manufacture of basic metals by 14.9% yoy and manufacture of electrical machinery and apparatus by 3.2% yoy. In the rest of the industries prices went up, with the highest rates of inflation observed in mining of coal and lignite, energy and utilities sector, other mining and quarrying, manufacture of office machinery, manufacture of building materials, and manufacture of fabricated metal products.

International Trade and Capital

In December, the current account improved compared to the same month of 2007, for the first time during the year (although it re-

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Where Opportunities Emerge.

Sofia Office, Bulgaria

10, Dimitar Manov Str., 5th floor,
Sofia, 1408
Tel: (359-2) 953 15 85 Fax: (359-2) 953 19 89
E-mail: office@bg.sigmableyzer.com

mained negative). This happened mainly due to a significant shrinking of the trade deficit. Due to a decrease in imports (by €333 million yoy, or 17.3% yoy) that exceeded the drop in exports (by €164 million yoy, or 14.8% yoy), the trade deficit became smaller by €169 million yoy. Actually, December was the second consecutive month when improvements in the trade balance were observed. In November, the trade deficit became smaller as well, but only by €43 million yoy, as imports fell less (by €235 million, or 11.4% yoy) and exports went down more (by €192 million, or 15.1% yoy) than in December. The other components of the current account also showed a better performance in December than in November. Net services increased by €31 million yoy (compared to €25.9 million in November) and net income and current transfers decreased by only €27 and €36 million (compared to €110 and €55 million). All this made possible an improvement in the current account balance in December (by €138 million yoy), in contrast to November, when the current account worsened because of significantly worsening net income and transfers.

However, in December, the financial account was in deficit (of €579 million), for the first time in more than four years. The deficit was caused mainly by outflows of currency and deposits, both on the asset and liabilities sides (by €774 million in total), which means that there was a combination of a decrease in foreigners' deposits in Bulgaria, an increase in Bulgarians' deposits abroad and an increase in the demand for foreign currency in cash in the country. As a result, the sum of current, capital and financial accounts was minus €1,359 billion, and the decrease in reserves was €1,560 billion in December. Such a decrease in reserves was almost as large as the total increase in reserves during the first eleven months, when reserves became larger by €2,235 million (though during this period there were some months when the increase in reserves was also negative).

In 2008 on the whole, the current account deficit amounted to €8,278 million (24.5% of estimated 2008 GDP). The trade deficit was €8,832 million (26.1% of GDP), and the income balance was in deficit of €1,097 million, while services and net transfers were in sur-

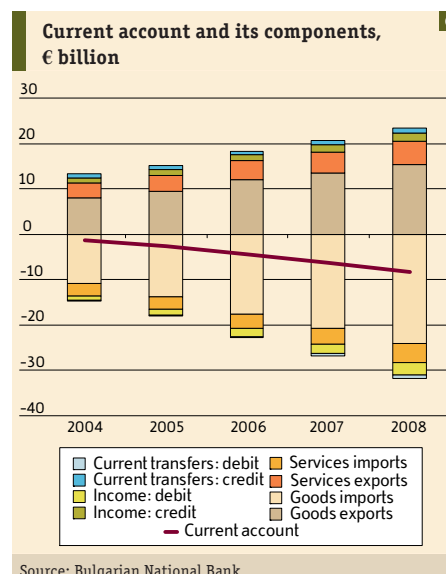
plus of €1,143 and €508 million. Compared to 2007, the current account deficit increased by €1,975 million (31.3% yoy) due to a rise in the trade deficit by €1,530 million (21% yoy) and expansion of the negative income balance by €645 million (or by almost two and a half times yoy). Net services and current transfers improved, but only by €28.2 million (2.5% yoy) and €172 million (51% yoy), thus compensating for only a tiny share of the worsening in trade and income balances. The financial account totaled €10,176 million in 2008, shrinking by €451 million (4.2% yoy) compared to 2007. In particular, foreign direct investments in Bulgaria stood at €5,430 million (subject to revisions), which covers only 66% of the current account deficit. The sum of current, capital and financial accounts was €2,505 million, and reserves increased by €2,490 million, slightly less (by €79 million) than in 2007.

risks in the country. The agency is especially concerned about Bulgaria's high external vulnerabilities, as large current account deficits under tight capital markets may lead to a sharp decrease in external financing. Furthermore, according to S&P, rapid loan growth during the last few years and a surge in real estate prices mean that in an economic slowdown, the banks' credit risk is likely to be high.

On a positive note, the agency believes that Bulgaria's banking system benefits from a high share of foreign ownership and high management standards brought by parent institutions. However, S&P notes that there still exists a risk that parent banks will be reluctant to give much support to their subsidiaries because of the continuing unfavorable market environment.

Furthermore, on February 17th, Moody's issued a report where it discusses the issue of support of West European banks to their Eastern European subsidiaries. According to the agency, the worsening economic situation in East European countries exerts negative pressure on Western banks' subsidiaries in these countries and, consequently, may lead to a decrease in parent banks' ratings. This, in turn, may cause increased selectivity in the support of Western Banks for their subsidiaries, with country risks being one of the main criteria for selecting candidates to receive additional capital. Thus, high-risk countries may suffer, and Bulgaria is one of them. According to Moody's, Bulgaria (along with Hungary, Croatia, Romania and Baltic counties) belongs to the most externally vulnerable countries among East European countries with investment grades.

In the middle of January, Moody's changed the outlook on the Bulgarian banking system to negative from stable. The reasons for this were the expectation of economic growth deceleration (mainly due to the forecasted lower levels of FDI), which would lead to deterioration of customer' financial state and subsequent problems with serving their debts, and financial difficulties faced by parent banks, which would have a negative impact on the amount and cost of additional capital provided to the subsidiaries.



Other Developments and Reforms Affecting the Investment Climate

On February 11th, Standard & Poor's (S&P) revised the Banking Industry Country Risk Assessment (BICRA) on Bulgaria to a higher risk Group 7 from Group 6 (on a 10 group scale). This occurred due to rising economic

Headquarters

123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA

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