THE BULGARIAN ECONOMY: ANALYSIS AND OUTLOOK

THE BULGARIAN ECONOMY IN 2006

annual report

AGENCY FOR ECONOMIC ANALYSIS AND FORECASTING

ISSN 1312-5478

31 Aksakov Str., Sofia 1000, Bulgaria
Tel. (+359 2) 9859 56 01, 981 65 97
Fax (+359 2) 981 33 58, 980 93 22
e-mail: aeaf@aeaf.minfin.bg
www.aeaf.minfin.bg

Contents

The performance of the Bulgarian economy in 2006 was marked by the country's expectations as to the Commission's decision on the date of its accession to the European Union and the evaluations of the Community institutions as to Bulgaria's progress on the commitments undertaken in the negotiation process. These evaluations were made available in two monitoring reports of the European Commission dated 16 May and 26 September 2006.

The first report took note of Bulgaria's progress but did not set a date for its accession to the Union as a full member state, voicing opinions that the country would be prepared to join the Community as of 1 January 2007 only if it resolved a number of outstanding issues. It also emphasized that Bulgaria needed to make further progress on anti-corruption measures, the reform exercise in the judiciary system as well as on another six areas raising serious concerns.

In its report of 26 September the Commission recommended 1 January 2007 as the date of Bulgaria's accession while giving a detailed account of the country's progress from May to September and focusing on the areas defined by the May report as requiring urgent measures and further effort. The Commission confirmed that Bulgaria had made significant progress on the pre-accession endeavour in the same period and demonstrated it strong will and determination to apply the EU acquis and rules as of 1 January 2007. However, the Commission also examined the weaknesses in the country's preparation for full membership and outlined measures to overcome them.

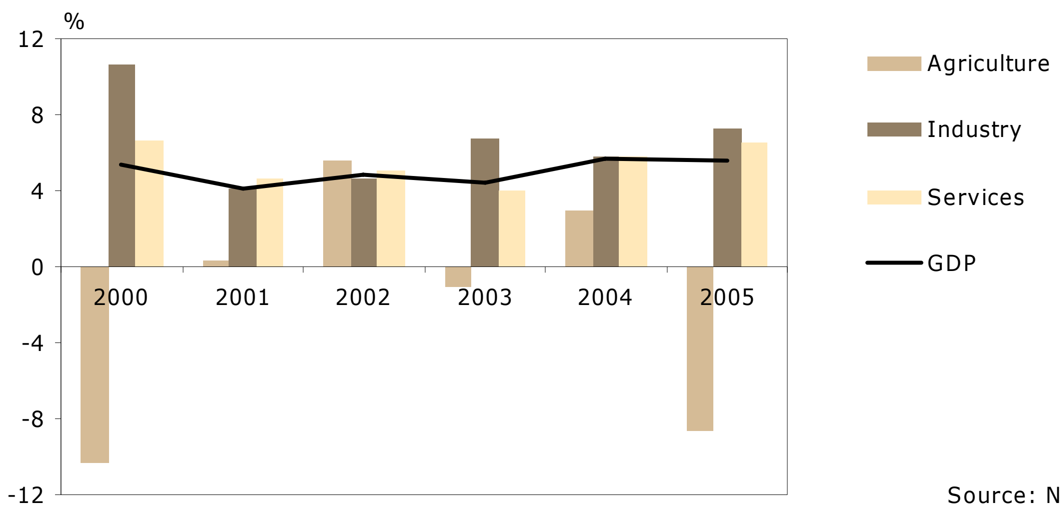
In 2006 Bulgaria made an all-out effort to fulfill the recommendations of the Commission set out in the two monitoring reports. As a result, it can be said that the country's legislation has been by and large brought into line with the EU acquis, embracing the latest attainments of the Community legal practices, which have proven their adequacy and efficiency. In addition, together with the adoption of the new administrative, tax, insurance and penal procedure codes, the country has made great strides in systematizing and improving the quality of the law making and enforcement process to meet its commitments taken in the negotiation process. This was further strengthened by administrative capacity reinforcement measures to ensure the effective and adequate implementation of the aligned legal measures. ▼

GDP

Ever since 1998 the Bulgarian economy has embarked on a sustainable growth path. For nine years in a row, the country's GDP has been steadily growing, speeding further up in the last two years. Over the 2001-2004 period the economy grew by about 5% on an annual average, advancing to 5.5% in 2005. At AEAF estimate, 2006 growth is to amount to about 6%. At the same time, 2005 economic growth in the EU-15 ran at 1.5% on average., and the expectations for 2006 are that GDP will pick up to some 2.6%. If further sustained, or if even growth in the Bulgarian economy gains further momentum in the next couple of years, i.e. economic agents make the best of the advantages of entering the internal market, the above development will prepare the ground for successful actual convergence with the other EU economies.

The manufacturing industries were the most vigorously performing sector of the Bulgarian economy over the past few years, posting a growth rate of 6.1% on a 12-month average throughout 2002 to 2005 vs. 5.3% in the service sector over the same period.

GDP growth by economic sectors



Source: NSI

The last two years, however, witnessed significant changes not only in the sector's growth rate but its structure as well. Annual growth picked up well above the 2001-2004 average to 7.3% in 2005 and 8.9% in the first half-year period of 2006 due mostly to the higher international prices of items, enjoying a large share in the country's export basket and robust performance of *construction*, which in turn boosted growth in all the up- and downstream industries.[1]

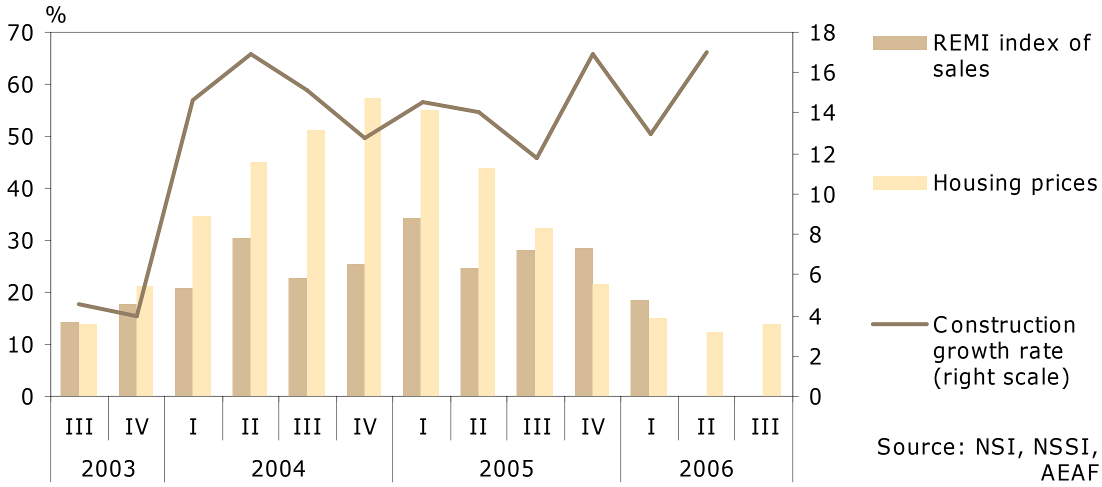
Growth in *construction* advanced to 15.2% in the first half-year period of 2006. Most entrepreneurs pointed to the strong expectations, having to do with the country's accession to the EU in the economy as the main reason for the robust real estate market. The entry into the market of large investors resulted in a greater demand for farm land and land in industrial areas. The number of long-term investors stepped up at the expense of financial investors.

Unlike office buildings, the construction of hotels and houses seems to have exhausted its potential. The supply of hotels on the Black Sea coast rose by about 50% due mostly to the unjustified expectations of investors for a quick return. Demand, however, was by and large

[1] E.g. cement, limestone and concrete products, metal products, PVC and aluminum joinery work, quarry slates, rubble work, sand and clay.

oriented to holiday complexes purchased to meet investor intentions. Which is why most property developers have turned to holiday villages rather than hotels.

Indicators in construction
(change over the corresponding quarter of the preceding year)

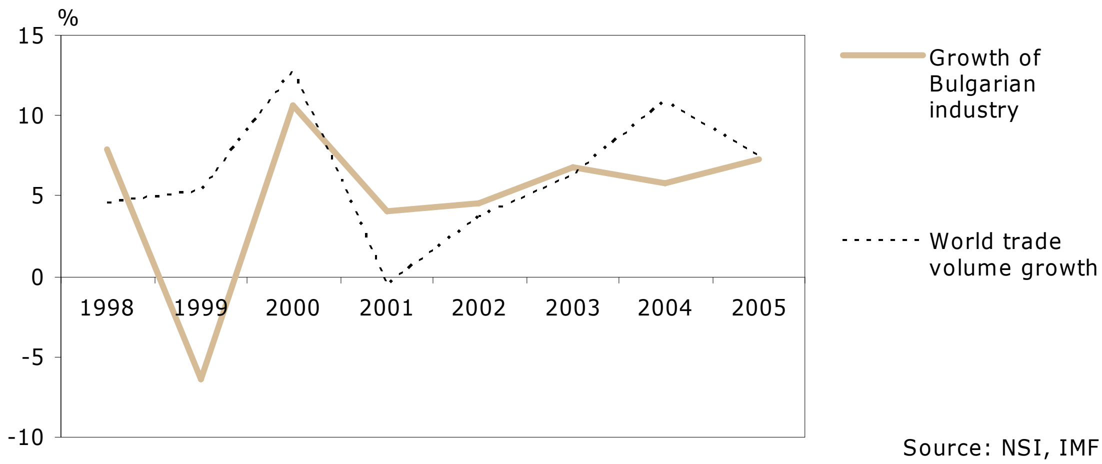


Source: NSI, NSSI, AEAF

Apart from construction and all the up- and downstream industries, *metallurgy*, *refined oil products*, *textiles and tailoring*, *food* and *electricity, heating and water and gas generation and supply* were the other vitally important industries for the sector's growth. They accounted for about 2/3 of total sales. *Metallurgy*, *refined oil products* and the textile and tailoring industries are export-oriented, leading to the strong dependence of the local economy on the business situation worldwide.

The favourable market situation worldwide and robust growth in *construction* have been the factors at work boosting industrial activity over the past two years. Sales growth was mostly due to the construction-related industries, e.g. extraction of other non-metal raw materials, products of other non-metal mineral raw materials, oil processing and non-ferrous metal ore mining. As for metallurgy, the reconstruction of the facilities at Kremikovtsi Steel Works and repair works of the one of the main furnaces at Kumerio Copper Plants in Pirdop led to a weaker growth in the first quarter. However, the manufacture of basic metals is expected to make a major contribution to the sector's growth in 2006.

Dependence of the Bulgarian industry on the international environment
(year-on-year growth rates)



Source: NSI, IMF

Sales over the January-September'06 period (y/y)

	Real change (%)	
	Total sales	Export sales
Industries reporting a significant positive contribution to sales growth		
Coke, refined oil products and nuclear fuel *	20.0	
Metallurgy and metal manufactures, machinery excluded	14.9	20.0
Manufactures of other non-metal mineral raw materials	20.4	14.2
Extraction, energy resources excluded	19.2	38.9
Industries reporting a significant negative contribution to sales growth		
Paper, cardboard; publishing	-4.7	-16.8
Rubber products and plastics	-3.0	-20.0

* *AEAF estimates of total growth in oil product sales, about 60% of which is attributed to export sales*

Source: NSI, AEAF

The price stabilization of energy resources in the medium term expected will probably hamper growth in the oil processing industry of Bulgaria. At the same time, production costs in the chemical industry and machine building are to go on the decrease, improving their competitiveness.

The contribution of the textile, clothing and food industries to total sales growth stepped down at the expense of the higher share of metallurgy, non-ferrous metal ore mining and refined oil products. All these changes in the structure of the sector have led to a switchover from labour-intensive industries (e.g. food, clothing and textiles) to industries of higher technological intensity in the past two years. 2006 witnessed a slight decrease in the share of the industries of higher technological intensity, as fostered by slower growth in machine building and the production decline in the manufacture of optical devices and apparatuses. On the whole, the Bulgarian manufacturing sector is considered to be of low technological intensity and high labour intensiveness.[2]

Manufacturing Industry Sales: Share of Branches by Technology Intensity

	2004	Jan-Sept 2006
Low-tech industries	39.6	32.9
Medium to low-tech industries	40.4	48.4
Medium to high-tech industries	18.0	17.0
High-tech industries	2.0	1.7

Source: NSI, AEAF own estimates

The decreased share of the low-tech industries was due to the poor adjustment of *food*, *textiles* and *tailoring*. The strong orientation of the food industry to the domestic market has

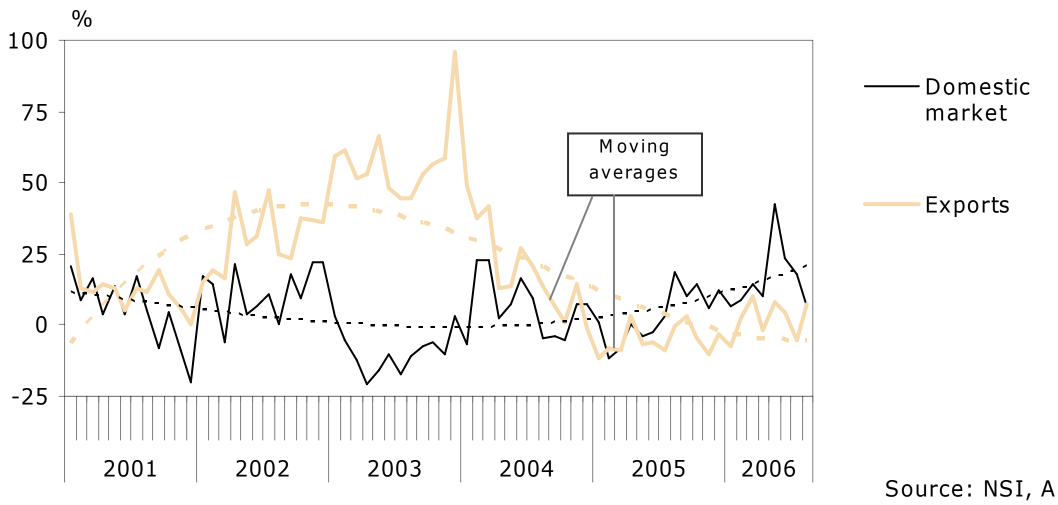
[2] A survey conducted by Bank Austria Creditanstalt points to production concentration in the new EU member states of medium to high technological intensity.

to do also with the very nature of the industry. In addition, local producers will have to make a sizable investment to meet EU requirements, the lack of which is currently seen as a major impediment to sales growth in the foreign markets, EU in particular. However, most problems in the industry (especially canning and meat processessing) derive from the growing manufactures' needs for quality raw materials rather than the application of the EU food safety rules and practices. Supply shortages are partially addressed by agri-food investments. New market niches are sought, relying mostly on the growth potential of organic farming. Despite the strict requirements, the lower local prices of organic food vis-à-vis Community prices make Bulgarian organic food a competitive industry. At the same time, more and more EU producers are showing keener interest in the local food market, making competition in the industry even stronger.

Textiles and tailoring were the other two industries reporting a certain slowdown in growth and partial re-orientation to the home market. The poorer export performance of textiles and clothing had to do with the liberalization of international trade in textiles and clothing and higher production costs in the country. The industry, however, is still characterized by stiff competition especially among small and medium-sized enterprises, which are heavily dependent on contract work. At the same time, some of them have already tried to develop their own products and assert them on the market. The strong competition not only of cheap Chinese and Turkish imports but some leading European design labels as well, given the rising purchasing power of the population, have given producers an extra stimulus to invest in research and development as well as in modern technologies and machinery.

The performance of textiles and tailoring in the post-2001 period has been also shaped by some political factors at work. China's accession to WTO in 2001 and the expiry of the 30-year agreement on textiles and clothing in 2005, allowing the signatory countries to set import quotas, boosted the exportation of low-cost Chinese items into the EU. As a result, growth in Bulgarian textile and clothing exports, most of which intended for the EU markets, slackened. However, as the Community introduced import quotas on Chinese textiles in 2005, local exports picked up. All this has hamstrung competition on the part of Chinese imports. On the other hand, Chinese manufacturers have turned to exportation into countries like Bulgaria. As a result, Bulgarian producers gained easier access to low-cost Chinese textile products for inward processing.

Estimate of the growth rate over the corresponding month of the preceding year and the trend in the domestic and exports sales in the textile and apparel industry



Source: NSI, AEAF

On the whole, growth in both export and domestic textile sales slowed down due to the competitive Chinese imports in the two market segments. On the other hand, clothing exports rebounded due to the use of cheap raw material imports from China, higher transportation costs on imports and the close geographic location of the country to the EU markets. Domestic clothing sales also picked up, as fostered by the rising purchasing power of the population, development of retail trade and swift advance of local trade marks in the market.

Despite the slowdown in the first half-year period of 2006, *services* continued to report the largest contribution to gross value added growth in the economy (15% on a 2006 average). The entry into the market of big shop chains made competition among retailers even stiffer. On the other hand, macroeconomic stability and higher income led to a lower share of self-sufficiency and a shift from trade in consumer non-durables to durables. The upbeat expectations of retailers as to sales and prices, reported in the NSI business surveys, had to do with the stronger effective demand in the country. However, the sector had to cope with greater impediments deriving from the scarcity of retail area and qualified work force, although the indicators remained comparatively low in absolute terms.

Finance has been the other industry, performing in a rather vigorous way over the past few years (about 13% on average over the 2002-2005 period). The sizable inflow of capital into the country, as boosted by the high return on investment and bright prospects of the upcoming accession to the EU, were the key factors at work behind the robust development of the financial market.

According to BNB statistics, revenue growth from tourism in the nine months to October slackened to 4.5% on an annual basis from 11% on a year earlier. Given the strong competition in the Balkans, the future development of the local sector relies on the diversification of the tourist products, the quality of the service and qualification of staff, the improvement and renovation of infrastructure, modern communicative methods and the country's project readiness for EU fund absorption and donor programmes, and last but not least investment in water treatment stations, waste collection technologies and infrastructure development.

Gross value added in agriculture has been steadily declining over the last two years. The 8.6% drop in 2005 was mainly due to the bad weather conditions. In the first half-year period of 2006 the sector was seriously affected by the GVA slump in crop production of -1.7%), caused by last year's floods and soil treatment problems in autumn. Bad weather had also an adverse effect on livestock production by way mostly of the higher prices of intermediate goods, i.e. growing production costs, hence higher prices of finished products.

Investment

Domestic demand was the key factor at work behind GDP growth by element of final use in both 2005 and the fist half-year period of 2006. The most vigorously performing component of domestic demand was investments, posting a 23% real rise. As a result, their share within total generated income in the economy ran well over 30% in the six months to July'06. Gross fixed capital formation (investment minus change in inventories) has been steadily growing for five years in a row, advancing from 8.5% in 2002 to 20.8% in the first half of 2006.

In the first half-year period of 2006, national savings provided for less than half of the investments made (44%) vs. 59% on a year earlier. Since 2000 they have been covering an ever decreasing part of total investment in the country (70% in 2000 to some 61% in 2005). National savings are by and large domestic savings due to the low share of net foreign inflows, which account for the remainder of the indicator. On the whole, the rate of domestic saving over the last six years has held steady at around 13% of GDP, which, however, turned out to be insufficient to meet the growing investment needs in the economy. The boosted investment activity and scarce national savings led to serious imbalances in the external sector, as manifested by the deteriorating current account deficit of the balance of payments. The non-government sector has been again a major source of deficit generation. The balance between savings and investments worsened from -8.5% in 2000 as percentage of GDP to -15.3% in 2005 and further down to -25% in the first six months of 2006. Household savings surpassed investments, making them again net savers in the economy for another year in a row. The net financial position[3] of households in 2005 accounted for 8.3% of GDP and 1.3% in the first half of 2006 (vs. 2.3% on a year earlier). Q3 net credit to households stepped up significantly to 6.1% of GDP.

On the whole, however, lending had little contribution to investment growth in 2006. Some 14.5% of the investments made were financed by way of loans as of June'06 vs. 28.4% in the same period of 2005 due mainly to the high base reached at the end of the same year. On the other hand, the share of loan financing in corporate investment activity declined as a result of the credit growth restrictions imposed by the Central Bank, which affected long-term credit in the utmost.

The private sector accounted for the bulk of investment made in the economy (about 83% of the investment total in 2004 and 2005, and 90% in the first half of 2006[4]). Investments, as measured by change in the acquisition cost of fixed assets, in the service sector posted the most robust nominal growth of 26.2% in 2005, giving way to investment in the manufacturing sector[5] a year later, where the acquisition cost of fixed assets almost doubled in nominal terms from 21% in 2005 to about 40% in the first half-year period of 2006.

The investment process in the manufacturing sector gained further impetus due to a number of factors. First, investments picked up due to the higher profit margin. In the first six months to July'06, the relative share of the gross operating surplus in value added for the whole economy stepped up by 1.3 percentage points (also due to the lower liabilities of employers on social security contributions and pension schemes), while advancing by 4.3 percentage points in the manufacturing sector alone. *Excavation and mining* reported the largest contribution because the share of profit in value added went up by 23.8 percentage points to 71.4%. This was largely due to the market situation worldwide, characterized by strong demand and high prices, which in turn led to a higher profit margin in *excavation* and *metallurgy*. Second, the increased investment amounts in *electricity, heating, gas and water generation and supply*, FDI including, were most probably due to the privatization of the

---

[3] The net financial position of households is equal to the net lending/net borrowing position under SNA. As there are no financial accounts compiled for 2005, we here apply the methodology used in a paper by Mikhailova G., "Financial Accounts Compilation and Analysis. System of National Accounts", Sofia, 2004.

[4] Vs. 83.7% in the first half-year period of 2005.

[5] Construction including.

country's electricity supply network – the processing industries and *electricity, heating, gas and water generation and supply* accounted for one-fourth of the FDI growth in the period surveyed. Third, investment activity (in the processing industries in particular) was further boosted by the brighter country's prospects of development, having to do not only with the stronger domestic demand but the potentially higher increase in foreign demand too, as related to Bulgaria's accession to EU. In the eight months to September 2006 export sales accounted for about 44% of industrial sales. The robust investment activity in the economy is expected to make local manufacturers more competitive in both the domestic and foreign markets and enable them to augment their own savings to meet the growing investment needs in the sector.

Furthermore, the service sector accounted for about 56% of the investment total in the economy in the first half-year period of 2006, though going some 3 percentage points down on a year earlier. These investments were mainly meant to meet the rising domestic demand as was the case with retail trade where the acquisition cost of fixed assets stepped up by 40% in the same period. As for the other sectors, it was again the relatively high profit margin that boosted the sizable investment amounts. However, stiffer competition as a result of the swift advance of leading shop chains and restructuring of the sector may lead to a lower profit margin. *Transportation*, *financial intermediation* and *real property transactions* also reported large investment inflows, having an indirect impact on the economy as a whole by improving the country's infrastructure and business environment.

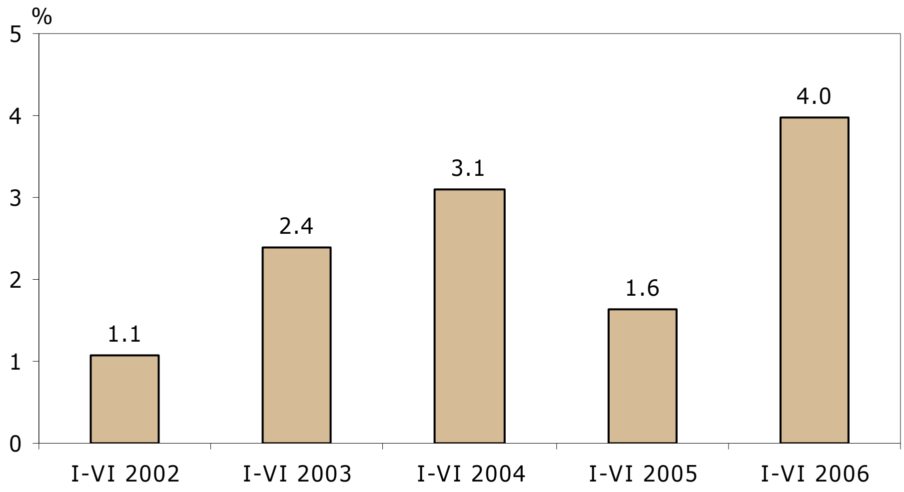
Investment growth in agriculture ran rather high too at 80.7 and 87.8% respectively in 2005 and the first half of 2006 due mainly to the faster absorption rate of the EU pre-ins. As of end-October, some 93% of the allocations under SAPARD measures were negotiated, and the funds utilized accounted for over 52% of the total amount agreed upon vs. 48% on a year earlier. Also, agri-food investment went on the increase mainly as a result of the growing need to meet EU requirements to farmers.

Consumption

Although much of the 2006 GDP growth was by and large due to investments, final consumption proved to be *the* factor at work behind the indicator's performance. In the first half-year period it stepped up 5.8% at constant prices on a year earlier and made a 5.3 percentage point contribution to income generation in the economy. Boosted private consumption resulted in a stronger consumer activity. Final household spending on marketed goods[6] went up by 6.9% in real terms in the first six months to July vs. a 5.5% increase in total consumer expenditures of households in the same period due mainly to the rising income from wages and pension benefits.

On the other hand, household income growth was mainly triggered by the higher employment rate since the start of 2006. According to data from NSI labour force surveys, the average employed numbers in the fist half-year period rose by 116.2 thousand or some 4% on a year earlier.

Employment Growth Rate



Source:NSI

The faster growth in the country's employment compared to the previous two years was mostly triggered by the vigorous increase in the private-sector employed numbers (6.2% up on a 12-month basis). Private-sector employment stepped up not only as a result of the robust business activity there (a factor influencing the indicator's dynamics in the past 8 years) but the reduced social security burden since the beginning of 2006 as well. According to AEAF analysts, the above measure is expected to greatly contribute to "casting light" on the grey economy and gathering official statistics on the employed numbers. The decrease in the social security burden total led to lower production costs and motivated employers to legalise the labour contracts and income of their employees.

The above conclusion draws upon an in-depth analysis of the employment dynamics by sector and industry, and wage estimates. As of early 2006, *trade* posted the highest contribution to job creation and a wage growth rate significantly higher than the country's average. A strong increase in employment was also reported by *construction*, *transport*, *communications* and the *processing industries*. Although it is difficult to gauge what amount of the 2006 employment growth was due to boosted business activity and the legalization of unregulated employment, it should be noted that in all sectors and industries, prevailed by micro and small enterprises, the grey economy (*services* in particular) enjoyed a relatively higher share within total employment than the manufacturing industries where the share of

[6] Imputed house rent,unincorporated activities and self-sufficiency excluded.

the large enterprises is considerably higher. There has already been one such attempt of the government to shed light on informal sector employment (back in early 2003) when it introduced the obligatory registration of labour contracts.

„Casting light" on informal sector employment was possible due to not only the administrative measures undertaken, but the restructuring of the industries (e.g. the entry into the market of leading shop chains in the retail trade sector), bank credit expansion to physical persons, etc. as well. These, however, are some extra factors at work, which have a rather long-term effect and cannot account for the large deviations in an indicator's performance as the employment increase in the first half-year period of 2006.

As a result of the fast increase in *retail trade* employment, given a persistent relatively strong value added growth compared to earlier periods, productivity remained almost unchanged on a 12-month basis. Therefore, despite the GVA growth in *construction*, *transportation* and *communications*, labour productivity declined due to the higher employment rate there. Since it is difficult to gauge how much of the increased employment in the same period was not due to a single administrative act of the government and, hence how much it reflected a development actually underway, and not just records that had hitherto remained hidden, it is impossible to say whether the decline in productivity in these two industries actually took place or was the result of improved labour statistics.

Growth rates of value added, employment and productivity by industry and sector of the economy

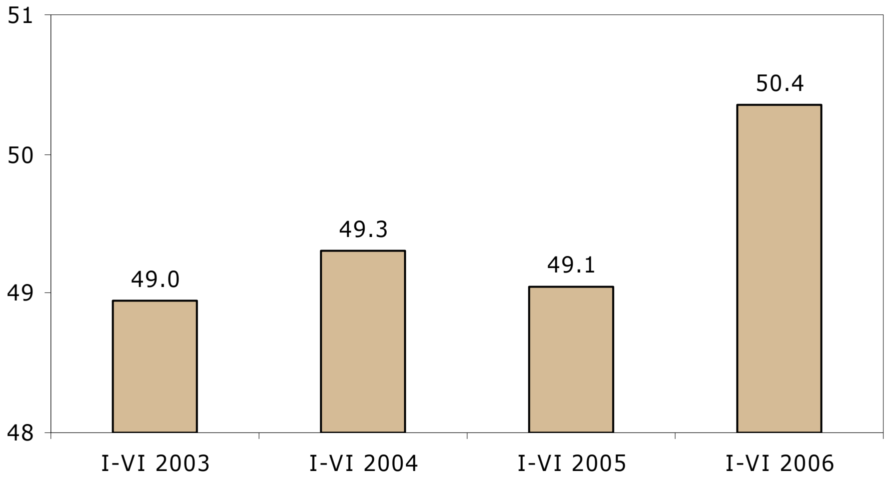
	GVA	Employment	Labour productivity
Total	6.0	4.0	1.9
Agriculture and forestry	-1.7	-4.6	3.0
Manufacturing sector	8.9	3. 7	5.1
Extraction and mining	19.4	0.8	18.5
Processing industries	6.1	1.7	4.4
Electricity, heating	9.7	-11.8	24.3
Construction	15.2	18.1	-2.4
Services	5.3	5.4	-0.1
Transport and communications	3.9	5.7	-1.7
Trade	11.6	11.4	0.2
Finance	9.5	-8.5	19.6
Other	3.7	3.2	0.6

Source: NSI

The fact that employment growth in the first half-year period of 2006 was by and large due to the "light cast" on informal sector employed rather than a significant increase in the participation rate has been further supported by NSII data on the over-performance of revenue from social security contributions having to do mostly with the bigger numbers of insured in the same period. The vigorous rise in employment in the six months to July'06 led to a higher participation rate. The relative share of workforce of 15 years of age and over stepped up to 50.4% on average, running some 1.3 points higher on a year earlier.

Third-quarter employment growth slowed down compared to the first six months of the year. According to labour force survey data, average employed numbers went up by 102.7 thousand or 3.3% relative to the July-September period of 2005. The strongest contribution to Q3 increase was posted by *trade* and *construction*, followed the processing industries. At the same time, *transport* and *communications* reported lower employed numbers on a year earlier. Q3 employment dynamics gives us solid ground to say that the effect of "lighting up" unregulated employment manifested itself mostly in the first half-year period and that the indicator's growth in the following months was greatly due to the higher participation rate in the economy.

Participation Rate*



* Of 15 years of age and over

Source: NSI

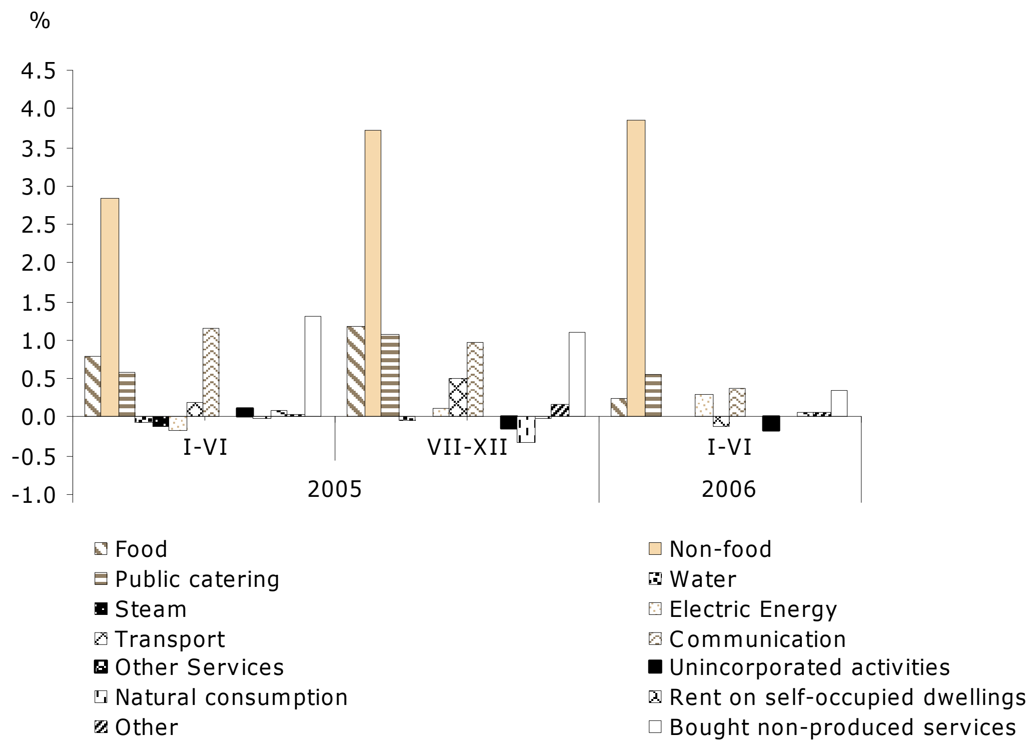
Household income growth was the other factor at work boosting consumption in the first half-year period of 2006. According to preliminary survey data on the employed numbers and wages, average wages amounted to BGN 337 for the whole economy in the six months to July, stepping up by nearly 10% in nominal terms and 1.6% in real terms on an annual basis. The nominal-term growth reported hit a record high in the past few years and was mostly triggered by the higher income in the private sector where average wages posted a year-on-year increase of 12.2% vs. only 7.3% in the first half of 2005. Nevertheless, real wage growth in the economy remained rather low and failed to produce such a significant impact on real growth in consumption as employment dynamics due to the relatively higher monthly inflation in early 2006.

Over the January-June'06 period, *trade* posted the strongest increase in average real wages of 10.5%, followed by *electricity, gas and water generation and supply* (10.4%), *extraction and mining* (8.9%) and *financial intermediation* (4.5%). The higher income from employment in *trade* accounted for over half of the indicator's growth in the whole economy.

The upward trend in household income was further evidenced by household budget survey data. In the six months to July, money income per household capita stepped up by 4.7% on average in real terms (y/y estimate), spurred mostly by income from employment, pension benefits and entrepreneurship. It should be also noted that income from entrepreneurship and property has been steadily gaining in importance since mid-2005.

The year-on-year increase in income led not only to higher consumer spending but some alterations in its structure as well. Expenditures on non-food items, accounting for nearly 70% of the growth in final consumer expenditures, outstripped food expenditures. The latter's contribution to the stronger final consumer spending amounted to only about 5%, running considerably lower compared to earlier periods. The faster growth in non-food expenditures vis-à-vis expenditures on food items is indicative of a household consumption relaying on a higher purchasing power in the economy. In the first half-year period of 2006, expenditures on water, steam generation and electricity rose by 5.3% in real terms and their contribution to growth in final consumer spending went up by 0.5 percentage points. The latter, however, was also due to the price change reported by the above items. At the same time, expenditures on services rendered (transport and communications) posted the strongest decrease, going up by a bare 1.9% on an annual basis, though.

Contribution to Real Household Consumption Growth by Expenditure Groups



Source: NSI

Income is expected to carry on influencing consumption and exert an ever stronger impact on it by the end of the year as Q3 average wages went on rising rather fast. At preliminary estimate, overall for the economy Q3 average wages amounted to BGN 354. The indicator rose in both nominal and real terms by 11.7 and 4.7% respectively, with the private sector being again the main contributor to real income growth with 6.8% vs. only 2.4% posted by the public sector. Average wages since the start of the year have followed the same pattern of dynamics as in 2003 when the government instituted the obligatory registration of labour contracts. The significantly stronger nominal average wage growth compared to earlier periods has indicated that the reduced social security burden contributed greatly to bringing much of informal sector employment, hence income, to light. Also, the mid-year increment in pension benefits of 5% -for benefits amounting BGN 120 (658 991 retirees), and 4% for benefits between BGN 120 and 150 (299 778), is also expected to have a healthy effect on consumption.

Unemployment

The stable development of the private sector over the past few years has provided a solid basis for the downward trend in the jobless rate for another year in a row. According to labour force survey data, the unemployed numbers in the nine months to October amounted to 311.5 thousand or some 9.1% of the economically active population, stepping down by a whole percentage point on a year earlier. The above trend was further evidenced by the administrative statistics of the Employment Agency (EA). On a monthly average, registered unemployment throughout January to October decreased by 1.9 points relative to the same period of 2005. It should be noted that ever since 2005 the impact of the active labour market measures and programmes of the government has lessen due mainly to the narrower scope of the subsidized employment promotion programmes. In the nine months to October, the average monthly numbers of employed under the measures and programmes of the Employment Promotion Act amounted to 96.0 thousand, or some 8.7% down on a year earlier. The Programme "From Social Aid to Employment Promotion" was again the most significant source of subsidized job creation and demand, accounting for 51.1% of the total numbers covered by programmes and measures in the same period. The largest-scale labour market initiative of the government has been underway for four years now, but as there are no data on what portion of the participants in the programme have found new jobs in the primary labour market, its contribution to sustainable employment creation and effective use of budget resources are questionable. An interim assessment of the programme's impact on the market was made as early as 2005, but the findings have not been made available to the public yet. However, according to information of the Ministry of Labour and Social Policy, the programme has provided employment to the bulk of jobless, who without having been given this job opportunity would have joined the cohort of long-term unemployed. In addition, the programme has shortened unemployment spells and contributed to improving employability skills. Another conclusion points to the rather significant share of employers who made the most of the programme to expand their activity. At the same time, according to EA data, although the programme's focus was on private-sector employers, most of the funds utilized as of October'06 came under projects of the local governments and district governors' offices to support community service activities. It should be also be noted that the majority of unemployed participants have re-signed up with the job centres, hitting a record high of nearly 95 000 in 2005 when the government programme was scheduled to end. In the nine months to October'06, however, these numbers stepped down to 55.8 thousand. It is also possible that these statistics have reported the same unemployed twice, e.g. once when they have been made redundant, and then for a second time when they were hired under another project, terminating in the same year. However, all this considered, the data available indicate that the majority of unemployed numbers involved in the programme have failed to find new jobs in the primary labour market and therefore re-signed up with the job centres in the hope of getting labour-readjusted again under the same measure. This, however, comes into clash with the very rationale of the programme and questions its efficiency. In 2007, the budget allocations to support the active labour market measures and programmes of the government are to decline to BGN 190 million on an annual basis, which together with the expected increase in minimum wages to BGN 180 on a monthly average, will inevitably lead to a further narrowing in the scope of the active employment promotion policies. Along with that, a great deal of work is yet to be done restructuring the programme by a stepwise re-allocation of budget funds to vocational training and professional qualification, as well as to creating primary labour market incentives to employers to hire more unemployed. All this is expected to have a longer-term and healthier effect on both employability skills and future labour adjustment of the jobless numbers compared to any short-lived fix to unemployment problems.

Share of budget allocations to active labour market measures by type of application in 2004

	Training	Job rotation and job sharing	Employment promotion measures	Labour market integration of disabled people	Direct job creation	Incentives to business start-ups	Total
EU 15	40.6	0.4	18.3	18.0	16.2	6.6	100
Belgium	21.3	-	16.5	11.8	50.0	0.4	100
Czech Republic	12.8	-	35.7	25.0	22.7	3.8	100
Denmark	35.5	-	30.3	34.2	0.0	-	100
Germany	42.5	0.2	9.9	17.2	15.1	15.3	100
Estonia	76.9	-	12.8	-	0.0	10.3	100
Greece	18.5	-	25.3	19.6	-	36.6	100
Spain	22.2	1.5	42.7	12.8	14.7	6.1	100
France	42.5	-	13.6	11.7	31.7	0.5	100
Ireland	36.8	-	14.6	7.1	41.5	-	100
Italy	41.4	0.5	45.5	1.2	1.8	9.6	100
Cyprus	:	:	:	:	:	:	:
Latvia	32.9	-	7.1	8.2	51.8	-	100
Lithuania	39.9	-	25.5	1.1	33.5	0.0	100
Luxemburg	:	:	:	:	:	:	:
Hungary	22.3	-	45.6	4.5	24.9	2.7	100
Malta	:	:	:	:	:	:	:
Netherlands	31.8	0.0	2.6	49.7	15.9	-	100
Austria	64.8	0.0	12.9	11.9	9.5	0.9	100
Poland	:	:	:	:	:	:	:
Portugal	52.8	0.0	31.0	8.3	7.4	0.5	100
Slovenia	:	:	:	:	:	:	:
Slovakia	14.2	-	10.9	1.3	48.5	25.1	100
Finland	52.0	6.5	15.9	12.8	10.9	1.9	100
Sweden	34.6	0.6	18.5	43.0	-	3.3	100
Great Britain	82.6	-	1.0	13.6	2.5	0.3	100
Bulgaria	12.6	-	5.1	2.2	78.4	1.8	100
Roumania	2.6	-	53.7	0.4	42.9	0.4	100

: n.a.
- zero
0 negligible number

Source: Eurostat, own estimates

An interesting example of the current labour market policies is based on the experience of the EU member states. In 2006, Eurostat published data on budget expenditures on and participants in the various labour market policies in the EU member states and the two acceding countries- Bulgaria and Roumania.[7]

[7] European Social Statistics, Labour Market Policy, Expenditure and Participants, Data 2004, European Commission, Eurostat.

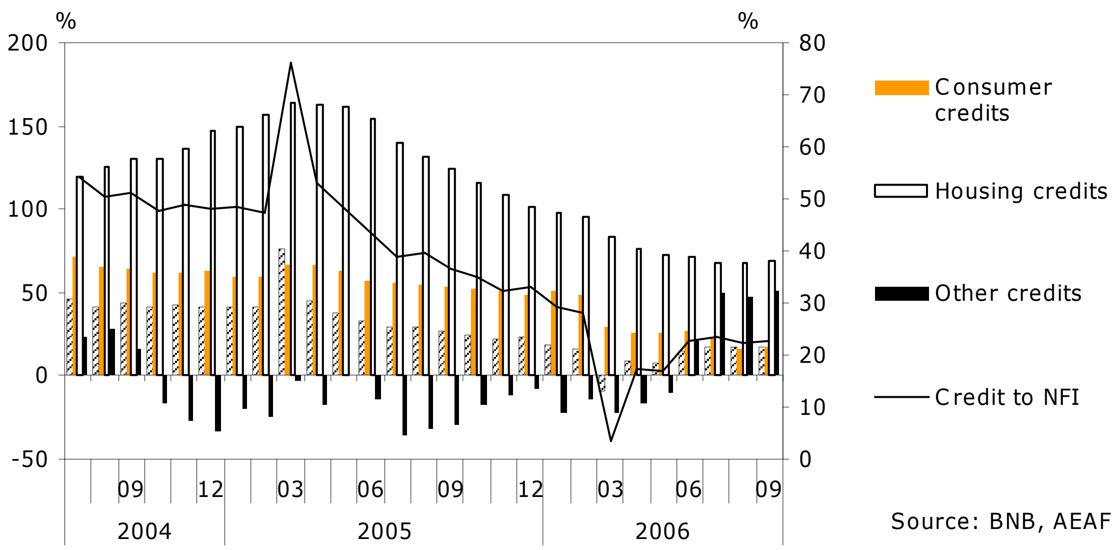
As evident from the table above, expenditure on vocational training enjoyed the heaviest share in spending on active labour market measures on average in EU 15, followed by incentive packages to employers to hire unemployed, labour market integration of disabled people. Expenditure on programmes, creating subsidized employment ranked last. An overview of the labour market policies of the new EU member states indicates that in all of them but Latvia and Slovakia expenditures on vocational training and incentives to employers had the upper hand in budget spending on active labour market measures. In the case of Bulgaria, however, these data reveal that not only were the bulk of budget allocations used for direct subsidized job creation in the economy but also that the share of resources was rather significant vis-à-vis the other countries. At the same time, it is also noteworthy that the information contained in the table refers to 2004 when the programmes numbered some 100 000 jobless, and over the past two years their scope has narrowed down. However, according to EA statistics, they are still absorbing the bulk of budget resources for active labour market policies. In addition, given the fact that the country’s jobless rate has posted a significant drop in the past couple of years and is currently running close to the EU average, the government should adopt a new approach to unemployment and shift its policy focus to more viable measures. Relying on the experience of the other member states and pursuing a long-term decrease in the jobless rate, the government should re-allocate the budget resources supporting its active labour market measures to vocational training and qualification programmes for the unemployed as well as seek ways to provide incentives to private-sector employers to hire and train unemployed.

Banking Sector

Unlike 2004 and 2005, 2006 did not witness any clear-cut indications that credit growth contributed to the country's stronger consumption. Growth in all types of loans but housing credit slowed down, with consumer loans posting a most drastic decline. In the nine months to October'06, they stepped up by only BGN 142 million in volume terms vs. well over BGN 700 million in the preceding two years.

In June 2006, the Central Bank announced that it was about to gradually loosen the administrative restrictions on commercial bank lending, introduced in 2004 and 2005. August saw the removal of the progressive scale of the additional minimum required reserves banks had to keep in case their credit portfolios had stepped up at a pace higher than the ceilings set out in Regulation #21. Furthermore, banks were required to submit regular information on loans payable to third parties but serviced and administered by the banking institutions themselves. In October, having achieved its stability goals, the Central Bank authorities announced that the administrative restrictions on credit growth would be completely removed as of the start of 2007.

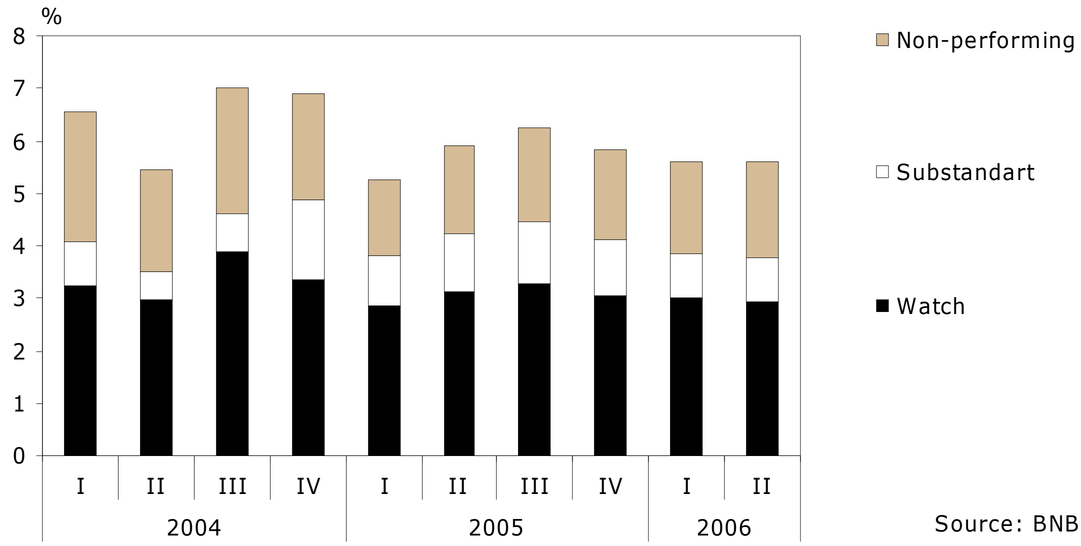
Annual growth rate of credit to NFI



Source: BNB, AEAF

One of the main concerns on BNB agenda had to do with the likely deterioration in the quality of bank credit portfolio due to the relaxed lending procedures as a result of the stronger interbank competition. In 2004 and early 2005 when credit growth surpassed 50% on a 12-month basis, most banks managed to maintain a comparatively good quality of credit portfolio. This was partly due to the large amounts of fresh loan extensions classified as regular. However, with the entry into force of the direct ceilings in the second quarter of 2005 credit growth slowed down significantly to 32.9% as of the year's end. But as credit risk manifests itself with a certain lag in time, the worsened credit portfolio in the second half of 2005 was mostly due to loans extended in earlier periods. However, credit portfolio quality somewhat improved due to the tightened supervision regulations and institution of the credit register in mid-2005. As a result, the share of regular loans went up to 94.39% vs. 94.09% on a year earlier, whereas the share of "watch" credit and bad loans went on the decrease. At the same time, the share of non-performing loans advanced slightly to 1.82% as of the end of June'06 vs. 1.7% in the same period of 2005.

Quality of credit portfolios



Source: BNB

It is also likely that consumer credit growth data have been slightly misleading and consumption growth in the second half-year period of 2006 was, by and large, due to the loan resources extended to households. A considerable portion of the loans did not go directly through the banking system and therefore not reported as bank credit proper. For example, households may have used different leasing schemes to buy goods, making the most of the relaxed terms of approval compared to bank consumer credit. Unfortunately, the lease activity statistics available cover only a short time span (the last quarter of 2005 and the first half-year period of 2006), which makes the estimation of their contribution to consumption growth in the economy rather difficult. On a year earlier, total lease stocks as of end-September almost doubled, posting a year-on-year nominal rise of around BGN 900 million. Claims on non-financial institutions accounted for a considerable part of all claims under lease contracts (85% in the twelve months to September'06). At the same time, it should be noted that claims on households under lease contracts had stepped up by BGN 117 million inside a year, matching consumer credit growth in the same period.

On the other hand, soon after the introduction of the bank credit ceilings commercial banks started selling part of their portfolios to local non-banking institutions and foreign financial institutions in an attempt to bypass BNB restrictions. And while formally meeting the Central Bank's requirements commercial banks reported significantly lower amounts of the loans they administered on their balance sheets than the actual volume of extensions of both household and corporate credit.

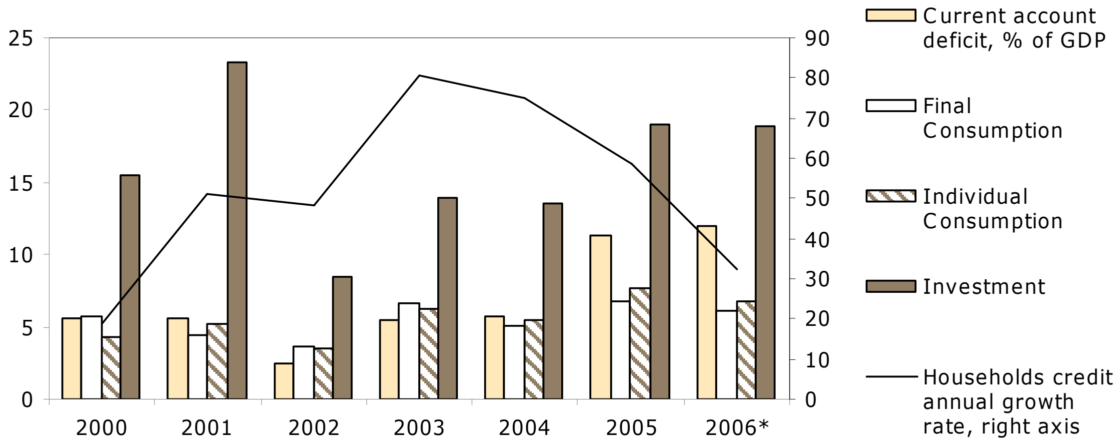
BNB measures of the preceding two years aimed mainly at withdrawing liquidity from the system and thus reduce risk, jeopardizing the quality of commercial bank credit portfolio. The use of non-banking institutions for consumer lending purposes, sale of bank credit and direct borrowing of companies from abroad were the most commonly used methods by banks to circumvent BNB restrictions. All this accounted for the strong increase in both consumption and investment, the ever-worsening current account deficit and, last but not least, the slowdown in credit growth. Nevertheless, it should be noted that the key factors at work behind the vigorous rise in consumption had to do with the higher employment rate and nominal household income in the economy.

Consumer and mortgage loans turned out to be a major source of credit risk. According to some BNB publications, the quality of the latter has deteriorated[8] due most probably to the stiffer competition in the two segments, which led to higher risk in an attempt to gain a

[8] See BNB Quarterly Review, *Commercial Banks in Bulgaria*, throughout 2005 and 2006.

stronger market share. This was further reinforced by the higher consumer and mortgage credit interest, as compared to corporate loans. Such a development justified the latest amendments to the Central Bank regulations on the re-classification and provisioning of consumer credit and the amount of security, baking up mortgage loans.

Credit Growth Dynamics and Real and External Sector Indicators



* nine-monthly period of 2006

Source: NSI, BNB, AEAF

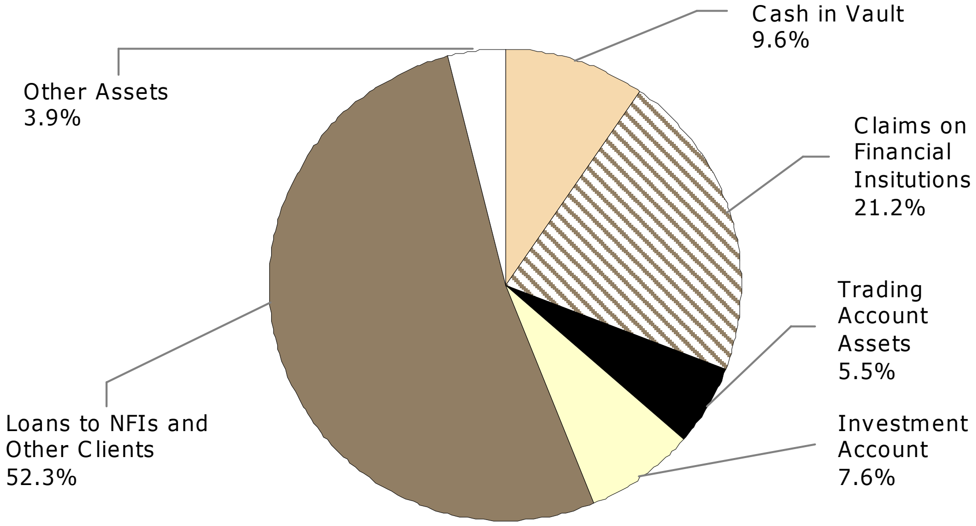
According to the same BNB publications, the quality of trade credit has improved, as its growth slowed down on an annual basis, enabling banks to apply stricter requirements to loan security and borrowers.

The amendments to the banking supervision regulations and direct credit growth ceilings affected not only bank lending policies but the allocation of assets on their balance sheets. The steady and comparatively high increase in the deposits of residents and the return on the sale of loans, on the one hand, and the impossibility these resources to be placed on the market again in the form of loans, on the other, resulted in a lower share of credit to non-financial institutions and other customers in bank assets to 51.9% in September'06 from 55.2% on a year earlier. Contrary to the tendencies at work in 2004, the deposits of local banks at foreign financial institutions went on the increase at the expense of loans. The share of net claims on financial institutions advanced from 16 to 21.3% over the September'05-September'06 period due mainly to the rising Euro-area interest rates, allowing banks to accumulate reserve funds for lending in the future when the ceilings are removed as of the start of 2007.

Lending restrictions did not undermine the financial performance of banks. Instead, they have led to certain alterations in the weights of the different sources of revenue. Since early 2005, net interest income has been rising at a slower pace due mostly to the decreased loan extension volumes, increased interest on credit, having to do with the rise in interest rates worldwide, and narrowed interest rate spread between deposits and loans. At the same time, some non-interest revenue items, e. g. fees and commissions, gained further importance as did the rising loan provisions in the same period. 2006 sustained the above trends while witnessing a drop in interest expenditures on resources borrowed from other banks and the re-integration of credit provisions, which led to stronger bank profits. At the same time, losses on trading account assets had a negative effect.

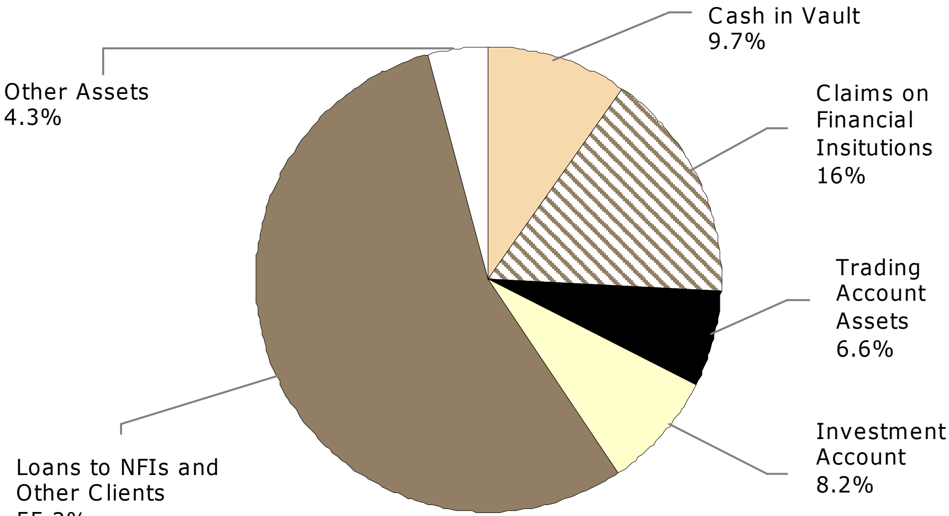
The structure of banks assets is expected to undergo some changes with the removal of the credit growth ceilings in early 2007. Bank credit supply will step up, and with a view to the high cost of credit banks are expected to initially use their own deposits at foreign banks for financing purposes. All this will reiterate the trends of 2004 when the share of claims on financial institutions stepped down at the expense of credit to non-financial institutions.

Assets of the commercial banks as of 30.09.2006



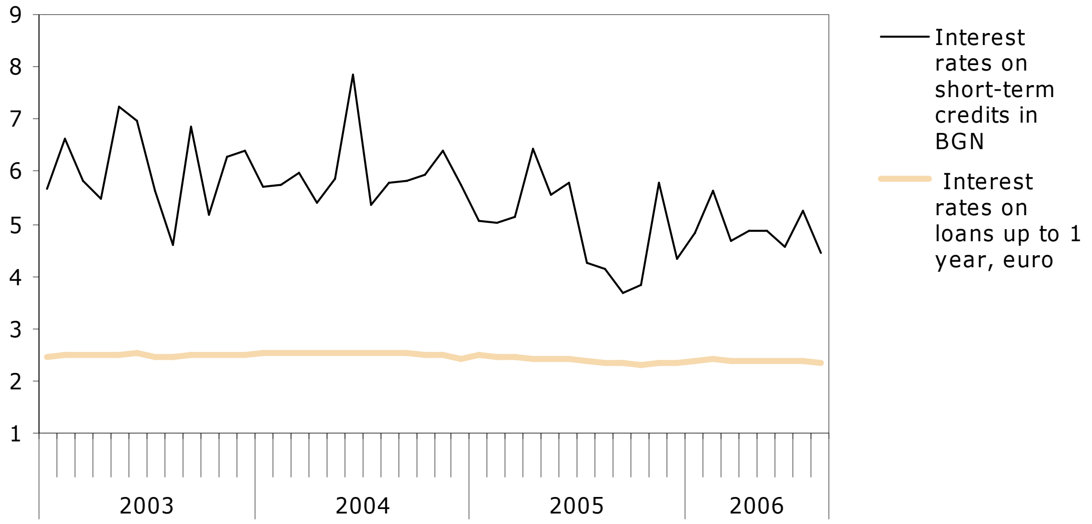
Source: BNB

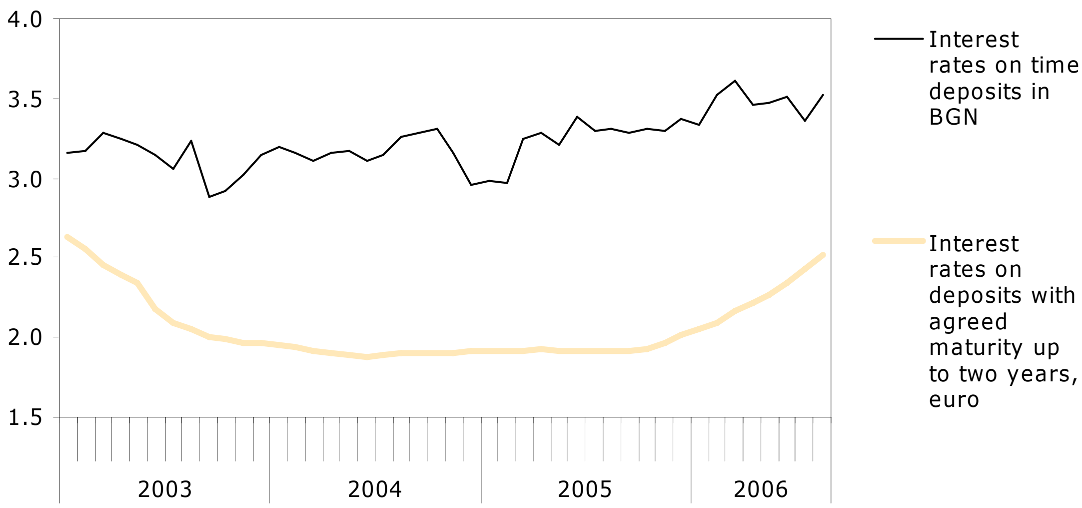
Assets of the commercial banks as of 30.09.2005

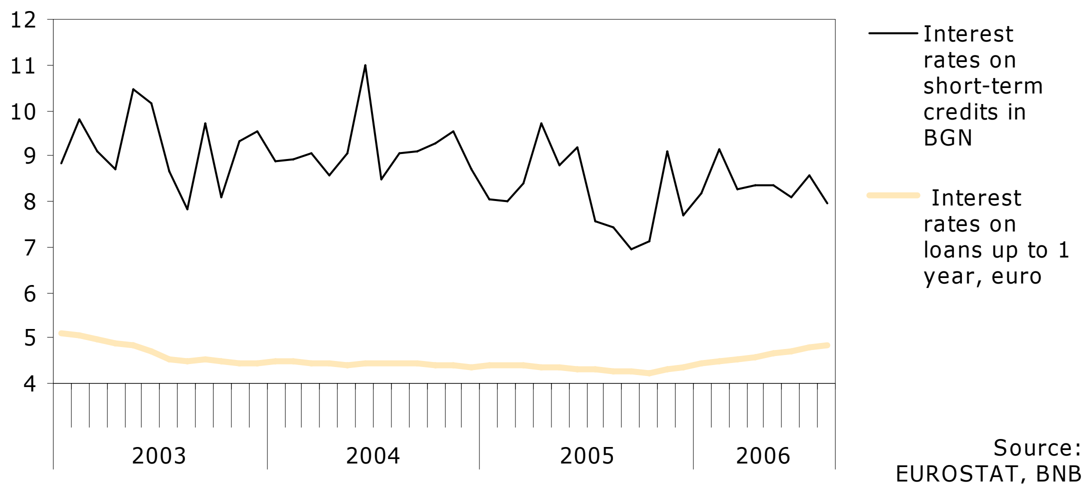


Source: BNB

BG and EU Spread







Source: EUROSTAT, BNB

As for reducing credit risk and maintaining financial stability in the sector, the credit squeeze was a necessary and justified step. The banking system carried on maintaining quality assets (credit portfolios including) while reporting strong capital adequacy and liquidity indicators. It can be said that BNB measures have served their purpose, but as the full effect of the credit squeeze is to manifest itself in the medium term it is still too early for any overall assessments.

Local credit interest ran higher than the interest rates in the EU due to the higher risk premium in the member states. In 2003 and 2004 credit interest stepped down as a result of the stronger competition among banks to lend resources to the private sector and higher liquidity in the system. This trend somewhat slowed down with the introduction of the credit growth ceilings in 2005 and led to relatively high levels of the interest rate spread of about 5 percentage points.[9]

Since the end of 2005 ECB has been steadily raising the re-fi rate to counteract the higher inflationary risk in the Euro area. All this has affected the interest rate dynamics in the local interbank market (interest, in Euro and BGN in particular, has gone on the increase since the start of 2006), without however bringing about a significant change in trading volumes.

The relatively steady high interest on credit failed to produce an adverse effect on corporate loans and investment activity. Neither did it affect consumer loan volumes due maybe to the fact that companies had access to direct external borrowing and the swift advance of non-banking financial institutions in the market. ▼

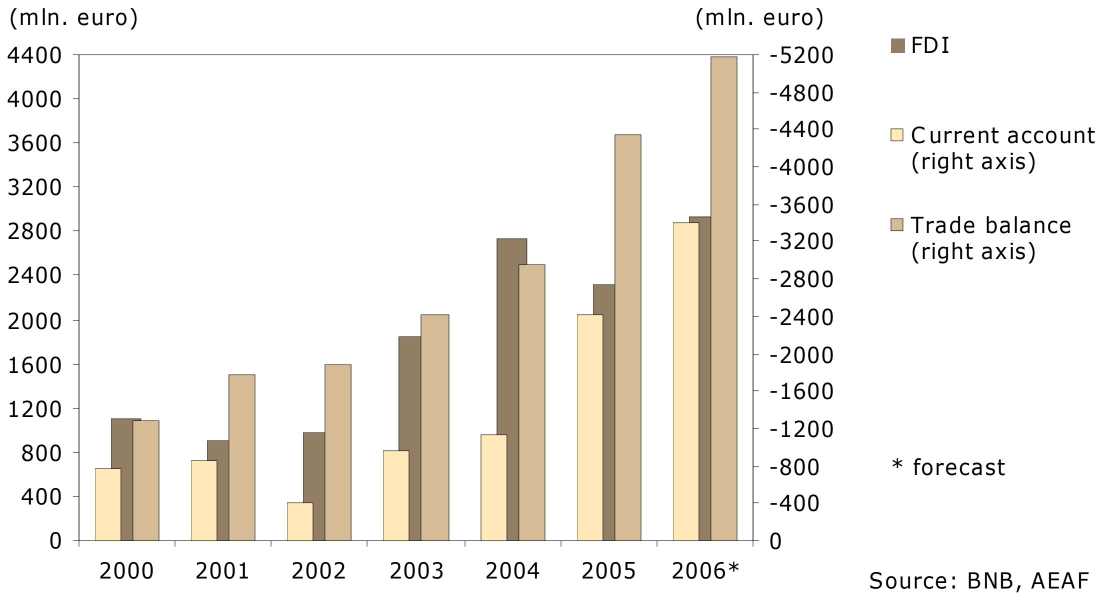
[9] Interest on new deposits stepped up but not at such a fast pace to bring about a significant drop in the interest rate spread.

Balance of Payments

In 2006 the current account deficit carried on deteriorating, hitting MEUR 2 094.2 in the nine months to October vs. MEUR 1 226.2 on a year earlier. At preliminary estimate, the 2006 deficit is to go up by about 2.5-3% (as percentage of GDP) due mostly to the worsening trade balance, which over the January-September'06 period amounted to –MEUR 3 455.5 vs. -2 976.9 million on a year earlier.

BNB measures, aimed mainly at improving bank portfolio credit, led to a slower consumer credit growth while restricting consumption, hence consumer import growth in the economy. The robust nominal increase in consumer imports has been shaped by the strong growth in the manufacturing sector, vigorous demand for intermediate goods and strong investment activity in the country, which triggered not only the importation of investments goods but sizable FDI inflows as well. The current account deficit has been deteriorating in all the years of economic growth in the post-1998 period and has been determined by both the increasing final consumption and strong business activity in the country.

Current account, trade balance and FDI



Source: BNB, AEAF

The strong increase in consumption, entailing a rise in consumer imports and an ever-deteriorating trade balance, is a pressing problem calling for urgent action aimed at reducing its effect. The rest of the strong import growth, which is usually associated with a higher trade and current account deficit and spurred by stronger sales (export sales including) and higher capital inflows into the country (mostly FDI) should not cause any concerns. Such a model of fast growing economies, reporting huge current account deficits, has been demonstrated by the Baltic countries, the most dynamically reforming one in particular – Estonia. Furthermore, the deficit in the local economy has been so far successfully covered by the financial account surplus. The FDI inflows in the nine months to October'06 provided for over 80% of the trade deficit while covering the current account deficit in full. Despite the higher external trade deficit, the country's overall balance in the nine months ran positive at MEUR 1285.8, or three time higher than in the same period of 2005.

The very nature of the Bulgarian economy and vigorous performance of the manufacturing sector (e.g. metallurgy, oil processing, etc.) make the country all the more dependent on raw material imports (mineral fuel and oil). In the nine months to October'06 they accounted for 36.5 and 23.1% respectively of total import volumes at CIF prices. At the same time, though they enjoyed the largest relative share in Bulgarian imports, raw materials made little contribution to the deteriorating trade balance in the same period because the *exports (FOB process) – imports (CIF prices)* balance did not undergo any significant changes[10]. Unlike them, however, energy goods were a key factor at work behind the higher trade balance. According to BNB statistics, the higher trade deficit in crude oil, oil products and gas imports and oil product exports was responsible for 52.7% of the year-on-year growth in the country's total trade deficit, with this development being by and large due to the higher crude oil prices worldwide.

On a year earlier, the importation of consumer goods, which is directly affected by consumption dynamics, stepped up by MEUR 317.3 (at CIF prices) in the nine months to October'06, running some MEUR 50 to 60 higher than the year-on-year increase in 2005 (compared to 2004). Nevertheless, the stronger 2006 consumer imports were triggered by the higher employment rate and average nominal income, whereas the significance of loan financing to their growth stepped down compared to earlier periods.

Investment goods posted the strongest import increase in the January-September'06 period, going up by MEUR 505.6 (at CIF prices), compared to the same period of 2005 due to the boosted investment activity of local entrepreneurs and keener interest of foreign investors in the Bulgarian economy. According to BNB estimates, FDI inflows amounted to MEUR 2845.1 (with only some MEUR 25 from privatization deals), running twice as high as in the nine months to October'05. Overall in 2006, FDI are expected to go well over MEUR 3500, hitting a record high since the outset of transition.

The scarcity of disaggregate data makes gauging the effects of foreign investment inflows rather difficult. Nevertheless, there can be identified several sources of FDI impact on the current account. In the first place, this is the importation of investment goods, the growth of which advanced from 19.3% on average in the 2003-2005 to 22.2% in the nine months to October'06 alone (or MEUR 442.9)[11]. Second, they affect direct investment income payments, which comprise repatriated profit and interest payments on intra-company credit. In the 2003-2005 period, payments on the above item rose by about 40% on average vs. 47.7% (MEUR 163.8) alone in the nine months to October'06. Another transmission channel of FDI impact had to do with the growing fees on consulting. They are a main component of the *other services* item, which increased by 14.2% on average in the 2003-2005 period and 28.1% in the nine months to October'06 (MEUR 151).

Although they made a major contribution to the higher current account deficit, the increased FDI inflows also had a healthy effect on a small and open economy like Bulgaria because it was mostly through investment injections that production expanded and facilities were renovated, and employment and factor intensity of production boosted. Equity, which accounted for the bulk of FDI into the country, provided a reliable measure of the potential of their effect, in particular that part of equity not associated with privatization, which having risen at a steady pace throughout the years, now hit a record high of 175.2% in the nine months to October'06.

Although the bulk of FDI are a non-debt source of financing, they can also trigger large amounts of outflows from the economy. Reinvested profit depends not only on the return-on-investment options but their alternative price as well, i.e. the international interest rate dynamics. Any change in the latter, however, affects another important item of the investment inflows into the country, i.e. the *other capital* item, which reflects intra-firm indebtedness (having steadily advanced since 2005, it accounted for 43% of FDI in the Jnuary-September'06 period).

In the past few years, the service balance provided for a relatively large portion of the trade deficit. In 2006, the surplus on services worsened to MEUR 733.3 vs. MEUR 829.1 in the nine months to October'05. The slower growth in revenue from tourism was due to the higher fee

[10] The balance in the nine months to October'06 amounted to MEUR 832.5 vs. 856.6 million on a year earlier.

[11] Vehicles imports have been taken out of the group of investment goods for reasons of estimation accuracy.

payments on consulting, travel abroad and, above all, the lower than expected receipts from tourism (only 4.5% up in the nine months to October compared to an 11% rise in 2005). Although the reasons for the above slowdown remain largely vague, unofficial forecasts suggest that the industry is unlikely to post the same growth rate as in the boom period of 2002 to 2004. The sector faces a number of problems having to do not only with the underdeveloped infrastructure and density of property development but also the inability of many tourist companies to offer competitive products in terms of both quality and price, compared to some of the neighbouring countries.

Following the amendments to the methodology of reporting income from unofficial unemployment of Bulgarian citizens abroad, net income from employee compensations turned out to be a major source of financing the current account deficit, which made up fully for net payments on investments. In the nine months to October'06, net income from employee compensations carried on rising (7.5% on a year earlier), at a slower pace though. However, as a result of the robust increase in net payments on investments of 46.8%, net income stepped down to MEUR 31.3 from MEUR 204.7 in the same period of 2005. FDI posted the strongest increase in payments. At the same time, the accelerated accumulation of short-term private-sector external debt presupposed larger amounts on servicing costs. As a result, at preliminary estimate the net income balance is to gradually run into a deficit further undermining the current account deficit.

The increased capital inflows into the local economy led to higher net payments on investment. Net portfolio and other investment accounted for MEUR 488.9 out of a total of MEUR 3287.8 of a financial account surplus. The inflows on the *other investment* item posted a strong rise, with local bank deposits at foreign financial institutions stepping most vigorously by MEUR 1297.5 over the January-September period[12]. This was due to both the removal of the progressive scale of minimum required reserves, which banks had to maintained had credit growth advanced at a rate faster than the ceilings set out in BNB Regulation #21, and the rising Euro-area interest rates[13]. At the same time, liabilities on other investment also went on the increase due mostly to the significant contribution of private-sector borrowing from foreign lenders (MEUR 1460 worth of a rise, or three times as high as in the nine months to October'05 when it amounted to MEUR 505.4).

The small share (of 3.5% only) of net portfolio investment in the financial account is indicative of the stability of the financial inflows, as it is also a typical channel of speculative capital into an economy. Having decreased most significantly by MEUR 1270.6 on a year earlier due to payments on the Bradies, net portfolio investment in the January-September 06 period advanced by MEUR 115.9. However, the expectations are that the integration of the financial markets and purchase and sale of financial assets will gain momentum with Bulgaria's accession to the EU as of January next year.

Intra-company indebtedness is part of total non-financial private-sector debt, which as of the end of August hit some MEUR 5491.7, or triple the amount reported in end-2003. The steady increase in the international interest rates constitutes a potential risk for the country's balance of payments, as it will raise debt servicing costs and have both a short- and mid-term effect on the *income debit* item of the current account. On the other hand, the accumulation of private-sector liabilities, which will have to be paid back at some point in the future, depending on their maturity date, will trigger large amounts of outflows from the economy. Furthermore, the increased share of short-tem debt, which stepped up from 14.3% in December03 to 29.2% as of the end of August'06 poses additional risk to the sustainability of the balance of payments.

Estimates of the current BoP situation indicate that the Bulgarian economy is integrating in the EU and world markets rather successfully. However, the fast increase in private-sector foreign debt and short maturity are a potential risk, the manifestation of which can take the form of sizable outflows from the current account, given a sharp rise in the international

---

[12] Vs. an increase of only MEUR 6.7 in the same period of 2005.

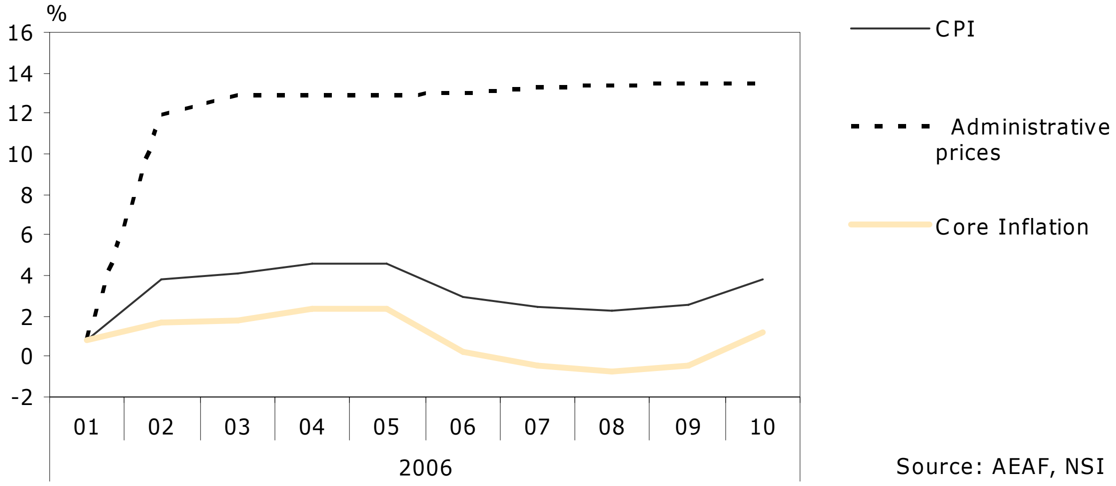
[13] The 6-month deposit LIBOR (Euro) stepped up from 2.59% in December 2005 to 3.53% in September 2006.

interest rates. To cushion the effect of one such unfavourable scenario, the government should pursue tougher macroeconomic discipline while promoting savings and thus lessen the dependence of Bulgarian investors on foreign lending

Price Dynamics

2006 inflation amounted to 6.5% as of the year's end and 7.3% on a 12-month average due largely to the higher administered prices. Since the start of 2006 administered prices advanced by 13.8%, posting a 2.9 percentage point contribution to overall inflation. At the same time, market prices reported a lower increase of 4.5% on a year earlier.

CPI Inflation 2006
(cumulative from the beginning of the year)



Source: AEAF, NSI

The strong increase in administered prices was mainly triggered by the new excise duty rates on cigarettes in early 2006. The government decided to introduce the duty rates initially planned for 2006 and 2008 as early as this year in an attempt to avoid the effect of the harmonized excise duty rates on the country's inflation in 2008, when Bulgaria will be strictly monitored for the fulfillment of the Maastricht criteria, which among other things include also price stability. This measure alone made overall inflation advance by 2.7 percentage points. In addition, the start of the year also witnessed the institution of the new excise duty rates on spirit drinks and liquid fuels.

Consumer food prices posted an aggregate increase of 5.4%, whereas producer price inflation in the food industry rose by 8.8%. The producer prices of bread and bread products went up by 13.5%. As a result of the poor yields worldwide, wheat prices stepped up most robustly, affecting local prices. Thus for example, commodity exchange trading in wheat was carried out at BGN 150 per ton (VAT excluded) in the summer months and up at about BGN 280-300 in November. Q4 consumer prices of flour and bread increased by 21.6 and 16.9% respectively. The contribution of annual flour and bread price inflation to overall inflation amounted to 1 percentage point.

In the first half-year period of 2006, crude oil prices were steadily rising to USD 74 per barrel only to set slowly back afterwards to USD 62 per barrel in December.[14] Cumulative fuel price change in the CPI ran negative at 2.4%. The producer price drop in oil products stood at 7.4% as of the year's end.

On a 12-month basis, market non-food prices and free service prices stepped up by 3.5 and 4.4% respectively. The higher year-on-year increase in service prices lived up to expectations, as they are set by demand and the Balassa-Samuelson effect and therefore rise at a stronger pace than non-food items. However, the 2006 increase in market non-food prices (period's cumulative) ran higher compared to earlier periods throughout 1998 to

[14] According to WB data.

2005.[15], which can be said to have been spurred by the higher effective demand for this commodity group. According to GDP data, the first half of 2006 witnessed a relatively high increase in household consumption (of non-food items in particular of 14.5%).

[15] The above comparison refers mainly to the commodity groups of clothing, footwear, furniture, refrigerators, cookers, washing machines, cameras, etc.

Government Budget

2006 has been another year in a row marked by the strong execution of the government budget plan due mostly to the vigorous revenue performance and high nominal revenue growth in almost all tax items. The consolidated cash surplus amounted to BGN 2.1 billion in the nine months to October (by 37.5% higher on a year earlier), whereas the primary surplus ran at BGN 2.7 billion.

Total revenues in the same period advanced by 9.5% on an annual basis as a result of the strong tax collection rate. Tax revenues posted an 11.3% year-on-year rise. As in 2005, the high import volumes were again the main factor at work behind the fast growth in indirect tax revenue. VAT revenues grew by 17.2%, accounting for 81.3% of the budget projections. By the end of the year, they are expected to go well above the levels budgeted. Revenues form customs duties advanced by 19.5%, running already well above the 2006 projections. In late 2005, most retailers had built up large stocks of excise goods in anticipation of the higher duty rates to take effect in early 2006. All this had a rather negative effect on excise duty revenue amounts in the first quarter, but following the depletion of stockpiles, revenues picked up at a steady pace, reporting a 15.8% increase in the nine months to October.

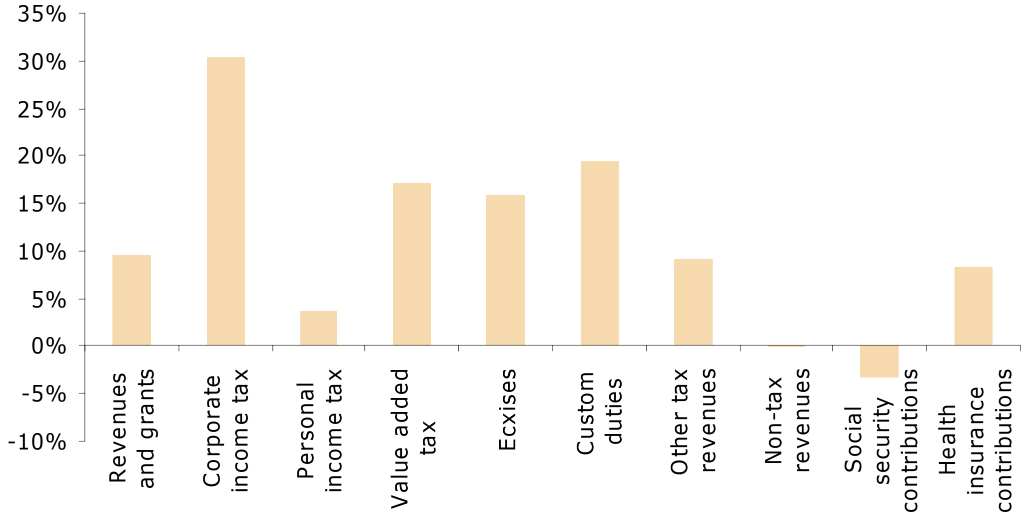
The most significant amendment to the social security burden in early 2006 had to do with the 6 percentage point decrease in the national pension scheme contributions. At preliminary estimate, the above amendment was to result in about BGN 700 million worth of budget loss. However, according to Q1, Q2 and Q3 data, revenues from social security contributions declined by 3.4% on a 12-month basis, which made some BGN 370 million of a loss for the budget, at AEAF estimate. All this implies that the effect of the reduced contribution rate has been largely overstated due most probably to the extra impact of the measure on the country's hidden employment. Nine-month nominal growth in average wages went up well above 10% on an annual basis, whereas 2006 NSSI estimates drew upon a 6.3% increase. At the same time, employment stepped up at approximately the same rate as the one provided for in the budget projections. The same trend was also discernible with employment growth, which picked up rather strongly since January, compared to the preceding two years.

Provided the upward trend in the performance of social security contributions is further sustained, revenues from the same item by the end of the year are expected to over-perform as follows: social security contributions paid by employers – by about 4.4%; from the amounts shared by employees - about 7.3%; and contributions paid by self-ensured by over 14%.

The country's economic development since the start of the year suggested that the effect of the reduced tax burden on the economy would be a lot greater than expected. AEAF macroeconomic estimates of early 2006 relied on real investment growth of 9% in the same year, whereas the updated forecasts of October pointed to a 16.7% increase. The higher than expected investment growth was due to both the stronger anticipations of FDI inflows and the understated effect of the lower social security contributions. Initial estimations suggested that investment growth was to pick up by some 1.7 percentage points while current forecasts point to about 2.6 percentage points.

The incentives to consumption growth were also seriously underestimated, as evident from the increase in both employment and wages, which ran well above initial expectations (pointing to an accelerated growth in wages and employment of 0.2 and 0.1 percentage points respectively).

Growth of the budget revenues by elements for the period: January - September 2006/2005



Source: MF

The revenue total from health insurance contributions over the January- September period went up by 8.3% on a year earlier due to the robust performance of receipts from the personal contributions of employees (some 31.3% up on an annual basis) and the contributions made by employers (a year-on-year increase of 5.8%).

The favourable economic development in the first half-year period led to improved financial performance of companies. At preliminary NSI estimate, the gross operating surplus in the economy stepped up by 16% in nominal terms on a year earlier, compared to a nominal increase in the region of 10 and 12.4% in earlier years. Corporate tax revenues rose by 11% in the nine months to October, given no changes in the tax rate.

Consolidated budget expenditures in the same period rose by 5.8% solely at the expense of current expenditures. Capital outlays remained unchanged on a year earlier due partly to the slowdown in spending. Interest payments declined by 7.1% in the January-September period, whereas subsidies decreased by c 24%. The lower subsidy allocations were mainly due to the financing extended to the public health sector, but are expected to catch up with the budget projections by the end of the year when most outstanding costs in the sector will be met.

2006 fiscal policies laid special emphasis on the social area. Consolidated budget spending on social payments in the period surveyed advanced by 13.2% on a year earlier, as triggered by the higher expenditures on pension benefits and aid. Payments on health insurance enjoyed the heaviest weight in social aid growth, which had to do with the higher amounts on hospital and dental care, as well as medicines.

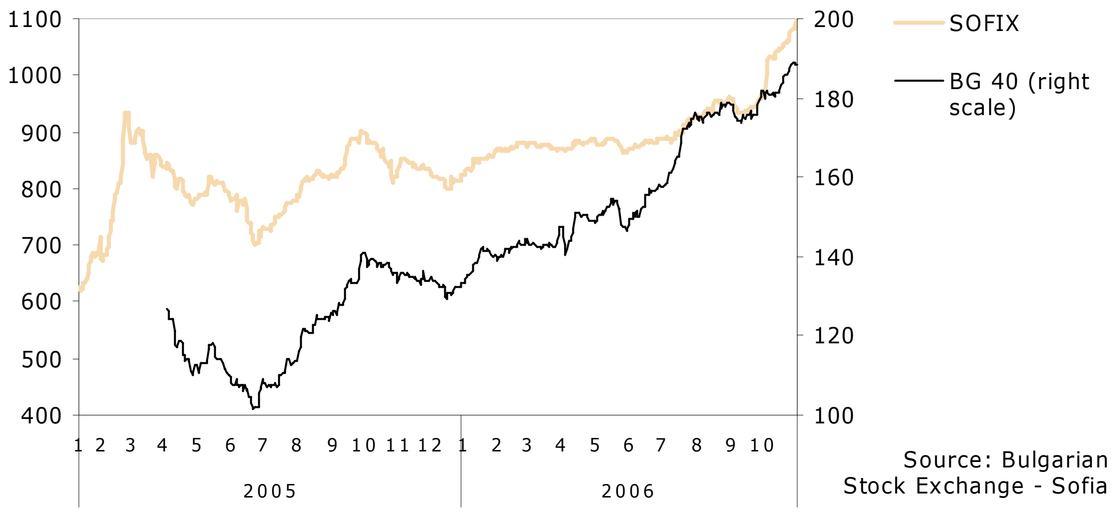
At preliminary estimate of the Ministry of Finance, the 2006 surplus went as high as 3.7% of GDP (vs. 2.4% in 2005). The contribution of government consumption to GDP growth is to remain positive, although it is expected to step down on a year earlier as a result of the curtailed budget expenditures. From the point of view of cyclicity of the economy, tightening fiscal discipline is the right policy to pursue and also an adequate early response to a likely overheating of the economy. Under such circumstances, fiscal policies should restrain from giving too strong incentives to private consumption as they would entail an increase in the price level rather than any real growth in income. The budget performance in 2006 has indicated that the current state of affairs allows room for further steps aimed at reducing the direct tax burden without running into a deficit. Nevertheless, any such action is untimely and largely inappropriate, as real growth in the economy is to carry on outstripping potential growth next year, which calls for the implementation of more conservative fiscal measures.

Therefore, tax policy incentives should focus on investment rather than consumption because the former may provide for a higher potential growth in the future.

Capital Market

2006 was marked by a strong performance of the capital market. The stock exchange indices posted significant growth rates. As of the end of October, SOFIX advanced by 32.1% on a 12-month basis, and BG 40 by an even stronger 41.3%. The key factors at work behind these developments had to do with the upbeat expectations of Bulgaria's accession to EU as of January 1st, 2007 and improved access of more foreign players to the local capital market, which has not achieved its full potential yet. Besides, the vigorous capital market performance was fostered by the stable macroeconomic environment and sustainable economic growth, which made it possible for companies to make high profits.

Bulgarian Stock Exchange Index and BG 40



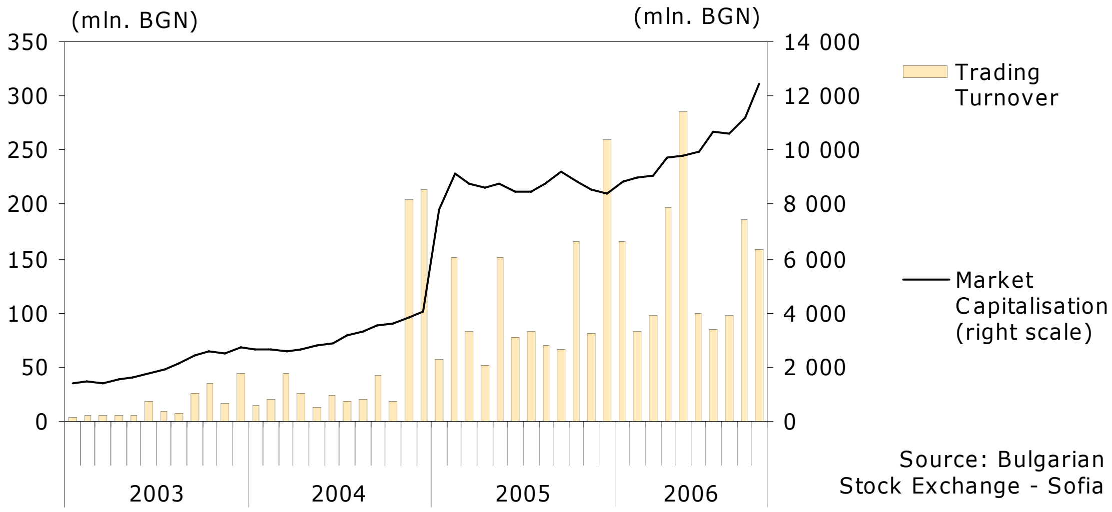
Source: Bulgarian Stock Exchange - Sofia

Last year saw a turnaround in the company delisting tendency on the Bulgarian Stock Exchange (BSE). Initially, companies were forced to list on the stock exchange in the wake of the first mass privatization wave and most of them opted subsequently to change their status to closed-end funds and go out of stock exchange trading. However, having become aware of the advantages of the relatively cheap financing via the stock exchange, most companies made a comeback to the exchange, numbering 339 as of the end of October vs. 331 at the end of 2005. In addition, listed companies raised their capital, pushing prices and indices up. September witnessed the first public offering of shares of the increased Chimimport AD capital. The excess demand for the company shares vis-à-vis supply indicates that there is idle money in the economy ready to be put in use and invested in lucrative businesses or blue-chip shares.

There were also in 2006 a larger number of individual market players, apart from the institutional investors who carried on showing strong interest in the stock exchange. The latter, as represented mostly by pension funds, reported a higher portfolio share of shares and bonds, following the amendments to the Social Security Code of February 2006. They removed the requirement, treated by EU law as privileged access of the government to financial institutions, for pension funds to invest a certain portion of their assets into government securities. The amended code led to increased investment in securities traded on the stock exchange, reported by all types of pension funds, with this share going well over 30% of the total investment portfolio as of the end of September (vs. 10-11% at the end of 2005) at the expense of the decreased share of government securities. The average yield rate stepped up to 4.74% in July compared to 3.01% in December 2005.

Despite the positive trends afoot in the past few years, the local capital market liquidity remained rather low. The ratio of average monthly turnover to average monthly capitalization in the nine months to October'06 ran at 1.44% vs. 0.81% on a year earlier.

Bulgarian Share Market: Market Capitalisation and Trading Turnover



Source: Bulgarian Stock Exchange - Sofia

2007 is expected to sustain the upward trends in the capital market due to the upbeat expectations having to do with the country's economic performance and accession to EU. The stronger assets of the pension funds, higher income in the economy, expectations that most listed companies will carry on performing in a robust manner are considered to be a powerful additional stimulus to stock market trading and the market indices.

What to expect following Bulgaria's accession to EU

On January 1st, 2007 Bulgaria became a full member of the European Union. Accession has many dimensions – economic, social, cultural, legal, etc. In an economic aspect, changes have to do with the fact that local economic agents will be treated in the same way as those originating from the other EU member states. Bulgarian manufacturers will be free to sell their produce in the single market provided they have met the Community safety and quality requirements, standing fair chances to further expand and develop. At the same time, companies from other member states will compete with Bulgarian manufacturers on an equal footing to place their products on the local market, challenging their viability.

All this will affect the performance of Bulgarian economic agents, for they will have to gear themselves to another pattern of behaviour, though not as radical as the one in the early 1990s, meeting the altered terms of business. Therefore, a logical question to answer is: what to expect as a result of the changed market conditions and size?

The stronger market competition following Bulgaria's accession to the Community will provide the necessary incentives to the economic agents to develop intensively and expand, enhancing their viability and competitiveness in the long term. In a short-term perspective, however, joining the EU means higher costs, having to do with the implementation of the EU standards and modernization of production to cope with the stiffer competition on the part of European manufacturers.

The bulk of the country's legislation has already been brought into line with the Community acquis. However, its implementation in some areas of activity, e.g. the environment, calls for significant financing. Most enterprises in the chemical industry, energy power generation and metallurgy will encounter great difficulties in terms of both finance and organization to meet the deadlines for the commitments taken in such a short time.

Another sector where a great deal of work is yet to be done is the food industry. A major problem arises from the outdated technologies in use in most agri-food enterprises, which in turn leads to quality raw material scarcities.

Access to the single market presupposes enormous opportunities for Bulgarian economic agents, enabling them to make the most of the EU systems and mechanisms of financing and export insurance, strengthening in addition their competitiveness.

Joining the EU means, in the first place, eased terms of trade with the member states. Agricultural trade will be further liberalized, as Bulgaria becomes a CAP country. Trade in industrial goods will be facilitated not so much by the removal of customs duties but the alleviated barriers to the exchange of goods (e.g. the mutual recognition of various technical regulations and minimum requirements). *Services* are expected to gain further momentum as a result of market liberalisation

Over the past few years Bulgaria has been reporting a strong FDI influx. The steady economic performance, successful reforms and low costs add to the factors fostering the sizable capital inflows into the country. Accession will inevitably augment FDI in the following years, for foreign investors will look at the country not just as another local market but part of a common system, offering greater opportunities for expansion and development.

EU membership will boost FDI inflows, which are largely influenced by the size and purchasing power of the local market, some gravitational factors (i.e. closeness of the FDI source-country to the recipient country), workforce qualification, natural raw materials, labour and other input costs, political and macroeconomic stability

Data on the new Central European and Baltic member states of the Union indicate that the bulk of investment has been mostly focused on the processing industries, real estate market, and the financial sector. In addition, some service centres in Europe outsourced its customer support and call centre functions to the new EU member states to make the most of the cheaper labour costs and professional qualifications of the work force. Some companies even outsourced some of their IT and accounting functions to daughter companies based in the Central European and Baltic countries.

The boosted investment activity and sizable capital influx are also the factors expected to foster labour demand and job creation. Being part of the common labour marker, part of the country's workforce may look for jobs abroad, but this is hardly anticipated to affect the otherwise high immigration outflow. Given the safeguard mechanisms and EU labour market restrictions, the above development is not to take place immediately after the country's accession. Bulgarian employers will also have to consider the fact that they will be competing with foreign employers in hiring workers, forcing them to raise wages in a gradual manner and make the country a better place to work, especially for the immigration inflow, low as it may be, though.

The country's macroeconomic development is used as a point of departure in all income estimates. In the past few years real wage growth has been outstripping real productivity in the economy. However, this trend is very likely to turn around in the next years. Value added in many industries may undergo restructuring, with the share of profit declining at the expense of the higher share of employee compensations.

The effect of accession on income growth will differ across industry and depend on the pace of adjustment to the common rules of the single market. Income in the export-oriented industries is expected to pick up at a stronger rate.

Early 2007 saw the enforcement of the Credit Institutions Act (OG, # 59 of July 21 2006), repealing the Banks Act. It lays down the terms and rules of granting licences, lending, supervision and termination of credit institutions aimed at creating a stable and viable banking system and mutual recognition of banking licences granted in another member state of the European Union. Therefore, foreign banks licensed in another member state will be able to operate in the local market under a comparatively relaxed regime, and vice versa.

The new act has been so designed as to promote competition in the local banking sector. With a view to the significant difference in credit interest in the EU and Bulgaria, many new market players are expected to enter the local market and focus mainly on lending to large companies with good credit history and creditworthy customers. Furthermore, again due to the interest rate difference, many local banks are likely to attract deposits from elsewhere in the Union. The country's accession has led to a lower risk premium, which is expected to result in a smooth decrease in deposit and loan interest and ease access to financial resources. At the same time, it should be noted that the Credit Institutions Act has also provided for deadlines that make the operation of banks on the local market earlier than mid-2007 impossible.

On the whole, the country's accession to EU is not expected to accelerate inflation. The factors that affected the inflationary process in the period following the institution of the currency board arrangement, will carry on having the same effect in 2007.

The alignment of excise duty rates and administered price adjustment will be further sustained in the first years of accession. According to the programme of the Ministry of Finance for the gradual harmonization of excise duty rates to the Community minimum, the rates on liquid fuels will step up and excise duties will be imposed on coal and electricity in 2007. Electricity and heating prices are to go on the increase too. There have been operating in the local market private electricity distribution companies for two years now, who are constantly investing in infrastructure and stand, according to their contracts, for the return on investment. The regulatory authorities have refused to authorize an increase in electricity prices for households.

The key factors to affect core inflation dynamics in the future will have to do with the international prices of raw materials and fuels, imports, the ratio of productivity to wage growth, effective household demand, etc. The removal of customs duties on trade with EU and adoption of common policies towards third countries will entail a certain drop in the customs duty rates on agricultural and industrial goods as well as a decline in the price level of some items. No upward pressure on the prices of clothing, home appliances and some food items, facing competitive imports is expected.

Service price convergence will take place at a faster pace. The service price level runs lower than the EU-25 average, compared to goods.[16] Service prices are also influenced by the Balassa-Samuelson effect. The different growth rates of productivity in the sectors of tradables and non-tradables in Bulgaria and the EU15 explains partly the different rates of overall inflation. At AEAF estimate, an increase of a percentage point in productivity in Bulgaria vis-à-vis EU15 will result in a rise of 0.6 percentage points in the overall gross value added deflator.

Non-food price inflation is expected to run low. Following the institution of the currency board arrangement, household consumption of durables (non-food items) has stepped up at a stronger pace than non-durables. Real income growth was one of the reasons for the higher share of durable goods in consumption. Despite the rising consumer demand, non-food price inflation has run the lowest, as they have faced competitive imports in the utmost with the liberalization of trade. All this hampers local manufacturers and retailers to meet increased demand by raising prices.

Food price inflation is not expected to run any higher than in 2006, given the assumption that there will not be external or internal shocks that may boost a price increase in agriculture and the food industry. However, some prices may go on the increase at a stronger rate than in 2006 due to sizable amounts of investment made to meet EU food safety requirements to the production of basic items such as bread, meat and meat products, milk and dairy products. All these industries started to fulfill EU requirements some years ago, but on the threshold of the country's accession to EU representatives of the producer associations made it clear that another rise in prices is inevitable. The speculative jump in prices excluded, the higher food prices may also be triggered by the fact that manufacturers are now free to place some of their produce on the EU markets

The country's accession to EU presents a serious challenge to the government budget. Bulgaria's full membership in the Community will have to do with significant changes in the financial flows, going through the budget, as well as major alterations to taxation. All this will result in net budget looses while calling for urgent restructuring on the revenue side to maintain the fiscal discipline needed for the strong revenue performance. Revenue losses will be mainly triggered by the way EU imports will be treated (i.e. they will be exempted from VAT levies on the territory of Republic of Bulgaria), and the fact that exports to EU will no longer qualify for tax credit. Overall, according to estimates of the Finance Ministry, the net effect of the loss is estimated at about BGN 450 million or some 0.9% of GDP. A similar effect has been discerned in some of the new EU member states. Its magnitude, however, depends on the trade balance of the relevant country with the Community. In addition, adopting the common customs tariff means lowering the current duty rates, hence revenues from customs duties (an estimated loss for the budget of about BGN 120 million, or 0.2% of GDP). At the same time, total budget loss is to run well over 1% of GDP and will not be covered by the extra revenue amounts from the higher excise duty rates.

On the expenditure side, national co-financing commitments are not expected to exert any pressure on the budget only if spending is properly restructured. Therefore, fiscal policy strategies will have to seek ways to incorporate additional budget payments in the current expenditure framework, for any other scenario implies that they will just add to the spending ceilings authorized and hence undermine the budget surplus. However, any such restructuring cannot apply to the country's commitments to make annual contributions to the EU budget, which are taken to be additional expenditures worth 1.1-1.3% of GDP.

[16] According to 2004 Eurostat data, the consumer price level in Bulgaria accounted for 58.7% of the level in EU 25, and consumer services represented some 31.9%.

The effect of the country's accession to EU is estimated as the sum total of the effects on the revenue and expenditure side and amounts to about 2.3% of GDP in the first year of full membership. It is to persist in the following years as well, but the pressure on public finance will not be not so tangible, as the fiscal programme will have been brought into line with the new institutional conditions. However, at present the government budget has all the capacity to absorb a shock of similar magnitude due to the prudent fiscal policies of previous years and cautious planning of the accession process. Nevertheless, the order of magnitude of the effect calls for maintaining the present fiscal policy stance, without making any room for easing, given the persistent current account imbalances.

The country's accession to EU opens up further opportunities for fast economic growth boosted by the EU structural funds. The reform implementation exercise has been provided for with significant allocations from the structural funds and national co-financing. However, it should be noted that the country' absorption capacity of Community funds depends almost entirely on the quality of projects, implementation effort made and coordination among businesses, the central and local governments, citizens. All this considered, Bulgaria will have significant amounts of financial resources at its disposal, which coupled with the appropriate policies will lead the economy to a higher trajectory path of mid-term growth and facilitate the convergence process.

The nation's integration into the EU market will promote employment and improve the standard of living, but accession alone will not do. All this will depend on the country's effort to avail itself of the opportunities given by accession, posing major challenges to future economic, social and demographic policies aimed at making Bulgaria a better place to live and work while preventing labour outflow.

Accession will also give economic growth a strong push due mostly to the boosted investment activity in a country already a member of the European Community and growing confidence of international financial institutions, as indicated by Bulgaria's higher credit standing. Transfers from agricultural funds will contribute to efficiency improvement in the sector, and infrastructure development investment will have a healthy effect on the whole economy. However, the extent to which the Bulgarian economy will be able to ride the wave of the growth impulse to fuel future growth will depend solely on the local economic agents and labour force as well as the institutions concerned. ▼