THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

THE BULGARIAN ECONOMY IN 2005

annual report

AGENCY FOR ECONOMIC ANALYSIS AND FORECASTING

CONTENS

In 2005 growth in the Bulgarian economy picked up, hitting a nine-month record high compared to earlier periods. GDP stepped up mainly as a result of the growth-conducive business environment, macroeconomic stability, favourable terms of trade in some major export items as well as the sizable financial inflows into the country.

The financial inflows into the economy boosted not only the country's investment activity but consumption as well by way of the credit intermediation of commercial banks. The growing foreign liabilities of commercial banks and their drive to make the most of the newly attracted resources in a very short time have resulted in a rather fast credit growth in the economy. On the other hand, the ever-rising consumer loans sent consumer imports on the increase. All this, together with the sky-high crude oil prices, robust investment activity and high raw material imports to cater for the operations of local firms were the main factors at work behind the worsening trade deficit and current account of the balance of payments. However, the current account deficit was successfully covered by the revenue amounts on the financial account, net FDI including.

Limited as they were, the active labour market measures and programmes of the government did not lead to any decrease in employment but only a certain slowdown in its increase. The private sector created enough jobs in the primary labour market not only to provide for a lower jobless rate in the economy, which now ran at a historical low, but also to help re-adjust some part of the unemployed numbers, joining the country's workforce again.

Under an ever-deteriorating current account deficit, the higher public-sector savings financed only partially the private sector's investment activity and made up for the scarcity of household savings in the economy. The budget surplus and revenues from privatization were used for payments on the Bradies still in circulation. At the same time, this strong inflow of financial capital, reported on the balance of payments, led to some overheating of the local economy.

Furthermore, Bulgaria is expected to remain relatively attractive for FDI, especially with a view to its accession to the EU. However, the measures meant to put the brakes on the country's rampant credit growth and rising competition in the financial sector have made room for a possible reversal in the financial flows between the rest of the world and local commercial banks, to be further enhanced by the higher interbank interest rates worldwide expected, in the Euro area in particular. The flow reversal may put at risk the future performance of the Bulgarian economy, resulting in a certain slowdown in growth, if not a slump altogether, in some basic pro-cyclical industries like construction and metallurgy, affecting most severely bank lending. On the other hand, imports may as well go on the decrease not only along the lines of deferred consumption but also along the lines of the lower demands of the local industries for raw material imports and a likely improvement in the country's trade balance. ▼

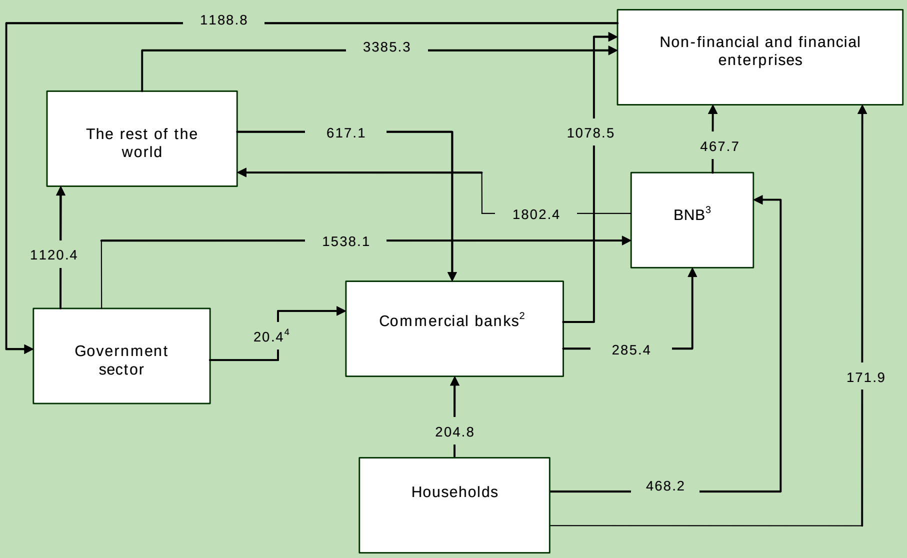
Financial Flows in the Local Economy and Between Bulgaria and the Rest of the World

The major trends underway in the Bulgarian economy in 2005 had to do with income growth, huge government budget surplus, ever-rising foreign trade deficit and robust bank lending, which was somewhat cooled in the wake of the latest BNB measures. These were by and large triggered by the financial flows into and between Bulgaria and the rest of the world, e.g. the huge current account deficit has been often associated with the robust lending activity of banks. However, the fact remains that banks have been pursuing such aggressive lending policies only due to the strong external financing of the past few years and their drive to make the best investment possible of their newly acquired financial assets.

The nature of the financial flows to and from the country has predetermined the net financial position[1] of the institutional sectors of the economy vis-à-vis the rest of the world. The pattern of behaviour manifested and policies undertaken affected the financial health of the sectors, the distribution of resources, and eventually their position vis-à-vis all remaining sectors. Tracing down the financial flows across sectors means identifying the net saver and net debtor in the economy, as well as the sector, contributing to imbalances.

Financial flows across the institutional sectors into the economy and the rest of the world[1]
over the 31st December'03 – 30th September'04 period

(mln. BGN)



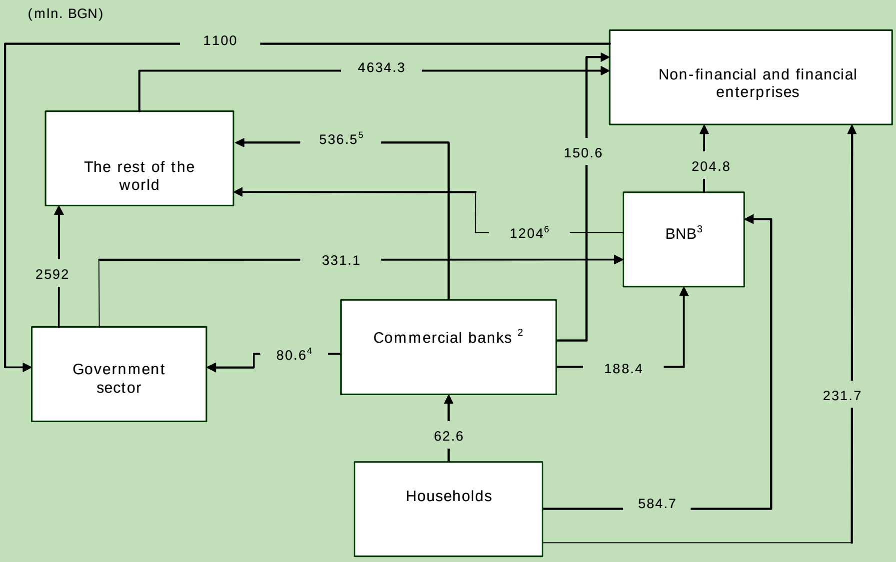
[1] Flow data relies primarily on the relevant sector's statistics.
[2] Data on the flows to and from commercial banks do not take into account the flows among banks. To obtain the *net lending/net borrowing* position account should be taken of the assets and liabilities not classified elsewhere.
[3] In calculating the net lending/net borrowing position of BNB, note should be also taken of the assets and liabilities not classified elsewhere.
[4] According to monetary statistics.

The net financial position of the government sector was strongly positive due to the tough fiscal policies in place, favouring the economy as long as they did not allow it to become a major perpetrator of twin deficits. i.e. not contributing to the deterioration of the country's

[1] Net lending/net borrowing which is equal to change in financial assets minus change in financial liabilities.

external position. Employing the above policies, the government financed some part of the investment activity in the economy, which picking up rather robustly as it was in 2005, could not be financed by the otherwise scarce household savings. Government savings stepped up mainly as a result of the improved revenue collection and boosted business activity. In the nine months to October, the inflows to the government sector from privatization (BGN 1426 million) and floatation of government securities[2] ran positive. The period also witnessed substantial outflows due to the BGN 2604.8 million worth of repayments on the country's foreign debt and government liabilities to BNB[3] (BGN 267 million) as well as an increase in the government deposit with the Central Bank, i.e. the fiscal reserve account. As a result the government sector proved to be a major net creditor in the economy.

Financial flows across the institutional sectors into the economy and the rest of the world[1]
over the 31st December'04 – 30th September'05 period



[1] Flow data relies primarily on the relevant sector's statistics.
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[3] In calculating the net lending/net borrowing position of BNB, note should be also taken of the assets and liabilities not classified elsewhere.
[4] According to monetary statistics.
[5] Financial flow data are based on monetary statistics. However, there is a great amount of discrepancy between balance of payments data and monetary statistics. Balance of payments data have been adjusted for exchange rate fluctuations and change in the market price of financial assets, whereas monetary statistics include even flows which are not due to pure transactions. Another reason has to do with the different methodology of reporting the privatization of the electricity supply companies. As balance of payments data are preliminary, further revisions and elimination of some part of the flow data discrepancies are also possible.
[6] Financial flow data are based on monetary statistics, which differ from balance of payments data. The reason for the discrepancy is that the latter take into account changes in the market price of monetary gold, included in the FX reserves.

The net financial position of households was also positive, and despite its growing indebtedness to the banking system, the sector remained a net saver in the economy. Most household savings, minus investments, were re-allocated to banks in the form of deposits (change in deposits minus change in bank loans was estimated at BGN 62.6 million), pension insurance funds[4] by way of additional compulsory and voluntary insurance contributions (BGN 231.7 million), and to BNB (change in money in circulation[5] – BGN 584.7 million). It should be also noted that while steadily improving in the past three years, the net position of

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[2] The net flow of government securities to all sectors amounted to BGN 115.3 million, whereas change in the securities held by commercial banks was estimated at BGN 333.7 million.

[3] The debt of the government to IMF is reported as government liability to BNB, hence a Central Bank's claim on the government, whereas BNB is responsible for meeting the country's liabilities to the Fund.

[4] Pension funds belong to the sector of non-financial and financial enterprises.

[5] Change in money in circulation minus vault cash. Besides, the underlying assumption here is that financial enterprises do not effect any significant changes, as they set the optimum level of vault cash to provide for current needs of liquidity.

households ran negative only in the period surveyed. The above trend was triggered by the growing household income, rising employment and pension fund assets in stock.[6]

As for BNB, besides the inflows from the government and household sectors, the period also saw some outgoing amounts to non-financial and financial enterprises due to the larger than expected decrease in the overnight deposits of financial enterprises (BGN 340 million). The net financial flows between the country and the rest of the world were allocated to the non-resident sector of the economy (BGN 1204 million) due to the higher FX reserves of BNB (BGN 1033.5 million up) and repayments on the country's liabilities to IMF. At the same time, BNB FX reserves stepped up due to the growing deposit of the government and commercial bank reserves with the Central Bank.

With the flight of financial capital from the country, net commercial bank outflows to the rest of the world were mainly intended and allocated to the external sector[7]. The growth in the foreign financial assets of commercial banks was largely due to the curbed credit expansion in the country, which in turn freed more resources in the economy. Commercial banks tended to take away idle money from the country in the form of deposits at foreign banks and placements while ensuring a higher return[8] on the one hand, and maintaining relatively good liquidity, on the other. The BNB's clampdown on credit growth led to a slowdown in corporate credit, resulting in significantly lower year-on-year bank flows to the non- financial enterprises in the nine months to October (BGN 421 million vs. 1033.7 million on a year earlier). At the same time, most financial enterprises sought ways to make powerful injections to commercial banks, following the decrease in loan extensions and rise in deposits, having to do with the increased resources of the pension insurance funds. All this exerted an additional downward pressure on the financial flows to the sector of non-financial and financial enterprises.

Non-financial enterprises were net debtors in the economy, reporting a strongly negative financial position, i.e. their liabilities surpassed significantly their assets. From the point of view of their non-financial position, it implied that the worth of the investment projects undertaken by the enterprises exceeded the savings accumulated. What they did in practice was attracting money from other sectors of the economy, as a result of which the inflow amounts ran well above the outflows. In addition, it should be noted that government and household savings allocated to the sector via banks could not meet the sector's investment needs. All this entailed larger inflow amounts into the country (BGN 4634.3 million) and a substantial increase in the private debt of non-financial enterprises in the last two years (mainly in the shape of trade and intra-firm credit). ▼

[6] Pension fund assets stepped up also due to the former two factors, i.e. income growth and higher employment.

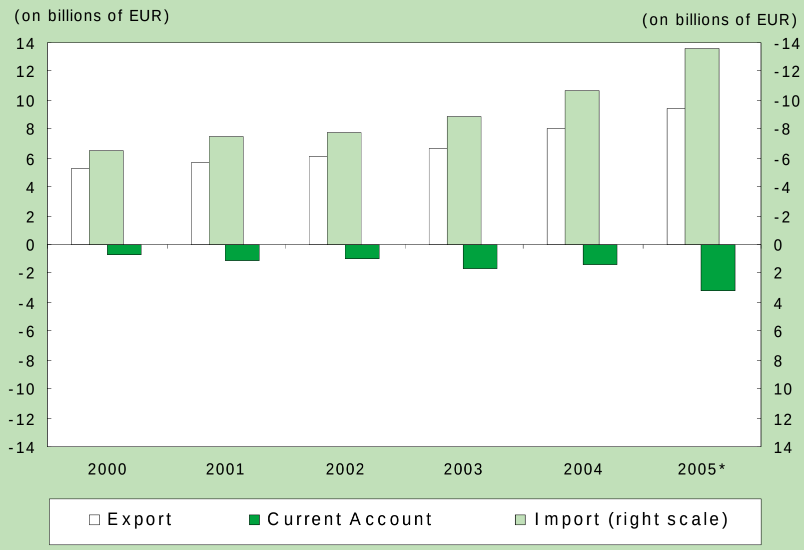
[7] According to the analytical accounting data of commercial banks.

[8] Ensuring a higher rate of return than vault cash or money kept as excess reserves on banks' settlement accounts at BNB.

Growing Trade Deficit

One of the most debatable issues in 2005 had to do with the current account dynamics of the balance of payments. As of end October the current account deficit amounted to MEUR 2226. It is expected to further deteriorate, hitting record high levels since the start of the transition to a market economy.

Current Account, Export and Import



Source: BNB

The above deterioration was mainly triggered by the ever-worsening country's trade balance. In the nine months to October, the trade deficit ran as high as MEUR 3190, or some 1179.7 million up on a year earlier. The deterioration by over 50% in the same period had to do with robust import growth, which ran 27.6% higher relative to the same period of 2004.

Imports stepped up mainly as a result of the strong contribution of energy and investment goods. The nine-month importation of each group rose by over MEUR 800 on a year earlier and accounted for two-thirds of the higher import growth in 2005. The bulk of the higher energy imports was solely due to price changes. According to BNB statistics, some MEUR 432.8 of the increased import costs on crude oil, oil products and gas in the three quarters to October was due to price factors, whereas another MEUR 153.6 was attributed to the larger import volumes. And yet, it should be noted that the oil price dynamics had a lesser net effect on the current account as the higher fuel prices worldwide also contributed to the rising export revenues. The aggregate effect of the price change in crude oil, oil products and gas over the January-October period led to MEUR 241 worth of a year-on-year deterioration in the current account balance.

The robust importation of investment goods does not as rule pose a threat to the performance of the economy, as they enhance its growth potential.

The importation of machinery, equipment and apparatuses reported a year-on-year increase of 35.1% and may be said to have been directly responsible for the growing production capacity of local firms. At the same time, it was vehicles among all investment import items that posted the strongest nine-month growth import of MEUR 316.4, or over 48% on a year earlier, and a larger value-term increase vis-à-vis consumer goods. The latter, however, also encompass automobiles other than vehicles under the group of investment imports, with the different placement being due to the category of buyer. Where vehicles are purchased by legal persons, they are reported as investment goods. And vice versa, when purchased by individuals, they are accounted as consumer goods. In actual fact, however, vehicles constituted about 30% of all investment goods and had to do with either transport services proper or some other back-up activities of firms in other sectors and industries. The robust importation of vehicles was indeed important to the business activity of the companies, but its role in improving productivity in the economy should not be overrated. As for the group of machinery, equipment and apparatuses, the largest ever increase in imports was reported by automated data processing apparatuses or specific equipment (e.g. self-propelled mechanical shovels and nuclear reactors) the importation of which was one-off and hardly ever to occur again in the near future. At the same time, the declining imports of machinery and equipment for the textile and tailoring industries were very symptomatic of the flagging interest of foreign investors.

Item	January-October			
	2004 (in MEUR)	2005 (in MEUR)	Change y/y (in absolute terms)	Change y/y (in %)
Current account	-918.6	-2226.0	-1307.35	142.3
Exports (FOB)	6537.2	7716.0	1178.75	18.0
Imports (FOB)	-8547.6	-10906.0	-2358.41	27.6
Trade balance	-2010.3	-3190.0	-1179.67	58.7
Services (credit)	2955.8	3165.7	209.91	7.1
Services (debit)	-2148.7	-2504.5	-355.76	16.6
Services (net)	807.1	661.3	-145.85	-18.1
Income (net)	-452.9	-422.3	30.69	-6.8
Transfers (net)	737.6	725.1	-12.52	-1.7

Raw materials items ranked third in importance to total import growth. They enjoyed the heaviest relative weight in the import basket (36.2% in the nine months to October), which was directly related to the activity of local firms. Therefore, the above growth should not cause any concerns as it was dependent on production.

Commodity groups	Exports (FOB)				Imports (CIF)			
	01-10.2004		01-10.2005		01-10.2004		01-10.2005	
	MEUR	2003/ 2004	MEUR	2004/ 2005	MEUR	2003/ 2004	MEUR	2004/ 2005
Total: o/w:	6 537	16.8%	7 716	18.0%	9 270	18.4%	11 831	27.6%
Consumer goods	2 186	7.2%	2 266	3.7%	1 490	26.2%	1 789	20.0%
Raw materials	2 829	22.7%	3 293	16.4%	3 716	18.3%	4 277	15.1%
Investment goods	860	13.9%	1 178	36.9%	2 418	22.4%	3 251	34.4%
Energy goods	662	32.9%	980	47.9%	1 571	9.5%	2 397	52.6%

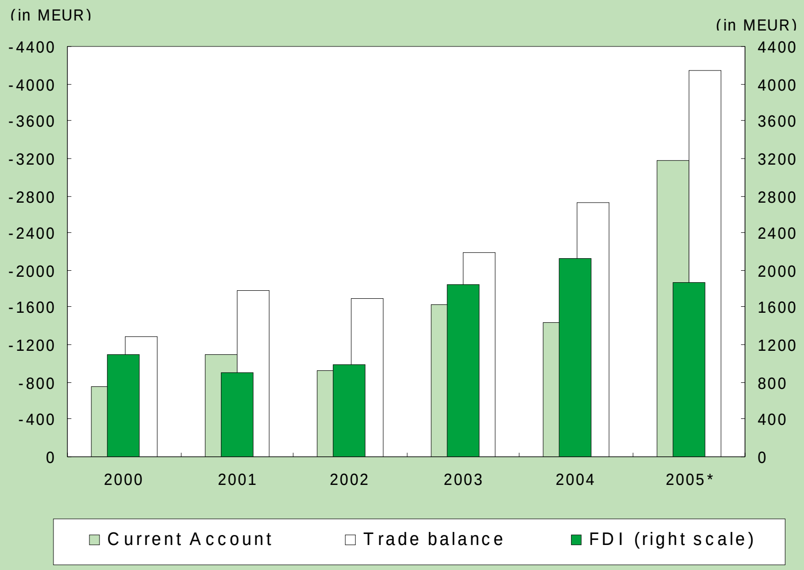
However, having posted some MEUR 298.6 worth of an increase in the three quarters, the dynamics of consumer imports raised major concerns. The importation of consumer goods had to do with the increased consumer demand, boosted by a number of factors such as the improved access to household credit, real income growth and higher employment. This should be also seen as a normal development evolving from the improved living standards in the past seven to nine years. All this has resulted in a stronger household consumption and inevitable alterations in its structure.

Exports also stepped up rather robustly (18% or some MEUR 1178.8 up in the ten months to November) especially against the relatively modest export rise in the country's major trading partner, the EU. The exportation of investment goods followed a fast growth rate (36.9% or MEUR 317.3) due mostly to the vigorous export performance of ship building. It is also noteworthy that 2005 export growth was mainly the result of a rather limited number of items and commodity groups, which besides ship building included oil products, non-ferrous metals and food raw materials as well. At the same time, footwear and clothing as well as cast iron, steel and iron exports, enjoying as a rule a high relative share within the total, went on the decrease, with NSI sales data implying that the downward trend was to be further reinforced. The shrinkage in ferrous metal exports was due to the adverse impact of metal prices worldwide. Furthermore, clothing and footwear exports declined mainly as a result of the competitive Chinese imports on some major export markets for the Bulgarian producers (mostly the EU member states), exploiting the very same competitive advantage as the local industry, i.e. cheap labour. At the same time, the chemical industry (chemicals, rubbers and plastics) has been steadily rebounding over the last few years. Chemical imports in the nine months to October increased twofold relative to the same period of 1999. However, the gas price rise of August'05 may bring about a turnaround in the above upward trend.

Therefore, it may be concluded that the country's export performance in 2005 relied heavily on the exportation of a very few items, essentially basic raw materials requiring a relatively low degree of processing. At the same time, although all investment export items posted a relatively high increase in 2005, their share within the total remained somewhat modest (15.3% in the nine months to October).

The sizable current account deficit was also due to the decreasing net revenues from services, which were by and large shaped by revenues from tourism. Compared to earlier periods, their growth in 2005 ran significantly lower (9.2%), indicating some exhaustion of the sector's extensive development potential and also suggesting that any further growth can only be attained by improving the quality of the services rendered rather than augmenting the accommodation capacity. Transport costs also stepped up, triggered by the high oil prices worldwide.

Current account, Trade balance & FDI



Source: BNB

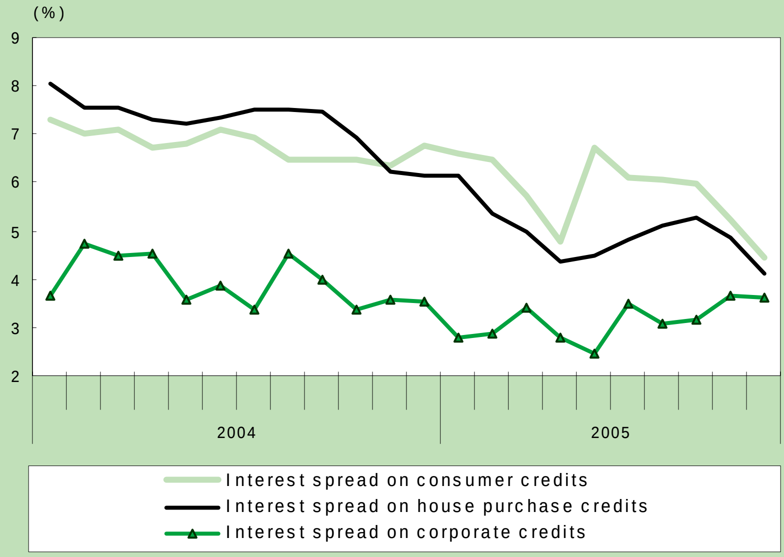
The Current account deficit is to a certain extent a result of the financial flows from and to the country. In the period January – September 2004 there is financial flow from the rest of the world, which amounted to BGN 2 mln. In the current year the rest of the world sector continue to have positive financial position in respect to the Bulgarian economy. However, in the first three quarters the financial flow stepped down to approximately BGN 400 mln.

The current account deficit was fully financed by the net revenues on the financial account of the balance of payments. Furthermore, while fully making up for the current account deficit of the past few years, net FDI were now expected to cover only some 60% of it. According to BNB statistics, FDI over the January-October period amounted to MEUR 1465.7, going well above their levels in the same period of 2004. In addition, the above amounts did not include receipts from deals with non-residents. As for deficit financing, the steady financial inflows into Bulgaria enhanced the stability and operation of the currency board and reduced the chances of any use-up of BNB FX reserves. The strong FDI inflows were further sustained in 2005 and were indicative of the high foreign investor confidence in the local economy.

Commercial Bank Lending

In 2004 the foreign liabilities of commercial banks stepped up rather significantly, increasing threefold inside a year only to BGN 4.9 billion due to the robust growth in foreign bank deposits at local banks. The Bulgarian banking sector proved to be extremely attractive for foreign investment because of its strong growth potential, higher return and acceptable risk. The interest rate spread on consumer and housing loans in Bulgaria and the Euro area in 2003 ran well over 8 percentage points and was mostly due to the underdevelopment of the local loan market, whereas the corporate credit interest rate spread surpassed 4 percentage points.

Interest spreads between lending rates
in Bulgaria and the Eurozone



Source: ECB, BNB, AEAF

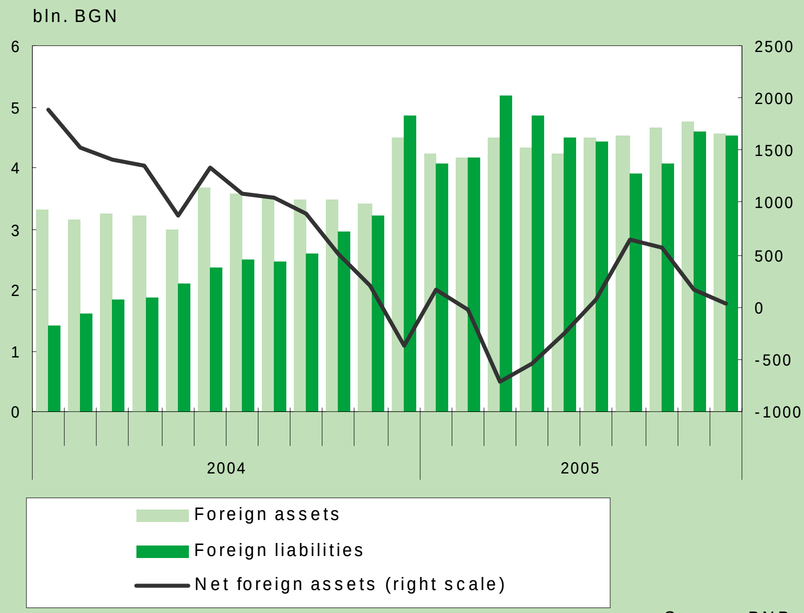
The credit expansion of the past couple of years has been by and large spurred by the financial inflows from the external world to the local financial sector. Commercial banks employed the free foreign resources in hand to increase their credit exposure to non-financial enterprises and households. As a result, 2004 bank credit to non-financial enterprises rose by BGN 2.6 billion (8.5%), and BGN 1.9 billion to households. The rampant credit growth in the economy raised some concerns having to do with creditworthiness and fears as to the likely effect of the increased household loans on the ever-rising trade deficit, the importation of consumer goods in particular. According to AEAF estimates, there was and still is a statistically significant correlation between the dynamics of the new loan extensions and consumer import growth. It was as early as 2004 that BNB undertook measures to curtail credit growth in the economy, but they proved to be rather ineffective. Despite the withdrawal of liquidity on the part of the government and some extra measures, bank credit expansion was not on the wane, as desired. Instead, they had a short-lived effect on the base interest rate dynamics[9] alone, as bank liquidity went on the decrease.

In March 2005, the Central Bank initiated a series of new measures to clamp down on the boisterous country's credit growth, announcing well in advance that it was to set loan growth ceilings and had banks surpassed them they would have to deposit additional required reserves on the their settlement accounts with BNB. The early announcement of the

[9] In 2004, the base interest rate was still estimated as the yield reported at the primary auctions of 3-month government securities.

amended regulations aimed mainly at giving banks enough time to gear themselves up to the new requirements. Instead, most banks sought ways to overstate the credit growth base, used for calculation purposes, invalidating the toughness of the measures. As a result, only within a single month – March, the foreign liabilities of the local commercial banks stepped up by over a billion BGN due mostly to the increase in foreign bank deposits at local banks. The fresh foreign inflows, together with some other liabilities, were mainly used by banks to increase their claims on the non-government sector, which only inside a month stepped up by over BGN 3 billion (BGN 2.5 billion worth of an increase in credit to non-financial enterprises, and some BGN 500 million of a rise in household loans).

Net foreign assets of the commercial banks

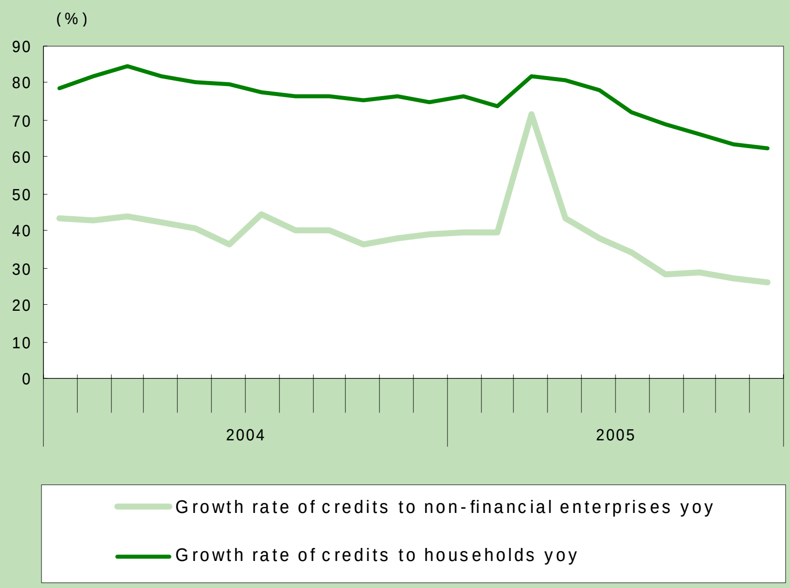


Source: BNB

The measures aimed at putting the brakes on credit expansion have given way to a series of changes in the patterns of bank behaviour and policy strategies. They started to seek ways to bypass and dodge the new regulations, re-channelling their credit flows. According to commercial bank balances, the latest restrictions have, indeed, led to a certain slowdown in credit growth, but this decrease was due to the restructured bank portfolios in attempt to avoid depositing additional required reserves. Most banks embarked on selling corporate credit to their major foreign share holders, making room for new lending. Corporate loans, the interest on which ran the closest to the counterpart rates in a global aspect, as well as due to the enormous amounts extended and low-liquid security, became unattractive for banks to hold them in their portfolios, given the above conditions. As a result, June credit to non-financial enterprises stepped down by about BGN 2 billion vs. the record high of March only to go up again insignificantly ever afterwards. Consequently, banks pulled out of this market niche and focused on individual customers in the form of consumer and mortgage credit. Household loans carried on rising steadily, though at a lower rate on a year earlier, posting a 26.7% six-month increase of BGN 1.36 billion as of end-September. Besides the higher return, these loans turned out to be banks' first choice also because of the greater possibilities for diversification, instead of extending larger amounts of credit resources to a rather limited number of companies and going beyond the credit growth ceilings authorized.

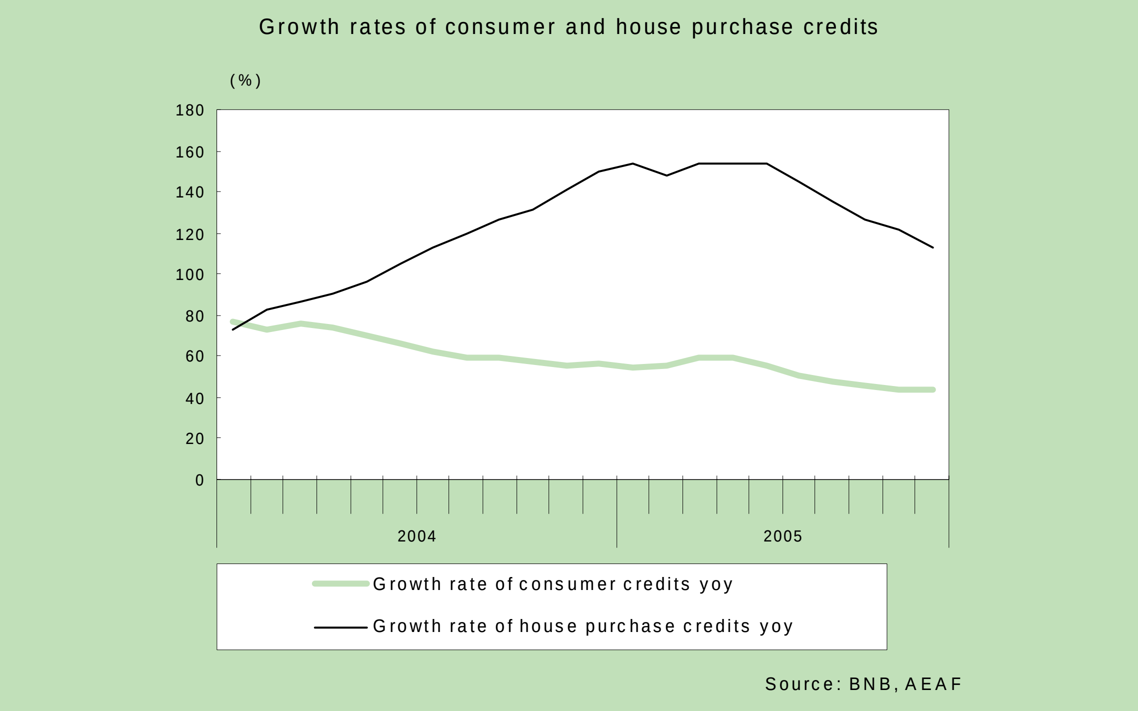
However, note should be also taken of another tendency underway. Banks started probing the consumer credit market as early as 2003, when consumer loans stepped up most vigorously by 74.5% (BGN 715 million) only to go on an even higher increase a year later. In 2005, consumer loan growth slowed down but their nominal-term rise (in BGN) ran well above the 2003 level. In 2005, however, the continuous growth rate decline on a 12-month basis was also coupled with a lower nominal-term increase in consumer loans, which as of end-October amounted to BGN 919 million, or some 25 million down on a year earlier. The housing loan market picked up in 2004 (a year later than the consumer credit market), posting a most robust BGN 598 million worth of a rise vs. only BGN 165 million in 2003. Unlike consumer loans, housing credit in 2005 reported an even higher nine-month nominal-term growth of BGN 756 million. Furthermore, the share of housing loans within the household credit total went up from 22.8% in end-2004 to 27.1% in October'05. At the same time, as long-term housing loans accounted for over 95% of total housing credit, their increase was likely to make up for the weaker year-on-year growth in long-term corporate loans in terms of the maturity structure of bank portfolios.

Growth rates of credits to non-financial enterprises and households



Source: BNB, AEAF

Stiff competition in the consumer and housing loan market has resulted in a significant drop in interest rates. Since April'05, housing loan interest has been running well below the long-term corporate interest rate in BGN. The narrowed difference in the return on credit in Bulgaria and elsewhere, expected rise in Euro area interest rates as well as BNB measures to curb credit growth have triggered some changes in the dynamics of some bank liability items. Ever since the end of March foreign liabilities had gone on the decrease. What followed was a steady withdrawal of and run on the foreign resources already attracted on the part of banks in an attempt to hastily secure funds to raise the credit growth base and thus circumvent the Central Bank's measures. In July the deposits of non-residents at local banks hit a one-year low of BGN 3.9 billion, opening the way for a significant increase in the deposits of residents, which were likely to replace the foreign funds withdrawn to finance credit growth in the economy. Relative to December'04, the deposits of local persons and firms stepped up by over BGN 3.3 billion, covering almost in full the BGN 3.7 billion worth of credit growth over the same period. However, it is still too early to say that the altered loan market run has resulted in a turnaround in the financial flows from the external world to local banks, as the last quarter witnessed a smooth gain in their foreign liabilities. In addition, considerable amounts of the financial inflows into the country were basically long-term, and the interest rate spread on loans and deposits in Bulgaria and the Euro area ran still higher in the local economy. Nevertheless, the risks of a turnaround in the flows should not be underestimated, as this may prove a serious hardship for the current account deficit of the balance of payments if the current high levels persist.



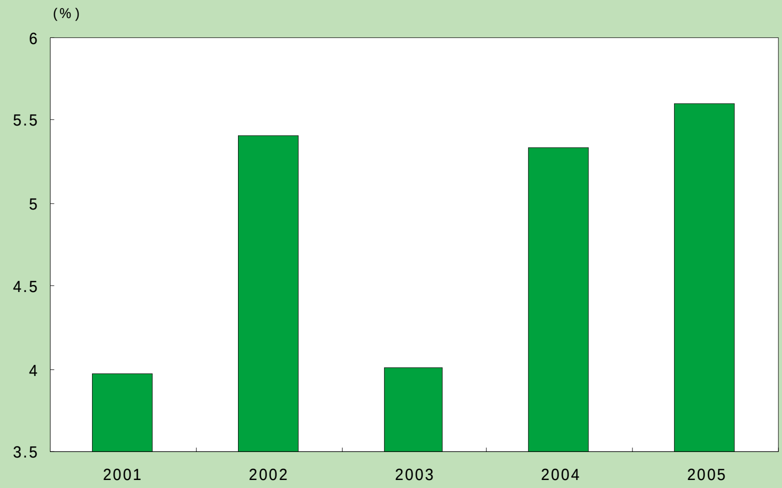
Although analytical accounting data pointed to a certain decline in the overall bank credit portfolio, consumer lending picked up, with consumer loan interest remaining higher than corporate interest rates. The increased share of household loans at the expense of corporate credit resulted in a healthy gain in consumption rather than investments and hence, faster and boosted importation of consumer goods rather than of investment goods. All this questions the tough approach to credit growth and raises a key issue, viz. are the brakes on the loan market themselves not a vehicle of deepening imbalances in the economy, without even touching upon the fact that these measures may come into clash with the integrity of the market mechanisms.

The financial stability of commercial banks has been a major concern on the Central Bank's agenda, though currently there are no signs of any deterioration. In this sense, BNB measures can be said to have been preventive in nature, accomplishing the mission assigned. Commercial banks remain stable. However, lending restrictions and the launch of vigorous and extensive campaigns for attracting high-priced financial resources may result in lower bank profitability, which is detrimental to their performance with a view to the additional costs on introducing the new Basel II requirements and competitive pressure of the developed EU financial institutions to be soon faced. Probably it would have been more appropriate if these measures had been aimed at tightening supervision rather than restricting their liquidity or imposing growth ceilings. Therefore, the drafting of consumer lending requirements, instituting clear-cut rules as to the transparency of information and responsibilities of the parties concerned is a must.

Robust Growth in the Economy

In the nine months to October'05 the Bulgarian economy reported the highest ever growth rate posted at this time of the year. Relative to the same period of 2004, rising by 5.6%, GDP stepped up to BGN 30 billion. The reasons behind the robust performance of the local economy were as followed: improved terms of business, macroeconomic stability, favourable terms of trade in key export items (e.g. non-ferrous metals) as well as growing financial inflows from the external world of the past few years. All this boosted the investment activity of the companies operating in the country and consumption via the credit intermediation of commercial banks.

GDP Growth
(january - september, %)



Source: NSI

The manufacturing sector was the most vigorously performing sector, posting a 7.9% nine-month increase in GVA. Foreign demand was steadily gaining in importance for the sector's development and export sales reported a larger share in the sales total. Nevertheless, its contribution to the performance of the different industries was rather uneven.

According to sales data, nine-month sales in the manufacturing sector stepped up mainly as a result of the strong contribution of energy and intermediate goods. In either case it was the growth-conducive terms of trade that boosted manufacturing and sales (the sky-high crude oil and oil product prices and robust global demand for metals). As for intermediate goods, metal production and casting enjoyed a most significant weight, with copper prices hitting a record high, going up by 44.6% since the start of the year only. The same industry, however, reported the most dramatic trend downturn. Having been a key contributor to 2004 sales growth, a year later ferrous metallurgy was consistently reporting a negative contribution, triggered by the worsened terms of trade worldwide.

At the same time, consumer non-durables rose at a healthy clip (of 5.7% in total sales, and 6.4% in domestic sales), running close to the growth rate of the economy. Furthermore, the domestic sales of durables went up by a strong 16.2% in the ten months to November due most probably to the higher household income and boosted consumer lending. And yet, despite the sales growth, the higher 2005 demand was satisfied by higher imports, indicating that domestic supply was lagging considerably behind demand.

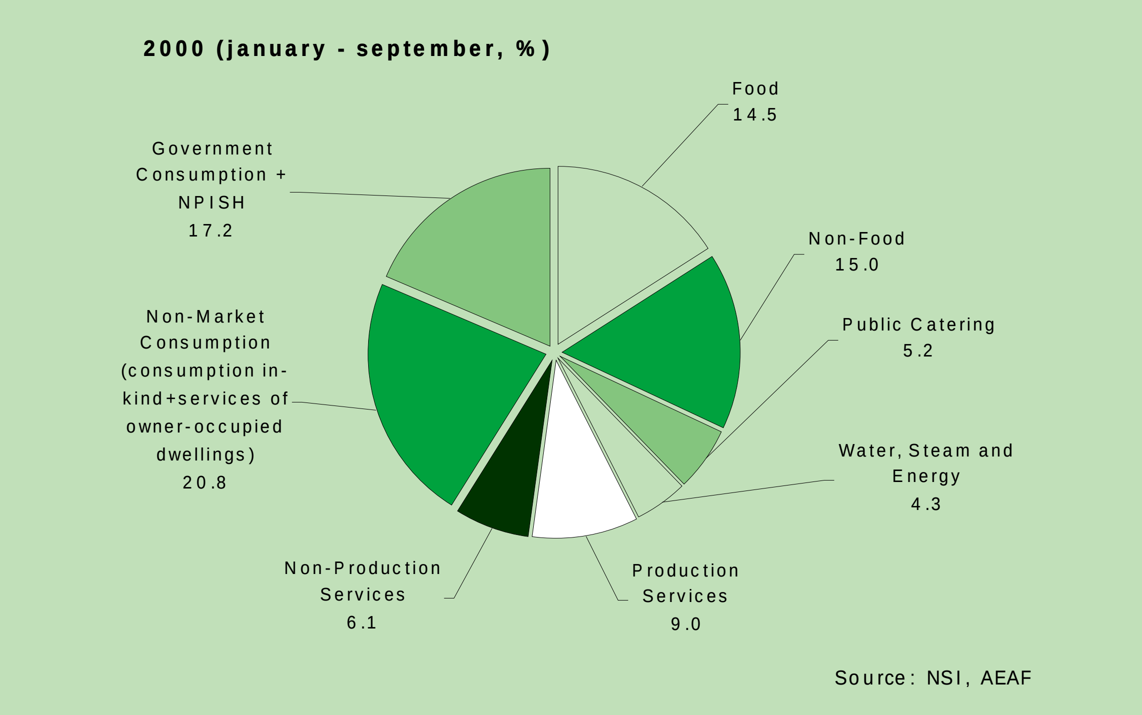
The strong dependence of the manufacturing sector on the performance of a very few key industries, which are susceptible to changes in the international business environment and price volatility, may put future growth at risk. For example, a possible deterioration in the currently favourable external market conditions (a price drop in some basic export items) will affect stocks and lead to worsening financial indicators for many enterprises, jeopardizing the country's trade balance eventually. However, as the domestic demand for consumer and investment goods picks up, there can be expected stronger stimuli for product diversification and steadier growth rates.

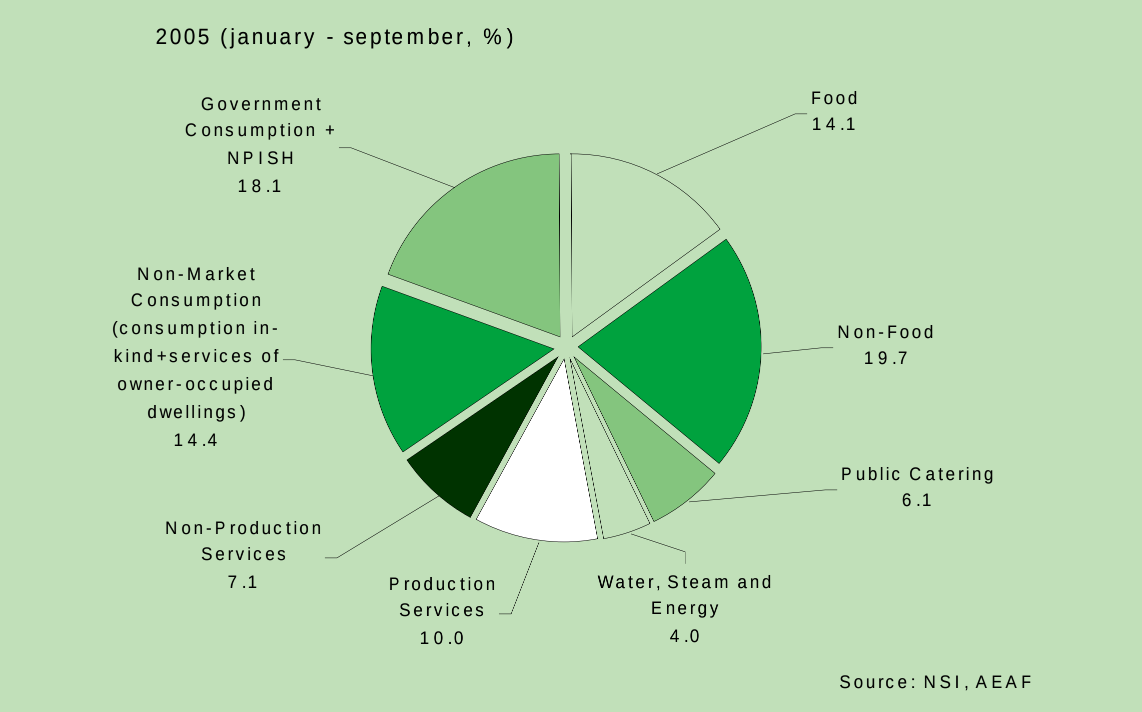
Income growth in the economy and the swift advance of the loan market after 2003 were the factors at work behind the vigorous performance of the construction sector and the up- and downstream industries. Real estate prices posted a two-digit rise as early as mid-2003, whereas demand went on the upswing in early 2005. Because of the relatively long production cycle in construction and non-tradable nature of produce, the supply and demand gap tends to be overcome with a certain lag in time. Having steadily risen in the past few years, gross output in the nine months of 2005 reported a two-digit increase of 20.3%, implying that supply has gained a headlong momentum. The above signs, however, were instantly factored in the market expectations, and the real estate price index cooled a bit to 32.2% in the third quarter. Therefore, robust supply and BNB lending restrictions may come out to declining growth rates in the following quarters.

The stable income growth has pre-determined the outstripping increase in services. In the nine months to October the sector grew by 6.1%, with all industries reporting a positive contribution. The strongest value added rise was posted by *finance* (20.1%) due to the high profit margin, followed by *trade* (12.4%), trade in non-food items in particular as a result of the increased country's consumption.

As for agriculture, uncertainty persisted, as the sector reported a decrease in both gross output and value added, prompted by the problems faced by livestock production in the first half-year period. Another upshot of the bitter weather and summer floods was that the unfavorable developments in farming further deepened in the third quarter and were to affect the value added indicator in the last one. Furthermore, the year-on-year increase in farm gate prices of 3.9% in crop production and 4.8% in livestock production in the third quarter suggested that there was a persistent undersupply of farm produce.

Having grown by over 5% on an annual basis in the preceding two years, household consumption in the nine months to October'05 advanced to 8% on a year earlier due probably to the rapid development of the consumer loan market. Other factors at work had to do with real income and employment growth in the economy, but they hardly ever contributed to its speed-up.



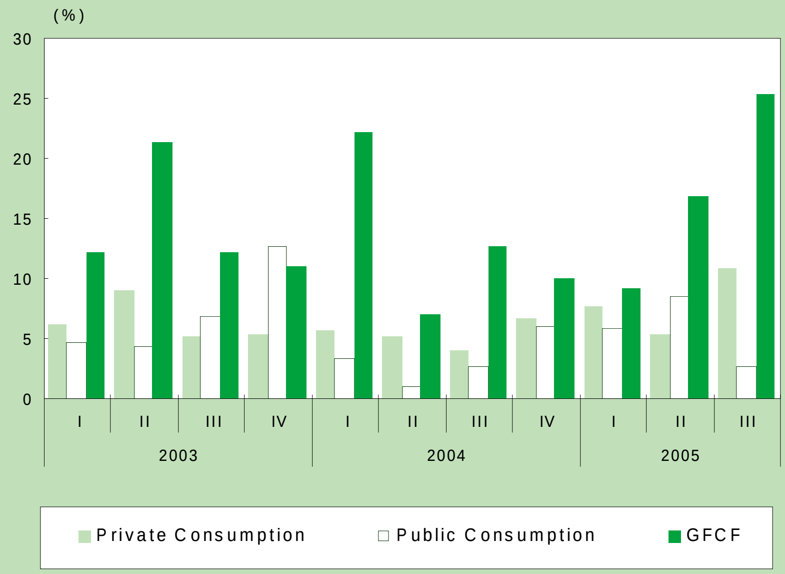


The steadfast and confident performance of the economy has made most economic agents upbeat about the future growth of real income. This was one reason for the “carry-forward” of consumption, resulting in a larger share of loan-financed consumption. This “carry-forward”, however, tends to have an adverse effect on long-term growth, limiting investment by way of lower savings, and check the growth potential. Having in mind that higher imports catered for the bulk of 2005 consumption, the aggregate effect produced was negative even in the short run. The above assumption draws upon the altered structure of consumption towards costly and quality goods like home appliances, cars, etc. most of which are supplied by foreign manufacturers. Furthermore, the share of self-sufficiency and food items has stepped down at the expense of the growing weight of non-food items (from 13% in 1998 to 18% in 2004, and further up to 20% in 2005).

Another indicator that consumption was going up mainly at the expense of the higher 2005 consumer imports was the structure of: retail sales revenues, the consumer import basket and domestic sales of the manufacturing enterprises. Sales revenues from food, clothing and household appliances advanced by 9.6, 19.6 and 19.2% respectively by October'05. At the same time, the nine-month growth in the domestic sales of food, household appliances and furniture slowed down to 4.5, 8.1 and 22.8 percentage points respectively, whereas revenues from clothing sales stepped up by only 2.7%. The stronger domestic demand was satisfied by higher importation in the nine months to October as followed: food imports went up by a robust 24.2% (vs. 12.3% in the January-August period of 2004); clothing and household appliances and furniture imports rose by 17% and 16.5% respectively (vs. 11.5% and 24.4% on a year earlier), whereas car imports went up by 33.6% (vs. 46.4% in the January-August period of 2004).

The higher interest rates in the country vis-à-vis the international rates, given reasonable risk due to the financial sector's stability, were the main reason behind the sizable capital inflows. All this, together with real income growth, has resulted in the mobilization of larger amounts of inactive resources in the economy, leading in turn to a higher marginal propensity to consume of 1.12 in the nine months to October vs. 0.74 on a year earlier. The increased spending on consumption goods was also evident from the swift and vigorous advance of the consumer loan market and faster rise in income from employment compared to income from capital. Put in more precise terms, while income from capital caters above all for the investment process, income from employment tends to finance both consumption and investments by way of savings accumulation. In 2002 wages accounted for 39% of value added, whereas two years later their share was up at 41%. At the same time, the first half-year period of 2005 witnessed a turnaround in the trend, and the share of income from employment went on the downswing by a solid percentage point to 41.9% of GDP from 42.8% on a year earlier. This, however, can be attributed to the 1.4 percentage point decrease in savings to 10.4% vis-à-vis the first half-year period GDP in 2005 rather than to consumption, which advanced by 6.6% or slightly up the GDP growth of 6.2%.

Domestic Demand Growth by Final Use Components (%)



Source: NSI, AEAF

The fast growing demand (consumption in particular) and undersupply result not only in certain foreign trade imbalances but also a fast leveling out of the actual GDP rate to the growth potential in the economy. At AEAF estimate[10] the 2003 and 2004 deviations from the potential GDP ran at 0.7% and -0.3%, whereas real growth in the following years is expected to surpass the growth potential by 0.2 and 0.4%. The above results seem to remain unsupported by the findings of the NSI business surveys about production capacity utilization. According to respondents, capacity utilization in 2005 averaged some 65.7% as of October, implying that more than 30% of the capacity was not utilized for production purposes. The high level of unused physical capital and relatively high current unemployment suggested that actual GDP was well below its growth potential. On the other hand, the robust nine-month real growth in both domestic and foreign demand of 11.2 and 6.5% respectively ruled out the availability of free production capacity, as there were no markets secured for the manufactured produce. Most probably, a substantial part of the physical capital was economically ineffective, trapped and even non-usable, but respondents kept on reporting it wrongly as a possible reserve for production expansion. The above assumption was further reinforced by the investment dynamics in the same period. Together with the ever-increasing capacity utilization, fixed capital formation stepped up threefold over the 1998-2004 period. In the nine months to October'05, gross fixed capital formation rose by 17.7% at constant prices and remained a major factor behind growth in the economy. The same was true for the jobless cohort – their vocational training profile and qualifications did not meet the demands of employers, which made them practically unusable in the production process and therefore irrelevant to the production growth capacity.

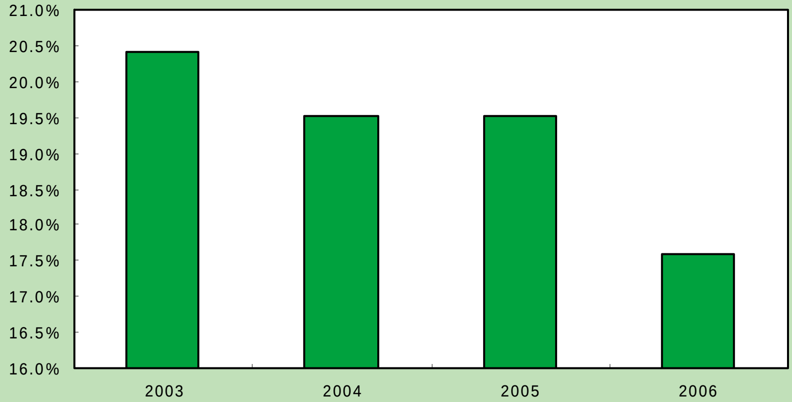
The vigorous employment growth and boosted investment activity provided for the relatively high values of the potential GDP, which had already risen by about 5% annually in 2003 and 2004. This process was further enhanced by the sizable FDI inflows into the country, facilitating the transfer of new technologies and know-how. The higher 2003 and 2004 employment was also due to the active labour market measures of the government, which however, resulted in a new pattern of reallocation via the budget rather than new job creation. However, the scope of the measures in 2005 was somewhat limited, entailing a certain slowdown in the employment growth rate. At the same time, investments in the first half-year period of 2005 went on the increase due to the strong contribution of the government. Public-sector investments were mainly infra-structure-focused, and not FDI in production, augmenting the growth potential of the economy in the long-term, i.e. an effect to be perceived in 2006, and 2007 and 2008 in particular. On the other hand, the slight overheating of the economy expected in 2006 may lead to a certain acceleration of inflation in the same year. ▼

[10] For more information on the methodology used, see Ganev, K. "Statistical Estimates of Some Deviations from the Macroeconomic Potential. An application to the Bulgarian Economy", AEAF, 2004.

Tough Fiscal Policies Counteracting a Likely Overheating of the Economy

Fiscal policies in 2005 aimed mainly at striking a balance between the boosted business activity in the country and economic stability. However, having in mind the current fears as to a likely overheating of the economy in the future, the above policy goals are somewhat contradictory. The sizable capital inflows through the balance of payments make these fears all the more realistic and call for an adequate policy response. Therefore measures should be taken to cool down the investment activity and aggressive credit expansion while avoiding an abrupt turnaround in inflows. The analysis of the fiscal policies pursued in the three quarters of 2005 has indicated that they meet the above requirements.

Tax insurance burden
(as % of income)



Source: AEAF, MoF

The early-year decrease in the profit and personal income tax rates resulted in a higher disposable income in the economy and fostered home demand. The lower direct tax burden made taxation more effective. At preliminary estimate, the total tax burden on income from wages stepped down by half a percentage point to 9.5%, whereas household disposable income rose by 4.5%. According to statistics, the marginal rate of household consumption went on the increase as a result of the higher disposable income, sending the current account deficit even higher. The positive net cash flows from the non-financial to the public sector reported a year-on-year rise due to the strict budget expenditure policies and sound revenue performance. The strong revenue collection (of VAT, customs and excise duties) as well as the robust business activity led to revenue over-performance and made the significant 2005 budget savings possible.

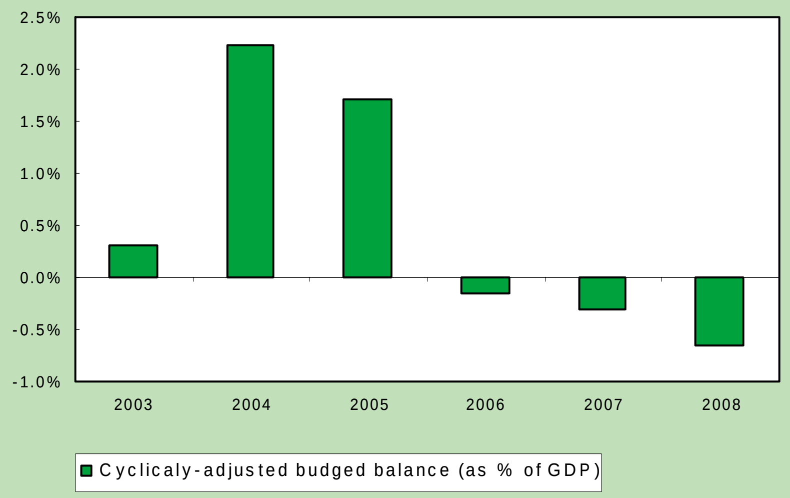
On the other hand, some institutional problems, e.g. the patterns of financing the National Health Insurance Fund (NHIF) brought additional pressure to bear on the implementation of the general budget and reduced the flexibility of the fiscal programme to respond to external shocks. On the expenditure side, 2005 was to see a significant over-performance due by and large to the higher amounts on health care payments vis-à-vis projections, with hospital care expenditures expected to post the largest increase. The fast growing patient numbers in excess of the cases funded under the 2005 National Framework Agreement resulted in higher hospital costs. In 2005 NHIF unblocked some BGN 85 million of its contingency reserve while planning to spend more money from the revenue over-performance expected to make up for the hospital care deficit. At preliminary estimate, however, the above amounts will prove insufficient to cover the Fund's deficit, which will have to be ultimately financed by way of budget allocations.

Hospital financing raised by public funds did not meet the volume of medical care services rendered, neither did it provide for the dynamics of the patient flow and advance of the modern technologies and medications used by hospitals. In addition, the sluggish restructuring and inadequacies, having to do with the dual pattern of hospital care financing (i.e. by the NHIF and the Public Health Ministry), have been the main factors at work, generating over-indebtedness on a regular basis.

Another problem entailing huge amounts of hospital expenditures, and hence ever-growing indebtedness, was that the NHIF covered only some 70% of the actually incurred costs on the clinical paths in the same proportion, without taking into account the hospital capacity and complexity of treatment. Another reason behind the sizable deficit had to do with the fact the Fund did not provide for emergency care.

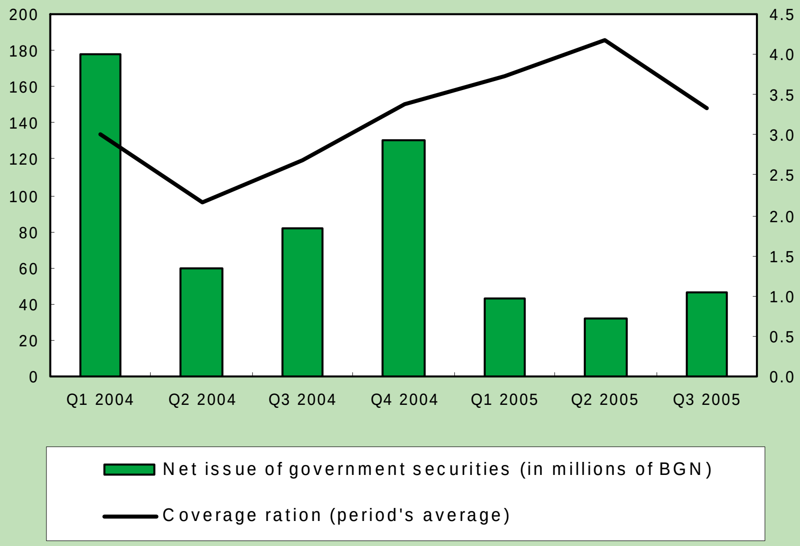
Drawing upon the cyclical pattern of economic performance, the significant savings of the public sector may at some point start functioning as a stabilizer of aggregate demand. Government fiscal policies over the 2004-05 period can be said to have been rather restrictive in stance, given the enormous cyclically-adjusted surplus. All this shows that the effect of policy tightening went well beyond the impact of the built-in stabilizers. The need, however, for stricter and tougher budgetary discipline remains, as the contribution of public consumption to economic growth was sustained in the first half of 2005, going even slightly up on a year earlier.

Cyclical fiscal position



Given the ever-worsening current account deficit, the larger amounts of public-sector savings in 2005 catered for the investment activity of the private sector only in part and made up for the dearth of household savings in the economy. Fiscal policy, on the other hand, should focus not only on its cash balance but the ways of financing it as well. The patterns of budget financing have a most perceptible impact on the country's economic development and may be used as an instrument for overcoming the challenge of the huge capital inflows. An adequate policy response then calls for withdrawal of liquidity from the banking system. Put in more precise terms, it should amount to a series of sterilizing operations, restricting the growth-conducive effect of the foreign financial inflows on domestic demand while narrowing the gap between aggregate demand and supply. By October'05, government securities had gone on the increase in volume terms. However, due to the large amounts on due securities, the net issue of government securities stepped down significantly on a year earlier. The domestic demand for government securities followed suit as a result of the higher yield on bank credit portfolios. Nevertheless, it held comparatively strong, ensuing ever dropping yield rates and even record lows reported at the primary auctions.

Issue of government securities and demand



Source: MoF

On the whole, 2005 sustained the net cash inflow from the banking to the public sector, though in a smaller size, as there was practically no need for any further budget financing, and revenues from privatization grew most robustly over the same period. At the same time, the need to withdraw liquidity from the banking system remained strong in an attempt to induce a smooth rise in the interest rates and reduce the risks of overheating the economy. Therefore, given the current account deficit in place, government economic policies should aim at keeping the capital inflows within reasonable limits while avoiding the flight of capital from the country. Higher interest will lessen the chances of a trend turnaround in the financial flows, given the fast rising interest rates in the Euro area and the USA. On the other hand, liquidity can be also effectively reduced by issuing mostly discount bonds, which will draw out money from the sector throughout the period to their maturity date rather than ordinary bonds, which inject funds on a regular basis by way of coupon payments.

As for the budget, the upshot of the above policies will be an increase in the fiscal reserve account. From the point of view of liquidity in the economy, whether savings pile up in the fiscal reserve account or are mobilized to service the foreign debt comes to the same effect because the relevant policy decision depends, among other things, on the market conditions. For example, a more active issuing policy is likely to exert a certain pressure on the expenditure side of the budget through the higher interest payments on the domestic debt to be made, which may, otherwise be reduced by lower payments on the foreign debt if the fiscal reserve account is used for its ahead-of-schedule repayment. In this sense, the fiscal policies implemented in the three quarters of 2005 can be said to have responded in a most adequate manner, drawing upon the budget surplus and revenues from privatization for repayments on the Bradies then in circulation. January'05 saw some USD 937.5 million worth of a buyback of IABs at their face value, with the cost savings from interest upon maturity in 2011 amounting to USD 200 million, according to estimates of the Finance Ministry. In July the government conducted another buyback of DISCs worth USD 607.4 million. As a result, the government and government-guaranteed debt as of end-September stepped down by 18.8% relative to the end of 2004. Net payments to the external sector remained strongly negative, deteriorating on a year earlier. Repayments on the country's foreign debt made up for the higher interest payments on the domestic debt, resulting in a 2.8% year-on-year drop in total interest expenditures.

Social Implications of the 2005 Government Economic Policies and Their Impact on the Labour Market

2005 government social policies had been in the limelight of controversy since mid-2004 when the next year's budget formulation process began. The most debatable issue had to do with the minimum wage rise (to BGN 150) to be applied in early 2005. A major criticism amounted to the likely adverse effect on the competitiveness of local entrepreneurs as a result of the higher labour costs to be met and poor job opportunities for workers of low labour productivity. At the same time, the opinions voiced expressed a serous concern that the government was trying to influence the average wage dynamics by raising the minimum wages. In fact, minimum wages perform, above all, a social function, as they are an instrument for providing some social shelter to the most impoverished population whose income suffered a most dramatic decrease in 1996 and early-1997. Ever since 1998 minimum wages have been stepping up at a faster rate than average wage growth, evidencing the willingness of the government to reduce extreme poverty. It should be also noted that 1998 minimum wages held steady at a level a lot higher than other income from employment, accounting for 28% of the country's average wages. A key social policy goal in the post-1998 period had to do with the speed-up in minimum income growth, recovering the purchasing power of the lowest-income group in the wake of the country's economic collapse in 1996 and 1997.

Year	Minimum average monthly wages (in BGN)	Average annual monthly wages (in BGN)	Share of minimum wages within average wages (%)
1993	1.3	3.2	38.8
1994	1.8	5.0	36.8
1995	2.5	7.6	32.3
1996	3.8	13.2	28.9
1997	33.9	127.9	26.5
1998	51.3	183.3	28.0
1999	64.0	201.0	31.8
2000	75.3	224.5	33.6
2001	87.3	240.0	36.4
2002	100.0	257.6	38.8
2003	110.0	273.3	40.2
2004	120.0	292.4	41.0
2005	150.0	320.7*	46.8*

* Preliminary estimates

Source: NSI, AEAF

In 2002 minimum wages restored their early-1990s weight within average wages, even surpassing it in the following two years. The outstripping growth in minimum wages vis-à-vis average wages has made the country comparable to the relative ratios in most EU member states. Therefore, whatever steps the government is to undertake in the future, it will have to bring minimum wage growth into line with average wage increase in the economy.

Furthermore, there is the political will in place, as indicated by the minimum wage figures (BGN 160) in next year's budget projections. As result, 2006 minimum wages are expected to run some 6.7% higher in nominal terms compared to 2005.

Minimum Wages by Country

	Monthly minimum wages (in EUR)	Updated as at:
Belgium	1 234.21	01.6.2005
Bulgaria	77	28.1.2005
Croatia	285	01.1.2005
Cyprus	631	01.4.2005
Czech Republic	238	01.1.2005
Estonia	172	01.1.2005
France	1 217.88	01.7.2005
Greece	589.47	01.9.2005
Hungary	232	01.1.2005
Ireland	1 326.00	01.5.2005
Latvia	121	01.1.2004
Lithuania	159	01.7.2005
Luxembourg	1 466.77	01.1.2005
Malta	562	01.1.2005
Netherlands	1 264.80	01.7.2003
Malta	208	01.1.2005
Portugal	374.70	01.1.2005
Roumania	91	01.1.2005
Slovakia	179	01.10.2005
Slovenia	512	01.8.2005
Spain	513	01.1.2005
Turkey	304	01.1.2005
Great Britain	1 273	01.10.2005

Source: Federation of European Employers

In 2005, the country's minimum wages amounted to only EUR 76.7 on a monthly average. Minimum wages in the new EU member states ran the lowest in Latvia (EUR 121), which was 1.5 higher than in Bulgaria. In all other new member states minimum wages were at least two times higher than in Bulgaria. Furthermore, the minimum wage amounts in the country ran lower than even in Roumania (EUR 91), Turkey (EUR 304) and Croatia (EUR 285). The above figures show unambiguously that minimum wage dynamics did not jeopardise the competitive position of local manufacturers.

The above conclusion was further reinforced by NSI data on employee compensations as percentage of GVA. Minimum wage growth exerts as a rule an upward pressure on average wages by way of collective bargaining in industries where remuneration runs very close to or slightly higher than minimum wages. However, at AEAF estimate, the contribution of the higher minimum wages to wage bill growth in the economy was relatively small. On a year earlier, labour costs in the first half-year period of 2005 had stepped up by 7.3%[11] in nominal terms. At the same time, income generation grew at a faster pace, resulting in a lower share of employee compensations within GVA (from 42.8% in the first half year period of 2004 to 41.9% a year later).

Share of labour costs within GVA

(%)

	1st half-year period of 2004	1st half-year period of 2005
Overall in the economy	42.8	41.9
Agriculture and forestry, fisheries and hunting	11.1	12.8
Manufacturing sector	47.1	44.5
Mining and extraction	54.7	52.6
Processing industries	49.0	46.1
Electricity, gas and water generation and supply	42.9	41.1
Construction	41.0	39.1
Services	44.9	43.6
Trade, repair of cars and home appliances	56.0	54.8
Transport and communications	32.3	29.8
Hotels and restaurants	42.7	42.0
Finance, credit and insurance	29.6	30.7
Other services	50.1	49.4

Source: NSI

As evident from the table above, the share of labour costs within value added was on the decrease in most of the industries.

Therefore, it can be concluded that minimum wage growth in 2005 did not put at risk the country's business activity. Neither did it result in a higher unemployment rate among the poorly-qualified workers. Data from the NSI survey on employees and wages also indicated that the indicator's contribution to the average wage increase in the same year was rather insignificant. On the other hand, over the past few years employers had to shoulder the far more difficult challenge of the higher social security burden, hampering new job creation and hence employment growth. This was the main reason why the government decided on reducing the burden on income from employment by 6 percentage points as of the start of 2006. At AEAF estimate, however, the resources set free by the above decrease are not be immediately rechannelled to job creation. Rather, the effect is to manifest itself in the years to come with the improvement in the business environment and investment activity boost.

At preliminary NSI estimate, average wages in the nine months to October'05 amounted to BGN 315, posting a year-on-year nominal- and real-term rise of about 9% and 4.3% respectively. The 2005 upward trend in income was further evidenced by the official NSI

[11] According to National Accounts data.

statistics on household budgets, whereby money income per household capita went up by about 7% in real terms on a yearly basis due to the growing income from employment and retirement.

Growth rates of productivity and real wages in the nine months of 2005*

	Growth in productivity**	Real wage growth
Overall in the economy	3.4	4.3
Agriculture, forestry, fisheries and hunting	2.7	3.9
Manufacturing sector	2.1	3.4
Mining and extraction	5.6	6.9
Processing industries	4.4	4.0
Electricity, gas and water generation and supply	-4.8	1.0
Construction	0.8	3.7
Services	4.6	4.7
Transport and communications	4.6	3.9
Trade, repair of cars and home appliances	10.2	1.3
Finance, credit and insurance	10.9	5.0
Other services	2.2	6.8

* Preliminary data
** Productivity estimates rely on GVA data at 2004 prices and the employed numbers according to labour force surveys

Source: NSI, AEAF

In the nine months to October'05, real average wages[12] outstripped labour productivity[13]. At the same time, while average wages have stepped up at a rate higher than the post-2000's average, productivity grew at the same pace as the indicator's average. Average productivity in the economy had outperformed significantly real wage growth[14] throughout the 2000-2004 period but in 2003 when it posted a year-on-year decline due mostly to the government measures aimed at improving the collection of social security contribution having to do with mandatory registration of labour contracts with NSII. In 2004, however, the effect of the administrative government measures (the active labour market measures and programmes including) weakened and productivity went on the increase again.

Nine-month employment advanced at a slower rate on a year earlier due mostly to the reduced employed numbers under the active labour market measures. At the same time, productivity did not slow down on an annual basis, with the indicator performing most robustly in the service industries as followed: *financial intermediation* posted the highest increase of 10.9% coupled with a fast rise in gross value added and employment. *Trade*

[12] At preliminary NSI estimate.

[13] As estimated on the basis of the GVA data at 2004 prices and employed numbers according to the labour force surveys.

[14] The estimation of the annual growth rates rely on NSI data as to GVA and the average annual pay-roll numbers and average annual wages.

followed suit with some 10.2% as a result of the larger increase in income, given a relatively slow growth in the employed numbers. Average wage growth (1.3%), however, lagged behind the country's average. Labour productivity in *transport and communications* posted a strong advance of 4.6% on an annual basis, outstripping real average wages. As for the manufacturing sector, the indicator ran the highest in *excavation and mining* (5.6%), fostered by the boosted business activity. Productivity rose by 4.4 and 0.8% in the processing industries and construction respectively, with the increase in both cases being due to the faster income growth vis-à-vis employment while decreasing in electricity, gas and water generation alone. At the same time, extraction and mining reported a slower growth in productivity compared to real wages.

In 2005 the scope of the active labour market measures and programmes was narrowed, relying on approximately the same amounts of budget allocations of some BGN 204 million as in 2004. At the same time, budget extensions stepped down under the largest-scale government programme "From Social Aid to Employment Promotion" while increasing for measures supporting employment and vocational training under the Employment Promotion Act. The smaller scope of the active labour market programmes of the government indicated that the higher 2005 employment was by and large due to the private sector. However, *From Social Aid to Employment Promotion* remained the largest source of supply and demand for subsidized jobs. The start of project approval procedures under the programme was coupled with a clash of interests between the central and local governments as a result of the re-allocation of funds from the municipalities to the district authorities, private-sector employers and NGOs.

The government pointed at three main reasons for the altered policy agenda priorities. First, The Ministry of Labour and Social Policies believed that by devolving the programme implementation to private companies it would provide better on-the-job opportunities for the unemployed at the same company after the termination of their temporary employment. The opinion of the AEAF analysts, however, is that such an outcome is as likely to occur as the unemployed are able to find jobs in the primary labour market on their own, having once participated in a local or any other project under the programme. Therefore, giving priority to the private sector does not increase the chances of the jobless to remain employed on a long-term basis. Private-sector entrepreneurs do some business activity in pursuit, above all, of profit maximization, whereas most of the jobless hired under the programme cannot be involved in activities having to do with profit-making[15]. Hence, employers will have to invest in the unemployed, so that the latter generate some value added. As a result, most employers avoid retaining the workers hired under the programme following the termination of subsidized employment.

Another reason for the re-allocation of funds from the municipalities to the district authorities and private-sector employers had to do with the programme implementation inadequacies on the part of local governments (ineffective and inefficient work, inaccurate reporting of funds, etc.). However, a major question is: how capable is the private sector of giving the jobless better incentives and motivation compared to local governments? Even assuming that they will apply a tightened control, there is absolutely no assurance that the operations of the entrepreneurs are transparent and public. It is our belief that job centres apply follow-up control rather than preventive oversight. In addition, avoiding the drain of budget funds means binding private employers in some reasonable form by way of additional requirements, e.g. retaining the hired workers well after the termination of subsidized employment as is the case with the employment promotion measures under the relevant act, guaranteeing longer-term employment to job seekers, etc. As for the re-allocation of projects from the local governments to the district administrations, it was not a prudent step either, as it amounted to financial centralization of a kind, resulting in higher programme implementation costs, weakened control and even misappropriations. Furthermore, district

[15] In fact, the programme also provides for project proposals on the part of employers whereby the unemployed are involved in some basic production operations. However, priority is given to projects of social importance, measures having to do with the improvement of working conditions in enterprises, etc., as a result which the share of the former is relatively small.

governors are responsible for bringing together national and local interests as to employment promotion issues as well as oversee government policy implementation rather than for project management.

A third reason behind the changed policy priorities has to do with the insufficient local administrative capacity and scarcity of equipment. Having in mind that the programme had been underway for a third year in a row, the local authorities were supposed to have already gained some experience in ensuring the equipment needed. Besides, their capacity to meet such demands depends largely on the pace of the decentralization effort aimed at giving local governments greater financial independence. Therefore, the re-allocation of employment promotion projects from the municipalities to the district administrations makes it difficult for the local authorities to build up experience in managing local financial flows.

Despite the altered priorities in the project approval exercise, most long-term unemployed, made redundant under the programme, were ultimately re-employed under the different activities of the same programme. All this implies that the output delivered was the same as in 2004 irrespective of the employer. Therefore, government action in 2005 seemed unjustified and not well-grounded leading to unnecessary social tension.

Apart from minimum wages, wage dynamics in the budgetary sector is another instrument employed by government income policy. Since 2005 budgetary sector wages have been updated once a year (in mid-year), with the increase of July'05 amounting to 3.6%. 2006 budget projections provide for another rise of some 6%. In implementing its policies as to budgetary wages, the government was trying to bring them into line with the growth rate of productivity, without exerting any pressure on the private sector to raise wages above productivity and jeopardise its competitiveness. However, according to NSI data, 2005 average wages in the budgetary sector stepped up at a relatively fast pace, posting a nominal-term rise of 13.1% in the nine months to October'05 on a year earlier. Over the same period, real average wage growth ran well above the rate of increase in productivity, suggesting that the government was pursuing a pro-active income policy in relation to budgetary sector employed, exerting an upward pressure on the country's average wages compared to 2004. At the same time, real wage growth in the private sector ran closer to GVA growth, indicating that the sector had a larger income growth capacity to bring the pay rates into line with productivity.

A juxtaposition of the indicators' performance in Bulgaria and EU shows that while the country's wages were lagging significantly behind the EU average, running about 18 times lower than EU (25)[16], productivity was only three times lower than EU (25). As in the long run the two indicators are expected to step up at the same rate, at some point in Bulgaria's convergence to EU wage growth should outstrip productivity to catch up with the indicator in the Union. ▼

[16] According to 2002 data of Eurostat.

Accelerated Inflation

2005 inflation ran higher than expectations. At end-of-2004 estimates, 2005 inflation was to amount to about 3.5% (as of the period's end) and some 3.3% on an annual average. As of end-November'05 alone, cumulative inflation stepped up as high as 5.58%, and was expected to go further up to 6.56% in December. Annual price inflation was anticipated to average 5.05%.

The above dynamics was triggered by a number of factors. On the one hand, it was the higher than expected crude oil prices that surpassed preliminary estimates, sending production costs in many industries on the increase. On the other, the stronger heating price increase vis-à-vis forecasts exerted an additional upward pressure on consumer price inflation. Furthermore, the extensive flood damages suffered by crops resulted in more expensive food prices (a year-on year change of 5 points compared to earlier estimates, and an estimated contribution to the food price index of 2.73 percentage points). The increased 2005 consumption was another factor at work, which pushed the prices of some non-tradables up. At the same time, the market prices of some non-food items, which can be said to be tradables, stepped up insignificantly, despite all factors affecting the price inflation of some other goods and services. All this was due to the fact that they faced the strong competitive pressure of imported counterparts in the utmost, reporting a year-on-year change that was quite expected.

	2005										
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI
CPI	0.74	0.87	0.33	1.07	-0.48	-1.31	0.10	0.58	1.40	1.18	0.99
Core inflation	0.82	0.80	0.36	1.22	-0.66	-1.70	0.04	0.63	1.60	1.41	0.85
Food iprices	1.24	0.98	0.37	1.30	-1.55	-3.93	-0.70	0.74	2.68	2.30	1.56
Tradables	0.18	0.01	0.02	-0.21	0.20	-0.26	-0.01	-0.01	0.43	0.59	0.42
Market service prices	0.70	0.83	0.31	1.77	0.25	0.22	0.84	0.30	0.22	0.86	0.55
Fuel prices	0.02	1.66	1.46	2.74	-0.08	2.98	2.21	2.90	2.61	-0.25	-1.64
Administered prices	0.45	1.12	0.22	0.52	0.21	0.11	0.29	0.41	0.69	0.34	1.51

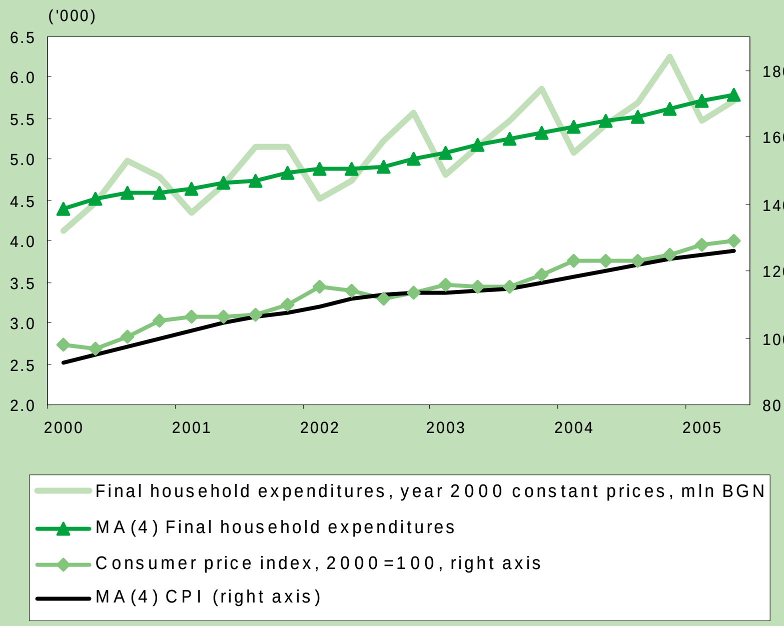
The robust consumer demand, as triggered by household income growth and eased access to credit, led to a price rise, of services in particular. 2005 saw a certain increase in the following service prices: health care, not covered by the NHIF, tuition fees, leisure activities, cinema and theatre, accommodation. The relative weights of most of the above consumer basket items posted a significant year-on-year rise. The restructuring of household consumption towards a greater share of the services used exerted an upward pressure on price inflation, a process to be further sustained in the next years, as the demand for market services, e.g. quality health care, tuition, leisure and recreation, is expected to grow. At the same time, the prices of some other services, which had been subject to administrative pricing, were expected to decline in relative terms (e.g. telecommunications).

Furthermore, the restructuring of household consumption and service price increase had to do with the Balassa-Samuelson effect in the economy. Growing productivity and wages in the sector of tradables and non-tradables lead as a rule to a higher demand for services, which are considered "superior" goods, influencing prices.

Also note should be taken of the pricing policies in the energy sector and public utilities, which despite the privatization process and market liberalization, are still subject to state regulation. Companies are first required to justify the production costs and investment made and then request from the regulatory body to sanction a possible rise in the tariff rates. However, as pricing is not completely transparent and pricing methodologies are inaccurate, there are concerns that end-user prices take into account some proportion of the loss or costs, which could have otherwise been optimized, rather than the investment actually made.

Real consumption stepped up not only in the sector of services, which are essentially non-tradables but in the sector of non-food items as well. As most of them are tradables, they face a strong pressure on the part of imported counterparts, which in turn makes it impossible for local producers to meet higher demand by raising prices.

Final consumer expenses and consumer prices



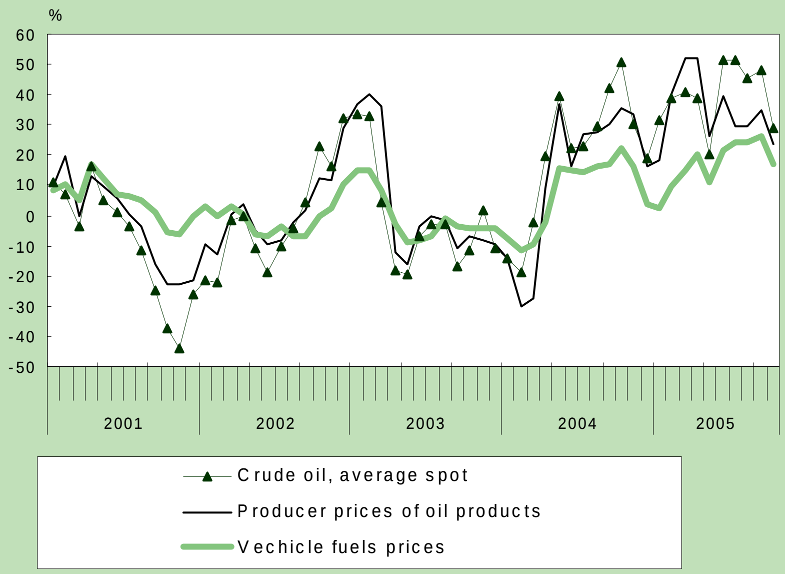
Source: NSI, AEAF

As for the agricultural sector and food industry, the price rise had to do with supply problems. In addition, agriculture is one of the most dynamic sectors as far as prices go and fluctuations inside a year are difficult to forecast. Besides the seasonal price volatility, it suffered two other shocks – extensive flood damages in summer and early autumn and the robust fuel price increase, which resulted in an upward pressure on retail prices and a slight change in the seasonal profile of supply. Furthermore, there are several industries, which can be said to have been continuously suffering from chronic problems of undersupply (e.g. meat production and processing). In the nine months to October, meat and meat product prices went up by 7.9 and 6.3% respectively. According to data of the producer organizations, the meat processing industry is heavily dependent on the importation of frozen meat to meet local underproduction. Meat import quotas at reduced duty rates are negotiated on a yearly basis, but they are quickly used up and there are again raw material shortages, triggering a retail price jump, as was the case in end-2004. Obviously, meat production should be either further expanded and/or preferential import quotas increased.

At MA estimate, supported by data on dairy imports and exports, 2005 witnessed a decrease in dairy production and imports and an increase in exports. The year-on-year contraction in domestic supply resulted in a price rise as followed: milk (7.0%), dairy products (2.1%), and butter (3.9%). The investments made to meet EU food safety requirements exerted an additional upward pressure on dairy prices. According to data of SAPARD agency, the number of projects approved and completed in dairy production under Measure "Improving the processing and marketing of agricultural and fishery products" went on the increase.

In 2005 crude oil prices carried on rising, hitting a record high in August that broke through the psychological barrier of USD 70 per barrel. In the following months, oil prices stepped down and steadied around and below USD 60 per barrel. All this affected the country's fuel prices, which posted a 22.6% increase since the start of the year. On the other hand, the higher fuel prices led to a nine-month price rise in transport services (railway transport excluded) of 12.1% on average.

Crude oil average spot (in leva), producer prices of oil products and vehicle fuels (12-month change)



Source:NSI. AEAF

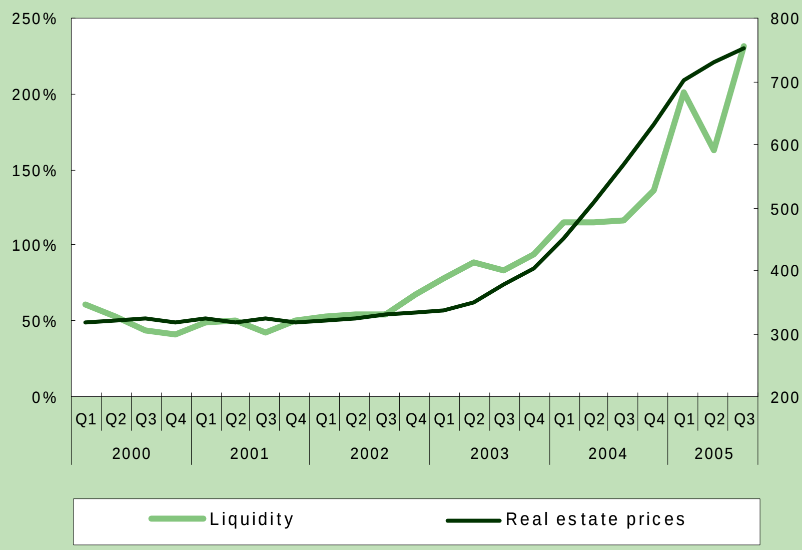
The price increase in a basic energy source such as crude oil has a direct effect on the industries and consumer prices while influencing indirectly industries, which seemingly do not depend on the oil price dynamics by way of the higher production costs, or by restructuring household consumption and spending. Higher crude oil prices lead as a rule to higher production costs in the industries processing the raw material or using it directly like refined oil products, chemicals or non-metal raw materials. Furthermore, refined oil products or products heavily dependent on crude oil deliveries are a basic input item (e.g. food industry, metallurgy, road, air transport, etc.). As a result, the higher 2005 crude oil prices triggered a stronger increase in PPI vis-à-vis consumer prices. At AEAF estimate, the direct effect of the 10% increase in crude oil prices on consumer prices amounted to 0.29 percentage points, whereas its indirect effect on production costs in a number of industries ran at 0.40 percentage points.

Possible effects of a likely turnaround of the capital flows

The stronger the dependence of the local economy on foreign capital, the greater the effect of a likely turnaround in the capital flows on the real economy. Furthermore, the magnitude of the effect is determined not only by the inflow volumes but their liquidity as well, i.e. are foreign inflows threatened to go on the decrease and is foreign capital already operating in the economy likely to flow out.

Over the past few years liquidity in the economy has gone on the increase. BNB FX reserves were steadily rising by 12.6, 16 and 27.5% in 2002, 2003 and 2004. Given the currency board arrangement, the ever-growing FX reserves of the Central Bank have led to a robust growth in money in circulation and money supply. The boosted performance of the banking system of the last couple of years added to the above strong increase. Banks are an effective provider of liquidity in the economy, as they transform illiquid assets into liquid liabilities. On the whole, the banking system is one of the sectors, making the most of foreign capital. As of end-September'05, bank foreign debt went up as high as MEUR 2049 vs. MEUR 1692 in end-2004. Bank foreign liabilities outstripped bank assets (foreign financing posted a 21% increase in the nine months to October vs. a 19% rise in bank assets over the same period).

Liquidity* and real estate prices



Source: BNB, NSI, AEAF

* Liquidity has been calculated as the sum of the claims on the non-government sector and M1 minus quasi money, and the result obtained is compared to nominal GDP. This is one way of illustrating the dynamics of the money going in the economy minus the money flowing out of it in the form of savings, with the result obtained being compared to nominal GDP.

Higher liquidity in the economy affected the country's asset market – real estate, financial assets, investment in equipment and machinery. On the other hand, the higher prices of assets influenced the real economy via the banking system because the higher the market value of real property the higher the value of corporate or household loan security, hence the easier the access to bank credit. At the same time, the strong demand coupled with price growth and increased profit margin in construction boosted the sector's performance and made banks ease their lending terms for entrepreneurs and buyers alike. Although real estate prices had already stepped up most robustly in 2004, gross value added in construction in 2005 posted a most significant gain on a year earlier. *Finance* and *construction* reported the strongest real GVA growth in the first half-year period of 2005 of 30.1 and 24.5% respectively. In addition, these were the sectors where the bulk of foreign investment was focused.

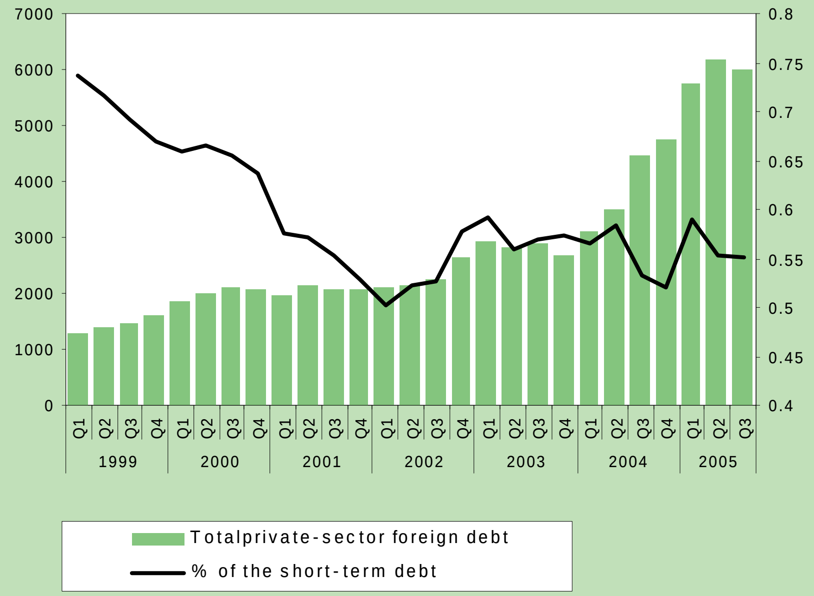
As income went on the increase household creditworthiness improved and credit access was eased. Despite the slowdown from 56.5% in 2004 to 43.9% in end-September'05, consumer loans in the nine months to October ran very close to the 2004 growth in nominal terms. Note should be also taken of the robust growth expected in December resulting in a stronger nominal-term increase on a year earlier. At the same time, higher household income, together with the loans extended, accounted for the higher liquidity in the economy and hence vigorous solvent demand for goods and services. Furthermore, apart from the volume-term change, demand also reported a notable shift to commodity groups that had been unavailable in the local market for the bulk of consumers. Other things being equal, rising consumption generated inflationary pressure, which was not yet perceived as higher demand-pulled inflation. The altered structure of consumer demand may have been a possible reason for the above development. As household income increased consumers tended to consume more and more imported goods because of their higher quality or unavailability of local counterparts. In this sense, the prices of imported goods remained largely exogenous while putting the brakes on local prices due to stiff competition. At the same time, with the development of the local markets there has appeared a large range of new goods and services. Therefore, increased consumption as a result of the higher available liquidity triggered by vast consumer lending on the part of banks did not lead to a significant price rise while boosting local production. However, the price level may go on the increase in the medium term under the impact of the market mechanisms and provided the high level of liquidity is sustained.

Higher liquidity may affect the real economy in yet another way. As the average maturity of receivables and payables of companies and individual rises, household consumption picks up, given the same amount of initial income. All this makes short-term capital management easier, allowing companies and enterprises to respond quickly to changes in demand. The Central Bank's restrictions on lending resulted in an ever-growing firm indebtedness. Most enterprises were forced to seek alternative sources of financing their operations, resulting in a huge influx of financial resources, enormous private-sector debt to foreign creditors, and stronger dependence of the local firms on direct foreign financing (in the form of trade credit). The ratio between short-term foreign trade credit to the non-financial sector and total imports stepped up from 27% on average in 2004 to 33% in the nine months to October'05. Due to the growing domestic consumption, hence imports, local firms needed an ever-rising short-term capital to cater for expansion. Obviously, part of these resources was secured in the form of foreign trade credit.

A major threat to growth in the economy, especially when it is coupled with an increase in the foreign or domestic debt has to do with a turnaround in the financial flows between the country and the rest of the world, as triggered by either oversupply in the local market, or by generating instability from an external source.

Of all potential local sources of future instability in the economy construction deserves special attention. Given robust growth, low-interest foreign financing and return abroad, local asset prices may go well above the current levels. Real estate price rise in 2005 slowed down. In the second and third quarters they posted a rather modest increase of 4.3 and 2.9% (relative to the preceding quarters) vs. 12.3 and 12% on a year earlier. The next two years are expected to see more housing area placed in the real estate market, which may exert a downward pressure on prices, bringing about a lower investment demand for real property and cooler level of activity in the sector. A decline in construction will affect all up- and downstream industries as well as banks, which over the past few years have been extending mortgage loans rather generously. On the other hand, the lower value of loan security will cool down lending even for projects that are not directly focused on real estate development. In addition, the influx of foreign financing channelled to banks and construction may plummet, as the growth rate of bank assets steps down and risk in the construction sector goes on the increase.

Private-sector foreign debt

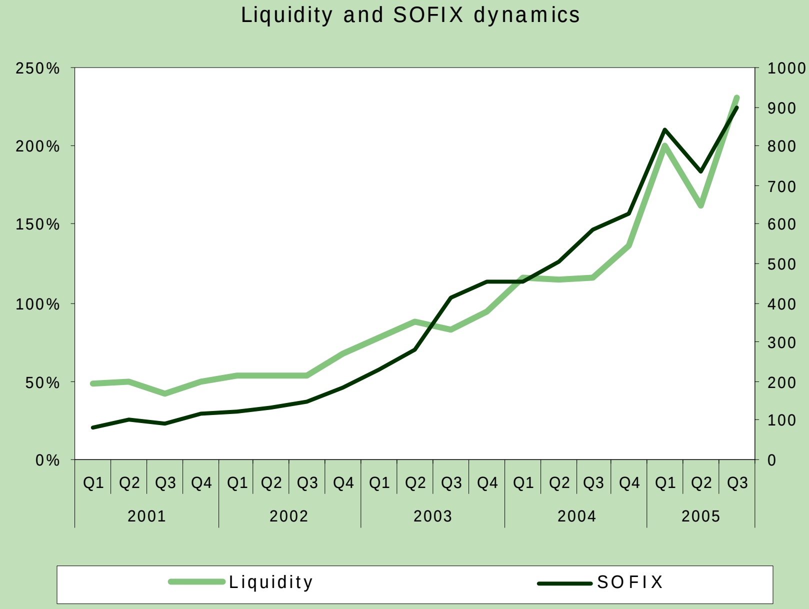


Source: BNB, AEAF

Whenever the market of banking services is experiencing a boom as is the case in Bulgaria the interrelation between firms and banks becomes all the more pronounced. Bank assets, as percentage of GDP, stepped up from 50% in 2003 to 73% as of end-October'05. The stronger interrelation between the real economy and banks increases risk in the economy even due to the higher share of debt in the balance sheets of the firms alone or their dependence on bank financing to raise larger amounts of working capital or investment. As the development of local financial intermediation relies heavily on foreign capital, any slow down in the inflows may affect liquidity in the real economy and lead to weaker growth. On the other hand, a growth slowdown in the economy and domestic consumption may result in a significant shrinkage in imports and improvement of the trade deficit while making a lot of enterprises face serious debt servicing problems.

Investment in equipment enhances the production capacity in an economy, producing a healthy long-term effect on its performance. As the bulk of machinery and equipment is imported, the increased investment demand is not likely to affect their price dynamics or relative prices as a whole. However, overinvestment in production capacity may be detrimental to the financial inflows, with return on investment proving to be unjustifiably lower than the investment itself.

Investment in financial assets and real estate in a lesser degree has to do with the pursuit of profit on investment. However, asset prices cannot post a significant rise due to the underdevelopment of the financial system, in particular the limited investment opportunities in the market. As there are few investment opportunities in the economy, real estate proves to be a second-best choice of many investors.



Source: BNB, NSI, AEAF

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As a result of the steady strong growth in the economy and upbeat expectations as to the country's development, its accession to the EU including, the risk perceived decreased rather quickly. This together with the sale of the Bulgarian Telecom and some other smaller companies on the Sofia Stock Exchange rechannelled vast amounts of resources to stock-exchange trading. The bulk of this idle money in the form of compensatory instruments had been for a long time characterized by lower liquidity and higher risk vis-à-vis money in circulation. In early-2005 huge amounts of the compensatory instruments in hand were transformed into real-life money and BTC shares. It was this vast idle money in the economy, among other things, that sent the stock exchange indices rather high in January and February. In the two months to March, the SOFIX advanced most vigorously by 45%, given significant volumes of trading, hitting an all-time high of 932.44 in end-February. What followed, however, was one of the longest price corrections of the last couple of years. The development of the Bulgarian Stock Exchange in 2005 illustrates rather neatly the consequences of a sharp increase in liquidity and follow-up shrinkage due to the scarcity of fresh money to sustain the price of assets high. At the same time, as price corrections intensified the propensity to take risks steadily declined and large amounts of money were re-channelled to companies securitizing investments in real estate and land, which are taken to be relatively less susceptible to market fluctuations. In addition, with the decrease in return on investment in financial assets, investment portfolios are to undergo some restructuring towards a higher share of the foreign assets purchased resulting in a drop in the price of the local financial assets and a flight of capital form the country.

There are a number of external factors that may bring about a turnaround in capital flows. The most important of them, however, has to do with the interest dynamics world wide, the Euro area in particular. There are several transmission channels of interest rate dynamics into the emerging economies. First, the higher interest rates in the world markets suppress business activity in the construction sector and industries susceptible to the interest rate dynamics (car manufacture, heavy industry, etc.), which are also main users of raw materials. Any decline in the consumption of basic raw materials may affect their prices, and ferrous and non-ferrous metals enjoy a significant share in the country's export basket. Furthermore, as already pointed out, the development of the Bulgarian economy is heavily dependent on the performance of the mining and excavation industries and any change in the global market situation may influence the local manufacturing sector.

Second, higher interest rates have a direct effect on debt repayment, be it private or government, especially when it is short-term and of floating interest. Having in mind that the government debt has been steadily falling over the last few years and the bulk of it is of fixed interest (52.74% as of end-September'05), it follows that the ever-growing private-sector debt may pose a major threat. If economic agents find it difficult to service it, business activity will deteriorate drastically. Third, the increase in the interest rates in the industrialized nations will make investment in the emerging economies less attractive and exert an extra downward pressure on capital inflows. ▲

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