BUSINESS SURVEY SERIES

THE BULGARIAN ECONOMY IN 2004

annual report

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CONTENTS

EXECUTIVE SUMMARY

2004 sustained the strong economic growth of the past few years. GDP stepped up as high as 5.6%, hitting a 14-year record high, whereas employment rose by 2.2%. As a result of the labour market upswing, the participation rate in the economy went up to 49.7%. The average 2004 unemployment rate decreased by 1.7 percentage points on a year earlier. In addition, Q3 unemployment plunged to 11% of the working population, reaching a trough ever since the NSI started conducting labour force surveys.

Growth in the economy was mainly demand-driven. The contribution of total exports to GDP ran at 7 percentage points. On the other hand, consumption enjoying the largest share within GDP by component of final use slowed down from 6.6% in 2003 to 5% in 2005, retaining its high growth rate, though. The above development was mainly due to the robust consumer credit growth, rising employment and real household income.

Gross fixed capital formation reported a 12% year-on-year rise, posting a 2.3 percentage point contribution to GDP growth. Unlike preceding years, the bulk of 2004 investment was now due to national savings, triggered by and large by current transfers from abroad. Furthermore, the last few years have witnessed larger investment injections in energy power and water generation, tourism, trade, machine building, communications, transport and manufacture of vehicles.

On the demand side, all sectors of the economy made a positive contribution to the country's GDP, with *services* (6%) again in the lead, followed by the manufacturing industries (5.3%). Following the 2003 decline, agricultural growth advanced by 2.2%.

End-of-2004 consumer price inflation ran some 4% higher than in 2003, whereas average annual inflation amounted to 6.1%. The major factors at work behind the CPI dynamics had to do with the year-on-year increase in administered and food prices. Though partially offset by the lost USD's ground to the EUR, the higher crude oil prices put an upward pressure on local consumer prices.

In the last three years, average annual inflation in Bulgaria has run well above inflation in the EU-15 (2.8 percentage points up on average), moving up by some 4.1 percentage points in 2004 alone. The real appreciation of the BGN to the EUR, deflated by the CPI, was not due to tradables but to non-tradables (services) and administered prices, and was not indicative of any loss of competitiveness.

Competitiveness can also be examined by way of direct comparison between the real rise in average wages and productivity. In 2004 real wage growth (3.9%) outstripped productivity (3.1%). However, in the manufacturing sector and with some tradable services - financial intermediation, transport and communications - real wage growth lagged behind productivity.

The end-of-2004 government debt/GDP ratio amounted to 40.9%, or some 7.4 percentage points down on a year earlier. The above decrease was spurred by the nominal-term GDP growth, depreciation of the USD to the single European currency and sizable budget savings made in the year, which the government mobilized to exercise its call option to buy back some USD 774.4 million worth of DISCs at their face value (releasing a security to the total amount of USD 293 million). As a result, the country's foreign debt went down in both USD and BGN terms by 3.5 and 10.5% respectively.

2004 sustained the upward trend in money supply. Broad money reported a year-on-year nominal-term increase of 23.1%, implying that remonetisation in the economy was well underway. As of the year's end, the M3/GDP ratio reached 53.7% vs. 48.1% in 2003. Money supply stepped up mainly due to the robust net domestic assets of the banking system (33.2% up). Domestic credit - the most important component of net domestic assets, rose by 34.3% despite the drastic decline in claims on the government sector. The restrictive measures of the Central Bank failed to produce the effect desired and private-sector credit stepped further up by 48.7% to 37.1% of GDP, with loan maturity going on a steady increase.

Stronger bank lending and the boosted investment activity were the key factors at work shaping the dynamics of the balance of payments dynamics. According to preliminary BNB data, the 2004 current account deficit amounted to MEUR 1447.1 or 7.4% of GDP due mostly to the ever-deteriorating trade deficit of MEUR 2718 (14% of GDP).

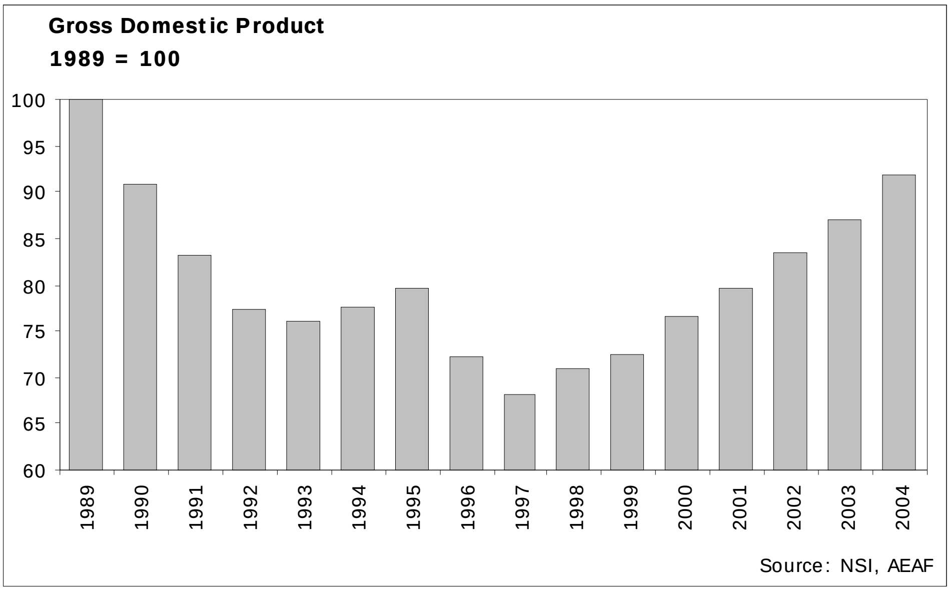
2004 saw a significant rise in the country's foreign trade turnover. Exports (FOB) stepped up by 19.9%, whereas imports (FOB) reported an even stronger increase of 20.8%. The high prices in the international markets and growth-conducive foreign demand boosted not only exports but imports as well, satisfying the vigorous demand of the export-oriented industries for raw materials.

Net revenue from services and current transfers made up for half of the 2004 trade deficit. Net revenue from services amounted to MEUR 723.5 (or MEUR 200.3 on a year earlier), with this growth being mostly due to the robust rise in revenue from tourism of 20%. At the same time, net current transfers ran as high as MEUR 888.1, producing a most tangible healthy effect on the current account balance due to the sizable rise in private transfers.

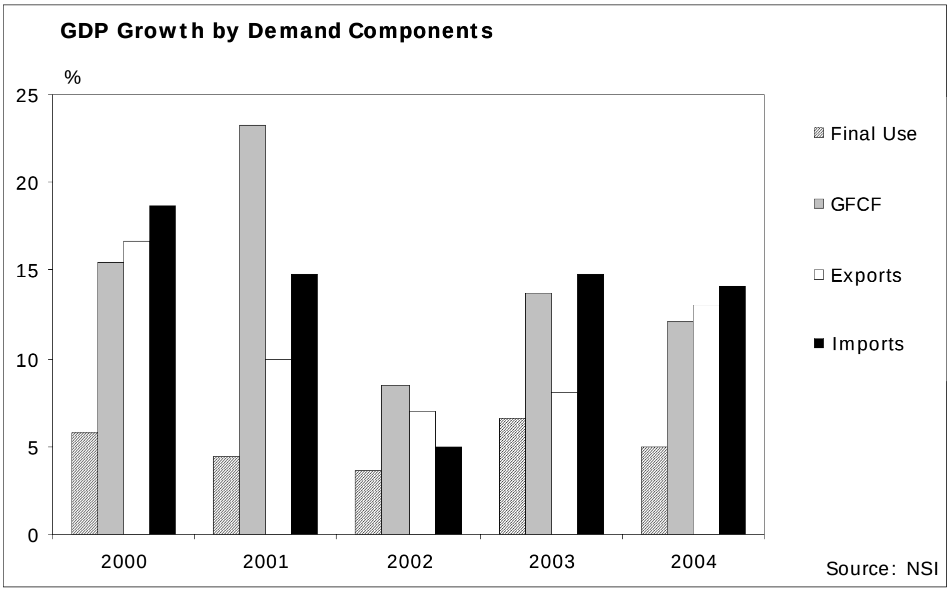
On a year earlier, financial inflows went on the increase in volume terms. As a result, the financial account ran a MEUR 2707.5 worth of a surplus, covering fully the current account deficit. The bulk of last year's inflows had to do with the rising non-financial sector credit from abroad and deposits of non-residents with the local commercial banks, as prompted by the lower foreign interest rates. In 2004 FDIs incorporated a new sub-item, i.e. *mergers and acquisitions*, accounting for the Mobitel transaction. The latter (-MEUR 649.5), however, excluded, net FDIs into the country amounted to MEUR 1939.5, running some 1.5 times higher than the current account deficit. Revenues from privatization in the same year totalled MEUR 936.3, including receipts from the sale of the Bulgarian Telecom and some electricity supply companies in December. FDIs, other than from privatization, were estimated at MEUR 1177.9.

GROSS DOMESTIC PRODUCT

The Bulgarian economy has grown for a seventh year in a row. Since 2000 growth has been running at about 4%-5.5% and well above growth in the □-□15 by around 2   3 percentage points. Having stepped up by 5.6% in volume terms, 2004 GDP amounted to BGN 38 billion at current prices, hitting a record high since the onset of the transition but failing to set back at its 1989 level. However, AEAF expectations are that this is to take place in 2006. The share of the private sector in value added went up by 3 percentage points to 76.5%.

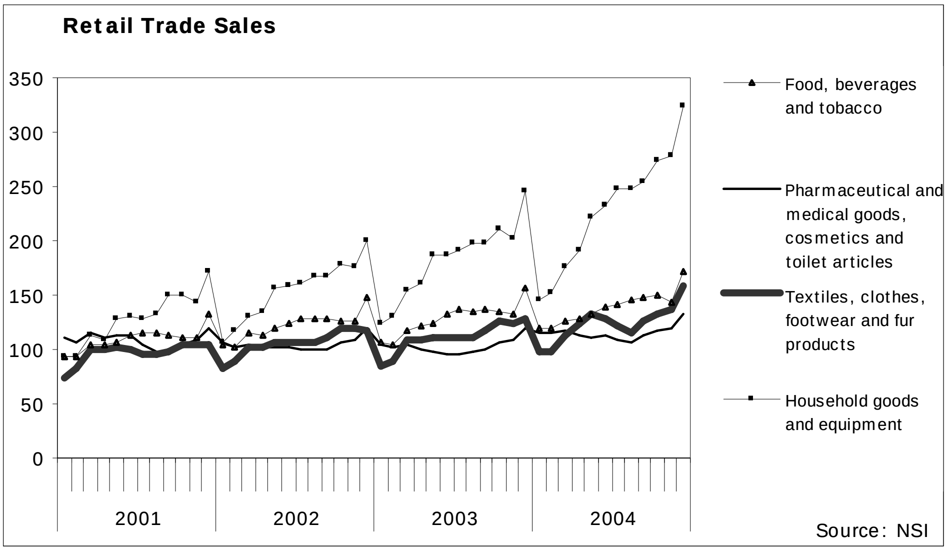


Growth in 2004 was essentially demand-driven. Exports posted a 7 percentage point contribution to GDP but failed again to make up for the stronger imports despite the improving export performance of the past three years. All this resulted in a negative external sectors contribution to economic growth of 1.9 percentage points.



Consumption, enjoying the largest relative share within GDP by component of final use, slowed down to 5% from 6.6% on a year earlier. Both private (5.4% in 2004 vs. 6.4% in 2003) and public consumption (3.5% vs. 7.6% on a year earlier) reported a slower growth rate. At the same time, a key factor boosting consumption in the same year had to do with the robust increase in consumer credit (59.9%). The share of consumer loans in final household spending stepped up to 10.4% from 7% of total consumer expenditures in 2003. Consumption growth was also reinforced by the rising employment and real household income. However, it should be noted that real wage growth (3.9%) lagged behind GDP, bringing about a lesser increase in individual consumption.

2004 sustained the upward trend in the countrys welfare, as evidenced by the structure of consumption by commodity group. Over the last few years food consumption has been growing at a slower rate vis-à-vis non-food consumption. As a result, the share of the former stepped down to 13.8% in 2004 (vs. 15.9% in 1998[1]), whereas the latter's weight advanced to 18.1% of GDP (13% in 1998). In 2004, the share of food consumption in GDP went up by 0.2 percentage points on a year earlier, with the increase being fully offset by the 0.6 percentage point decrease in self-sufficiency, showing a deeper penetration of market relations. According to household budget data, the share of *other money expenditures* posted the highest rise (from 8.5% in 2003 to 10% of the money expenditure total), including capital expenditures[2] on education and tuition, etc. The above trend was further supported by retail trade data, which indicate that food sales, beverages and tobacco products including, reported the slowest growth rate of 7.5%, whereas the other three commodity groups grew by over 10% (retail sales of household and home appliances stepped up most vigorously by 22.3%).



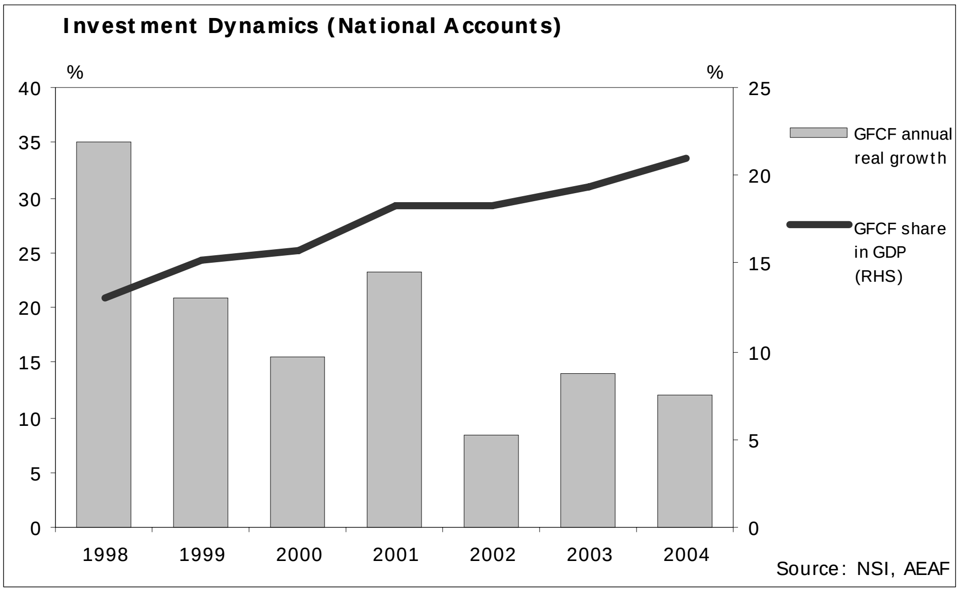
The year-on-year decrease in public consumption was triggered by the restrictive budget policies, bringing about a certain decline in the contribution of final consumer spending of the government to GDP (0.1 percentage point vs. 1.1 in 2003). At the same time, collective consumption went on the increase as a result of the higher expenditures on education and defence, which were and still are major concerns on the government agenda.

Gross fixed capital formation went up by 12% on a year earlier and made a 2.3 percentage point contribution to GDP growth. Unlike the preceding years, the bulk of 2004 investment was now covered by national savings, which stepped up mainly as a result of current transfers from abroad.

2004 data on acquisitions of fixed tangible assets by sector of the economy have not been made available yet. However, the information referring to the public sector alone, together with the FDI statistics and findings of the NSI investment surveys in the manufacturing sector show that the largest amounts of last years investments were made in electricity and heating, gaseous fuel and water generation and supply, transport and communications. At the same time, agri-food investments reported a year-on-year decrease. In addition, the growth slowdown in food, textile and clothing exports taken into account, there can be said to be in the economy a steady shift from the labour-intensive to the capital-intensive industries. However, the expectations

[1] *1998 was the first post-crisis year to see some economic growth.*
[2] *Purchase or housing construction.*

for a sizable inflow of FDIs into Bulgaria are mainly based on the global tendency towards outsourcing in countries where production costs are low, which together with the countrys accession to the EU, may ensure foreign direct investments to the total amount of some EU 1.5 - 2 billion.



Overall in the past few years, investments have reported a remarkable increase in the following industries: energy and water generation, tourism, trade, machine building, transport and vehicles. According to the NSI investment activity survey of 2004, investment in the manufacturing sector was mainly aimed at replacing worn-out equipment or the mechanization and automatisation of the manufacturing process or bringing in new technologies. The intentions of most entrepreneurs are to sustain the robust investment growth of the preceding years and make the best of it in supplying new equipment and expanding the production base. Moreover, they expect that the higher demand for their produce is to eventually result in higher capacity utilization.

Services

All sectors of the economy made a positive contribution to GDP growth in 2004, with services and the manufacturing industries in the lead with 6 and 5.3% respectively. Following the 2003 decline, agriculture rebounded, posting a 2.2% growth rate.

Ever since the institution of the currency board arrangement in Bulgaria, the service sector has been a major engine of growth in the economy, stepping up most robustly by 37%, given a six-year growth in GDP of 35%. The ever-rising contribution of services to the countrys business activity has been pre-determined by the following factors at work: in the first place, this was the stable growth in real household income, which has led to a relatively faster increase in the demand for services and hence consumption vis-□-vis food demand, for example. On the other hand, the sectors expansion was mostly due to the growing use of specialist services on the part of producers. For example, more and more enterprises happen to use the services of outside accounting or marketing companies rather doing the job internally.

Furthermore, services are essentially non-tradables and therefore face little competitive pressure on the part of foreign companies. At the same time, communications, financial intermediation and transport excluded, local services tend to be labour-intensive rather capital-intensive, resulting in a low sectors productivity (trade in particular). However, trade has been rapidly growing in the past couple of years due to the huge foreign investment injections having to do with the local market penetration of large chains of shops and supermarkets.

Tourism was another sector posting a most healthy gain in 2004 and making a significant contribution not only to value added growth but to curtailing the current account deficit as well. According to 2004 balance of payments statistics, revenue from tourism totalled BGN 1.746 billion, going up some 20% in nominal terms on a year earlier. At the same time, the statistical office reported that the number of foreign tourists to Bulgaria rose by 12%, with the majority of them coming, as a rule, from the neighbouring countries as well as Germany. Though rather slowly, Bulgaria has been attracting more and more well-to-do holiday makers as a first-choice destination. Based on the strong growth potential, the expectations are that the next couple of years will sustain the sizable investment amounts in the sector and boost economic growth.

The development of tourism is intimately related to the performance of another sector, i.e. transport. The keen investor interest in the concession of Varna and Bourgas airports was indicative of the fact that the government was able to attract significant investment amounts to the sector by way of public-private partnership. According to data of the Transport Ministry, the concessionaire, Copenhagen Airports, will inject some MEUR 526 worth of investment to improve the operation of the facilities. In addition, 2005 is expected to see a number of developments, having to do not only with the airport concessions and construction of the Trakia Motorway but also with the changeover of ownership of Bulgarian River Navigation and Bulgarian Maritime Navigation.

Communications and financial intermediation have been the service industries reporting the most robust performance in the past few years. The licence of the third GSM operator granted to the national telecom, the appearance of new players in the fixed phone lines market as well as the tender for the licence of a third-generation mobile phone operator, awarded to MobilTel, are expected to further boost competition in the sector and eventually bring about a certain price drop in the services rendered. At the same time, the privatization of BTC by public offering of the 35% residual state-run share on the stock exchange was crucial not only to the operations of the countrys telecom but the development of the Bulgarian capital market.

Overall, the business climate in the service sector improved significantly. The NSI business surveys in retail trade and some other service industries indicate that the expectations of the entrepreneurs for the following six months improved on a year earlier due mainly the adequate legal business framework and better competitive position of the companies.

Manufacturing Sector

Value added growth in 2004 amounted to 5.3%, with the share of intermediate consumption in gross output reporting a certain rise from 69.5% in 2003 to 71.2% in 2004 (the rise being most pronounced in electricity, gas and water generation and supply). Most probably, the high crude oil prices contributed to the slower increase in value added vis-□-vis gross output, as the oil price rise had not been passed onto end-users but taken fully upon by the producers and distributors instead. All this was indicative of a certain pressure on the expenditure side and difficulties in passing the higher prices of raw materials onto consumers. At the same time, construction was the only industry where the share of gross value added in gross output stepped up. The robust demand for housing and office buildings resulted in a fast increase in real estate prices and made it possible for the producers to retain their strong pricing power.

One of the factors fostering the development of the local manufacturing sector had to do with the growth-conducive business situation in the metal markets worldwide, vigorous demand and rising prices in particular. The robust and stable economic growth in China and the USA provided a solid ground for the above trend,

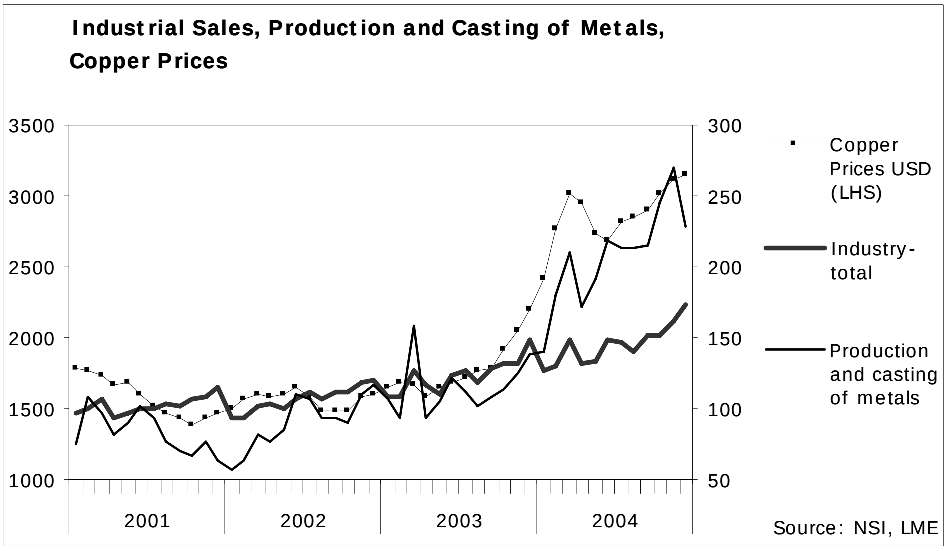
2004 Sales (y/y)

	Real-term change (%)	
Sectors Reporting a Significant Positive Contribution to Sales Growth	**Total**	**Export Sales**
Metal production and casting	86.5	109.1
Food and beverages	15.1	35.0
Machinery, equipment and household appliances	32.9	44.7
Metal products, machinery and equipment excluded	44.6	80.2
Products of other non-metal mineral raw material	24.2	3.0
Sectors Reporting a Significant Negative Contribution to Sales Growth		
Radio, TV and telecommunications equipment	-21.5	72.7
Printing and publishing, TV and audio recording, CD writing	-2.2	91.1

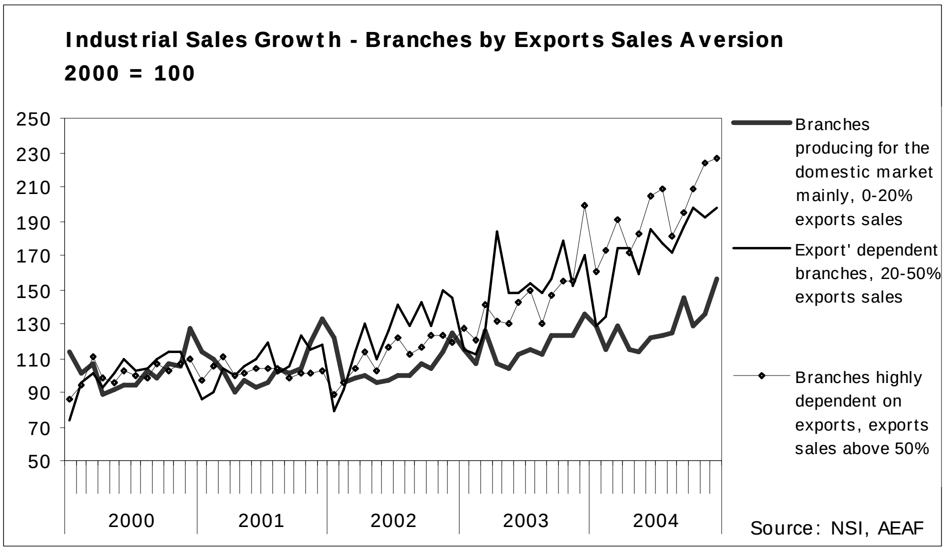
	Real-term change (%)	
Highest Contribution to Exports' Sales Growth	**Total**	**Export Sales**
Metal production and casting	86.5	109.1
Machinery, equipment and household appliances	32.9	44.7
Food and beverages	15.1	35.0
Tobacco products	22.6	93.1
Metal products, machinery and equipment excluded	44.6	80.2
Clothing, leatherwear included; skin dressing	12.7	15.9
Textiles and products thereof, clothing excluded	23.6	25.2
Metal ore mining	26.1	71.9

	Real-term change (%)	
Highest Contribution to Domestic Sales Growth	**Total**	**Domestic sales**
Food and beverages	15.1	9.9
Products of other non-metal mineral raw material	24.2	36.5
Machinery, equipment and household appliances	32.9	17.9
Metal products, machinery and equipment excluded	44.6	28.3
Metal production and casting	86.5	16.3
Mining of non-metal materials	36.7	45.9

Source: NSI, AEAF



which was further enhanced by the strong performance of the automobile industry and construction in the OECD countries. Metal production and casting posted the most significant contribution not only to the sales total but export sales as well, accounting for 19.5% of the countrys exports (vs. 16.1% on a year earlier). Furthermore, the terms of



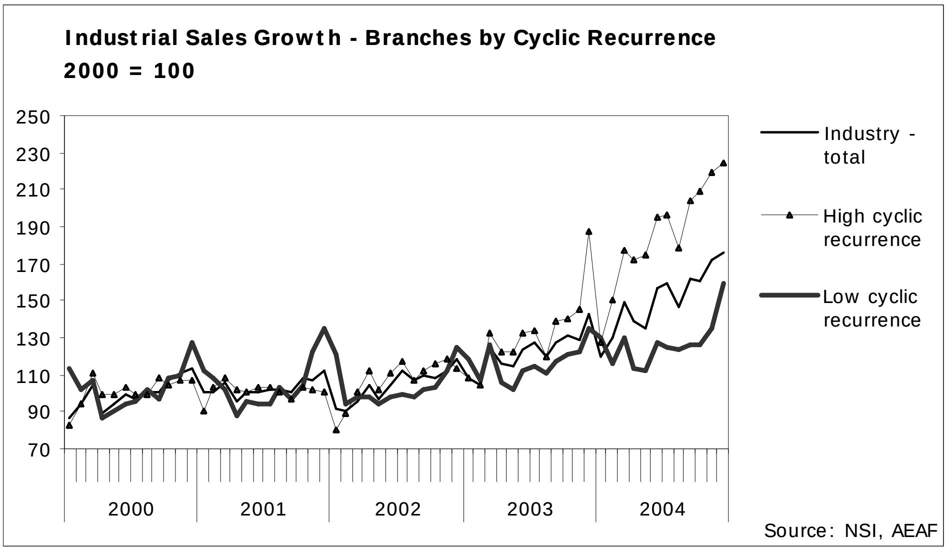
Branches producing for the domestic market mainly, 0-20% exports sales
Mining of coal and lignite; extraction of peat
Mining of non-metal materials
Manufacture of food products and beverages
Publishing, printing and reproduction of recorded media
Electricity, gas, steam and hot water supply
Collection, purification and distribution of water
Export' dependent branches, 20-50% exports sales
Mining of metal ores
Manufacture of tobacco products
Manufacture of pulp, paper and paper products
Manufacture of rubber and plastic products
Manufacture of other non-metallic mineral products
Manufacture of fabricated metal products, except machinery and equipment
Manufacture of office machinery and computers
Manufacture of radio, television and communication equipment and apparatus
Manufacture of medical, precision and optical instruments, watches and clocks
Manufacture of motor vehicles, trailers and semi-trailers
Branches highly dependent on exports, exports sales above 50%
Manufacture of textiles
Manufacture of wearing apparel; dressing and dyeing of fur
Tanning and dressing of leather; manufacture of luggage, handbags, saddlery, harness and footwear
Manufacture of wood and of products of wood and cork, except furniture
Manufacture of chemicals and chemical products
Manufacture of basic metals
Manufacture of machinery and equipment n.e.c.
Manufacture of machinery and equipment n.e.c.
Manufacture of motor vehicles, automobiles excluded
Manufacture of furniture; manufacturing n.e.c.

trade in the industry improved, with the import prices of steel and cast iron lagging behind export prices by some 7.8 percentage points. As for precious metals, export prices reported an even stronger increase vis-à-vis import prices of 21.9 points.

2004 growth in the manufacturing sector was mainly demand-driven. The highest year-on-year sales growth was reported by the export-oriented industries, which posted a 41% rise in sales vs. only 16% of the other two groups of industries.

Another factor boosting growth in the manufacturing sector had to do with the expansionist policies of the Central European Bank (ECB), which maintained interest rather low in a historical perspective, affecting the domestic bank interest rates. At the same time, the BGNs exchange rate peg, declining risk premium and still large credit interest rate spread between the Euro area and Bulgaria encouraged Bulgarian banks to borrow more and more funds from the EU and re-channel them to the local market. The eased credit access, decreasing interest and upbeat expectations as to the performance of the Bulgarian economy fostered the consumption of durables, and hence production meeting local demands. As a result, all construction related industries like the *manufacture of other non-metal mineral raw material*, *metal products, machinery and equipment excluded*, and *non-metal raw material extraction* posted the most robust sales growth in the domestic market.

The stronger performance of the export-oriented industries was due to the fact that most of them are capital-intensive and rely heavily on the interest dynamics worldwide. In addition, demand is strongly cyclical in pattern. However, the local industries manifesting a distinctly low cyclical behaviour, have to do with public utilities and the manufacture of fast- moving goods. All of them rely on secure markets and face little foreign competition. Therefore, they cannot take any advantage of the current favourable business situation. The historically low EU interest gave a strong push to all the manufacturing industries, producing investment goods (construction including), as well as consumer durables. The local industries and metallurgy followed suit reporting relatively high growth rates in 2004.



Low cyclic recurrence branches
Mining of coal and lignite; extraction of peat
Manufacture of food products and beverages
Electricity, gas, steam and hot water supply
Collection, purification and distribution of water
Manufacture of tobacco products
High cyclic recurrence branches
Mining of non-metal materials
Mining of metal ores
Manufacture of other non-metallic mineral products
Manufacture of fabricated metal products, except machinery and equipment
Manufacture of chemicals and chemical products
Manufacture of basic metals
Manufacture of machinery and equipment n.e.c.
Manufacture of electrical machinery and apparatus n.e.c.
Manufacture of motor vehicles, automobiles excluded
Manufacture of furniture; manufacturing n.e.c.

2004 witnessed the beginning of some downturn trends in the Bulgarian manufacturing sector. Growth in the clothing industry slowed down, even reporting a year-on-year decline in the last months of 2004. The increased labour costs having to do with the higher average wages in the industry as well as the stronger competition on the part of some Asian manufacturers on markets where local producers were well placed has led to a certain loss in competitiveness. As a result, clothing and footwear exports contracted to 18.9% of total exports vs. 21.9% on a year earlier.

Agriculture

According to preliminary data of the NSI national accounts, value added in agriculture stepped up by 2.2% in volume terms. However, any follow-up GDP statistics are to be revised upwards, as the sectors growth, according to the economic account data, amounted to 14%[3]. Agricultural growth was mainly boosted by grain production, which rose by a robust 53.6% in real terms. All cereals posted a most remarkable growth rate as followed: barley (124.9%), wheat (97.7%), oats (96.9%) and maize (82.8%). The year-on-year increase in grain production led to lower food prices and hence a lesser contribution of the items to annual inflation. Furthermore, as a result of the higher cereal prices in 2003, the areas under crops stepped up, with the areas under wheat reporting a 15.5% rise[4] on a year earlier. In addition, production also rebounded due to the higher yields reported. Average 2004 cereal yields ran the highest over the past four years. Wheat yields

[3] *The analysis draws upon the economic account data in the agricultural sector, released by the NSI for the first time. Any discrepancy with the national account statistics have to do not only with some differences in the methodology used, but differences in the samples as well.*

[4] *„Crop Yields 2004 Harvest", MAF, Agri-statistics Department.*

averaged 381 kg/decare, hitting a 15-year record high[5] and spurring cereal output (3.96 million tons) by 98% on a year earlier when there were serious grain balance problems. At the same time, high yields and quality can be only achieved provided the required agri-technical activities have been properly carried out[6], a thing that was not done in 2004 despite the growing rate of area utilization and intensive use of certified seeds. Furthermore, the application of up-to-date phytosanitary measures and crop fertilization are still limited due mainly to the scarcity of funds, making farming all the more dependent on the weather conditions and turning it into a highly risky industry, which coupled with the low profit margin, provide no incentives to the local producers.

The strong dependence of agriculture on the climatic conditions was growth-conducive for grain production but also detrimental to vegetable production, which posted a negative contribution of nearly 2 percentage points to total value added growth in the sector. The smaller areas under crops and lower yields, together with the bad weather conditions in spring and early summer, led to a volume-term contraction in tomato and pepper production of about 45% and 31% on a year earlier[7]. Like vegetable production, fruit production declined too, reporting a 20% shrinkage and a negative contribution of 2.4 percentage points to agricultural growth. In addition, 2004 sustained the downward trend in some of the fruit-bearing areas under crops[8].

Technical crop production stepped up by 26.4% on a year earlier due mostly to the growth in sunflower production at the expense of the higher yields reported, as the areas under sunflower reported a year-on-year decrease. Rape seed production almost doubled (a 98% rise in volume terms) relative to 2003. Tobacco production grew by 1%, with the quota utilization rate going up by around 10 percentage points on a year earlier to 91.7%[9].

The expectations for a negative contribution of livestock production to growth in the agricultural sector came true. Livestock production stepped down by 1.5% while retaining its share of 31% in gross value added relative to 2003. At preliminary estimate of the Agriculture Ministry, sheep and goat numbers as well as bee hives decreased, as did meat and honey production[10]. The decision of farmers as to a certain decrease in the animal numbers may have been influenced by the higher 2004 prices of feedingstuffs, as prompted by the weak 2003 cereal harvest. Besides, being a major factor in costing, feedingstuff prices had also a most adverse effect on meat pricing. Despite the decline in livestock production, there were discerned some favourable trends underway like, for example, the outstripping rise in the numbers of sows. Obviously most producers assessed the business situation as growth conducive and planned to augment their potential for future activity.

The robust performance of the agricultural sector led to a year-onyear growth in agricultural exports of 24%, outstripping agricultural imports (14%)[11]. The above growth was mainly triggered by cereals[12], the exportation of which in 2003 was rather modest due to the temporary ban on wheat exports. 2004 sustained

[5] *Source: NSI, MAF.*

[6] *For further information, see Wheat Market Outlook over the 2004-2005 period and 2005/2006 Forecasts of the Marketing Department of MAF.*

[7] *MAF, Marketing Department, 2002-2004 Market Outlook for tomatoes, peppers and onion.*

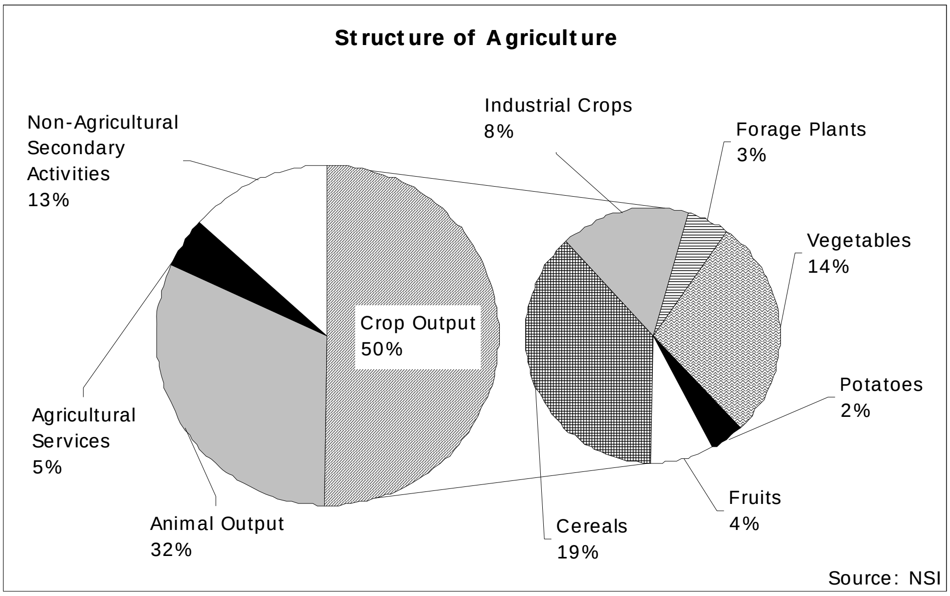
[8] *MAF, Marketing Department, 2002-2004 Market Outlook for apples, peaches, apricots and plums.*

[9] *MAF, Tobacco Market Outlook over the 2003-2004 period.*

[10] *MAF, „2004 Agrarian Report“.*

[11] *Source: BNB.*

[12] *Source: MAF.*



the foreign trade deficit in fruit and vegetables, despite the improvement in fruit trade. The trade deficit in milk and meat deteriorated further largely as a result of some non-tariff restrictions, the operation of a few enterprises licensed to export into the EU and under- utilization of the duty-free quotas[13]. Nevertheless, the country improved its position of a net exporter of agricultural products almost twice on a year earlier.

High production costs remained a major problem faced by the sector. Average farm-gate prices ran close to production costs due, by and large, to the small size of the holdings. Land parcelling having to do with ownership restitution was an important impediment to the development of a modern and efficient farming in the country[14]. However, 2004 witnessed a certain improvement in the sectors efficiency. Furthermore, a data comparison between intermediate consumption and production costs evidenced a lower share of intermediate consumption in gross output, pointing to lower production costs in 2004. This may have been due to the sizable agri-food investment rise, as indirectly indicated by the growing absorption capacity of SAPARD funds, which are by definition investment spending. The resources absorbed from the start of the programme to the end of 2004 accounted for 65% of the total extensions foreseen over the 2000-2006 period, corresponding to a share of the investment payments under SAPARD in value added of around 3%. In addition, the share of the investment approvals and commitments amounted to about 9% on average

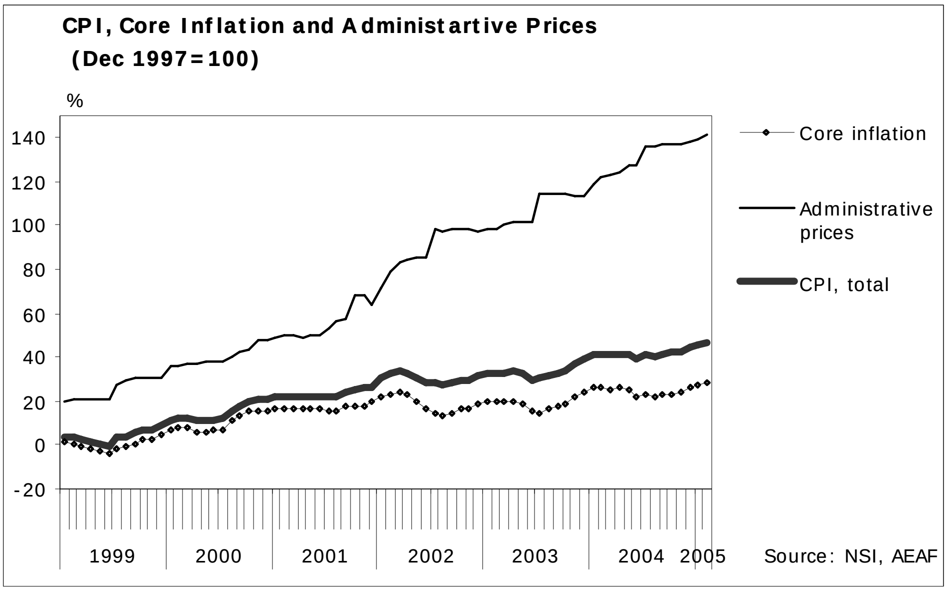
Another positive tendency in 2004 had to do with the gradually declining share of non-arable land in total agricultural land (from 8.9 to 8.5% in 2004). Most farmers expect the above tendency to persist well into 2005 as well.

[13] *See the 2003 Meat Market Outlook and 2004 Forecasts of the Marketing Department at MAF.*

[14] *MAF, 2004 Agrarian Report.*

INFLATION

Following the relatively high end-of-2003 inflation, consumer prices in 2004 ran close to the level of the preceding years. Inflation over the December'03 December'04 period amounted to 4%, running close to the last 5-years low (reported in 2002). 2004 inflation averaged 6.2%, going some 4 percentage points up on a year earlier. The above development was due to the monthly inflation indices of end-2003 when food prices had a most adverse effect on inflation. Consumer price dynamics in 2004 was again shaped by administered and food price change in the year as well as the high crude oil prices worldwide.



Impact of Administered Prices

As a result of the alignment of the countrys tax legislation to the EU acquis, the excise duty rates on tobacco products stepped up, approximating the Community minimum rates. All this led to higher inflation in January and February. Also January saw a certain price rise in postal services. In May the Bulgarian Telecom restructured its price list and raised the city call rates and subscription fees[15].

July witnessed the last in a series of planned rises in electricity prices, aimed at reducing subsidizing in the sector and bringing in the cost-plus method of pricing. The preferential tariff schedule for consumption of up to 75kWh was retained, and the overall electricity price increase reported amounted at 10.59%. Again in July, the prices of hot water supply, power generation and district heating rates stepped up, with the rise being reported in the CPI as late as November with the start of the heating season. On a year earlier, heating prices increased by 9.74%. Furthermore, passenger railway fares went up by 13.52%. Administered prices in the December03 December04 period rose by 11.39%, reporting an 11.04% change on a years average. Their contribution to 12-month inflation was estimated at 2.81 percentage points.

The higher 2003 electricity and heating prices led to higher household spending, triggering a certain rise in the weight of administered prices in total expenditures and hence in the consumer basket used to

[15] *Although the sale of 65% of the Bulgarian Telecom to Viva Ventures Holding took place in February 2004, the prices and fee rates set by BTC were reported as administratively priced items throughout the year.*

calculate the CPI. As a result, their contribution to the countrys inflation stepped up, without any change in the number of administratively priced items.

Impact of Food Prices

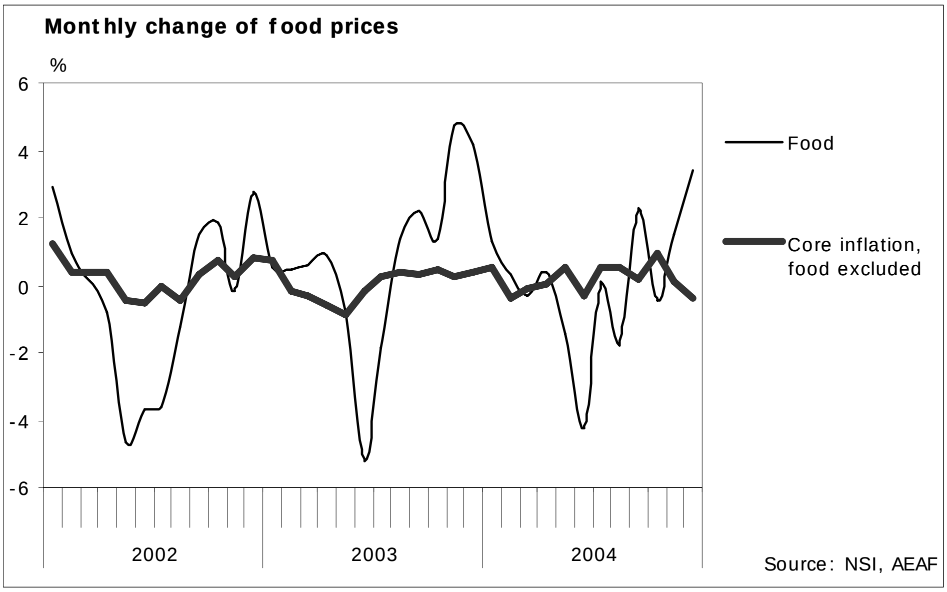
Free price dynamics followed closely the dynamics of the CPI, posting a 4.55% increase on a years average. Twelve-month inflation ran at 1.57%.

Monthly Core Inflation

Groups	January	February	March	April	May	June	July	August	September	October	November	December
Food	1.30	0.35	-0.28	0.41	-1.46	-4.22	0.00	-1.72	2.29	-0.49	1.52	3.42
Tradable goods	0.04	-0.28	0.03	-0.28	-0.29	-0.26	-0.07	-0.45	0.25	0.44	0.31	0.08
Non-tradable goods	0.99	0.18	0.13	0.19	0.15	0.26	0.95	0.30	0.03	0.65	0.78	0.24
Fuels	0.69	-2.35	-1.12	0.62	4.32	-2.03	1.15	3.90	0.47	3.38	-2.23	-3.50
Core inflation	0.94	0.00	-0.19	0.24	-0.52	-2.37	0.26	-0.64	1.26	0.22	0.83	1.57

Source: NSI, AEAF

Food prices, unprocessed food prices in particular, tend to manifest as a rule the strongest volatility in the consumer basket. Moreover, enjoying a relatively large share, food price change has a powerful effect on monthly inflation.



The end-of-2003 grain balance had to be supported by way of cereal imports due to the poor harvest. However, serious yields problems were faced by other countries in the region as well. As a result, bread prices reported a most vigorous increase in the second-half year period of 2003. The expectations for a better harvest in 2004 came true, and the year witnessed a turnaround. In December, bread prices stepped down by 14.06% on a year earlier.

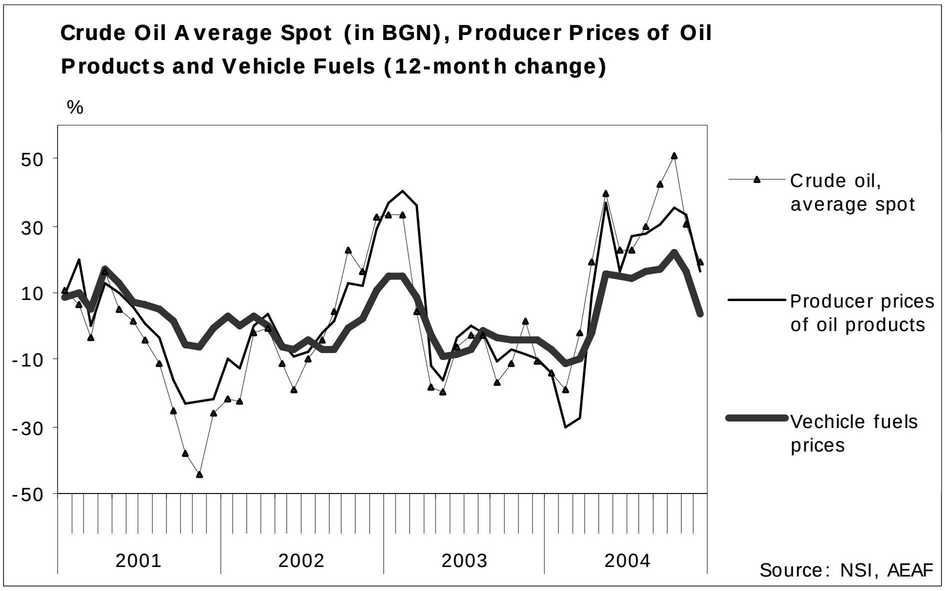
The distinctly seasonal profile of fruit and vegetable price dynamics influenced monthly inflation throughout the year. On the other hand, as the end-of-year rise in meat prices, prompted by fears of undersupply in the local market, was rather unexpected, the government authorized the importation of meat at reduced duty rates and prices set back at their normal level.

Impact of Crude Oil Prices

In end-2003 crude oil prices worldwide went on the upswing sustained throughout 2004. Hitting a peak in May04, the month-on-month increase in oil prices ran well above 10%. Then following a short-lived period of slight correction in July, prices carried on rising and in October they stepped up as high USD 46.88 per barrel, posting a most robust growth of 55.9% relative to December03.

The more expensive oil prices were due not only to a number of speculative factors at work and market agitation but some imbalances as well. On the supply side, the emerging risks were mainly of political, military and economic nature having to do with the extraction and transportation of crude oil from some exporting countries like Iraq, Russia, Nigeria and Venezuela. At the same time, there were strong fears as to the demand and oil supplies of China, North America and Asia, making the world markets all the more sensitive. According to data of the International Energy Agency,[16] global demand for crude oil in 2004 amounted to 82.5 million barrels daily, whereas supply ran at 83 million barrels on a daily basis, with demand often surpassing supply in the first and third quarter of the year.

The impact of the expensive oil prices on the countrys inflation was rendered indirectly by way of the higher prices of automobile fuels and fuel for heating. However, the direct effect of the soaring oil prices was passed by the growing production costs in the large oil-consuming food and chemical industries and automobile transport onto end-user prices.



Local car fuel price rise lagged behind the increase in crude oil prices worldwide. In the fist half-year period, the oil price change in USD terms was partly made up for by the appreciation of the single European currency, hence the BGN, to the US dollar. Moreover, some part of the price change was shouldered by the intermediaries along the downstream chain and was thus not passed onto end-user prices. Therefore, the 12-month increase in automobile fuel prices ran at 3.74%, or well below the increase in the prices worldwide and the producer prices of refined oil products. The contribution of car fuel prices to total annual inflation was estimated at 0.11 percentage points.

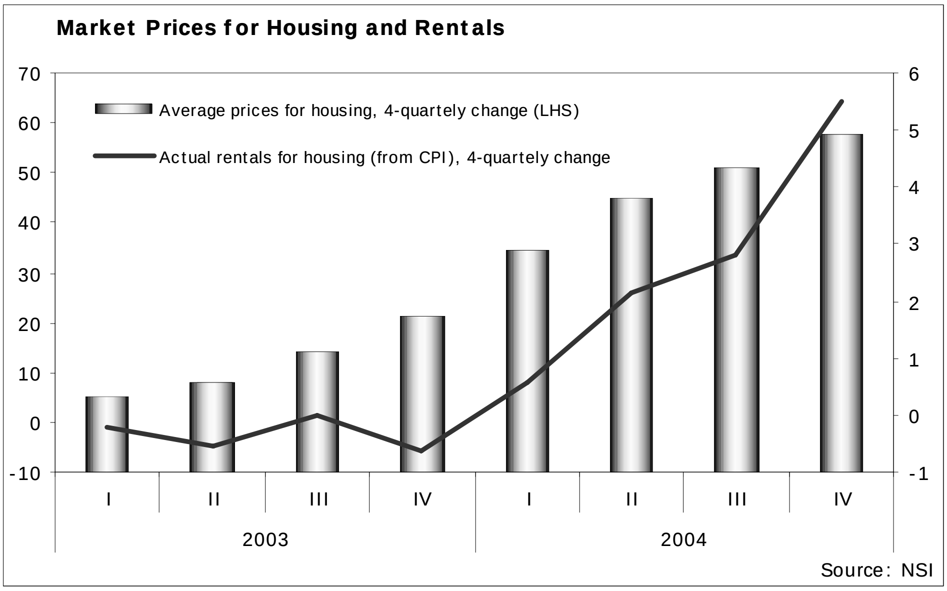
Dynamics of Real Estate Prices

In 2004 the real estate sector was one of the most vigorously performing markets in the Bulgaria[17]. According to NSI data, 2004 real estate prices went up by 47.5%, with the increase being posted by the district and municipal centres other than Sofia and Varna (unlike the preceding years), i.e. by some more backward regions where a certain „catching up“ in prices was discerned. Although the CPI takes no account

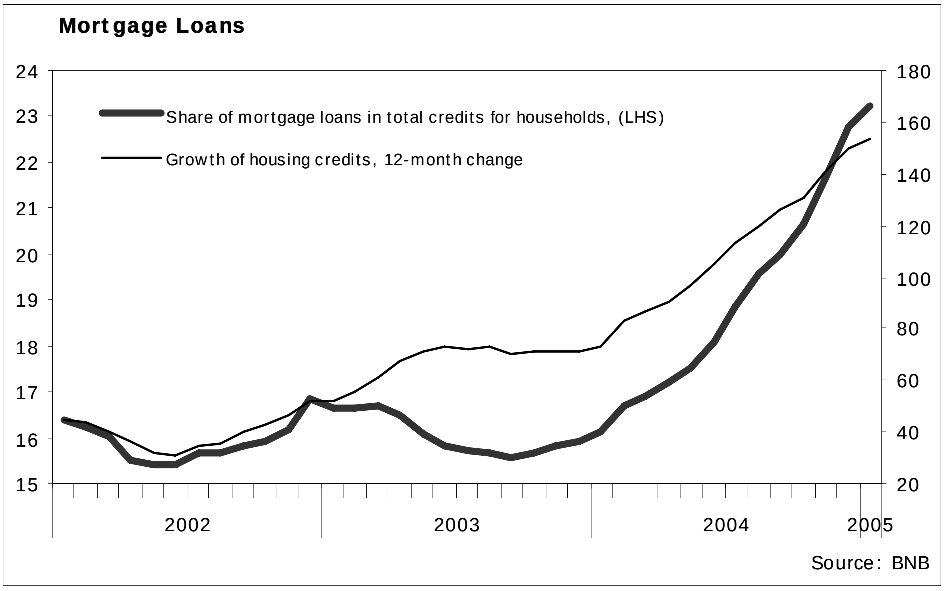
[16] *International Energy Agency http://www.iea.org.*

[17] *NSI data on the average prices of apartment housing in the district cities.*

of the price dynamics in the real estate sector, it can be expected that any price rise may give rise to an increase in consumer prices.



The number of construction permits in 2004 was growing rather fast. Building approvals stepped up by 70.4% on a year earlier, having to do with the upbeat expectations of entrepreneurs as to the price dynamics and demand in the sector. In the short run, the growing number of construction permits is likely to lead to rising orders and possible overstocking, allowing for a certain decrease in fixed costs and greater price flexibility. In a mid-term perspective, the above developments are expected to trigger supply.

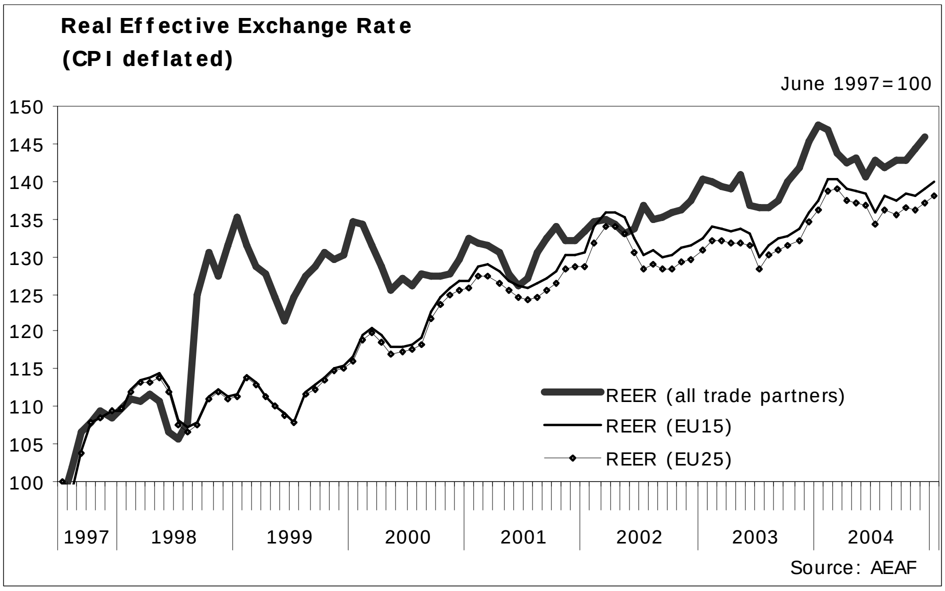


Higher demand was mainly fostered by the credit expansion in the country, in particular mortgage loan growth and strong demand for real estate on the part of foreign citizens. 2004 witnessed a sharp increase in housing credit amounts. On a year earlier, mortgage loans stepped up most robustly by 149.9%, with their share within household loans steadily rising, whereas interest declined.

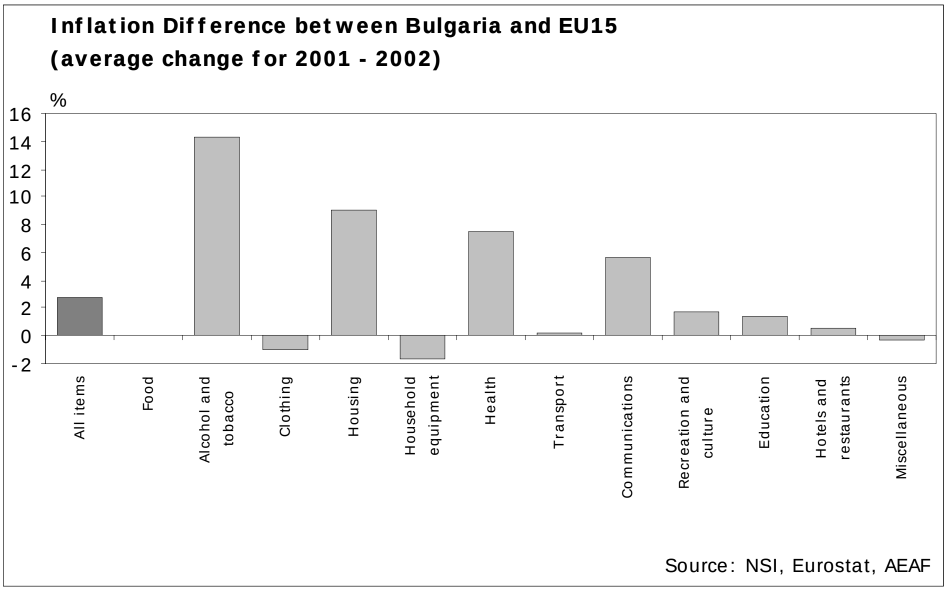
According to unofficial data of some real estate agencies, housing demand on the part of foreign citizens and Bulgarian non-residents went on the increase, i.e. most deals were carried out with money and income earned elsewhere. Moreover, it can be assumed that foreign citizens have tended to purchase cheaper rural and urban real property because of the lower cost of living in the country. Also, some of the properties were bought by Bulgarians, seeking other ways to invest some of their free money in hand.

Dynamics of the Real Effective Exchange Rate

The dynamics of the BGNs real effective exchange rate (REER) has been pointing to a significant and stable rise since the institution of the currency board arrangement[18]. Over the 1998-2004 period (periods cumulative) the appreciation of the REER, as deflated by the CPI, amounted to 24.3% vis-à-vis all the countrys trading partners and 24.4% against the EU-5. In 2004 alone, the local currency appreciated by 3% on a years average vis-à-vis all Bulgarias trading partners and 3.9% in relation to the EU-15. The appreciation of the REER vis-à-vis the EU-15, whose share in the countrys foreign trade ran at 52% in 2003, was mostly due to the lower inflation rate compared to Bulgaria. At the same time, the national currencies of Bulgarias major trading partners other than the EU-15 lost ground to the BGN in real terms, despite the significantly lower local inflation. All this was due to the depreciation reported in the period surveyed while the BGN was and still is pegged to the single European currency.



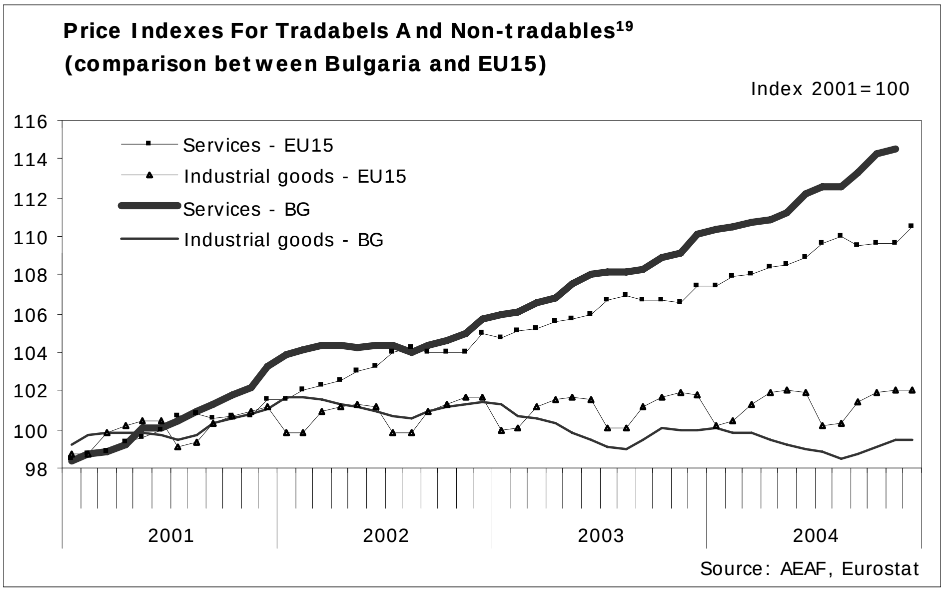
The real effective exchange rate is a reliable indicator of price competitiveness in the economy. However, estimated by way of the CPI alone, it demonstrates a number of disadvantages. In the case of Bulgaria, the fact remains that the higher countrys inflation (vis-à-vis the EU-15) was solely due to the higher dynamics of non-tradables, which can hardly ever give a faithful account of a deteriorating competitiveness in the economy. Therefore, an in-depth analysis calls for the use of other deflators as well and the breakdown of the price indices by commodity group or industry depending on whether or not they are an object of foreign trade.



As it is almost impossible to provide all the data on all Bulgarian trading partners and due to the re-orientation of local exports to the EU, the REER has been hereby estimated vis-a-vis the EU-15 by three price deflators as follows: consumer prices, value added and unit labour cots. Twelve of the EU-15 have already adopted the single European currency,

[18] *Any rise in the REER indicates a real-term appreciation of the Bulgarian currency.*

whereas the remaining three member states enjoy a rather low relative share in the countrys foreign trade. In addition, as the BGN has been pegged to the single European currency, the REER is almost fully dependent on any price change in Bulgaria and the EU-15 countries.



Average local inflation over the past three years ran well above inflation in the EU-15 by some 2.8 percentage points, and 4.1 points in 2004 alone. At the same time, tradable price inflation in Bulgaria (food and beverages, clothing and footwear, household appliances, etc.) has remained almost unchanged, lagging even behind the EU-15.

The BGNs appreciation to the EUR, as deflated by the CPI, was not due to tradables, which are an object of foreign trade, but administered prices and non-tradables (services), which were, therefore, not indicative of any loss of competitiveness in the economy.

The real effective exchange rate, as estimated by the value added deflator, for the whole of the economy pointed to a real-term appreciation of the Bulgarian currency of 16% over the 1998-2004 period. And again, the prices of non-tradables advanced at a faster rate (the REER went up by 23.4%) vis-�-vis tradables, whereas the BGN gained, too, considerable ground against the EUR (the REER in the tradable sector stepped up by 17.7%)[20]. At the same time, as growth in productivity (periods cumulative) outstripped real wage growth, it can be assumed that the appreciation of the REER, as calculated by the deflator of value added, may have been due to the higher spending on capital, further evidenced by the REER estimates on the basis of unit labour costs.

Overall in the 1998-2004 period, the BGNs REER, as rendered by unit labour costs, depreciated by 8.2% (26.7% in the sector of tradables, and 20.7% in the sector of non-tradables). The indicators performance showed that competitiveness in the economy was steadily improving, as the BGN depreciated in real terms. On the other hand, unit labour costs represent some average and not marginal labour costs. Therefore, the depreciation may have been triggered by the decreasing share of labour and growing share of capital in value added. Over the same period, the relative share of employee compensations in value added went down from 43.3% in 1998 to 40.8% in 2004.

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[19] In the figure above non-food items are treated as tradables and services as non-tradables. In the case of Bulgaria the above data do not give an account of the administered prices. Furthermore, the data are not seasonally adjusted. The distinctly seasonal pattern with industrials in the EU-15 was due to the group of clothing and foot wear.

[20] The manufacturing sector (construction excluded) is treated as tradable, whereas services (health care, education, public administration excluded) as non-tradables.

Drawing upon the analysis of the latter two indicators, it therefore follows that:

- first, even if there was a certain deterioration in price competitiveness in the period surveyed, it was solely due to the higher capital expenditures related to the robust investment growth. The latter, however, is indispensable to achieving sustainable growth in the economy and hence improving competitiveness in the long term;
- second, wage growth has not jeopardized competitiveness since the institution of the currency board. Furthermore, productivity in the Bulgarian economy has tended to rise at a faster rate vis-□-vis the EU-15, with labour demand in the sector of non-tradables going on the increase.

EMPLOYMENT AND THE JOBLESS RATE

The labour market performance in 2004 was influenced by the sustainable growth in the economy of the past few years. The creation of sustainable private-sector employment, coupled with the active labour market measures of the government, made the jobless rate step down to record lows.

At preliminary estimate of the NSI survey on wages and employees, the average annual employed numbers in 2004 went up in absolute terms to some 3 236.4 thousand. However, the 2.2% rate of increase lagged considerably behind the 2003 rate of 6.3% due probably to the fade-out of labour contract registration which had a one-off effect in the year of measure application. However, the recently released final NSI data on the average annual employed numbers pointed to a major difference from the preliminary 2003 estimates (about 146 thousand up). The higher than expected increase was prompted by some of the private-sector industries (trade, agriculture, hotels and restaurants, construction, etc). Therefore, it can be assumed that the above industries reported the highest number of newly-employed as a result of the compulsory labour contract registration, which in turn shed some light on the dealings of the shadow economy and spurred the robust growth in the employed numbers.

The 2004 employed numbers stepped up mainly due to the boosted business activity in the private sector of the economy. The average number of employed in private-sector companies went up by some 97.3 thousand or 4.1% on a year earlier, with the largest contribution to job creation being posted by trade, which also reported a wage growth higher than the sectors average. All this may have been due to the market entrance of big trading companies ousting the small local shops, which provided self-employment to the owners and their families.

The rapid development of the service sector last year led to a faster increase in the employed numbers in *financial intermediation* (15.8% up on annual basis), *real estate transactions and business services* (6.7%), *hotels and restaurants* (6.1%). In addition, private-sector employment in *transport and communications* rose by 8.4% due not only to the increased business activity but the sale of the Bulgarian Telecom. However, the growing employment in the private-sector companies failed to make up for the decreasing employed numbers in the public sector and overall employment reported a 1.1% year-on-year decline. In 2004, the Ministry of Labour and Social Policy drafted a new employment promotion package targeted specifically at workers made redundant in enterprises earmarked for restructuring in the same year, which however has not yet taken effect.

As for private-sector employment in the manufacturing industries, the highest year-on-year increase was reported by construction (13.2%), triggered by the boosted business activity. Furthermore, some 86% of the processing industries posted a 12-month increase in the employed numbers, ranging from 32.9% in the timber industry (manufacture of timber and products thereof, furniture excluded) to 0.2% in the leather industry. At the same time, the *manufacture of coke and refined oil products* registered the largest number of employment redundancies (14.8%) due probably to the incomplete restructuring effort in the enterprises already privatised.

Structure of the Annual Average Number of Employed by Sector
(thou)

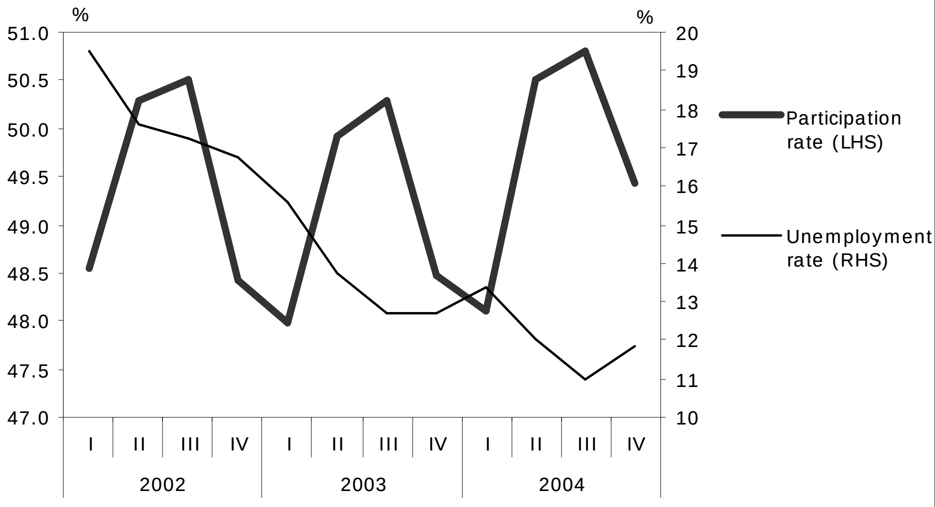
	2003 Total	2003 Private sector	2003 Public sector	2004* Total	2004* Private sector	2004* Public sector
Total	**3166.5**	**2394.8**	**771.7**	**3236.4**	**2492.1**	**744.3**
Agriculture, forestry, hunting and fishing	**806.6**	**794.6**	**12.0**	**807.7**	**795.9**	**11.8**
Industry	**862.7**	**744.0**	**118.7**	**892.1**	**789.8**	**102.3**
Mining and quarrying	*33.4*	*15.9*	*17.5*	*30.6*	*16.3*	*14.3*
Manufacturing	*636.2*	*603.9*	*32.3*	*657.5*	*633.6*	*23.8*
Electricity, gas and water supply	*59.2*	*5.1*	*54.1*	*58.7*	*5.0*	*53.7*
Construction	*133.9*	*119.1*	*14.8*	*145.3*	*134.8*	*10.5*
Services	**1497.2**	**856.2**	**641.0**	**1536.6**	**906.4**	**630.2**
Transport and Communications	*213.0*	*112.9*	*100.1*	*210.7*	*122.4*	*88.3*
Wolesale and retail trade	*412.8*	*410.1*	*2.6*	*430.2*	*428.2*	*2.0*
Financial intermediation	*35.2*	*29.2*	*6.0*	*35.3*	*33.8*	*1.5*
Other services	*836.2*	*304.0*	*532.2*	*860.4*	*322.0*	*538.4*

** Preliminary data* *Source: NSI*

As the scope of the active labour market measures and programmes of the government was narrowed in 2004, all public-sector employment, but *welfare services*, *public administration and compulsory social insurance*, *real estate transactions and business services*, which reported an increased employed numbers on a years average, ran some 3.5% lower on a year earlier.

Higher employment in 2004 resulted in a higher rate of participation, which stepped up for the first time since 2002. According to data of the NSI labour force surveys, the relative share of the working population (of 15 years of age and above) went up by 0.5 percentage points on a year earlier to 49.7%. The indicator s growth may have been influenced by the declining discouraged numbers, as some of them had left the out-of-labour force cohort due to the robust private-sector demand and effect of the active employment promotion programmes of the government.

Participation Rate* and Unemployment Rate



* Persons over the age of 15 Source: NSI

Given the stable growth in private-sector jobs and the active labour market policies, the jobless rate went on decreasing in 2004 as well. The number of people who had defined themselves as unemployed in the NSI surveys stepped down by 49.3 thousand and third-quarter unemployment hit a record low of 11% ever since the labour force surveys were launched. On a years average, 2004 unemployment ran some 1.7 percentage points lower than in 2003.

Unemployment (NSI and Employment Agency)

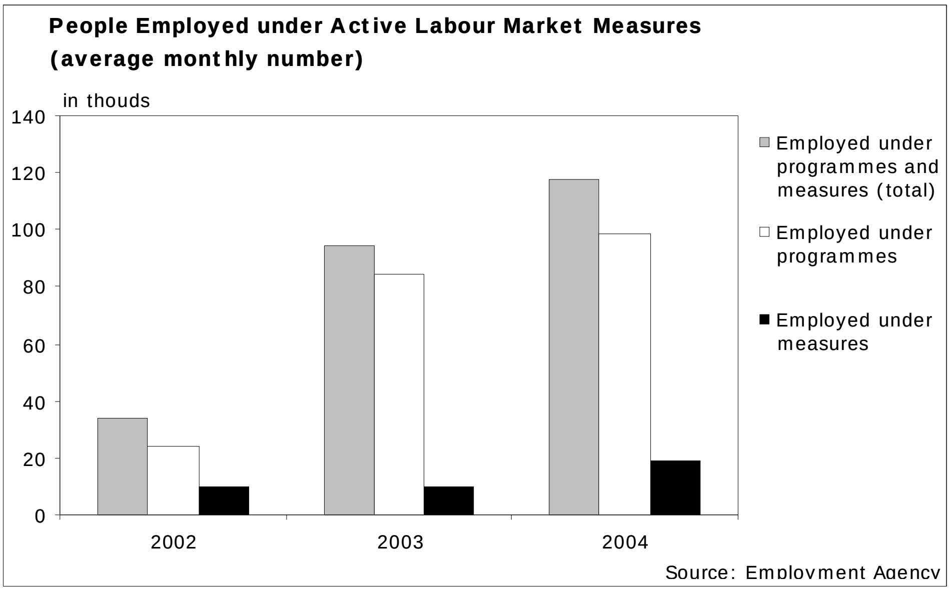
	NSI (thou)			Employment Agency (thou)		
	2003	**2004**	percentage change y/y	**2003**	**2004**	percentage change y/y
*Number of unemployed**	*449.1*	*399.8*	*-11.0*	*528.0*	*469.2*	*-11.1*
*Unemployment rate (%)**	*13.7*	*12.0*	*-1.7*	*14.3*	*12.7*	*-1.6*

* *Average annual number*

Labour force survey data supported the general downward trend of registered unemployment. According to the administrative statistics of the Employment Agency (EA), the average annual number of registered unemployed stepped down at the same rate as the jobless numbers according to the NSI estimates of about 11%. The unemployed numbers in 2004 were steadily declining throughout the year but the third quarter. The likely reasons behind the end-of-year increase in the indicator had to do with some seasonal factors at work and reduction in employment under some of the programmes of the Ministry of Labour and Social Policies. However, despite this, the average Q3 jobless numbers ran some 9.4% down on a year earlier, steadying at a six-year low. Average 2004 registered unemployment reported a 12-month decrease at the same rate as the one accounted for by the NSI data (1.6 points) and practically set back at its level prior to the start of the restructuring effort in the economy (mid-1998).

The 2004 decrease in the countrys unemployment was largely due to the intensive private-sector job creation in the primary labour market rather than the active employment promotion policies in place. It should be also noted that job centres are only one way of looking for a job or hiring work force, as a result which the contribution of the private sector to job creation in the economy was significantly higher than the one, reported by the EA. Around 89% of all newly- employed in 2004 found new jobs through the intermediation of the job centres and agencies, with the above percentage being prevailed by employed in the primary labour market (12 000 on a monthly average, going some 29.8% up relative to 2003). The bigger number of employed in the real sector of the economy was prompted by the countrys stable macroeconomic environment and sustainable growth, which in turn led to higher labour demand on the part of entrepreneurs. According to EA data, the job vacancies posted by private-sector employers stepped up by 37.3% on a 12-month basis, whereas the jobs occupied went up even higher by a robust 50%. As a result, the share of the private sector in primary labour market job creation increased by 12.7 percentage points on a year earlier to 95.1%. At the same time, the scope of the active employment promotion measures and programmes was further broadened, at a slower pace though. In 2004, the average monthly numbers of employed under the Employment Promotion Act amounted to 117.6 thousand, or some 23 thousand up relative to 2003.

In 2004 again the active labour market policy drew upon a differentiated approach to the risk cohorts of unemployed, which lied at the core of a set of vocational training and professional qualification measures and programmes to help people in disadvantageous position and improve the employability of the jobless. More specifically, the National Programme „From Social Aid to Employment Promotion“ continued to provide the largest source of subsidized employment in terms of both supply and demand, covering some 93.6 thousand on a monthly average or about 80% of all involved in the different employment measures and programmes in 2004. As it has been mainly targeted at jobless with over one year of registration with the job centres, the above numbers contracted by 11.8% on a year earlier, according to EA data. Furthermore,



since the reintegration of the long-term unemployed into the labour market is hampered by the low level of education and professional qualification, the number of unemployed doing professional qualification courses went on the increase. The number of jobless who had completed professional qualification courses under the different measures and programmes totalled 15.3 thousand, or 21.9% up on a year earlier. In addition, the number of jobless employed after training stepped up most vigorously by over 50% on an annual basis because vocational training and qualification gave them extra flexibility in the labour market and more job opportunities in the real sector of the economy. As unemployment decreased and job creation in the private sector picked up speed, the discrepancy between the needs of employers for qualified work force and the skills offered by job seekers became all the more pronounced[21]. That is why raising the level of professional qualification was a top priority on the employment policy agenda of the government in 2004. Employers tended to show keen interest in the preferential measures having to do with the development of vocational skills as part of the lifelong learning process, encompassing 61% of all involved in the different measures. On a year earlier, there was also a significant rise in the employed numbers under some of the employment promotion regimes having to do with: the professional qualification and/or apprenticeship of jobless under 29 years of age (10.2 thousand vs. 3.6 thousand in 2003); professional qualification through internship and/or apprenticeship, which posted a four-fold rise on a yearly basis; and raising the qualification of those already employed (some 5.1 thousand new inclusions). In 2004, the scope of the protective measures of the government active labour market policy aimed at encouraging employers to hire work force of the most vulnerable cohorts was further broadened. As a result of the differentiated policy approach applied, the number of employed from the riskiest groups almost tripled[22]. Overall under the different employment measures there worked in 2004 some 19.2 thousand on a monthly average or nearly twice as high as in 2003, whereas the jobs created amounted to 23 343.

The analysis of the labour market in 2004 places special emphasis on the key role of sustainable economic growth for the countrys rising employment and decreasing jobless rate. However, subsidized job creation in the economy is still decisive for the performance of the labour market indicators. The employment promotion programmes may produce a positive quantitative effect in the short term, but as there are no statistics on the job performance in the primary labour market of all involved in the programmes their contribution to sustainable employment is questionable. All this calls for some estimates of the net effect

[21] *A July 04 survey on employers needs for qualified work force, ordered by the Employment Agency.*

[22] *People with lifelong reduced working capacity, youth with reduced working capacity, unemployed women above 50 years of age and men above 55 years of age, single parents and mothers with children under 3 years of age, people released from jail.*

of the active labour market measures and programmes to be made. What is more, according to EA data, the number of job seekers actually employed under the programmes and measures proved to be bigger than planned. The largest-scale government initiative „From Social Aid to Employment Promotion“ alone provided work to some 30% of unemployed above the initially planned numbers. All this gives an account of the larger amounts spent vis-□-vis the projections of the action plan, and implies that there was some re-channelling of resources to this particular programme. It is therefore appropriate that the government narrows the scope of the active labour market policies as originally intended. It is also necessary that these allocations are redirected essentially to the private sector because it creates sustainable employment in the economy. In addition, the scope of the government policies is to be further narrowed down in 2005, which if ever happens, will lead to an even greater slowdown in unemployment decrease.

WAGES

According to preliminary NSI data, average annual wages stepped up by 10.3% in nominal terms vis-à-vis final 2003 estimates while going some 3.9% up in real terms (deflated by the average annual CPI).[23] Average wages reported the fastest growth rate in industries where business activity was relatively high like: manufacture of vehicles; machinery and equipment, not classified elsewhere; extraction and mining, energy resources excluded; and health care. Hotels and restaurants and trade also posted a healthy increase in wages but it is difficult to say if the increase was due to the boosted business activity or the preliminary nature of data, as the latter undergo as a rule the most significant downward revisions.

The slower increase in average wages vis-à-vis GDP growth was largely due to the different employment profile by industry. Employment stepped up fast in industries where the average wages reported by the NSI ran lower than the countrys average. At preliminary estimate, for example, employment in the timber industry (furniture excluded) increased by almost one-third, whereas average wages accounted for 70% of the countrys average. Other industries where employment grew relatively faster were as followed: manufacture of rubber products and plastics; construction, the food industry, other welfare services (probably due to the effect of the active labour market measures); textiles, products thereof and clothing, etc., with average wages lagging behind the countrys average. At the same time, average wages and employment ran higher than the countrys average in *public administration* and *compulsory social insurance* as well as the *manufacture of other non-metal raw material*. However, employment in most industries where average wages were relatively high went on the decrease: all extraction and mining industries, coke, refined oil products and nuclear fuel, chemicals, transport and communications, including the manufacture of vehicles, machinery and equipment, not classified elsewhere, all them posting a healthy increase in both sales and average wages. Therefore, employment over

Labour Productivity and Real Average Wages Growth in 2004*

	Labour Productivity Growth	*Real Average Wage Growth*
Total	***3.1***	***3.9***
Agriculture, forestry, hunting and fishing	***2.1***	***3.7***
Industry	***1.8***	***2.0****
Mining and quarrying	*20.4*	*3.2*
Manufacturing	*3.4*	*3.2*
Electricity, gas and water supply	*-3.8*	*-1.1*
Construction	*0.6*	*0.8*
Services	***3.3***	***4.9****
Transport and Communications	*6.8*	*2.9*
Wolesale and retail trade	*8.3*	*10.1*
Financial intermediation	*10.6*	*2.7*
Other services	*1.2*	*4.7***

** Preliminary data*

*** Aggregate real average wages are weighted with annual average number of employed in the particular sector*

Source: NSI, AEAF

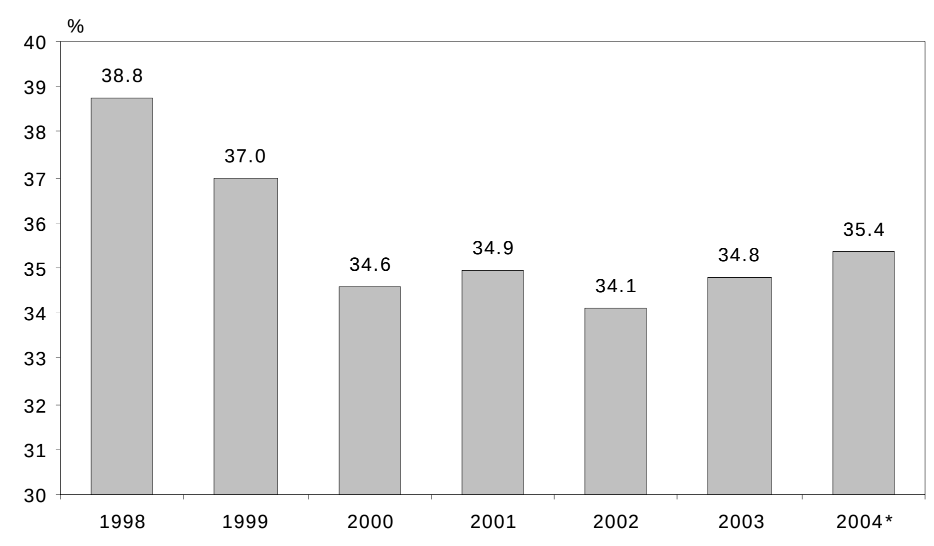
[23] *The Statistical Office revises average annual wage data and final data run as rule lower than the initial estimates. It therefore follows that a juxtaposition of the initial 2004 data and final 2003 statistics will amount to an overstated growth in average wages in the year. If, however, NSI revisions run close to the revisions of the last three years, the 2004 nominal-term growth will be around 6%, whereas the real-term growth will border on zero.*

the past two years can be said to have recovered only in industries hiring poorly qualified work force and paying relatively low wages.

Productivity[24] in the economy in 2004 improved by 3.1% (at 2003 prices), with the fastest rate being reported by the extraction industry (20.4%), where value added stepped up and employment declined, following the restructuring of the industry. Productivity also ran relatively high in some of the service industries (financial intermediation, trade, transport and communications) due to the robust performance of the whole sector. At the same, the indicator has stepped down for a second year in a row in *electricity, heating, gas and water generation and supply* as a result of the lower GVA.

In 2004, productivity seemed to lag behind real wage growth. However, a comparison by industry and sector implies that it is still too early to view the above development as an indication of a certain loss of competitiveness in the economy. The slower growth rate of labour productivity vis-□-vis average wages (0.8 percentage points) was by and large due to trade and electricity, heating, gas and water generation and supply as well as the agricultural sector. On the other hand, productivity growth in the manufacturing sector and some of the tradable services (financial intermediation, transport and communications) outstripped real wages. Moreover, final average wage data in both trade and agriculture (as well as in some service industries) are subject to the most significant revisions because of the specific structure of employment. A comparison between 2004 wage data and preliminary 2003 statistics suggests that if the revisions of the final 2004 data are the same as the adjustments of the last three years, productivity growth in even trade and agriculture will eventually outstrip real wage growth. Of course, these are only assumptions, as final employment and wage data in the economy, as well as the follow-up revisions of GVA estimates will be made available in about a year s time.

Share of Compensation of Emploees % GDP



* Preliminary data
Source: NSI

The outstripping growth of average real wages vis-□-vis productivity is only acceptable in the short term, i.e. within no more than two or three years. It should be also noted that average wage growth in the past few years lagged behind GDP growth, given a declining employment rate well until 2001 included. As a result, the share of employee compensations in GDP went down to 34.1% in 2003 from 37% in 1999. It was only in the last two years that it has gone on the increase (up to 35.4% in 2004), running, however, still well below the components share of around 51% in the EU-25. The only EU member states or applicant countries where the share of compensations in GDP was below 40% were Turkey, Greece, Lithuania and Latvia.

[24] *Calculated as the ratio of GVA to the average annual numbers of employed.*

The different weight of employee compensations in GDP vis-à-vis most EU member states may have been due to the following factors at work:

■ first, this is the different structure of the economy (for example, a dominant agricultural sector as in the case of Turkey and Greece).

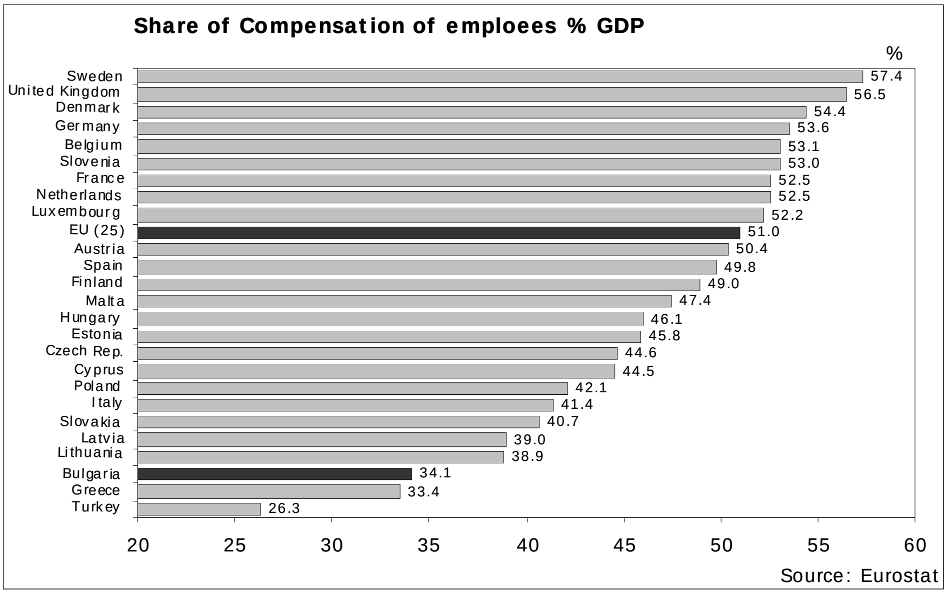
The agricultural sector accounts for about 11% of GVA in Bulgaria vs. around 2% in the EU-25. At the same time, the share of compensations runs as low as some 8% of the sectors GVA. This is mostly due to the fact that Bulgarian agriculture was, and still is, prevailed by small family holdings where the bulk of income earned is of the mixed type, i.e. it is difficult to be divided into income from employment and income from entrepreneurship;

■ second, a prevailing sector of micro-enterprises, ensuring self-employment to their owners or their families, bringing about a relatively high share of mixed income.

In the case of Bulgaria these are trade and transport where the employed numbers run relatively high. However, with the consolidation of business in the above industries (e.g. the entrance of large chains of shops in the market), average wages and the share of employee compensations in GVA are expected to increase relatively fast. In the past two years the share of compensations within GVA in the service sector grew by about 5 percentage points up to 44.6%, setting back at its mid-1990s level;

■ third, a different level of profitability in the different countries.

It is very likely that the profit margin Bulgarian entrepreneurs work at is higher vis-à-vis the same industry in the developed EU economies. However, with the opening of the Bulgarian market and easing the capital flows from the European Union into the country, competition in the domestic market is expected to become stronger and hence lead to a certain decrease in the acceptable profitability level in some industries. The process may be further reinforced if the demand for qualified work force steps up in the next couple of years, which will, in turn, boost average wage growth.

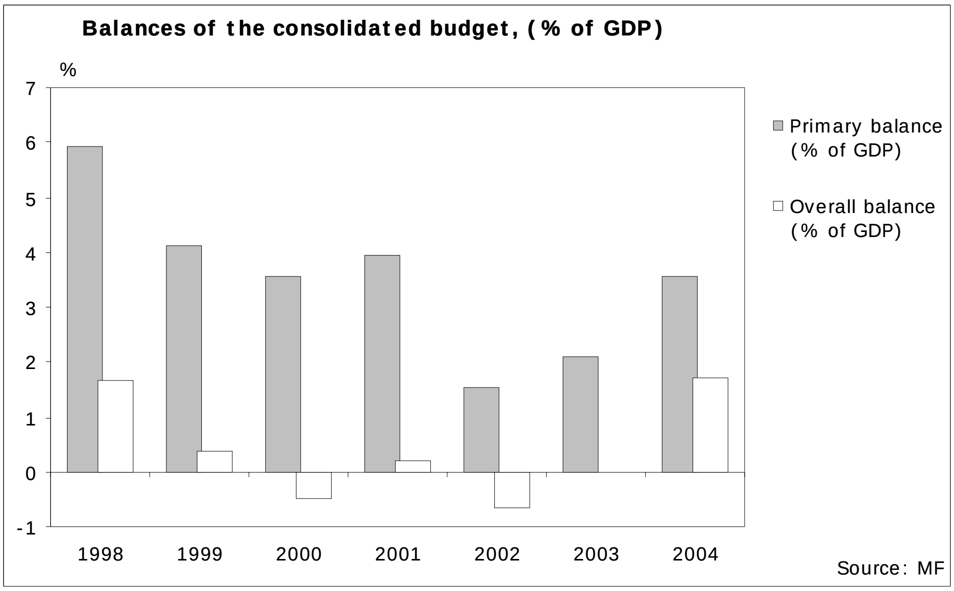


If we assume that Bulgarias convergence to the EU is *inter alia* convergence of the levels and structure of income by source, the share of employee compensations in GDP will go on the increase, calling for an outstripping growth in real wages vis-à-vis real GDP growth. Furthermore, if we assume that employment in the next couple of years does not go on the decrease, real wage growth will have to run higher than productivity in the economy for at least two or three years.

GOVERNMENT BUDGET

The 2004 general government budget ran a huge surplus, accounting for 1.7% of GDP, due to the over-performance of revenues. The primary balance, as a major indicator of the fiscal policies in place, went up to 3.6% of GDP vs. 2.1% on a year earlier. The need for maintaining such a high surplus should be assessed in the light of the external risks as well as the cyclical pattern of performance of the economy.

The main arguments in favour of the strongly restrictive fiscal policy stance are as follows: first, this was the external sector imbalances in place and hence the sizable current account deficit; and second, the need for public finance consolidation in an attempt to meet higher expenditures in the wake of the countrys accession to the EU. From the point of view of the countrys balance of payments, the general budget had a curbing effect on the current account deficit. The higher public savings were used to finance private-sector investment, reducing the needs for foreign capital. On the other hand, the avoidance of double general budget deficits was not strong enough an argument to justify the huge cash surplus. The current account deficit is not so disturbing as long as financial flows cover it and there is no downward pressure exerted on the FX reserves. The current estimates give no indication of any negative tendencies to that effect and point to a steady rise in the reserves in 2005 and 2006. The state of the balance of payments at the same time calls for cautious and prudent fiscal policies and not an artificially high deficit on the general budget.



The countrys accession to the EU in 2007 is expected to bring about a certain rise in net public expenditures of about 2 percentage points of GDP. However, the budget buffer provided for in the preceding years in the form of a surplus will help lessen the shocks without jeopardizing the fiscal position in the first year of accession. And yet, it is more appropriate for the surplus to be accumulated in a stepwise manner by 2006. Furthermore, the above process is to be carried out by working out the expenditure side of the budget so that EU funds absorption replaces specific budget spending and hence has a healthy effect on the budget balance.

The most conclusive argument against the strongly restrictive stance of fiscal policies pertains to the cyclical pattern of economic performance. Estimates show that last year the economy was close to its potential, and yet well below it. It follows that there is still little risk of overheating and therefore no action to put the brakes on growth is to be taken. A 1.7% budget surplus may be justifiable if actual GDP growth exceeds the growth capacity in the economy by 4.5%, which was not the case in 2004. Also, it runs counter to the growth-enhancing policies of the government, which however should not be applied, given an overheated economy.

The robust budget performance suggests that a more ambitious reduction in the tax burden is also possible. However, before applying the above measure it is necessary to assess the budget generation process and find out if it is a temporary or persistent development. The tax reduction exercise is essentially a long-tem measure. At the same time, the analysis of the revenue performance last year indicates that some part of the over-performance was not due to long-term factors. Therefore, any sharp cut-down in taxes may give rise to a potential government budget deficit in the future.

2004 general budget revenues reached BGN 15.9 billion, accounting for 41.7% of GDP and running well above the initial projections by some 10.4%. The largest year-on-year revenue increase was reported by VAT, social insurance contributions and the non-tax items. The reasons behind last years over-performance of revenues were as follows: a large amount of conservatism in budget forecasts, revisions of some estimates in the budget framework as well as some adjustments in the macroeconomic indicators against forecasts. The effect of the latter factor was gauged on the basis of the AEAF model, incorporating in a successive order the macroeconomic estimates at the core of the 2004 budget and the actual statistical data for the same year. The BGN 156million of a difference in the results obtained may be interpreted as a contribution of the higher than expected economic growth to revenue performance. The above difference, however, should be viewed as a short-term factor, as there is no assurance that in the next couple years the economy will again perform above expectations.

Consolidated budget revenues

2004	***(mln. BGN)***	***Share in GDP (%)***	***Growth toward 2003 (%)***	***Overperformance* (%)***
Revenues and grants	***15854.6***	***41.7***	***12.7***	***10.4***
Tax revenues	***12774.0***	***33.6***	***14.9***	***10.8***
Corporate income tax	*938.2*	*2.5*	*-11.6*	*0.1*
Personal income tax	*1247.5*	*3.3*	*9.4*	*12.5*
VAT	*3891.3*	*10.2*	*25.5*	*16.6*
Excise and road taxes	*1881.0*	*4.9*	*21.8*	*7.7*
Custom duties	*292.5*	*0.8*	*26.5*	*43.2*
Social security contributions	*4079.5*	*10.7*	*11.7*	*5.8*
Other taxes	*443.9*	*1.2*	*15.8*	*29.2*
Non-tax revenues	***2626.0***	***6.9***	***-0.7***	***11.1***
Grants	***454.6***	***1.2***	***46.0***	***-2.3***

** toward law 2004* *Source: MF*

There are a number of factors influencing the performance of revenues, but since they are rather difficult to estimate, they are hereby presented as proposals in the budget forecasts. More specifically, they have to do with the distribution of the employed by income group and the level of tax compliance. According to all indicators, tax collection strengthened significantly in 2004, with the largest increase being posted by indirect tax revenues VAT, excise and customs duties as well as social insurance contributions. Furthermore, according to the National Revenue Agency, it was due to the increased voluntary tax compliance and tougher tax control. The magnitude of this effect may be estimated as the difference between the forecasts against the actual performance of the macroeconomic indicators and the actual level of revenues achieved. Amounting to BGN 305 million in 2004, it is to exert a long-term influence on budget revenues while having a one-off effect on revenue growth. The latter, however, was due to the fact that the estimated tax collection of the major revenue items was close to the rate reported by the developed European economies and any follow-up improvement is unlikely to take place. And yet, the increased collection rate allows for a further cut-down in taxes.

The calculations made lead to the conclusion that revenue over-performance in 2004 was largely due to the conservatism of the budget forecasts estimated at about BGN 800 million. It represented the difference between the revenue projections in the macroeconomic framework of the budget and the level of revenues laid down in the budget itself. The AEAF supports in principle the use of a conservative approach to budget planning as an extra buffer in case of unexpected shocks or contingencies. However, as any assessment as to the level of policy prudence is rather subjective, we believe that it should not surpass 1 to 2 % of total revenues or about BGN 300 million, given the current macroeconomic stability in the country.

With the above reservation in mind, it can be assumed that the 2005 budget may allow for some BGN 800 million to carry out the tax reduction exercise, provided there are no other policies in place meant to increase budget spending. The choice of the specific tax rates to be cut down depends on the effect on economic growth expected. Simulations have showed that indirect tax cut-down, at the same rate of loss for the budget, will bring about greater incentives for entrepreneurs compared to a likely decrease in the indirect tax rates. A possible explanation is that direct taxes have, in theory, a much bigger distorting effect on the decisions of the economic agents as to labour supply.

Furthermore, it should be noted that social insurance contributions are specifically meant to provide for the social policies of the government. It follows that the system of social insurance should be handled individually on its own, and any reduction in the contribution rate should draw upon the improvement of their collection alone rather than the strengthened collection of the other tax items. Therefore, the stabilization of the National Social Insurance Institute is to be given priority because of the tremendous importance of the social system to public finance sustainability. Cutting down the contribution rates is indispensable as it ensures all the necessary conditions for employment promotion. On the other hand, it should not hamper a major policy goal aimed at improving the budget balance of the social insurance system. In 2004 social policies were the main concerns on the government budget agenda, with special emphasis being placed on the higher pensions and ceilings, which resulted in 12.1% year-on-year increase in expenditures on pensions.

Budget spending on economic activities and services stepped further up and was mostly due to the higher absorption rate of the EU pre-ins. The largest beneficiary under these projects was the sector of transport and communications, which accounted for 41% of total budget expenditures in the real sector. At the same time, the budget subsidies allocated to the non-financial enterprises declined by 9.7% on a year earlier due to the decreased amounts provided for the energy-sector companies.

Other priority areas of budget spending had to do with education and defence where expenditures went up by 9.8 and 8.9% respectively. The robust revenue performance of the budget allowed for some additional funds to be allocated in mid- 2004 for the upkeep of fixed assets and equipment in schools.

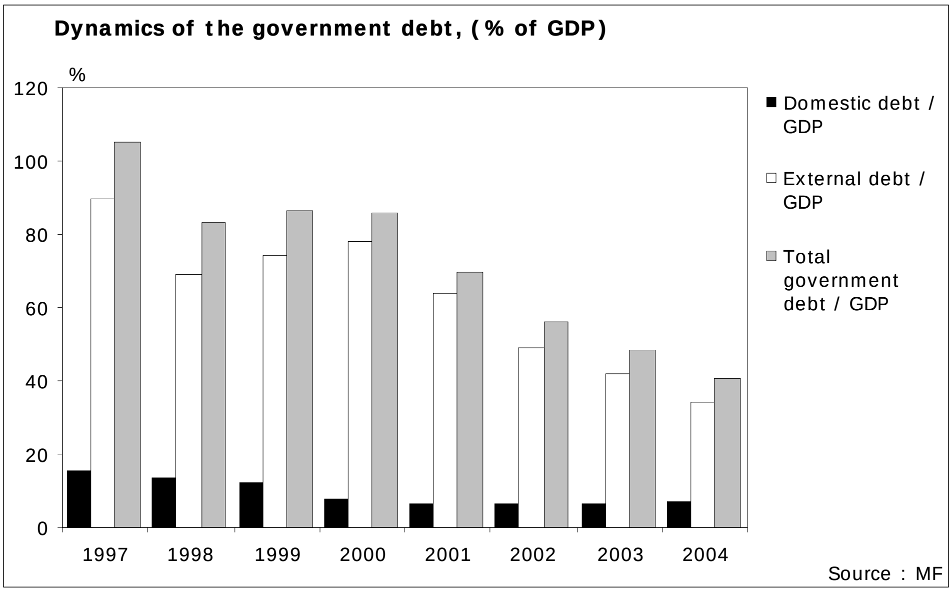
Overall in 2004, non-interest expenditures increased by 8.7% due to the higher social expenditures and

Expenditures by functions

2004	***Share in total expenditures, (%)***	***Growth toward 2003, (%)***
Total Expenditures	***100***	***8.0***
I. General Public Services	*7.3*	*1.6*
II. Defence and Security	*12.8*	*8.9*
III. Education	*10.9*	*9.8*
IV. Health Care	*11.6*	*4.2*
V. Social security and welfare	*34.5*	*9.0*
VI. Housing, Communal Amenities and Environment	*3.9*	*17.9*
VII. Recreation, Culture and Religion	*2.0*	*6.2*
VIII. Economic Affairs	*12.4*	*13.3*
I□. Expenditures, not classified under the other functions	*4.6*	*-3.7*

Source: MF

wages in the budgetary sector. At the same time, interest payments decreased by 3.7% as a result of the favourable EURs exchange rate to the USD and lower countrys foreign debt in a lesser degree. And vice versa, interest expenditures on the domestic debt reported a 10.8% rise, triggered by the positive net issue of government securities and higher domestic debt.



As of end-2004, the government debt/GDP ratio stepped down by 7.4 percentage points on a year earlier to 40.9% due mostly to the nominal-term GDP growth, USDs lost ground to the EUR and budget savings. The latter were used by the government to reduce the foreign debt by exercising its call option on a USD 774.4 million worth of a buyback of DISCs at their face value. The security released amounted to USD 293 million. The foreign debt declined in both USD (3.5%) and EUR terms (10.5%). Its share in the debt total went down by about 3.7 percentage points to 82.8% as a result of the above transaction and debt refinancing from domestic sources. In addition the downward trend in the share of the USD-denominated debt was further sustained at the expense of the EUR-denominated debt, lessening FX risks in debt servicing. The USD debt accounted for 39.4% of the debt total vs. 42.3% on a year earlier, whereas the relative share of the debt in EUR went up from 34.9 to 44.4% in end-2004.

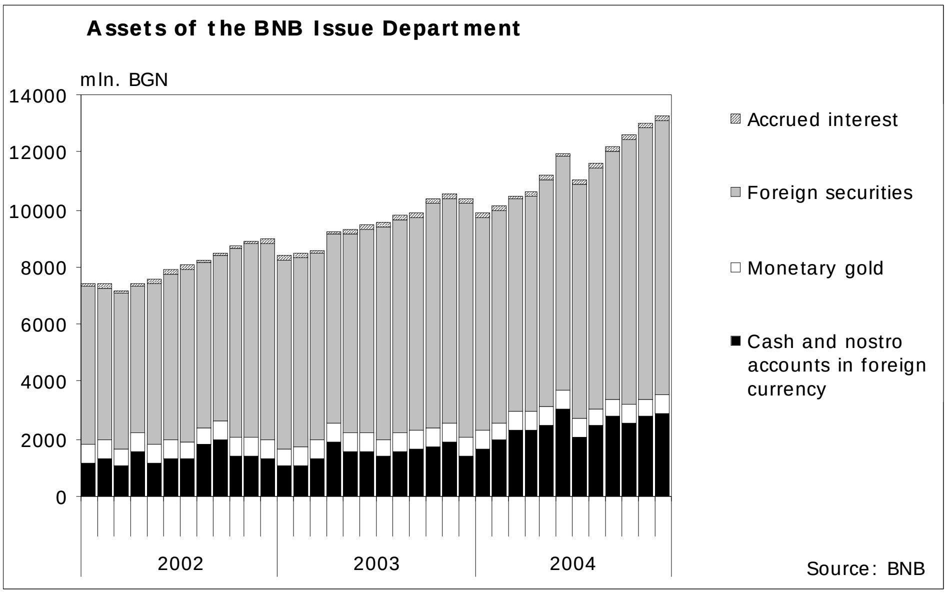
FINANCIAL SECTOR

Currency Board

The high rate of money supply growth persisted throughout 2004. Broad money increased by 23.1% (BGN 3.83 billion) in nominal terms thus signalling an ongoing remonetisation of the economy. In end-2004, the M3/ GDP ratio reached 53.7%, up from 48.1% in end-2003.

The banking systems net domestic assets stepped by 33.2% up (BGN 3.5 billion) and thereby accounted for the largest contribution to money supply growth in 2004. Regardless of the 11.3% growth of the banking systems net foreign assets (up by BGN 1.1 billion), they contributed somewhat less to money supply growth due to the shrinkage of commercial banks foreign assets. The depreciation of the US dollar to the lev was also responsible for this dynamics.

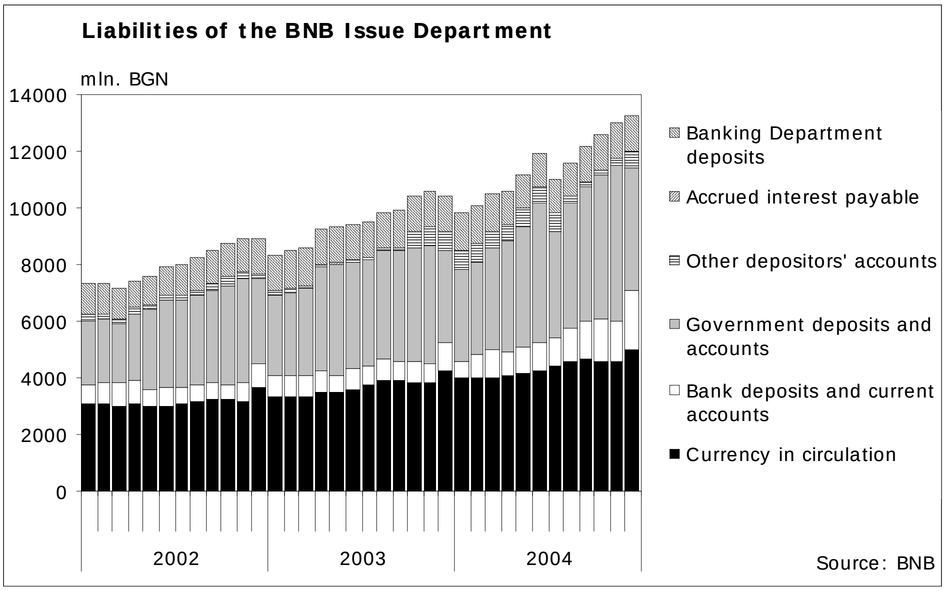
The central banks net foreign assets stepped by 35.4% (or BGN 3 billion) up primarily as a result of the increase of its FX reserves. The BNB Issue Departments balance sheet value grew by 27.5% up to BGN 13 241.7 million thus proving the stability of the currency board arrangement. Within the structure of FX reserves in 2004, the share of vault cash foreign currencies went up by 7.8% at the expense of the 6% decrease of the weight of tradable foreign securities.

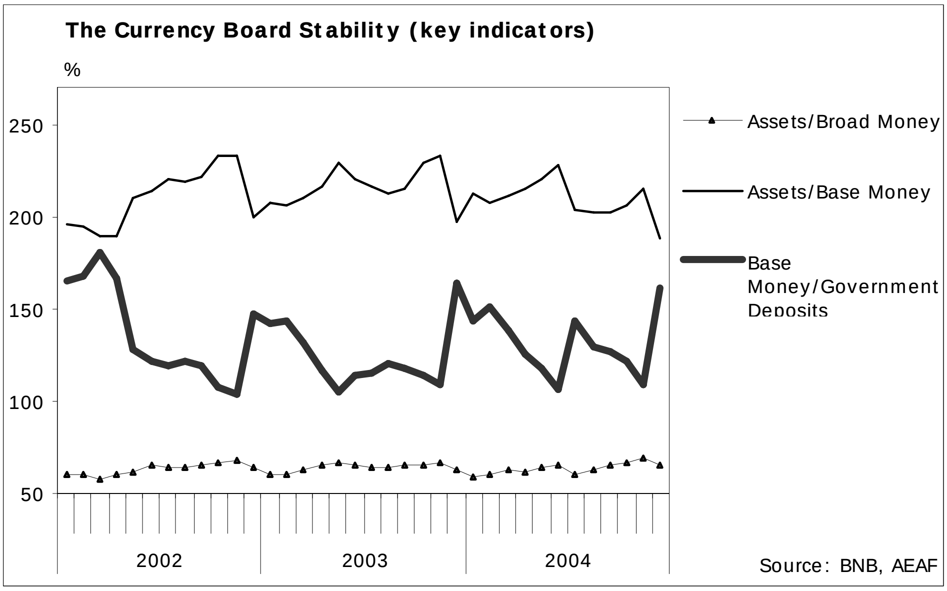


In 2004, privatisation proceeds[25], the satisfactory budget performance and a World Bank loan received resulted in the increase of the governments deposit with the BNB. In May, central government withdrew its deposits falling due in May from the commercial banks and transferred them in the central bank in an effort to curb credit growth in the economy thus also contributing to the increase of the fiscal reserve account. All these factors allowed the government to make repayments on the countrys foreign debt and to carry out another Brady Bonds buyback operation in end-July without any reduction of the currency board assets relative to end-2003.

Furthermore, the dynamics of FX assets was also strongly influenced by the 103.4% year-on-year increase of commercial banks settlement accounts and deposits with the BNB as a direct result of the measures

[25] *From the sale of BTC and a third GSM license in June.*





taken to slowdown credit expansion in the country.

The new regulations on the minimum required reserves affected the FX/ reserve money coverage ratio which fell by 9.5 percentage points relative to end-2003 to 187.6% in end-2004. However, base money coverage ratio stepped by 2.3 percentage points up to 64.9%.

In 2004, the net foreign assets held by commercial banks decreased by BGN 1.9 billion on a year earlier even hitting negative values in end-year. A sizeable inflow of funds from abroad in the form of attracted deposits and new credit lines was reported throughout most of the year thus making available to commercial banks more funds to be used for lending. In 2004, domestic assets increased by 49.1% (almost BGN 1.5 billion) either because commercial banks strived to diversify their assets or because there were free funds unabsorbed on the domestic market.

Domestic credit the most important component of net domestic assets stepped up by BGN 3.5 billion or 34.3% up on a year earlier. A record fall in claims on the government sector was reported. They decreased almost 2.5-fold relative to edn-2003 (a little over BGN 1 billion) to reach a negative value in end-2004 regardless of the typically high government expenditures in December. As a whole, the dynamics of bank claims on the government followed a steady downward trend with payments on the debt to IMF and the Bradies buyback operation only temporarily reversing the trend.

Commercial Banks Credit Expansion and Counteracting Measures

Claims on the non-government sector sustained very high growth rates in 2004. Lending to the private sector played the most important role for both the increase of money supply and the development of the entire financial sector. Regardless of the measures taken to curb credit expansion, claims on the non-government sector grew by 48.7% (BGN 4.6 billion) and the non-government sector credit/GDP ratio reached 37.1% against 28.1% in end-2003. Household loans reported the highest rates of increase, stepping by 74.8%, or BGN 1.9 billion, up on a year earlier. Lending to private enterprises reported the highest y-o-y rise in absolute terms, i.e. BGN 2.5 billion or 39% up on a year earlier. The credit extended to financial enterprises grew at the surprisingly high rate of 69.1% yet in absolute terms its increase remained negligible at BGN 175.6 million. As for the currency and maturity structure of new lending, the trends discerned in 2003 were sustained in 2004 as well. The share of foreign currency denominated credits grew from 41% in end-2003 to 45.6% in 2004 with 90.5% of them being in euro. There are a number of possible reasons explaining the ever growing weight of the euro in banks assets. In view of the shaky exchange rate of the US dollar the euro logically emerged as the preferred option due to the absence of any FX risks. Moreover, the bulk of business transactions is carried out in euro owing to the expanding business relations with EU member states.

The upward trend in credit maturity was sustained with long-term loans accounting for 28% of all credits in end-2004 against 18% a year earlier. The reported 127.5% year-on-year increase of long-term lending may have to do with the sizeable growth of investment in new fixed assets or greenfield investment. These investments gradually supplant the overhaul or partial renovation of old assets which are primarily funded by mid-term borrowed capital. This is a positive phenomenon with optimistic indications of the adaptation of the Bulgarian economy to competition and standards in the EU.

In 2004, housing mortgage loans reported the most dynamic development triggered by the real estate market upturn. The continual price increase of residential properties in the last years and anticipations that the approaching date of accession to the EU would send real estate prices soaring lay behind the boom in mortgage loans which went by 149.9% up to BGN 996 million.

Short-term and medium-term lending increased by 40.1% and 27% respectively. Consumer loans stepped by 59.9% up while increasing by about BGN 1 billion in absolute terms. Consumer credit expansion may be explained by the increasing incomes of households. Increased consumer borrowing and the use of borrowed funds for current consumption of local and imported goods pushed up consumer goods imports by 28.4% in 2004 against 17.8% in 2003.

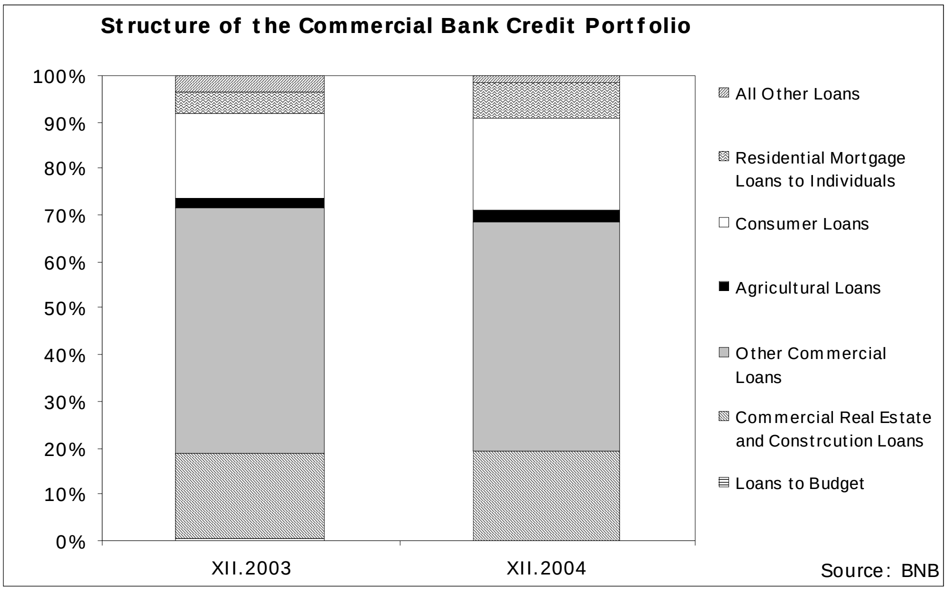
The trade deficit with a general upward trend and the link between consumer credits and consumer goods imports posed the issue of finding ways to curb lending with a view to reducing the BoP current account deficit. Besides, the situation of the banking system could well be jeopardised by the persisting high credit growth rates from the preceding year because of the higher credit risk taken by commercial banks. Therefore, the BNB and the government jointly decided to undertake action to withdraw liquidity from commercial banks.

In early-April 2004, the central bank amended its Regulation on the Evaluation and Classification of Risk Exposures of Banks. In the following month, the government started to withdraw its fiscal reserve from the commercial banks so as to cut back their liquidity. The implementation of these measures immediately resulted in a certain slackening of credit growth rates while the base interest rate increased to 2.86% in May and further to 3.84% in June triggered by the lowered demand for government securities. Initially, it seemed that the measures taken had produced the desired effect in the long term. However, July proved these anticipations wrong witnessing another 4.9% month-on-month rise in lending in spite of the new measure launched to expand the deposit base for the calculation of minimum required reserves maintained with the

BNB by banks. Starting 1 July 2004, commercial banks had to allocate also reserves to the amount of 4% on the attracted resources with maturity of over 2 years while since October 2004 only 50% of their cash in vaults and ATM terminals were recognised as minimum required reserves. The latter measures did not produce the desired effect and therefore on 6 December the central bank introduced another disposition on the maintained minimum required reserves requiring that banks allocate 8% reserves on the attracted resources with maturity of over 2 years. Furthermore, cash in vaults and ATM terminals were no longer recognised as reserves. Nonetheless, in end-2004 credits had increased by 48%[26] on a year earlier. For comparison, in 2003 lending reported 49.7% year-on-year growth.

The measures taken by the central bank and the government failed to curb both the overall credit growth and the increase of consumer loans. One of the reasons behind this is to be found in the fact that banks had managed to secure enough funds because of the growth of attracted resources. On the other hand, commercial banks are unlikely to abandon their lucrative credit expansion given the absence of any clear-cut indication for an aggravation of their credit portfolios or higher credit risk. Ultimately, commercial banks proved successful in managing their assets in a way that allowed them to sustain their aggressive credit policy in spite of the enhanced requirements for maintaining liquid assets in their settlement accounts with the BNB.

Regardless of the high growth of lending, data do not reveal any deterioration of commercial banks credit portfolios. As of September 2004, standard risk exposures accounted for 92.97% of all bank risk exposures against 92.7% in end-2003. The stable development of credit portfolios may also be due to the introduction of a credit register of loans worth under BGN 10 000 allowing banks to track indebtedness of minor borrowers.



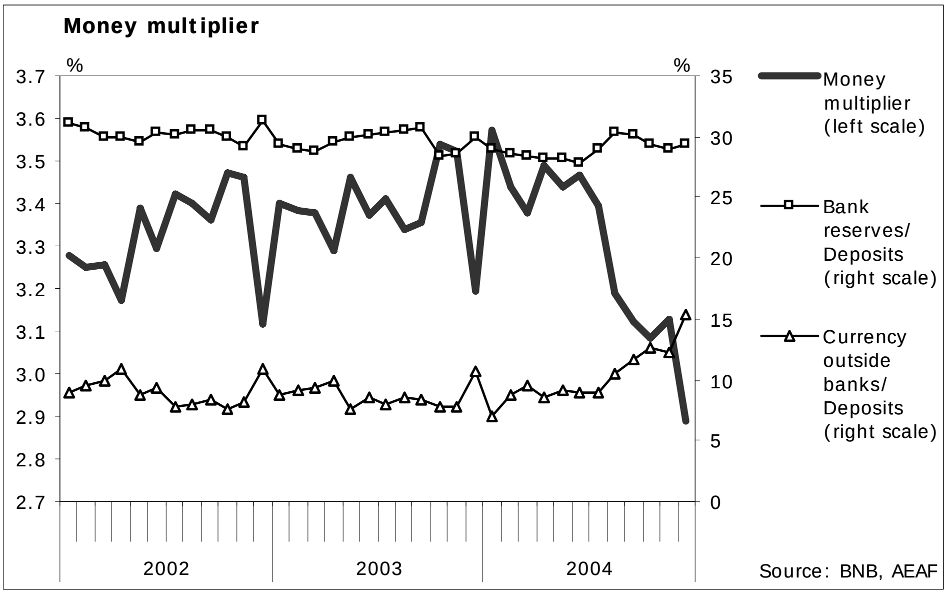
The growth rate of loan extension reflected on the dynamics of monetary aggregates. Highly-liquid aggregate M1 increased by 28.2% (BGN 2.3 billion) with overnight deposits accounting for the biggest contribution to money stock growth in 2004. Loans are generally absorbed via settlement accounts and as a result of the rise in corporate credit and the funds allocated for the newly established „Public Investment Company“, overnight deposits stepped up by 36.4% or BGN 1.5 billion. Money in circulation grew by 19.4% (BGN 753.8 million). Increasing by 18.6% (BGN 1.6 billion), quasi-money also contributed to money supply growth. Although their foreign exchange component still ran higher than the BGN component, time deposits in BGN reported a notable growth of 32.5% against

[26] *According to commercial banks consolidated balance sheet. The reported growth rate of credits differ from the one calculated by monetary statistics due to the differing data aggregation.*

an 8.4% increase of foreign currency denominated time deposits. Inasmuch as quasi-money to a great extent represents household savings, this dynamics signals that households are already more inclined to save in BGN. Besides, the share of BGN deposits has been steadily approaching that of foreign currency deposits. The total volume of deposits[27] followed the same trend with the BGN component already exceeding the foreign currency one, increasing by 36.5% in 2004 as compared to a 13.9% growth of the latter. The year-on-year increase of long-term deposits remained rather high at BGN 192.3 million, going by 95.3% up on a year earlier.

The measures taken in order to curb credit growth had a substantial impact on the money supply mechanism. Bank reserves stepped up notably, thus bringing about an increase in the bank reserves/deposits ratio. Thereby, the value of money multiplier followed a steady downward trend in the second half of the year to reach its lowest for the last four years 2.89 as compared to 3.15 in end-2003. As a result, the contribution of the multiplier ran negative on an annual basis and monetary base remained the only one to contribute positively to broad money growth.

The succession of measures to curb crediting influenced interbank money market interest levels as well. The interest rate dynamics was predetermined by commercial banks shortage or surplus of BGN funds. It is noteworthy that while the first measures to restrict credit growth pushed up interest rates at the interbank money market in

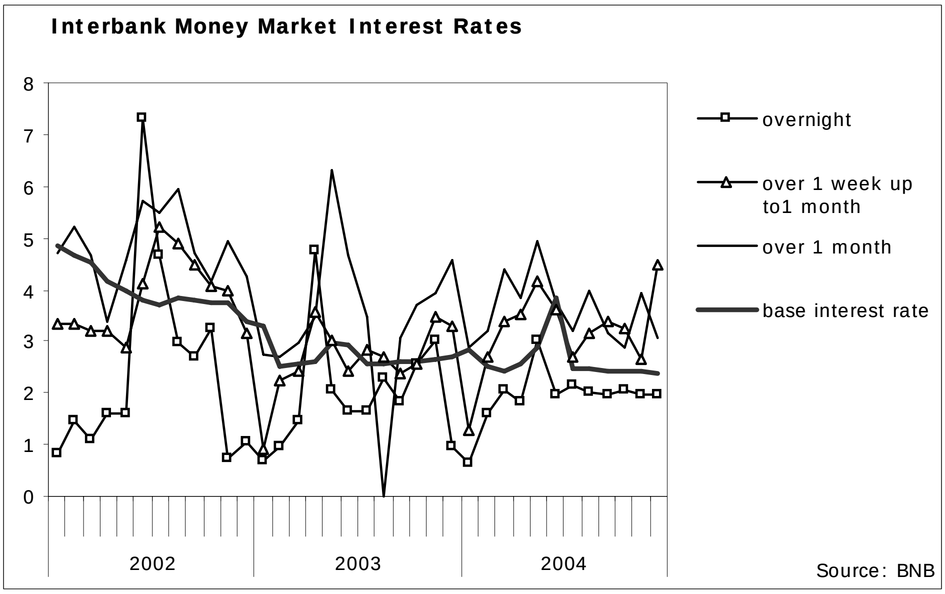


Monetary Base and Money Supply Mechanism

	Over the 31.12.2002 - 31.12.2003 period	*Over the 31.12.2003 - 31.12.2004 period*
Monetary base change (in BGN million)	*784.0*	*1792.1*
Coefficient of money multiplier variation (%)	*from 3.09 to 3.15*	*from 3.15 to 2.89*
Change in M3 by factor:		
1. due to a change in money multiplier (in BGN million)	*243.0*	*-1350.1*
2. due to a change in M3	*2423.7*	*5637.5*
3. due to a change in money multiplier and monetary base	*42.5*	*-459.4*
Change in M3 (in BGN million) =1+2+3	***2709.1***	***3827.9***

Source: BNB, AEAF

[27] *Comprising also overnight deposits and long-term deposits not included in money stock.*



BGN (3.09% in May 2004), the subsequent measures did not bring about any notable interest level changes thus signalling that banks have succeeded to manage well their liquidity. Since early-July 2004, the BNB has started to buy and sell euros from/to commercial banks at one and the same exchange rate thereby allowing commercial banks to use their euro assets to secure the required liquidity in BGN without incurring any exchange rate losses. Thus, as of end-2004 the BGN and euro interest rates on the interbank money market had almost equalised.

Commercial banks secured sizeable profit as a result of their credit expansion. In end-2004, commercial banks net profit amounted to BGN 434.1 million, stepping up by 14.3% on a year earlier. On the whole, the profitability indicators also improved in 2004. The net interest income/balance sheet assets ratio improved notably as a result of banks good management of their assets and liabilities. Commercial banks made the most from credit expansion using the interest rate difference between extended loans and attracted deposits. Another notable feature is the considerable increase of non-interest expenditures, indicating that the banking system operating expenses had gone on the rise. Expenditures for wages and social security contributions had also grown apparently as a result of the hiring of better qualified personnel to manage banks expanding credit portfolios.

Profitability Indicators of the Banking System* (% of average assets)

	12.2001	12.2002	12.2003	12.2004
Net profit	2.7	2.1	2.4	2.1
Operating profit	3.5	2.7	2.9	3.3
Net interest income	4.3	4.1	4.8	6.6
Operating expenditures	5.0	4.8	4.6	5.6
Foreign currency revaluation	0.3	0.1	0.2	0.2

** On an annual basis* *Source: BNB, AEAF*

The analysis of operating profit by bank groups shows that larger banks were more profitable. Non-interest expenditures/operating profit ratio ran smaller (148.5%) in Bank Group I while in Bank Group II it hit 317.7%. Bank consolidation would improve the stance of smaller banks vis-à-vis larger ones, making them abler to cope with competitive pressure. Smaller banks had a higher net income from interest because they offered relatively higher rates on credits and were unable to lower them. The ratio of net credit provisions to operating profit in this bank group also ran higher having to do with their relatively worse credit portfolios. As of September 2004, standard risk exposures in Group II stood at 91.84% vs. 92.97% in the entire banking system.

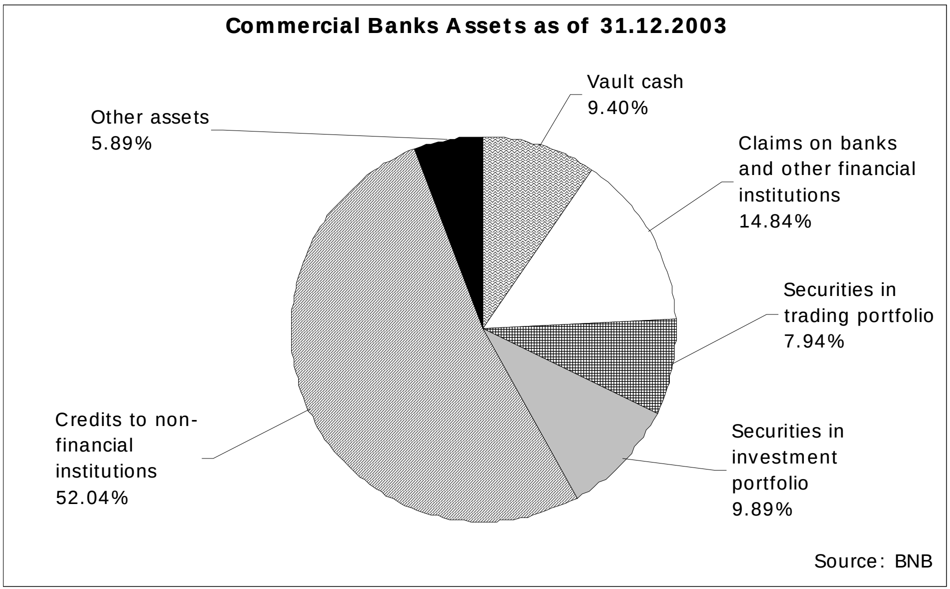
Operating Profit by Components and by Bank Group as of 31.12.2004*

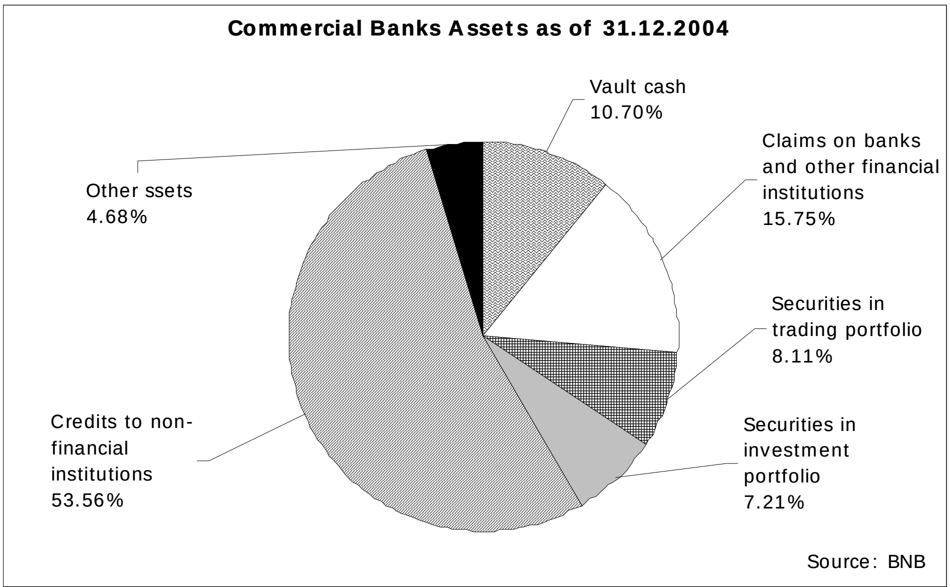
	Group I (%)	Group II (%)	Group III (%)
Interest and dividend income, net	186.1	298.4	169.0
Credit provisions, net	-23.3	-53.0	-3.5
Trading portfolio, gain/loss	3.1	17.1	2.1
Gain/loss on investments available for sale	12.2	7.6	-0.4
Gain/loss on investments held to maturity	1.6	-0.2	0.0
Other non-interest income	68.8	147.7	85.0
Non-interest expenditures	-148.5	-317.7	-152.2

** a + sign denotes a positive contribution to profit; a - sign denotes a negative contribution to profit*

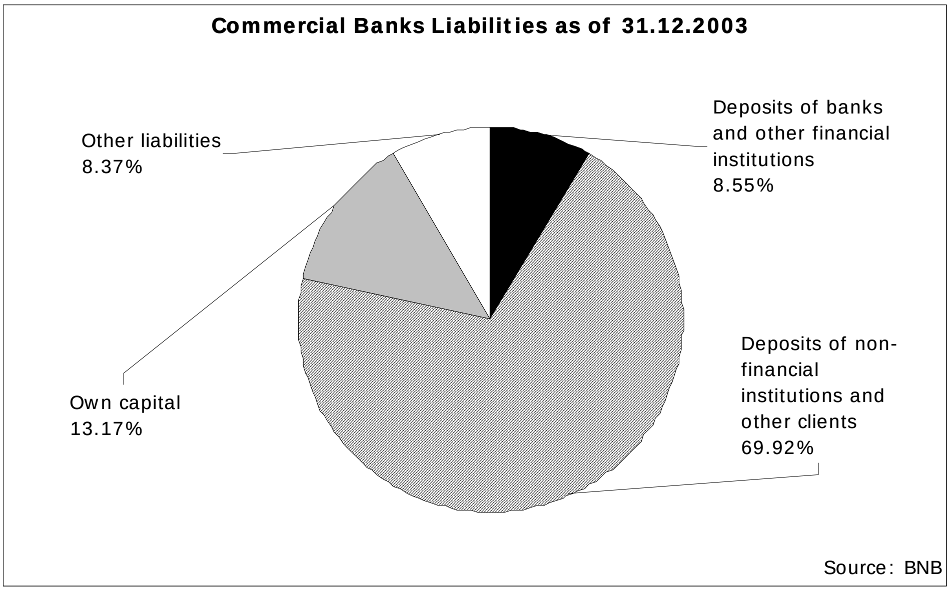
Source: BNB, AEAF

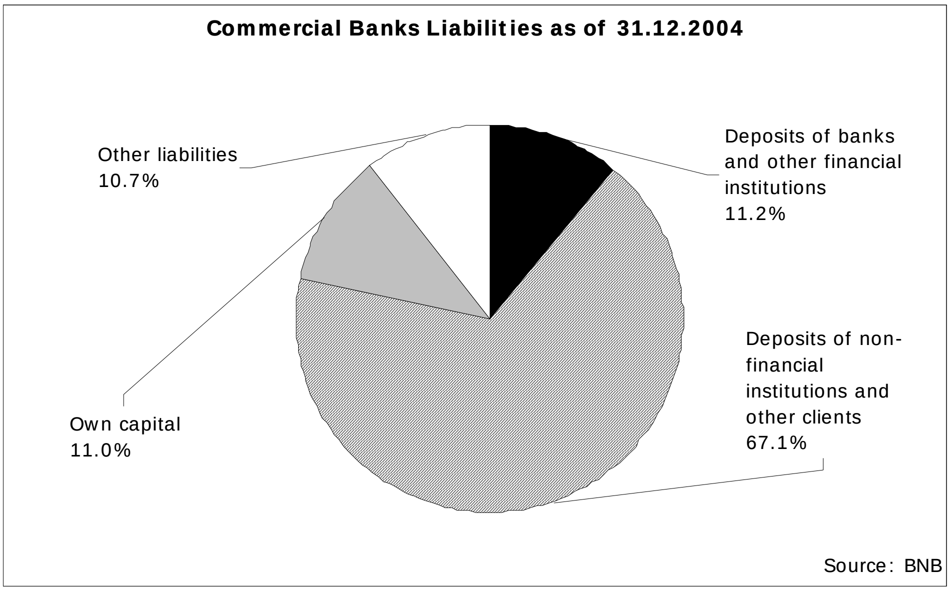
Credit expansion and the measures taken to restrict it also influenced the assets structure of commercial banks. Banking system assets reached BGN 24.9 billion. The pace of credit growth outstripped that of assets (43.8% year-on-year increase in 2004) and, as a result, the share of credits to non-financial institutions stepped up from 52.04% in end-2003 to 53.6% in end-2004. The weight of vault cash also went on the increase following the measures undertaken by the central bank to curb the growth of lending. The rising values of the primary and secondary liquidity indicators confirmed the banking systems overall good liquidity level. A turnaround was reported in 2004 in the downward trend in claims on banks and other financial institutions. Commercial banks expanded the volume of loans by seeking ways to attract more funds rather than by restructuring their assets.

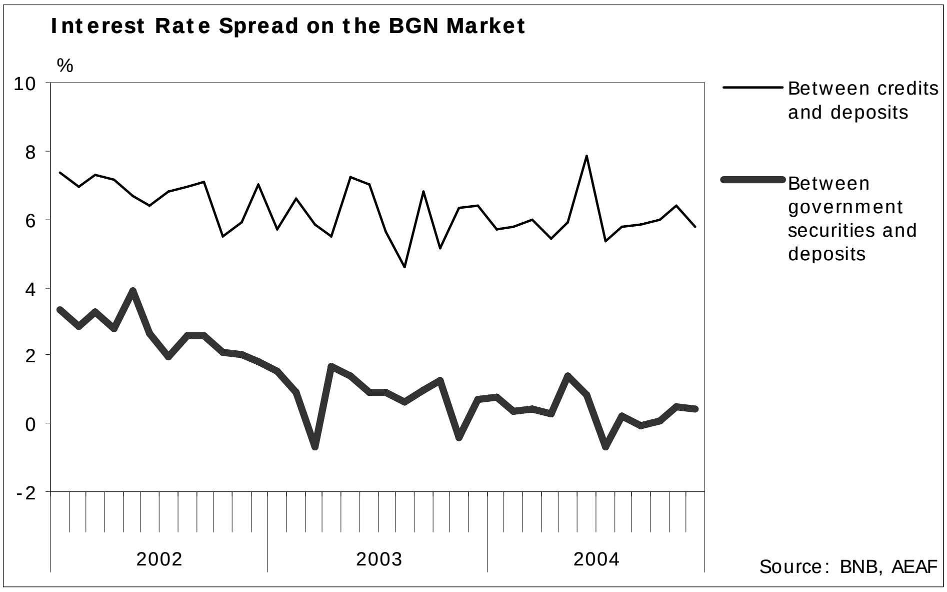




Banks policy to attract more deposits from the







various economic sectors reflected on the liabilities structure of commercial banks. Although the deposits of non-financial institutions and other clients stepped by 38% up (or BGN 4.6 billion) to reach BGN 16.7 billion, their share in the liabilities total shrank by 1.2 percentage points to 68.7%. It is noteworthy that the increased volume of loans extended was fully covered by the attracted deposits of non-financial institutions. Furthermore, commercial banks secured sizeable funds from foreign financial institutions in the form of time deposits and credit lines which helped them to maintain liquidity in spite of BNBs restrictive measures.

Striving to obtain competitive advantages in the race to attract more depositors and borrowers, commercial banks made efforts to offer a variety of new products not only to corporate clients but also to households. Some of the banks drastically lowered interest rates on loans and respectively raised interest on deposits and, as a result, bettered their market stance. Consequently, the annual average interest difference between short-term credits in

BGN and time BGN deposits went on the decrease, stepping down by 9 b.p. to 6% in 2004.

Competition among banks remained intense in 2004 as confirmed by the low values of the concentration indicators. Still, the concentration indicators as regards claims on non-financial institutions and other clients slightly went up relative to end-2003. The increase was due to the more active credit expansionist policies of the top three lenders, i.e. *DSK* Bank, *Bulbank* and *UBBank*. The value of the concentration indicators as regards bank assets and deposits sustained the downward trend having to do with the contraction of the market shares of the larger banks.

Measures of Concentration in the Banking Sector

	12.2000	12.2001	12.2002	12.2003	12.2004
Bank assets					
Herfindahl Index	0.11	0.09	0.08	0.08	0.07
Concentration Coefficient (%)	55.2	51.4	49.9	47.0	43.8
Claims on Non-financial Institutions and Other Clients					
Herfindahl Index	0.08	0.07	0.07	0.07	0.07
Concentration Coefficient (%)	43.6	41.3	41.6	44.1	42.4
Deposits of Non-financial Institutions and Other Clients					
Herfindahl Index	0.13	0.11	0.10	0.09	0.08
Concentration Coefficient (%)	62.2	58.3	55.8	53.1	48.7

Source: J. Miller, S. Petranov, „Banking in the Bulgarian Economy“, 1996; BNB; AEAF

Competition pressure from the part of bigger banks and the pending accession to the EU are a prerequisite for a future consolidation in the banking sector. The process was launched in 2004 with the signing of agreement for the purchase of *Hebros Commercial Bank* by *Bank Austria* and its subsidiary in Bulgaria *HVB Bank Biochim*. The full integration of the banks is to be completed in 2006.

Growing Role of Non-Bank Financial Institutions

Although the financial system was still dominated by banks, in 2004 non-bank intermediaries played an ever growing role providing economic agents with opportunities for alternative ways to raise and invest free resources in the economy. All indicators gauging the depth of financial intermediation of non-bank financial institutions improved. The ratio of market capitalisation of the stock exchange to GDP increased to 10.6% in end-2004 from 7.9% in end-December 2003. As of end-September 2004, insurance penetration ran at 2% (vs. 1.8% in September-2003). The ratio of pension funds assets to GDP and gross national savings stepped up to 2.1% and 13% respectively (vs. 1.5% and 11.8% in end-2003).

Depth of Financial Intermediation, % of GDP

	06.2002	12.2002	06.2003	12.2003	06.2004	12.2004
Commercial bank assets	39.9	45.0	46.3	50.2	55.8	65.6
Pension fund assets	0.8	1.0	1.2	1.5	1.7	2.1
Insurance premiums	1.7	1.9	2.0	1.9	2.2	-
Market capitalisation of the stock exchange	4.1	4.3	5.2	7.9	8.0	10.6

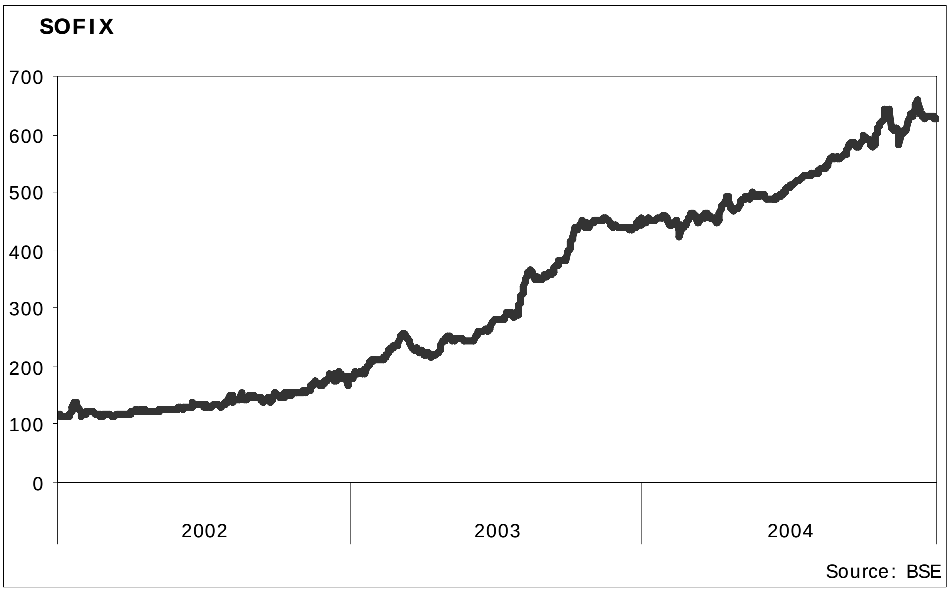
Source: BNB, FSC, AEAF, BSE-Sofia

As of end-2004, the total amount of accumulated assets in pension funds had reached BGN 787.4 million, reporting a year-on-year increase of 54.2%. The funds raised by universal funds reported the largest growth rate, stepping up by 128.9% on a year earlier to reach BGN 261.1 million. Some 2 million persons were insured in universal funds, accounting for 73.8% of the total insured in pension funds. This high growth pace is expected to sustain allowing universal funds to accumulate more assets than voluntary pension funds. The current leader had raised BGN 325.5 million vs. BGN 252.7 million in end-2003. Occupational funds provided insurance coverage to some 176.2 thousand persons and had accumulated by end-2004 assets worth BGN 200.8 million. The concentration of assets with all types of funds remained rather high. The four largest occupational funds managed some 91% of all assets in the group while the four biggest voluntary and universal funds were responsible for just under 90% of the funds raised.

In 2004, pension funds continued to pursue a policy of portfolio diversification. The share of investment in corporate bonds, shares and mortgage bonds went on the increase to reach about 22% of assets in all pension funds. Following a certain contraction of investment in securities listed for trading at the stock exchange reported in early-2004, in end-year pension funds resumed active investment in these securities. The substantial increase of the share of assets invested in mortgage bonds is noteworthy which was predetermined by the increased offer of diverse mortgage bonds. At the same time, intensified investment in financial instruments traded at the capital market boosted the development of the market itself. Universal and occupational funds restricted their investment in government securities most probably because of the falling interest rates on local government securities. Pension funds also opted for investing abroad yet the share of these investments was below 1%.

In end-September 2004, insurance companies reported a 23.1% year-on-year gross premium income growth up to BGN 549.2 million. Premium income in the general insurance industry grew by 21.9% in end-September 2004 (to BGN 487.5 million) while stepping up by 33.7% (year-on-year) in the life insurance segment. The latter reported a real turnaround in business expansion after the registered fall in income in 2003 then triggered by the new amendments to tax legislation in the country.

In 2004, the official stock exchange index, SOFIX, rose by further 39% after recording a 150% growth in the preceding year. The index growth rates slackened primarily because of the gradual approximation of the share prices of most companies, making up the index, to the values corresponding to their actual financial situation and the economy as a whole.

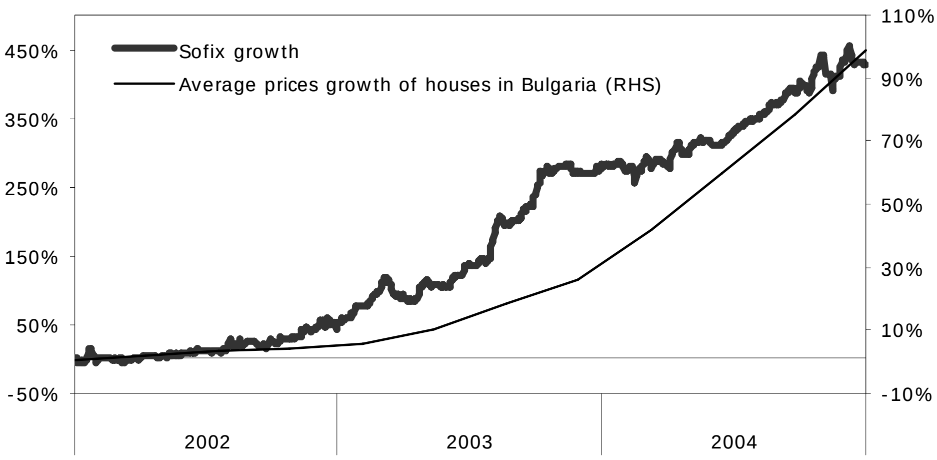


The concurrent effect of macroeconomic stability and sustainable GDP growth with exceptionally positive expectations for the future economic development pushed share prices up. By and large, the factors predetermining the stock exchange index rise were identical to those boosting the development of the real estate market. At the same time, the relatively low interest rates on bank deposits and the narrow assortment of available alternative investment instruments practically sustained the inflow of fresh financial resources exactly to those investment instruments that had already proved profitable enough to offset the risk related to them.

Although the thirteen companies, making up the index, accounted for over 50% of the market capitalisation of all 332 companies listed on the BSE as of December 2004, the companies not covered by the index reported a faster growth pace of share prices. This dynamics signals the growing interest in the smaller companies that had been hitherto estimated as more risky for investment whether because of intrinsic factors or due to the lower liquidity of the bulk of them.

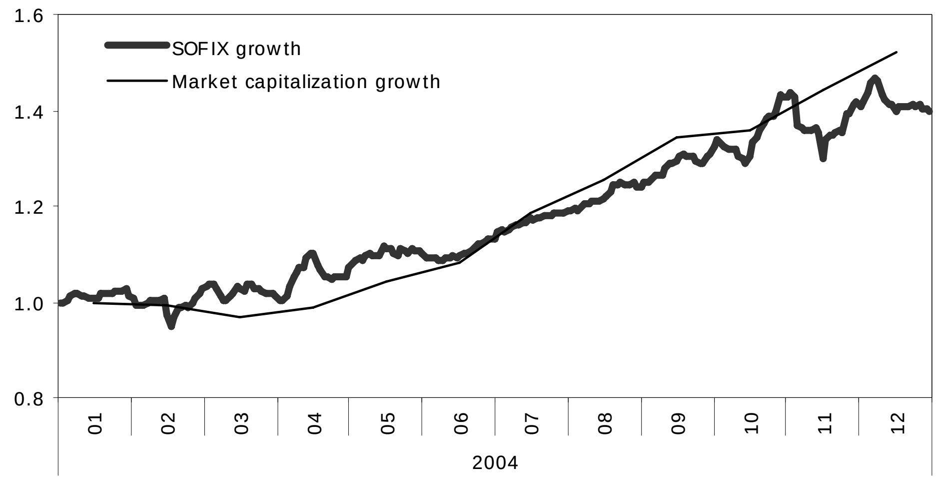
In 2004, the overall liquidity of the companies listed on the stock exchange improved. The average monthly turnover to average monthly market capitalisation ratio reached 1.75% in 2004, up from 0.75% in 2003. Regardless of their positive development, the values of

SOFIX Growth and Growth of Average Prices of Houses in Bulgaria



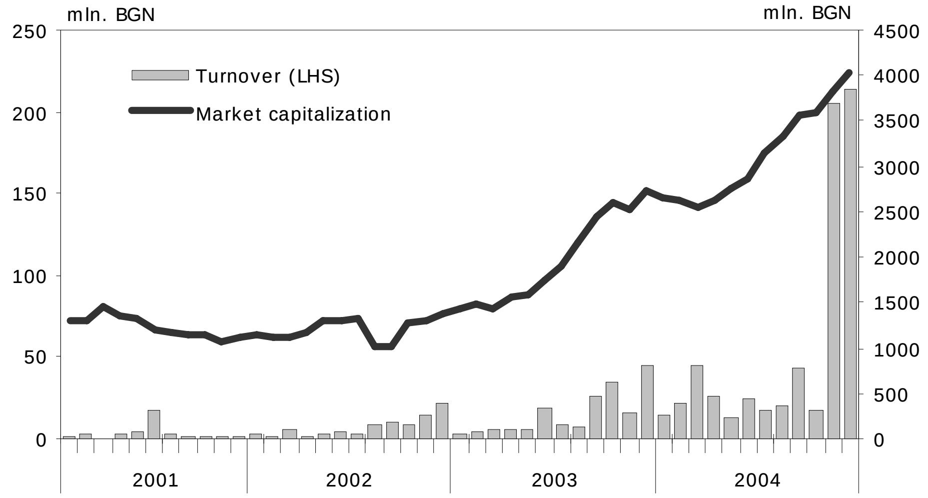
Source: BSE, NSI, AEAF

SOFIX Growth and Market Capitalization Growth



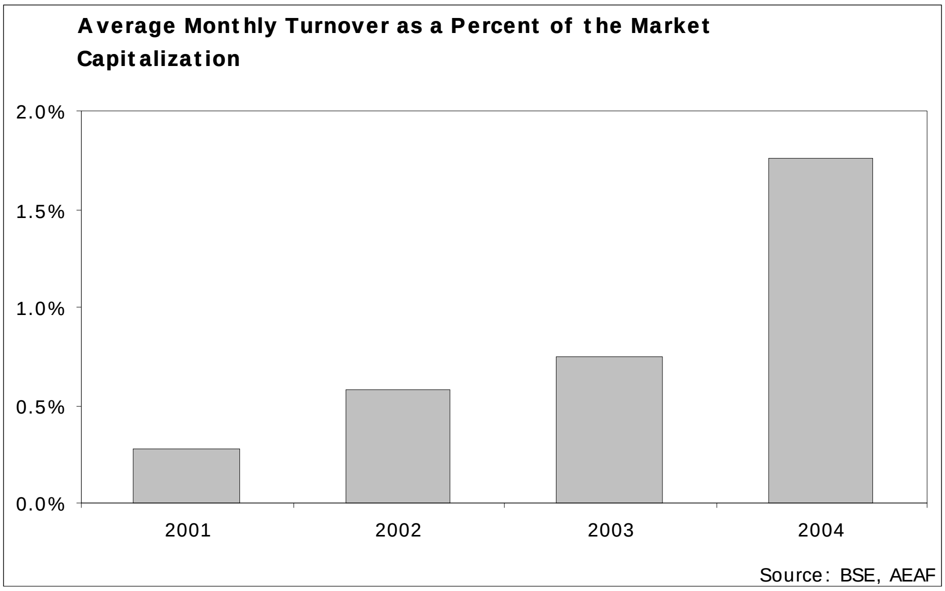
Source: BSE

Turnover - Market Capitalization



Source: BSE

these indicators remained much lower than the values typical for the other CEEC. The stock exchanges liquidity remained one of its major drawbacks. To a great extent, its low liquidity is predetermined by the limited volume of shares offered for sale because the majority shareholders in most companies hold a high percentage of the shares.



The simultaneous increase of both the volumes traded and the market capitalisation is a clear signal that the upward trend will persist in the short to medium term. However, due to the small volume of free shares in circulation, any drastic fluctuations of demand may also result in considerable price fluctuations that are not based on any fundamental changes of the price basis.

The privatisation of enterprises that are significant for the national economy continued to influence the stock exchange in 2004 as well. The divestiture of the firms in *Bulgartabac holding* group and the sale of the residual shares of *BTC* on the stock exchange were the ones that exercised a most profound impact on the BSE dynamics. The anticipated sale of the subsidiary companies in the Holding pushed up the share prices of the Holding and its most lucrative subsidiaries, viz. *Blagoevgrad BT* and *Sofia BT* just before the bids of the potential buyers were made known. Afterwards, as of October, their share prices dropped by 19-28% and failed to reach again their peak values, remaining however well above the 2003 levels. Because of the sizeable market capitalisation of *Blagoevgrad BT* and *Bulgartabac holding* both companies strongly influenced the dynamics of SOFIX index and their entangled divestiture was one of the underlying reasons behind the weaker growth of the stock market index in 2004. The trading volumes of shares of *Bulgartabac holding, Blagoevgrad BT* and *Sofia BT* sustained exceptionally high levels throughout 2004 both because of the diverging expectations of investors and the relatively high for the Bulgarian capital market volumes of available shares.

The other cardinal privatisation deal that of the Bulgarian Telecommunication Company had a more indirect effect on trading on the BSE since the residual state-owned shares of *BTC* were to be sold in early-2005 against compensatory instruments. Thus, the deal was instrumental for the re-channelling of funds from the purchase of shares to the purchase of compensatory instruments. Throughout the entire 2004, the trading volumes in compensatory instruments were comparable to the volumes traded in shares of companies making up SOFIX index while in certain months the former were considerably higher than the latter. The hefty share of *BTC* put up for privatisation and the sheer size of the company itself predetermined the lasting interest in the purchase of compensatory instruments. In early-2004, buyers strived to buy compensatory instruments in such volumes that could not drastically affect their prices. With the approaching of the sale date, however, the prices of compensatory instruments soared because of both the greater certainty around the divestiture itself and the increase of the size of the minority parcel offered for sale two months before the privatisation. The percentage put up for sale on the BSE was raised from 20 to 35 which was tantamount to a 75% increase of demand for compensatory instruments than the initially envisaged volume of demand, hence the hefty price increase reported in the months preceding the sale of BTC. Thus, while in early-2004 compensatory instruments were traded at 21% of their face value, by end-year and especially in the last quarter, their prices reached 91% of their face value.

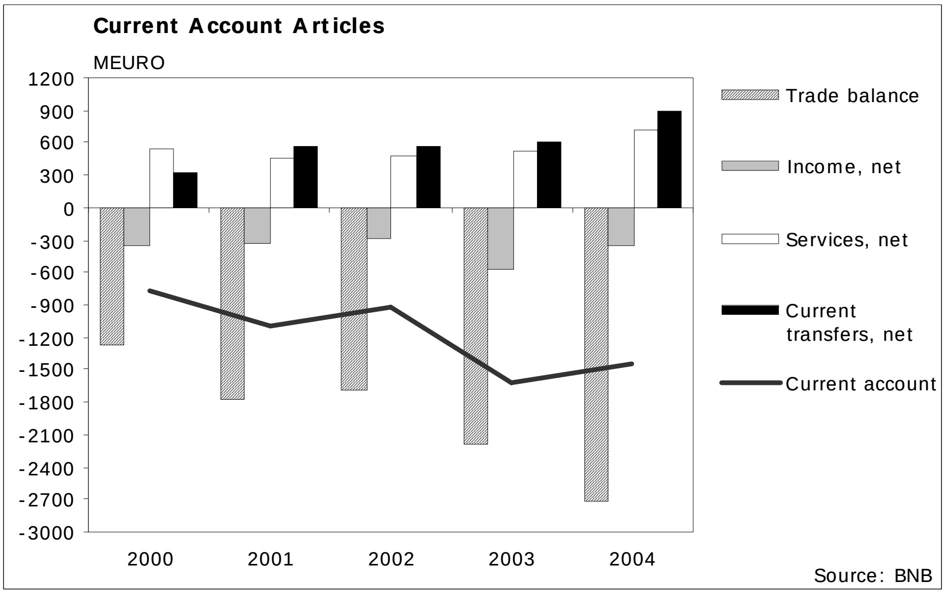
As of end-2004, the average ratio between the book value per share and its market value was close to 1, indicating that the markets average estimation of a company was identical with the book value of their own capital. At the same time, the average share price/earnings per share ratio was higher than the levels accepted as standard on the more developed capital markets. This could be due to both the companies current relatively low profitability combined with expectations for higher growth rates of their profit in the future as well as the investors underestimation of the importance of net gains leading to the attribution of more weight to companies assets. In other words, most companies view themselves more as a collection of assets rather than as profit generator.

	Share prices growth rate, Jan-Dec 2004 (in %)	**Share price/earnings per share ratio as of 29 Dec 2004**	**Book value/market value per share as of 29 Dec 2004**
SOFIX	*39.8*	*35.62*	*1.04*
Albena AD	*80.0*	*14.19*	*1.01*
Biovet AD - Peshtera	*88.0*	*75.25*	*1.18*
Blagoevgrad-BT AD	*36.0*	*10.11*	*0.74*
Bulgartabac Holding AD	*15.0*	*26.89*	*1.29*
DZI	*58.0*	*13.54*	*0.76*
Zlatni Piassatsi AD	*140.0*	*35.06*	*1.27*
Lukoil Neftochim AD	*110.0*	*48.02*	*0.58*
Neochim AD	*230.0*	*11.68*	*1.43*
Orgachim AD	*-6.0*	*2.72*	*0.97*
Petrol AD	*-19.0*	*22.67*	*0.56*
Slanchev Bryag AD	*-12.0*	*172.35*	*2.61*
Sopharma AD	*39.0*	*13.62*	*0.57*
CCB Commercial Bank AD	*74.0*	*16.92*	*0.57*

Source: BSE, AEAF

EXTERNAL SECTOR

According to preliminary BNB statistics, the 2004 current account deficit amounted to MEUR 1447.1 or 7.4% of GDP, improving significantly vis-à-vis the revised 2003 data.[28] The above development had to do with the improved balance on services (MEUR 200.3), income (MEUR 225.7) and current transfers (MEUR 275.5). The sizable current account deficit was mostly due to the persistent and huge trade deficit (MEUR 2718 or 14% of GDP), which further worsened by some MEUR 518.4 on a year earlier.



In 2004, the countrys foreign trade turnover stepped up significantly. Exports (FOB) went up by 19.9%, whereas imports (FOB) rose by 20.8% as a result mainly of the price dynamics of some of the basic commodities. Other factors behind the high countrys trade turnover had to do with the boosted investment activity and commercial bank lending. Also, the weaker USD to EUR and hence the BGN compared to the 1998-2003 period as well as the crude oil price fluctuations gave imports a strong push.

Current Account Items

	2003 (MEUR)	*2004 (MEUR)*	*Nominal*	*Change in %*
Current account	***-1630.2***	***-1452.8***	***177.5***	***-10.9***
Export (FOB)	*6668.2*	*7993.9*	*1325.6*	*19.9*
Import (FOB)	*-8867.8*	*-10711.8*	*-1844.0*	*20.8*
Trade balance	*-2199.6*	*-2718.0*	*-518.4*	*23.6*
Kredit	*2790.8*	*3361.8*	*571.0*	*20.5*
Debit	*-2267.6*	*-2638.3*	*-370.7*	*16.3*
Services, net	*523.2*	*723.5*	*200.3*	*38.3*
Incomes, net	*-566.4*	*-346.4*	*220.0*	*-38.8*
Current transfers, net	*612.6*	*888.1*	*275.5*	*45.0*

Source: BNB

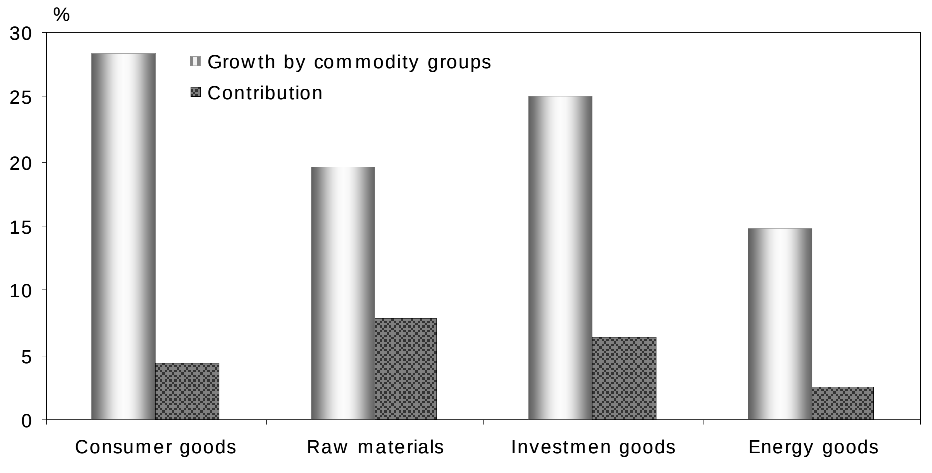
[28] *In its latest publication the BNB has revised the 2003 balance of payments statistics as followed: net income deteriorated by MEUR 125.1, whereas the current account deficit worsened from MEUR 1505.2 to MEUR 1630.3 or 9.3% of GDP. Furthermore, FDIs stepped up most vigorously from MEUR 596.6 to MEUR 1850.5. Also, the data on the portfolio and other investments item have been also revised.*

In the second half-year period of 2004 export growth (19.2%) ran well above imports (11.9%), making almost fully for the first half-year lagging behind. Imports reached some MEUR 11617.4 (at CIF prices), with a most robust increase being posted by raw material imports. Following suit the boosted investment activity, high prices worldwide and strong foreign demand, raw material imports for the export-oriented industries went on the increase as followed: cast iron, iron, steel and ore imports went up by MEUR 347.7, whereas plastic and rubber imports stepped up by MEUR 114.

The strong 2004 consumer import growth was propelled by the rising countrys consumption (mainly oriented to foreign goods) having to do with the year-on-year growth in household credit, nominal wages and employment, deferred consumption as well as the upbeat income expectations. Consumer loans rose by most vigorously by MEUR 513.4 (59.9%), matching the MEUR 419.5 worth of a year-on-year increase in consumer goods imports (28.4%). The importation of medicines and cosmetics and furniture increased by 34.9% and 23.1% respectively. Car imports also stepped up at a rather fast rate, spurred by the effect of the altered methodology of valuation.

Following suit the boosted investment activity and sizable FDI inflows into the country, investment goods imports posted a rather healthy gain of MEUR 617.2 (25%), raising its share within the import total to 26.5%. Machinery, equipment and vehicle imports went up by MEUR 411.7 (28%) on a year earlier. In the short-run, however, the increase is to result in a certain deterioration in the trade balance while bringing about a mid-term improvement in production capacity and strengthened competitiveness in the economy.

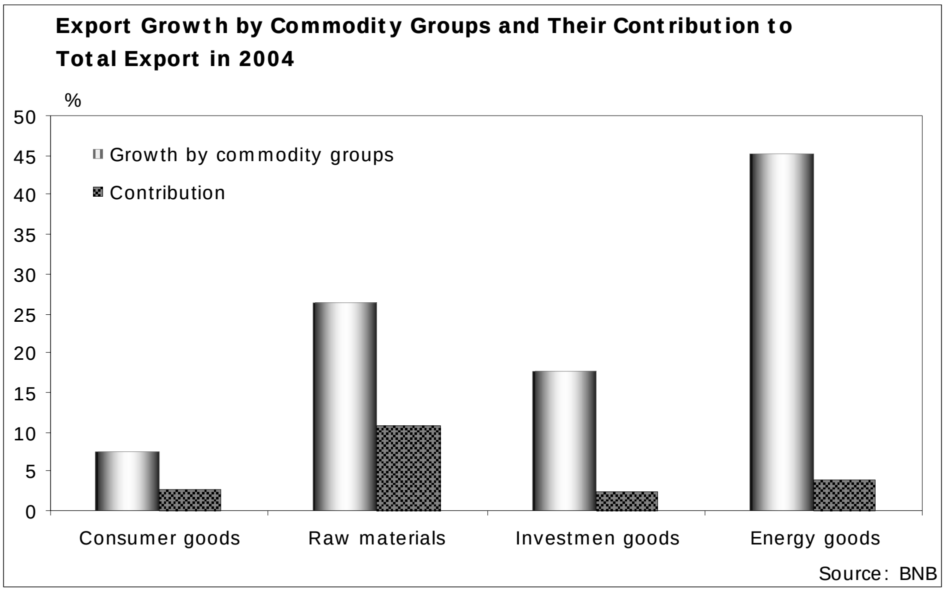
Import Growth by Commodity Groups and Their Contribution to Total Import in 2004



Source: BNB

In the first half-year period of 2004, the expensive single European currency made up for the higher oil prices in USD. In the following six months, however, crude oil prices went on rising, whereas the EUR ceased gaining further any significant ground to the USD. As a result, the average annual import prices reported a year-on-year increase of 17.1% in EUR terms and 30.3% in USD terms. At the same time, the import prices of gas in EUR decreased by 7.6%. The import volumes of crude oil and gas rose insignificantly, but oil product imports stepped up by 41.1%. Due to the combined effect of the above factors energy imports reported a modest rise of some 14.8%, although the international oil prices had meanwhile posted a more robust increase.

2004 exports (FOB) reached MEUR 7993.9, stepping up by MEUR 1325.6 on a year earlier. A major contribution to above growth was made by raw material exports (26.3% up on a year earlier and accounting for 43.6% of total exports) due to the growth-conducive situation in the metal markets worldwide. The high prices spurred a most vigorous rise in cast iron, iron and steel (MEUR 264.5, or 48.9%) and non-ferrous metal exports (MEUR 214.7, or 40.2%). Also, tobacco, food raw material and timber exports went on the increase.



Oil product exports reported a 62.3% nominal-term rise while going up by 36.8% in volume terms.

Slowing drastically down on a year earlier, consumer export growth amounted to only 7.6%. One of the main export items, i.e. clothes and footwear, posted a most dramatic decline from 15.8% in 2003 to 6.4% in 2004 due to the weaker competitiveness of Bulgarian producers, having to do with the growing labour costs in the country and adverse impact on Bulgarian products of the ever-depreciating USD to the EUR and BGN. Also, the expectations that the EU would remove the restrictions on Chinese imports in early 2005 may have come to the same effect, as they exert a strong competitive pressure on the local goods in industries of high labour intensiveness.

Like the exportation of labour-intensive and low value added products, 2004 growth in investment goods exports held steadily high, going up by 17.7% on a year earlier. Machinery, vehicle and other equipment exports have sustained an upward trend for a second year in a row.

The stronger growth in the developed economies and favourable conditions for the performance of the heavy industries boosted the countrys exports. Having risen by 11.6% in 2003, 2004 growth in exports to the EU (15) remained high at 14.9%. Bulgarian exports to □□ (25) stepped up by 16%, and the share of these countries in the export total went up as high as 58.2% due mainly to the strong exportation of ferrous metals to Greece and Italy, clothes and footwear to Germany and Italy, investment goods to Germany and electricity to Greece. The same items were at the core of the higher countrys exports to the Balkan region (31.8% up), Roumania and Turkey in particular (59% and 30.9% respectively up). Around 80% of Bulgarian exports were destined to the □□ (25) and the Balkan countries. As a whole, however, exports were distinctly oriented to the European region, with Germany in the lead (enjoying a share of 10.2% in exports and 14.6% in imports), followed by Italy (13.1% in exports and 9.8% in imports) and Greece (10.2% in exports and 5.7% in imports). Following the economic crisis in the Turkish economy, trade between the two neighbouring countries has rebounded in the past couple of years (accounting for 10% of Bulgarian exports and some 6% of imports). At the same time, the countrys trade turnover is to gain further momentum with Bulgarias integration into the EU markets. Furthermore, curtailing the trade deficit means improving competitiveness in the economy and attracting larger FDI amounts in the export-oriented industries.

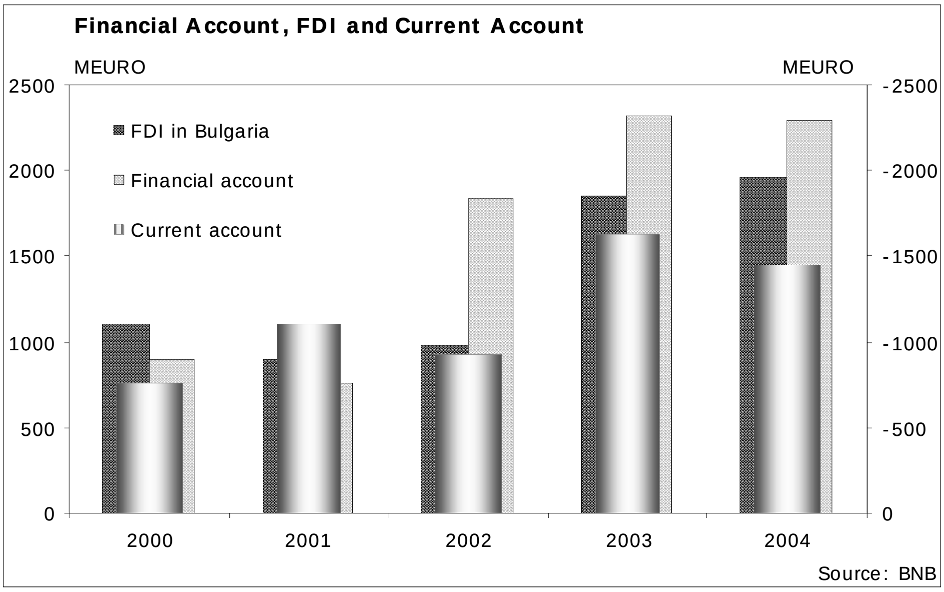
Almost half of the 2004 trade deficit was offset by net revenue from services and current transfers. Net revenues from services amounted to MEUR 723.5, or MEUR 200.3 up on a year earlier. Net spending on transport services ran at MEUR 263.4 vs. MEUR 186.1 in 2003 due mostly to the increased trade turnover. Revenues from tourism stepped up by MEUR 286.3 (19.9%) on a year earlier. The vigorous last two years rise of over 20% pointed to the robust growth potentials of the sector, with the investments made and improving infrastructures being at the core of the progress achieved. On the other hand, the sectors growth capacity is to be further enhanced by raising the quality of services rendered and attracting more affluent holiday makers. At the same time, the number of Bulgarian holiday makers visiting foreign destinations went up by 15%, with neighbouring Turkey being the most frequented destination. Holiday expenditures made by residents on trips abroad rose by 17.3%.

The income balance remained negative at MEUR 340.7 while improving significantly on a year earlier. Dividend payments to non-residents reported a year-on-year drop, contributing to the lower countrys deficit. Besides, the increased foreign ownership led to growing interest payments on intra-firm debts and dividends to foreign owners. The data on reinvested profit in the real sector are preliminary and therefore expected to undergo the same revision as in 2003, leading to further deterioration in the current account.

Last years net current transfers were up at MEUR 888.1, producing a most tangible healthy effect on the current account balance due mainly to the robust MEUR 198.6 worth of growth (33%) in private transfers (MEUR 798.8 up). Revenues from the EU pre-ins amounted to MEUR 216.7, stepping up by MEUR 81.7 on a year earlier. Net current transfers covered again some 30% of the countrys trade deficit while boosting the importation of consumer goods.

The 2004 financial account ran positive at MEUR 2707.5 (some MEUR 382.6 up on a year earlier), fully making up for the current account deficit. The financial inflows increased in volume terms relative to 2003 and both covered and spurred the huge trade deficit. In the medium term the above trend is to be sustained unless there is some significant change in the interest rate difference between Bulgaria and the EU or the USA. The huge current account deficit is a potential risk, and yet a normal development in a transition economy and should therefore not raise fears as to the countrys macroeconomic stability as long as it does not jeopardise the Central Banks FX reserves and bring about a decrease in domestic savings.

The bulk of cash flows reported in the financial account had to do with the Mobiltel transaction as well as the increase in foreign credit to the non-financial sector and the deposits of non-residents with Bulgarian commercial banks favoured by the low foreign interest.



In 2004 a new sub-item, i.e. mergers and acquisitions was added to the *direct investments* item, accounting for the Mobiltel transaction. The above item excluded (-MEUR 649.5), net FDI into the country totalled MEUR 1939.5, covering fully the current account deficit. Total revenue from privatization amounted to MEUR 936.3, including the sale of the Bulgarian Telecom and receipts from the privatization of the electricity supply companies. FDIs, other than from privatization were estimated at MEUR 1177.9 vs. MEUR 1538.5 in 2003. However, it should be noted that the 2004 data are to be further revised.

The largest investment amounts in 2004 were reported by Austria, the Czech Republic, the Netherlands and Germany. The increasing foreign ownership resulted in higher outflows of interest and dividend payments on intra-firm debts to foreign owners (a large percentage of the FDI is essentially intra-firm credit).

The lower size of Bradies and global bonds issued by the government and held by residents led to a decrease in the *portfolio investment-liabilities* item. July saw some MEUR 553.9 worth of payments on Bradies and the release of the security, bringing about a decline in the assets in foreign securities of MEUR 225.7. On the other hand, the portfolio investments of the commercial banks abroad stepped up by MEUR 197.

The foreign currency deposits of commercial banks abroad reported a year-on-year rise worth MEUR 553.8, going most vigorously up by MEUR 331.9 in December alone. Some part of them had to do with amounts paid earlier in the year (Mobiltel MEUR 180, and a syndicated loan amounting to MEUR 75). However, the above one-off transactions excluded, the downward trend in bank deposits abroad of the past two years was to slowly fade away in 2004. The foreign currency deposits of the non-banking enterprises declined by MEUR 52.4.

The financial account surplus was mostly due to the strong contribution of the *other investment-liabilities* item, which stepped up by MEUR 1964.7. The above growth was triggered by the enormous increase in all components but the government sector. Net foreign credit to local commercial banks rose by MEUR 406.9 as did the deposits of non-residents (MEUR 514 up). Net credit to the non-financial sector amounted to MEUR 887.3, with the bulk of it having to do with a single transaction.

In 2004, the Central Banks FX reserves grew by MEUR 1493.4, despite the ahead-of-schedule payments on the countrys foreign debt. Notwithstanding the higher imports, the BNB FX reserves/imports ratio went up to 6.1 months vs. 5.7 months on a year earlier. Net IMF credit use and the countrys net liabilities to the World Bank declined by MEUR 29.1 and 122.9 respectively.

THE BULGARIAN ECONOMY IN AN INTERNATIONAL PERSPECTIVE

The countrys macroeconomic stability and sustainable growth resulted in improved confidence in the local economy. This was further enhanced by the tough fiscal discipline applied, reduced public debt and higher FX reserves.

Credit Ratings of Fitch and JCRA

Country	Credit standing	Fitch Outlook	Date	Credit standing	JCRA Outlook	Date
Bulgaria	*BBB-*	*Stable*	*04.08.2004*	*BBB-*	*Positive*	*11.08.2004*
*Croatia***	*BBB-*	*Positive*	*08.07.2003*			
*Cyprus**	*A+*	*Positive*	*04.11.2003*			
*Czech Republic**	*A-*	*Stable*	*20.06.2003*	*A*	*Stable*	*01.05.2003*
Estonia	*A*	*Positive*	*07.07.2004*			
*Hungary**	*A-*	*Negative*	*12.01.2005*	*A*	*Stable*	*22.03.2004*
*Latvia**	*A-*	*Positive*	*07.07.2004*			
Lithuania	*A-*	*Positive*	*07.07.2004*			
Malta	*A*	*Positive*	*04.11.2003*			
Poland	*BBB+*	*Stable*	*06.05.2004*	*A-*	*Stable*	*08.05.2003*
*Roumania***	*BBB-*	*Stable*	*17.11.2004*	*BB+*	*Positive*	*15.11.2004*
*Slovakia***	*A-*	*Stable*	*21.09.2004*	*A-*	*Stable*	*19.08.2004*
Slovenia	*AA-*	*Positive*	*07.07.2004*			
*Turkey***	*BB-*	*Stable*	*13.01.2005*	*BB-*	*Positive*	*10.03.2005*

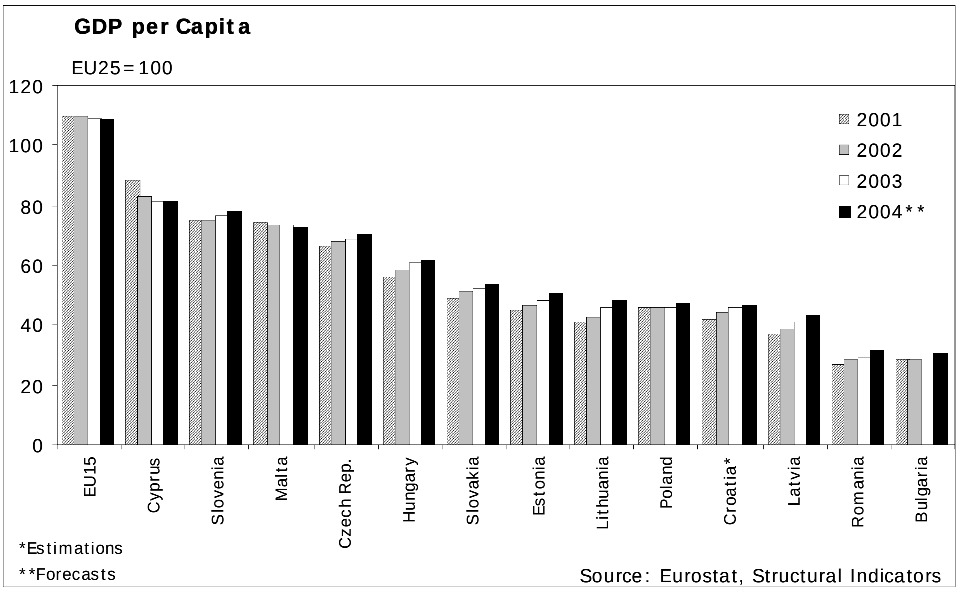
** Fitch Reconfirmed rating*
*** Fitch Changed rating*

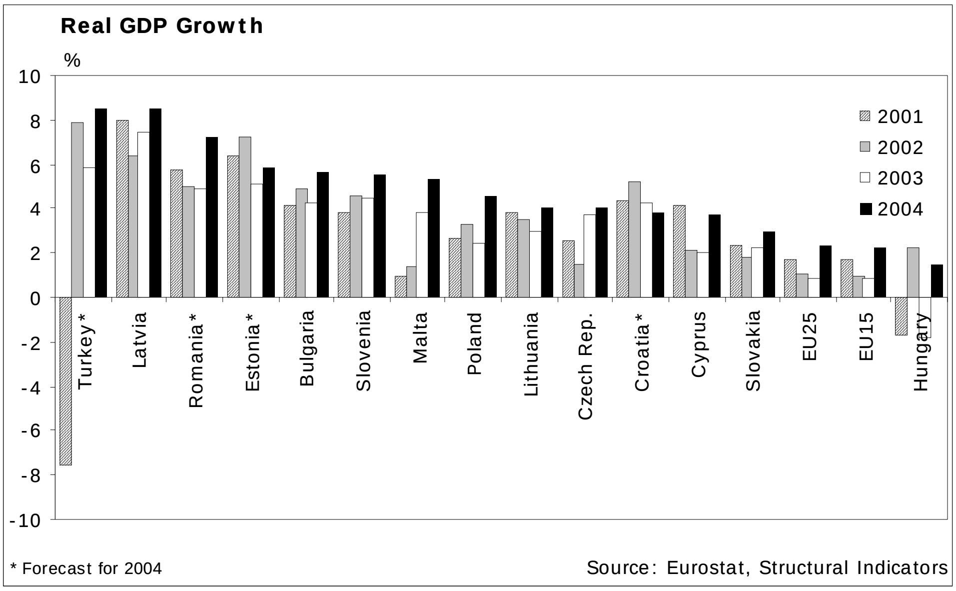
Source: Fitch & JCRA

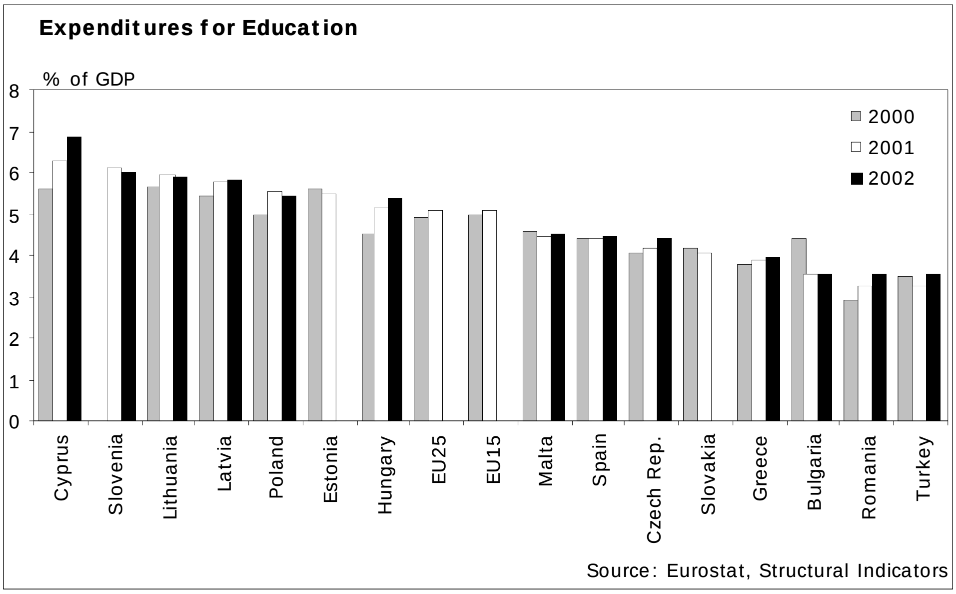
In June S&Ps awarded Bulgaria it first investment rating while revising the countrys outlook assessments from stable in 2003 to positive in February 2005. In November 2004 another credit rating agency, Moodys, upgraded the countrys standing from □□2/stable outlook to □□1/positive outlook. The expectations for strong economic growth in the country in the next couple of years, public finance sustainability and accession to the European Union will further raise Bulgarias credit rating.

As a result of its strong economic performance Bulgaria has already met three of the four Maastricht criteria[29], without being required to, at present. The fulfilment of these criteria, also known as nominal convergence, is a formal indication of the country s preparedness to join the Economic and Monetary Union (EMU) and hence adopt the single European currency. At the same time, although Bulgaria has made greater progress on nominal convergence vis-□-vis some of the new Community members like Hungary and Poland, for example, the fact remains that countrys standard of living is a long way off the quality of life in the EU and further effort is yet to be made to achieve real convergence.

[29] *Price stability excluded.*

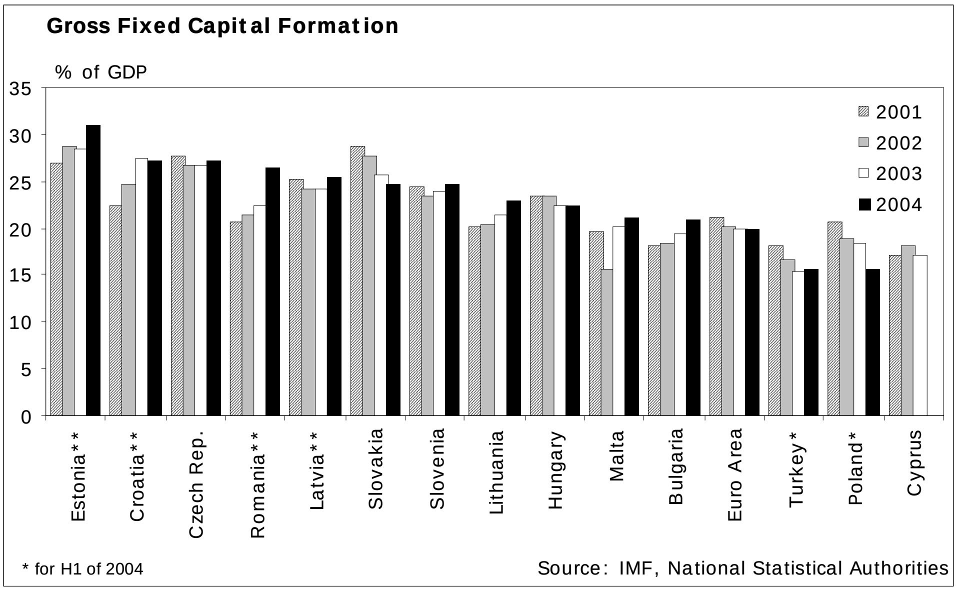






Owing to the vigorous growth of the past few years income per capita (as measured by GDP on the basis of purchasing power parity per capita) has grown faster than in the EU (25). In 2001 the indicator accounted for 28.6% of the EU(25) average, stepping further up to 30.8% of the Community average in 2003. At the same time, despite the significant catch-up on the part of Bulgaria, the country still ranks last vis-□-vis not only the EU member states but the other two acceding countries Roumania and Croatia as well. Moreover, the fact that income in Bulgaria accounts for some one-third of the EU(25) average implies that a great deal of effort is yet to be applied based on steadily higher than the EU average economic growth.

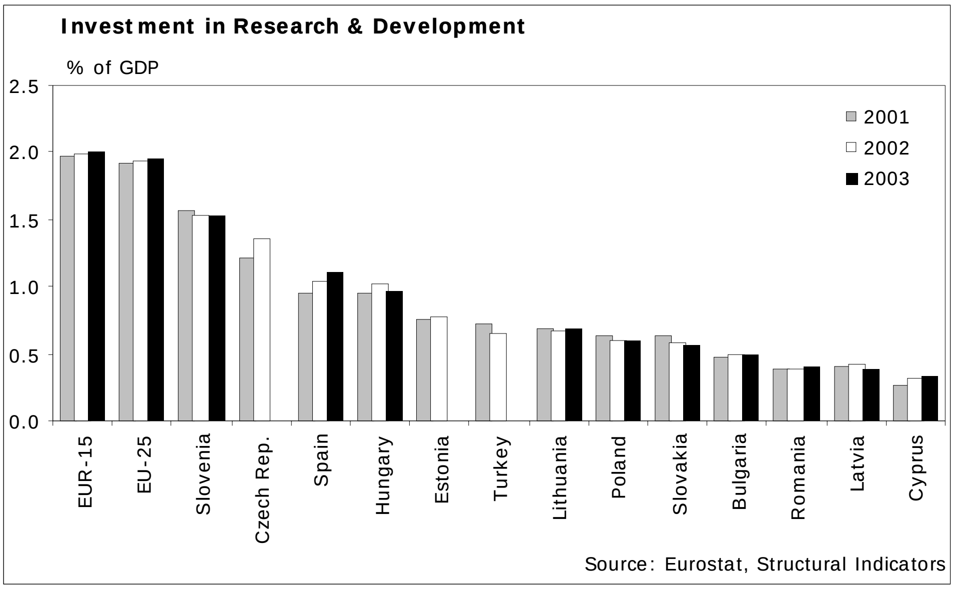
Higher productivity in the economy is indispensable to higher growth and hence a higher standard of living. On the other hand, the factors that can boost productivity have to do with investment in human capital and fixed capital formation as well as in research and development. Human capital investment will provide for qualified work force generating a high productivity rate in the economy, whereas investment in fixed capital formation will ensure the necessary conditions for bringing in high-tech production technologies. Furthermore, R&D investment will reinforce the countrys growth potential by introducing new environmentally- friendly technologies and innovation drawing upon natural resources in an economy-wise manner.



Human capital investment in Bulgaria[30] runs still well below the average in the new EU member states, Cypress, Slovenia and Lithuania in particular.

In addition, fixed capital formation, as percentage of GDP, ran lowest vis-a-vis the other EU member states, turning out the be the main reason behind the moderate growth and rather sluggish countrys catching up with the Communitys standard of living.

Furthermore, investment in R&D (as % of GDP) has also been rather low, if not the lowest among the other countries. Although there was some improvement in the indicators performance in the past few years, it has remained rather negligible to boost any significant growth due mainly to the absence of a robust innovation strategy, promoting output actually delivered.



Despite the macroeconomic stability and prudential fiscal policies, Bulgaria has been comparatively sluggish in approximating the EU standard of living. However, speeding up the process means raising productivity and capital in the economy, which can only be achieved by investing in human capital, fixed capital formation and research and development. ❑

[30] *As calculated on the basis of spending on education, as percentage of GDP.*

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